Cohesion MK Best Ideas

Investment Report

April 2021

Cohesion®
Accessing Superior Growth

Economic backdrop

We have talked in previous commentaries about the importance of investing with strong tailwinds behind us. It is doubtless easier to make money investing in a country where powerful economic forces are in our favour. India is a long-term beneficiary of such forces. In the short term, there is still attention being devoted to the effects of COVID-19, but all statistics point to India having been highly successful in mitigating the pandemic. The number of cases and deaths in India compares favourably with most Western economies on a per million people basis and speaks to the highly developed nature of India's digitised economy and health care industry that has been effectively used to manage COVID-19. The **Aadhar Card** is possibly the world's largest implementation of a national identification program linked to biometric data. It has also formed the base for a number of government schemes, including a roll-out of targeted subsidies, and more recently, to India's vaccination drive. India has linked its vaccination program to Aadhar Card-based identification and is issuing digital vaccination certificates, probably the largest such roll-out globally.

Some countries have chosen to undertake massive fiscal stimulus to keep their economies afloat during COVID-19 and may be forced to undertake austerity later to repay the substantial debts they've incurred. Whilst India has provided some stimulus, it has chosen not to throw everything at the crisis and therefore has plenty left in the tank for the future.

Further evidence of the recovery has shone through in the recent earnings season. Most Nifty 50 companies have now posted their earnings reports and a majority are ahead of analyst expectations. Despite the effects of the pandemic, robust domestic demand and recovering exports have led to generally positive surprises which in turn have led stock markets higher. This positive backdrop may have surprised some Western analysts, but not us. We do not regard the management of COVID-19, the well-received recent budget or the strength of earnings as coincidence but rather a reflection of the robustness of the Indian economy.

Economies matter – making money matters more

Whilst the health of an economy is important, it is important to remember that our aim is a simple one; to make strong risk-adjusted returns for investors across a wide range of economic conditions. We of course take notice of unemployment, the balance of payments, and inflation data but we passionately describe ourselves as bottom-up investors who look to make money in all economic environments by identifying mispriced stocks. Some investors get too caught up in looking at the macro picture rather than at identifying entrepreneurial management teams, undervalued assets and special situations that can make money regardless of economic conditions.

During any investment career, there are a few times that we look back upon as being moments of great opportunity; times when we were almost certain that we had unearthed a truly special theme or stock that had the potential to make a great deal of money. Who wouldn't want to jump into a time machine that took us back to reading an early "Buy" note on Tesla or Amazon? Sadly, with time travel being impossible, the best we can manage is to look for the next great idea and make sure we fully capitalise on it. **We believe we have found just such an opportunity.**

A rare opportunity – Public Sector Undertakings (PSUs)

We think you should file this report away safely and look at it again in five years to remind you that this was the note that brought "PSUs" to your attention. Many in the West are unaware of the importance of the Public Sector Undertakings in India and the potential bargains that this theme is presenting us with. However, you will I'm sure be well aware of a similar theme that played out across Europe in the 1980s and 1990s and there are some instructive similarities between the PSUs in India and what occurred in the privatisations wave in Europe. On 24th Feb 2021, speaking at a webinar on privatisation, **Prime Minister Narendra Modi said**, and we quote "**the government has no business to be in business**". There can be no doubting his commitment to either monetise or modernise Public Sector Enterprises. The importance of this statement cannot be emphasised enough, especially in the context of what **Mr. Modi has successfully delivered over the last 7 years in power** – both on intent and execution.

In the UK, we remember Conservative MP Geoffrey Howe extolling the "discipline of the marketplace." The message was a simple and compelling one; that privatisation would make the large utilities and other state-run businesses more efficient and productive, and thus make **Thatcher's Britain more competitive** relative to its continental rivals. The government sold off everything from AB Ports to Yorkshire Water and everything in between to break inefficient working practices and introduce capital discipline.

Privatisation transformed the British economy. Oversized workforces were sharply cut, and labour productivity sharply rose. As companies became more efficient, revenues increased along with market share, which caused workforces to re-expand. Customers benefitted from cheaper prices and better services. Even the anticipation of privatisation led to wholescale changes across state-run companies, generating a wave of growth momentum across the board. Stock market investors will remember the excellent profits made by early investors in many privatisations and also the string of take-over bids that followed.

Margaret Thatcher came to power determined to revive the stagnant British economy and introduced a plethora of reforms from deregulation to tax rate cuts, **but it was Thatcher's privatisation initiative that solidified her economic legacy**.

There are many parallels between Thatcher's UK privatisations and the Modi Indian PSU movement. The motivations of the Indian government are very similar and reflect a realisation that many PSUs are bloated and bureaucratic and simply not match-fit for a competitive world. In turn, when private sector companies have to deal with and rely on PSUs they are being handicapped by a partner that moves at an arthritic pace and this cannot be helpful for the health of the overall economy. The similarities with the effects of coal strikes, rail strikes, and power blackouts that blighted the UK in the '70s and '80s and which had such a damaging effect across the private sector are clear.

It is with this in mind that the Indian government set about privatising the PSUs. Many of these PSUs had fulfilled a valuable role post-Independence but have now become unwieldy behemoths in need of change. India's productivity base is much lower than its peers (22x less than China and 50x less than the USA) and the Indian Government's initiative to **follow in Thatcher's footsteps** is aiming to narrow this gap sharply. There are over 90 listed PSUs and a total of over 300 PSUs. These PSUs contribute over 30% of aggregate corporate profits in India covering a wide range of sectors including power, coal, chemicals, insurance, ports, and electronics, many of which are tied directly to the growth of the Indian economy. However, the combined market cap of all listed PSU companies is around INR 17.5 trillion (USD 232bn) as of 31st March 2021, which is only about ~8.5% of total BSE market cap of Rs. 204 trillion (USD 2.7tn). This disparity between share of profits and share of market cap is a **clear indication of the value gap**.

It would be fair to say that, in general, the PSU (and Public Sector Banks - PSBs) program has not always run smoothly. Most PSUs are down anywhere between 40-60% from peak levels and the overall PSU basket has remained virtually flat in market capitalisation over the entirety of the previous decade. The intentions of the Indian government have been very admirable but at times the execution has been less successful and this has helped to create an incredible opportunity:

- Many businesses had become bloated with high employee costs, lower productivity per employee, lack of clear direction to and from senior management, and excessive indirect government control over operations leading to inefficiency and bureaucracy. As a result, PSU contribution of profits has come down from a high of over 70% to around 30% over the last 2 decades. Most PSUs have seen their free cash flows stagnate and return ratios deteriorate sharply over last decade

- Even a number of PSUs with monopoly status in their respective industries (such as Coal India) which enjoy strong profitability and return ratios have increasingly been shunned by investors

- There has been continuous balance sheet deterioration and inefficient working capital in some PSUs. In several cases, especially where the government itself is a major client to the entity, receivables have ballooned and for companies such as Bharat Heavy Electricals Limited (BHEL) and Rashtriya Chemicals & Fertilisers (RCF) the receivables have been higher than the prevailing market cap

- An inability to monetise assets well: Many PSUs have large land banks or other strategic assets which were historically not well monetised. RCF as example again, trades at a fifth of replacement cost, and this is without factoring its "prime land bank" – 800 acres in Mumbai **– that could easily be worth INR 600bn (USD 8bn) or almost 15x current market cap**

- Continuous equity supply: between 2015-20, the government raised over INR 1tn (USD 13bn) just through sales to ETFs, in addition to raising a similarly high amount through offer for sale (OFS) to retail and institutional investors. In many cases, the government revealed its hand so much that the divestment schedule became almost predictable. This continuous equity dilution has constantly kept an overhang over the stocks, with investors wary of the next supply coming in soon after their investment

- Poorly managed IPOs: a very good example is one of our portfolio holdings, Indian Railway Catering and Tourism Corporation (IRCTC), which rose 6x from its IPO price in just 3 months of listing, thus highlighting how cheap the government had priced the IPO

Historically, these factors led to investors simply giving up on companies despite there being clear value in their share prices. This is where the opportunity lies. When fundamentally good and extremely cheap companies have been overlooked by other investors, amazing things can happen.

As a sector, Public Sector Banks (PSBs) have slipped between the cracks in the stock market. It's hard to think of a more unloved sector but this is where the very best opportunities can often be found. Some of the concerns are real and are around high-cost structures, low capital adequacy issues, and high costs of funding. This has led to significant derating in valuation multiples over the last few years. While the stock prices continue to be at multi-year lows, there have been positive developments in recent times such as the beginning of the consolidation of PSBs. Canara Bank is amongst the better managed PSBs and has emerged stronger post its merger with Syndicate Bank in April 2020. Despite Canara being a fundamentally good and improving bank, it is trading at what we believe to be unjustifiable valuations. Banks have tended to do well during periods of economic expansion and for this reason we also have SBI as one of our largest positions. This has served us well over the last six months with the **shares having risen by 50% during this period**. However, it is hidden gems such as Canara Bank that we are most excited about as we believe it is so grossly underpriced despite being a fundamentally sound business.

The catalyst

Of course, to monetise a great idea there needs to be a catalyst. Otherwise, companies can stay cheap forever and that's not what Cohesion MK Best Ideas is looking for. We don't just want to invest in cheap companies, good companies, or even good, cheap companies. We want to invest in companies where value will be unlocked and give our shareholders the chance to **generate exceptional returns**.

The government has taken a number of steps over last couple of years that clearly signal their intent to take a holistic look at the entire PSU divestment and privatisation subject. Key measures include:

- Consolidation of PSU Banks: Between 2017-2020, the number of PSU banks has been brought down to 12 from 27, and this is likely to get reduced further to 8 banks, as there are talks of 4 PSU banks getting privatised. The entire process has led to the creation of stronger and better entities, more capable of competing in the markets on an equal footing with leading private sector banks

- In 2019, DIPAM (Department of Investment and Public Asset Management) was made the nodal department for strategic stake sale in PSUs. This entity has been mandated with driving efficiency in PSUs and maximising the value that the Indian government can get from its PSU holdings

- Signalling a shift in intent from divestment (dilution in stake) to strategic divestment (transferring ownership and control) or full privatisation. DIPAM has announced the privatisation of entities such as Bharat Petroleum Corporation Ltd (BPCL), Shipping Corporation of India (SCIL), Air India, Concor, Industrial Development Bank of India (IDBI), Bharat Earth Movers Limited (BEML), Pawan Hans and Neelachal Ispat, which will likely be completed in FY22. In addition, the government has proposed to take up privatisation of 2 Public Sector Banks and 1 General Insurance Company in this financial year

- In May 2020, Finance Minister Nirmala Sitharaman announced that there will be a maximum of 4 public sector companies in strategic sectors, and state-owned firms in other segments will eventually be privatised

- In November 2020, the government announced that market cap performance will be added to the set of parameters for governing performance-related pay of Central Public Sector Enterprise (CPSE) staff

- Buyback of Hindustan Petroleum Corporation Limited (HPCL) recently (in which government did not participate) has been the first time in a long time that the government has taken a significant step to reward minority shareholders and also signalled its intent to enhance value in a PSU

- In the 2021 Budget, the above policy of strategic disinvestment of PSUs announced in May 2020 was approved. Subsequently, the Prime Minister has clearly indicated multiple times the intent of the government to follow through on this theme

It is clear from the above points that the key trigger for unlocking valuations in PSUs is now close; it only needs one major privatisation initiative to get concluded and we believe the entire pack will get re-rated substantially. This government imperative has been the missing ingredient. There has been a discernible change recently to the way that the government seeks to monetise its stakes in PSUs and also drive efficiency both of the operating companies and their balance sheets.

What provides extra credence to this is that over the last 7 years, substantially everything Modi has said he would do has been followed through. He has used his strong electoral mandate in both his first and second term, to not only **talk the talk** but also **walk the walk** on several key reforms that, together, are transforming the Indian economy. Whether it was revolutionising the country's taxation system through GST, Demonetisation, Make in India, Housing for All or the successful scaled use of Aadhar Cards, Modi has committed to and then delivered in each case and **we expect this privatisation mandate to be no different.**

So, this is it. One of the best investment themes uncovered by Madhu and his team in many years. A large pool of cheap, unloved companies with plenty of low hanging fruit and a government now intent on releasing the value that has been asleep too long.

How are we playing out this theme?

The fund has investments in five PSU stocks currently, including two of our top five positions by size. Combined, PSU holdings form around 23% of the fund's NAV as on March 31st.

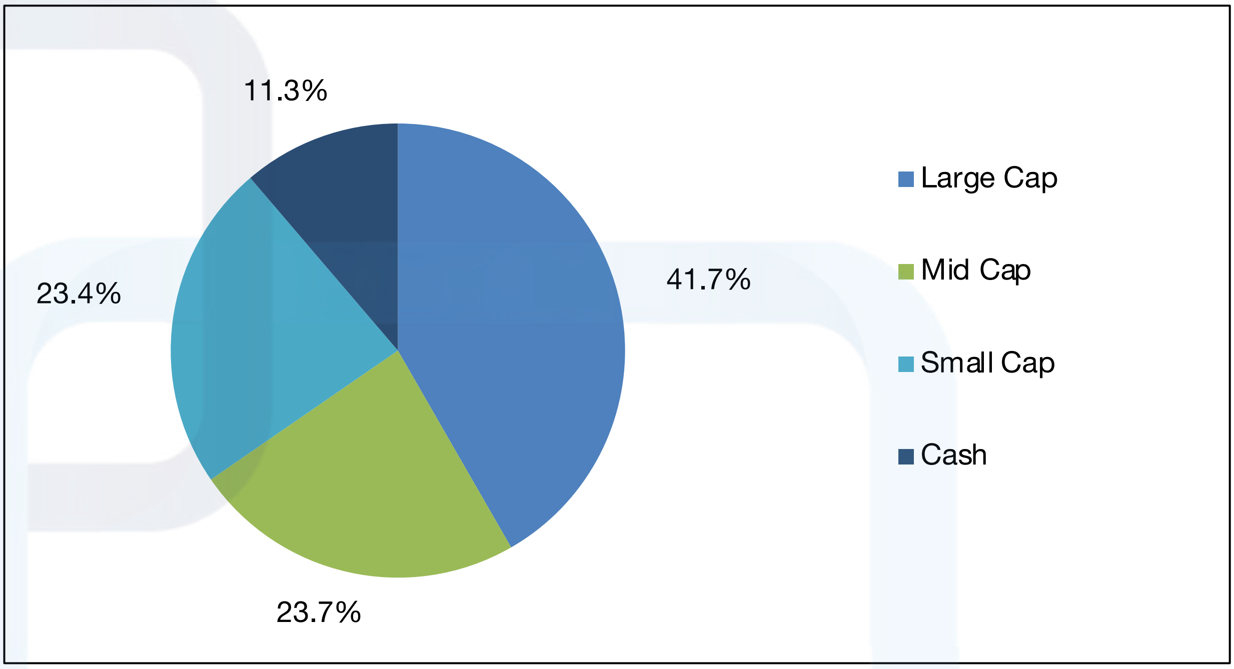
Bharat Petroleum Corporation Ltd (BPCL) is India's second largest oil marketing company and its third largest oil refiner. The government had indicated its intent to privatise BPCL in FY20, and has taken significant steps towards achieving this goal, with the transaction likely to conclude this year. We believe the sale will happen at a significant premium to current valuations, and it is likely the stock will get re-rated further, post the sale. There should be good interest from global oil majors in BPCL as it would provide them with a perfect base in a fast-growing economy. With this as a view, we recently entered BPCL, as we now have a very clear visibility towards its privatisation.

Public Sector Banks have long underperformed their private sector counterparts, with concerns including credit quality, high-cost structures, low capital adequacy issues, and high costs of funding. This led to a significant derating in valuation multiples over the last few years. A lot of historical non-performing assets though have now been provided for and a significant clean-up has occurred across all PSU banks including Canara. While the stock prices continue to be significantly below previous highs, there have been positive developments in recent times such as the beginning of the consolidation of PSBs.

As previously mentioned, Canara Bank is amongst the better managed PSBs and has emerged stronger post its merger with Syndicate Bank in April 2020. Unlike other smaller banks, Syndicate Bank was not under stress prior to the merger and the integration appears to have gone smoothly. The bank has managed its asset quality well and indeed has further improved this significantly. Despite Canara being a fundamentally good and improving bank, it is trading at a simply unjustifiable 0.6x FY22 tangible book value, 1.2x operating profits and 4x earnings. With most of the clean-up already completed, the bank is well-placed to take advantage of the next phase of growth in Indian economy. Also, with a lot of the earlier asset concerns already provided for, any recoveries could lead to a sharp rise in profitability and a material balance sheet improvement, which is certainly not being factored in the price today. We recognised this quite early and have seen our **investments in the stock rise by c50% in a short time**. We continue to hold large investments in Canara, as well as the leading PSU bank - SBI, and expect they will be key beneficiaries of both an improving economy as well as renewed buoyancy around the PSU theme.

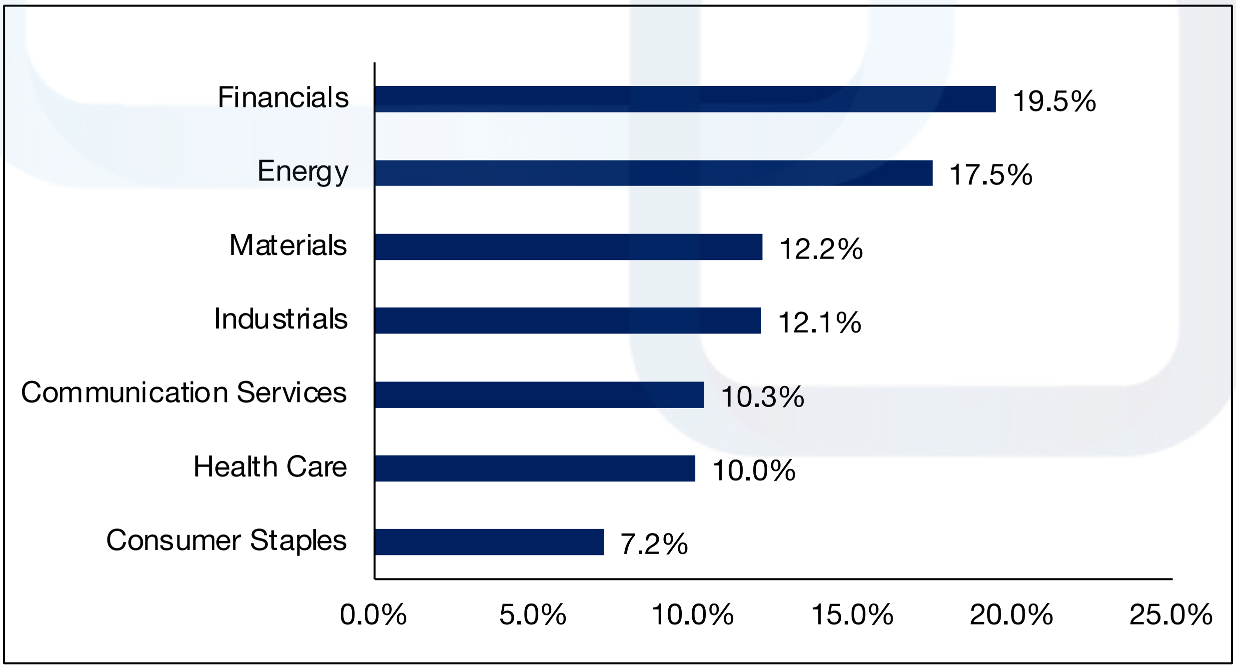
Portfolio – 31st March 2021

Market Cap Exposure



SEBI market cap breakdown – Large Cap: top 100 largest companies ranked by market cap, **Mid Cap**: 101-250 companies ranked by market cap, **Small Cap**: companies ranked 251 and onwards

Sector Exposure



Portfolio allocations may not add to 100% due to rounding

Top 5 Holdings

Security Name	% Holding to NAV
State Bank of India	7.59
Reliance Industries	7.59
Strides Pharma Science	5.95
Canara Bank	5.81
Bharti Airtel	5.62

Portfolio vs. Market Valuations

	PE Valuations	
	FY22e	FY23e
Cohesion MK Best Ideas	**18.4x**	**14.7x**
NIFTY 50	20.7x	17.5x
BSE 200	20.7x	17.3x

Portfolio vs. Market Earnings Growth

	Earnings Growth	
	FY22e	FY23e
Cohesion MK Best Ideas	**62%**	**25%**
NIFTY 50	39%	19%
BSE 200	39%	20%

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Disclaimer

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