Lindsell Train

Indian Takeaway

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I have recently been on holiday to India - in Rajistan visiting forts, temples, villages and crowded cities but in the process learned a lot more about the country. My interest was more than idle curiosity for it posed two important investment questions, both pertinent to our global portfolio. India of all countries has many of the characteristics that epitomise the potential from emerging markets. Are those implicit expectations of superior returns justified and realisable? Should we be content to gain exposure to this potential indirectly by investing in developed market companies that own operations in India (as we do now) or should we invest directly by owning companies listed on the Indian Exchange?

Let's first review some of the things that excite us about India. First it is a vast market. India's population is just over 1.2bn, second only to China. By 2030, at current rates of growth, the population will expand to 1.45bn, more than predicted for China. It has a young profile, with 50% under the age of 25. Per capita income is currently $1,500 per annum. Most of the population (61%) is rural, with 28% of GDP generated by agriculture. Currently only 74% of the population is literate. Improving literacy, together with increased urbanisation (Mumbai is India's most populous city yet it has a population of just 12 million) and industrialisation raise the potential for improved productivity and a rise in living standards.

Next, India may be underdeveloped by most measures but the paradox is that, by others, the country is quite advanced. We saw plenty of evidence in our travels to confirm the recent released statistic that less than 50% of the population has access to a latrine but at the same time mobile coverage everywhere was excellent - so no surprise that more than half the population owns a mobile phone. Indeed, in the major cities c.90% of the population has access to a telephone. India has a thriving software and media industry centred around outsourcing, suggesting the potential for further innovation and growth.

Finally, since independence in 1947 India has been a parliamentary republic operating a multi-party democracy with strong federal representation. Although this has brought political stability it is only since market based economic reforms were introduced, after the country was bailed out by the IMF in 1991, that the economy has begun to properly fulfil its growth potential. Even so, the much caricatured obstructive and corrupt Indian bureaucrat is omnipresent with all the excessive regulation and red tape that one might expect. Of course this hinders development, progress and over time has bred ingrained corruption right through the system. There is an ongoing political tension between progress, epitomised by market based reforms and exemplified by growing living standards, and interventionist measures to support those people seemingly most vulnerable to change, with bluntly designed short-term palliatives such as government subsidies. All this means that progress has and will continue to be held back by socialist leaning governments with politicians keen to preserve their control over markets and the dispersal of government largesse.

Hence the raw potential evident from the demographics continues to be smothered by bureaucracy and corruption, even if today it is not as suffocating as it was in the past. Over the last 20 years (to December 2011) the Indian stock market (BSE index) in US dollars has risen by 7.1% p.a., better than the S&P Index up 5.7% p.a. but perhaps not as much as might have been expected given the markedly better economic growth potential. This sense of potential unfulfilled will probably prevail in the future unless there is a marked change in the attitude of politicians to promote free markets. Given it required the national humiliation of IMF intervention to spur on the last significant market based reforms, investors should not rely on such change occurring organically.

Nevertheless, Lindsell Train does not invest in markets, but in companies - and the potential for growth, even if stifled by detrimental government policies, could still allow certain companies to thrive. These are those that directly benefit from the increase in future per capita income of the Indian population and will most likely result in expanding consumption expenditure for many years to come.

We have some indirect exposure to such Indian companies through our existing investments in consumer franchises quoted in developed markets.

The largest is through our holding in Unilever that owns 52% of a quoted subsidiary, Hindustan Unilever ('HU'). Lever Brothers first sold 'Sunlight' soap in India in 1888 and this long heritage has given the company a head start over others in establishing brands and, especially for India, a distribution system that covers the multitude of retail and wholesale outlets. Even today larger format retail stores such as supermarkets and convenience stores account for only 4% of Indian retail sales. HU's distribution system reaches nearly half of India's 14m outlets and over half the population buys its products. The company is particularly strong in soaps and detergents, that make up 46% of sales. For instance 'Lifebuoy' - a product reminiscent of school days whose antiseptic qualities not only cleaned but removed the top layer of one's skin - has 18% of the Indian soap market alone. Comfort, Surf and Cif, Unilever's other laundry and cleaning global brands, all have strong market positions. But it is in personal care (30% of sales) that the best margins are achieved (25%) and the greatest potential for growth exists. Vaseline is an example of a long established brand and Dove one that was first introduced in 1957 and is now the fastest growing hair category brand in India. Food and beverages (for instance Liptons and Knorr) make up the rest of sales but contribute less to profitability. Overall HU's margins average 17% and its sales, at c.$5bn growing at 15% per annum, make up 7% of Unilever's overall consolidated sales.

We move from soap to beer.

Arguably the jewel in the crown of Heineken's purchase of Scottish & Newcastle's assets in 2007 was the 37.5% stake in United Breweries ('UB'). UB dominates the Indian beer industry with a 54% market share and the leading brand Kingfisher, that has a 36% share. Importantly UB provides Heineken with a distribution platform for its own brand, launched last year. UB's sales amount to €1bn (6% of Heineken's) and Heineken's stake is valued at €1.3bn, 9% of Heineken's market capitalisation. Unlike developed market beer franchises, UB since 2002 has been cash consumptive given the need to expand plant and facilities and working capital. This has been financed with debt but also equity, through a rights issue. If we were a UB shareholder we would want debt to be a primary source of finance in the future.

The other business we own that has had a material Indian exposure stretching back to 1948 is Kraft, through its ownership of Cadbury. Cadbury's sales in India amount to $800m (just 1.5% of Kraft's consolidated sales) underpinned by Dairy Milk and Bournville chocolate brands, Eclairs and Halls lozenges. This year sales are up 40% following the successful launch of Oreo , Kraft's big US biscuit brand, and Tang a fruit flavoured beverage. Cadbury India's retail reach covers 700,000 retail outlets.

Two other companies with exposure to India are the spirits companies Diageo and Brown Forman, both represented in Lindsell Train's portfolios. However, both are selling premium brands in limited locations and supplied from overseas. Johnnie Walker Black, Captain Morgan rum and Jack Daniels all have nice market positions in what is today a limited market but this is sure to expand as consumers upgrade from local spirits. Interestingly, the other major shareholder in United Breweries apart from Heineken is United Breweries Holdings ('UBH') controlled by Vijay Mallya. UBH's other major assets include United Spirits, India's dominant spirits business, and Kingfisher Airlines. Mr Mallya needs more cash to fund his loss making airline and we are sure that Heineken would be delighted to invest further into United Breweries or Diageo into United Spirits should he decide to sell to raise further funds.

Then, Pearson generates about 2% of its sales from English teaching programmes In India. Currently 20% of the population speak English and Pearson is leading the endeavour to expand that percentage with its education programmes outside the state school system.

Finally, World Wrestling Entertainment ('WWE') has an important following in India as one of its most popular wrestlers, 'The Great Khali', is of Indian descent and has a prodigious following in the country, making his WWE shows the most watched sports content after cricket. Today, revenues from India make up c.5% of WWE's sales.

If we amalgamate these operations, the look-through Global Equity representative portfolio exposure to India amounts to a piffling 1% of the total developing market look-through exposure of 12%. The UCITS restrictions on portfolio concentration mean that it would be difficult, even if we thought it right, to increase our exposure materially - which illustrates the limitations of investing via the indirect route. The alternative, investing directly, comes with its own risks, especially with respect to governance, security of title and regulation, things we take for granted in Western markets but which are often compromised in less developed ones. India's governance may be better than in some jurisdictions as it was originally based on British principles, but the security of property rights and legal contracts is today inferior to that enshrined in British law.

Nevertheless, putting these concerns on one side, as a result of historic restrictions on foreign ownership of Indian companies, the parent companies of big foreign multi-nationals were not able to own 100% of their Indian subsidiaries. Consequently, today investors find themselves in the lucky position to be able to own shares in Indian quoted companies such as HU, Colgate Palmolive India, Nestle India. This legacy gives us access to wonderful consumer franchises exposed to the potential consumer growth that India promises but with the management and legal oversight and discipline of a large sophisticated multi-national company based in a jurisdiction whose governance we endorse – an acceptable level of comfort, we think, given how inimitable these franchises are.

Thus, although at current prices we think these Indian quoted companies would not qualify for inclusion in our portfolios due to their elevated valuations following recent strong performance, we will be monitoring a number of them carefully within our global universe.

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