J O Hambro Capital Management Group

A View From Asia

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Resilience: The ability to bounce or spring back into shape and position

There is always a debate in markets about what is the right price to pay for a good quality business. During this market cycle, since the 2008 lows in equity markets, businesses with growth characteristics have been rewarded with even richer multiples. Over the past nine years, with few exceptions, value as a style has remained unloved. On occasions, we did witness the value style outperforming growth (especially in times of macroeconomic stress or industry-specific worries), but that outperformance proved ephemeral. Despite an environment of reducing liquidity (central banks moderating QE) and rising interest rates, we have, so far, not seen any marked de-rating in valuation multiples for growth businesses. It is also a fair comment that in every market fewer businesses have delivered sustained growth in the face of several challenges, or are perceived to be in a position to do so.

Resilience matters

In the past few months, as I rejigged our portfolio, one big challenge I have grappled with is the high multiples for good quality businesses. Do I just buy stocks which appear to be squarely in the momentum trade, for whom valuation multiples already trade at significant premiums to the market? What if I misjudge the growth trajectory or the risks of industry disruption, currency volatility or a slowdown in the economy? In addressing those questions, the one metric I decided to reemphasise was resilience. Every business invariably goes through challenging times. When it does, it is either the inherent resilience of the business, or the ability of management teams to deal with and engineer the requisite change, that differentiates it from more pedestrian businesses.

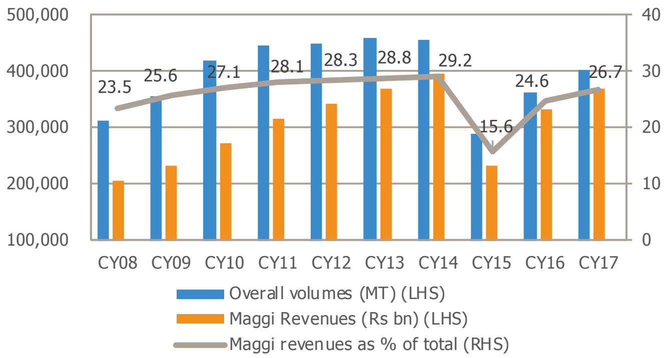
The unwelcome Maggi gift

One such resilient business I have added to our portfolio is Nestlé India (NI). A subsidiary of the Swiss multi-national, NI has operated in India for over a century and built upon its iconic brands in milk, nutrition, beverages, prepared dishes, chocolates and confectionery.

By far one of its biggest sub-brands was and is Maggi Two-Minute Noodles. Between 2009 and 2014, NI aggressively expanded its factories to take advantage of potential growth in India. Yet, under the direction of its parent, NI shifted strategy to focus on improving margins at the expense of volume growth. It cut back on low-priced, lower margin products. That strategy may be appropriate in developed markets, but in a poor/emerging country like India, it made little sense, in my view, for NI to focus purely on enhancing margin at the expense of market share, growing the market and innovation. To an extent, that misstep by management led to lacklustre revenue growth in the past.

To add to this, in June 2015, one of the regulators in India banned NI from selling Maggi noodles due to food safety concerns. The food safety commissioner of Uttar Pradesh, the most populous state in India, claimed that a package of noodles contained seven times the permissible level of lead. Despite the fact that NI was convinced about its safety and quality record, NI decided to recall the product. All associated products, like Maggi jams, ketchups and beverages, were also badly affected, as consumers were naturally cautious. From a dominant 60-65% market share in noodles, NI's market share almost halved overnight.

Nestlé India and Maggi volumes



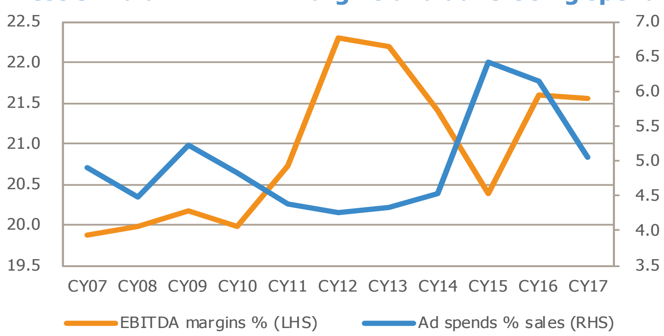
Source: Nestlé India and IIFL India.

A fresh approach

But the brand was and remains iconic and NI had a lot at stake. Tackling the problem head on, NI appointed a new CEO, an old India hand. Under his direction, the management team and the company addressed the safety issue as a priority to regain trust. Simultaneously, it changed course and enhanced its innovation capabilities. In the subsequent couple of years, 42 new products were introduced. NI's strategy turned 180 degrees, away from higher margins to growing volumes and market share with the help of innovation.

This new approach manifested itself in increased advertising and sale promotion spend. Just to put it in perspective, Nestlé globally has close to 2,000 brands; in India, it had just 20. India represents just 2% of global sales for Nestlé but has always remained a country that has great promise. There is an increased recognition by its parent that India needs to be run to meet the aspirations of Indian consumers; the local management team has been given the freedom to do so. Fortune favours the brave. This time around, NI has some tailwinds to aid what now seems to be a path towards sustained and highly profitable growth over the next few years.

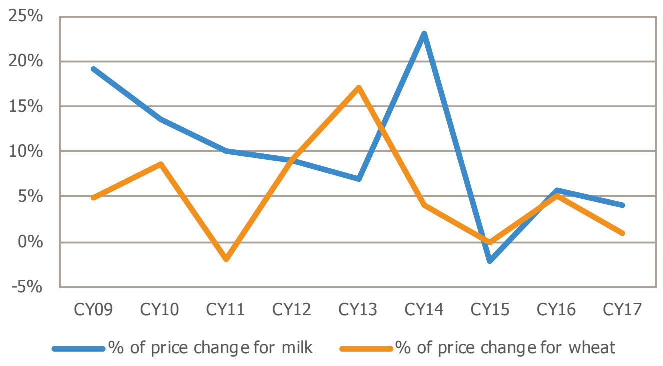
Nestlé India – EBITDA margins and advertising spend



Source: Nestlé India and IIFL India.

Commodity prices, particularly the ones most relevant to NI such as milk and wheat, have eased across the globe. This enables NI to take the higher costs from oil-related packaging products in its stride without feeling any pressure on margins. There is evidence of a recovery in consumer demand after two years of disruption post demonetisation and the introduction of a goods and services tax (GST). This nascent recovery could sustain as India heads into a general election, scheduled by May 2019 at the latest.

Milk and wheat price change



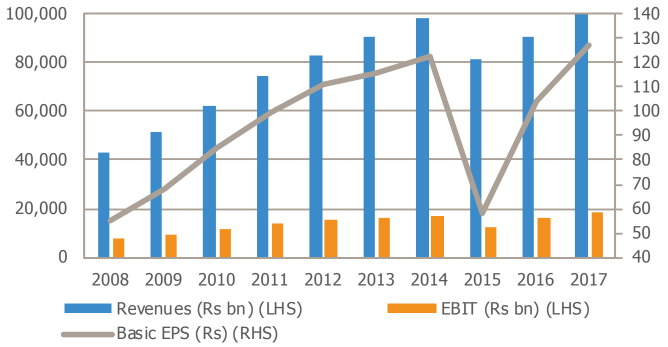
Source: Nestlé India and IIFL India.

As is typical of governments when they approach elections, Prime Minister Modi's administration has started to loosen the purse strings and hand out largesse to rural voters to appease them. As the rural economy starts to see better income growth, I do think NI will keep innovating and introduce more brands from the parent into the Indian market.

A rich valuation but consider the growth prospects

This leaves us with the question of NI's valuation: the stock trades on a 50-52x multiple for 2019 earnings. For some, that's a nosebleed-inducing valuation. On the face of it, that multiple does look rich. Yet I would suggest we put it in perspective, looking at financials from 2013 onwards. In the past four years, NI's revenues, earnings and earnings per share have barely budged.

Revenues EBIT and EPS have flat-lined



Source: Nestlé India and Credit Suisse.

There were genuine reasons for a below par performance. However, in my view, we are on the cusp of change. If the company does execute on its plans, it is quite feasible that in the next four years revenues and earnings double from where they were at the end of 2017. In what could be a turbulent period for macroeconomic reasons across the world, that kind of resilient sustained growth will deserve premium multiples. That's why I am willing to take this positive view on Nestlé India.