A Tale of Two stocks and our Investment Process

This note is a Tale of Two stocks: one 'Value' and one 'Growth' in the Gateway to India Fund. When we use the terms 'value' and 'growth' we refer to their popularly understood connotations. We explain how we are style agnostic, and we do not differentiate between value or growth style factors.

Indeed, value is not a statistical measure. A company's worth is the present value of its future cashflows, however it has become popular to use price multiples as a crude approximation of this. We believe that relative valuation measures, whilst useful, need to be interpreted carefully. The low valuation in a 'Value' stock could be reflective of an inferior business with a low growth outlook. Thus, a low statistical measure say in terms of P/E ratio may not necessarily be reflective of an attractive investment opportunity. Similarly, high valuation in a 'Growth' stock could also be reflective of strong confidence in the growth outlook of a business's cash flows. Therefore, a high statistical measure in terms of P/E ratio may not necessarily reflect an unattractive investment opportunity.

There is however a thin dividing line. A *growth stock* can be a 'value' bargain if the business continues to surprise positively on the growth front. At the same time, a *value stock* can start delivering on higher growth. A 'change' in business fundamentals is what is required. Adopting Sir Isaac Newton's Second Law of Motion to Financial Physics, the motion (stock price movement) of an object (a business) is affected by a force (change in fundamentals) applied to it.

To demonstrate this, I have outlined our investment thesis on two contrasting companies: Wipro and Dixon Technologies.

Wipro Ltd: Out of favour ***Market Cap – US$33bn***

The v*alue stock* in discussion today: Wipro Ltd. It is the fourth largest IT services company in India, with a sales turnover of US$8.3bn in FY20 and an employee count of 190,000. The company has a global presence with the Americas and Europe accounting for the majority of revenues.

We started investing in Wipro in September 2020. It was a quality business that was out of favour, undervalued, and undergoing a 'change' not just in its leadership but also in the overall growth outlook for its business - a powerful combination.

Wipro's business growth has underperformed its peers over the last 5 years:

Table 1

	5 year CAGR (%)		
	Sales	**PAT**	**Mcap**
TCS	11%	11%	7%
Infosys	11%	6%	1%
HCL Tech	14%	9%	1%
Wipro	5%	2%	-6%

Source: Ocean Dial Research – Figures are for 5- year period ending FY20

This has been due to a conservative attitude, a series of execution issues, and more importantly, a lack of top management stability over the years. As a result, the share price has underperformed.

Despite this, there was demonstrable evidence of a strong business model. It has reported an average Return on Capital Employed (ROCE) of 19% in the last 5 years. Adjusting for Cash and Cash equivalents, which have averaged ~50% of its capital employed, it has clocked a Return on Invested Capital (ROIC) of 31% over the last 5 years. Free cash flow generation annually has also been more than 100% of net profit. Nearly 60-70% of its free cash has been distributed to shareholders by way of dividends and buybacks.

Disappointment with its operating performance led to its abandonment. Five years ago, the stock traded at ~10-15% discount to the top two IT services companies - TCS and Infosys – on a 1-year forward P/E basis. In September 2020, when we started investing, it was trading at 15x one-year forward earnings, around a 40% discount. What attracted us the most was that it was available at a free cash flow yield of 6% (near to 10-year Govt bond yield) thus providing a high margin of safety. Our Reverse DCF analysis in September 2020, also indicated that the share price was imputing a sales growth of only 5.5% over the next 9 years in comparison with a realised sales growth of 8% over the last 9 years.

In August 2019, Wipro appointed a younger dynamic new Chairman, Rishad Premji, who in turn instigated the recruitment of Mr. Thierry Delaporte from Capgemini as MD and CEO in May 2020. A change in management came with a renewed commitment towards growth.

The undervaluation and changes in management were going unnoticed, a key signal of this coming in August 2020. As part of our broader primary research, we participated in a conference on IT services companies arranged by a domestic broking house. While most large IT services companies in the conference had an attendance of 25-30 investors in the video calls, the Wipro conference had only one participant – Ocean Dial! A clear case of lack of interest and 'out of favour' status which encouraged us to dig deeper.

At the same time, it was becoming obvious that in the 'post-Covid' world, IT services companies started building tailwinds in their growth rates as companies globally adopt digital transformation faster than usual, especially on the cloud migration and cybersecurity front. It had been some time since we have seen Wipro and the IT services sector have the ability to grow double digits in dollar terms.

So far, the thesis has panned out as per our expectations. The new CEO has flattened the organisation by reducing reporting units and operating costs across divisions and has refocused on growth by making two smart acquisitions. Wipro has hired new local leaders in all the important geographies. Furthermore, growth rates across the industry have jumped sharply in the last two quarters. Most importantly, something more is underway that we did not expect initially i.e. margin expansion. In this 'work from anywhere' environment, offshoring of IT services to India has risen, bringing with it margin expansion due to India's cost advantage. Thus, Wipro's margins have expanded in the last three quarters as the offshore revenue mix has risen. We have upgraded Wipro's profit growth forecast by 4-8% for the next two years to reflect this.

Dixon Technologies Ltd: Growth and scale with it ***Market Cap – US$3bn***

The *growth stock* we discuss today is Dixon Technologies, a manufacturing company, which can loosely be characterised as the mini Foxconn of India. Dixon is in the 'electronic manufacturing services' (EMS) business. The company manufactures electronic consumer durables such as LED lighting products, LED TV sets, washing machines, and mobile phones on behalf of OEMs and brand owners.

In FY20, Dixon reported a sales turnover of US$650m, PAT of US$16m, ROCE of 26%, and at that time a market cap of US$600m.

We have always liked the consumer durable space due to its low penetration in India and high growth prospects. However, competition was intensifying and it was getting harder to identify a brand that could emerge as a sustainable winner. In comparison, in January 2020, we noticed that Dixon had become the outsourced manufacturer of choice for most of these brands, making it a proxy for growth in the broader electronic consumer durable space.

As part of our primary research we had meetings with purchasing managers of four brands selling in India – one Korean, one Chinese, one German, and one Japanese – with a focus on their manufacturing operations and Dixon's capabilities. Our discussions reassured us that outsourcing of manufacturing in the electronic consumer durable space was only going to rise as more brands preferred to focus on marketing and sales, where the main battle was, leaving manufacturing to Chinese/Indian companies who are proficient in their manufacturing skills. Most importantly, all of them acknowledged Dixon's execution capabilities and cost advantage with labour cost being one-third that of Chinese manufacturers.

While our confidence in Dixon was building up, the stock "appeared" expensive at ~31 times one year forward earnings. Then Covid struck in March 2020. The share price fell by 20%, allowing us to add Dixon to our portfolio at ~24x one year forward earnings in March 2020. At that time, we forecast the company to grow its net profit at a CAGR of 25-30% over the next 3-5 years.

In April 2020, the government also launched its plan to come up with a Production Linked Incentive (PLI) scheme for mobile phone manufacturing in India. The PLI scheme gives an incentive of 4-6% of production value to manufacturers for a period of 5 years. The idea is to make India a manufacturing and export hub for mobile phone manufacturing by taking advantage of the diversification of supply chains in the global economy (China+1), a trend that will now accelerate post-Covid. We did not account for Dixon winning a license under PLI. This was just an option value.

Over the last few months, there has been a positive 'change' in Dixon's growth prospects as its opportunity set has expanded. It has won new customers, expanded capacities, and added new segments of products. Dixon has won a license under the PLI scheme to manufacture mobile phones and has already won contracts with two large global mobile phone companies. Furthermore, the government has announced PLI schemes for 13 other sectors. Dixon is exploring related PLI opportunities in IT hardware, Telecom equipment, and LED lighting. There is a scale 'change' happening for Dixon which will be funded from internal accruals. See Table 2 below which shows how our estimates have been revised.

Table 2

	FY20	**FY23 estimates**		**Revision**
		in March 2020	**in April 2021**	
Sales - US$m	650	1053	2379	+226%
PAT - US$m	16	36	62	+172%
ROCE %	26	30	42	+40%

Source: Ocean Dial Research

Dixon now aspires to be among the top global EMS players. Economies of scale due to PLI schemes will create a virtuous cycle of competitive advantage, export opportunity, and thus further growth.

Dixon's valuations, however, have also risen from 24x one year forward earnings in March 2020 to 55x currently. Our Reverse DCF analysis shows that the current share price is implying a CAGR of 22% in Sales and 24% in PAT over the next 10 years. While this asking rate is steep, it may not be unrealistic. Given the multi-fold rise in the share price, our stance in the last few months has been to book profits and size our exposure.

To summarise, both companies are multi-year stories where our initial thesis is currently playing out. Barring a change from new information, we intend to hold them for the long-run.

There a quite a few examples of Value and Growth stocks in the Gateway to India Fund. Value and growth are not mutually exclusive but are complementary in achieving diversification in a portfolio. Our whole focus is identifying quality businesses which we believe have capital efficiency with sustainable growth and are available at attractive valuations considering the underlying business.

Tridib Pathak
Principal Advisor, Gateway to India Fund
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