OCEAN DIAL

House **of** **O**cean **D**ial Series – **HOOD**stock

India Capital Growth Fund's Industry Leaders: #2 Welspun India

India Capital Growth Fund's investment mandate is the small and midcap sector of India's listed universe. This can create the impression that our investee companies are less proven or even un-scalable, since a lower market capitalised investment universe can conceal a portfolio of industry leaders, some domestic and others global. Having discussed Kajaria Ceramics (£1.5bn market cap), India's largest kitchen and bathroom tile manufacturer as our first demonstration of this, it made sense to follow this up with India's largest exporter of home textile products – Welspun India.

Their core strength is in towels, bedsheets, and rugs where their clients range from the likes of FC Barcelona and Manchester City, to John Lewis, Costco, Sainsbury's, and Tesco. They are also licenced to supply Royal Ascot and manufacture the iconic Wimbledon Tennis Club annual championship towel. Preferential tariff treatment from the EU for Pakistan and Bangladesh has made greater inroads into Europe a challenge. However, Welspun's strongest market is the USA where they are the fifth largest player for towels with a 20% market share, and ninth largest for bed sheets with a 12% market share. This helped the company cross $1bn of annual revenues for the first time in FY21 (ending 31st March this year). Despite an impressive journey, albeit with inevitable hiccups, we believe the company has laid the foundations to enter a higher growth and returns plane. What excites us is that a market capitalisation of $1bn is not reflecting this.

Before expanding on why we believe that Welspun's financial performance is set to drive higher returns for shareholders, it is worth highlighting what attracts us to its business model. One advantage is that India is the largest producer of raw cotton. Whilst neighbouring countries such as China have a strong textile industry based on artificial fibres, this local advantage has helped Welspun dominate the bed and bath space. Furthermore, rather than aiming to be a high volume low value player the company has focused on innovation to help entrench its relationships with its high profile clients. The company has developed over thirty patents. One example, Hygrocotton®, has enabled Welspun to weave a hollow yarn to allow fibres to wick away moisture more effectively and for towels and bedsheets to become softer and more luxuriant over time (see for example its benefits evangelised by one of Welspun's luxury UK clients – Christy). 29% of its revenues come from such in-house innovation driven products and we expect this number to grow. The company has three world class, vertically integrated manufacturing facilities and this alongside its research capabilities, and strategic partnerships with top global retailers, provide a strong platform for incremental growth.

We think this platform is facilitating a transformation of Welspun's business model. Firstly their capabilities have led them to enter higher growth segments in the advanced textile space with products such as medical wipes, FemCare, and air filters. Secondly the company is becoming a branded player alongside its B2B focus. Its recent in-licence brand tie-ups with Martha Stewart and Scott Living are allowing it to penetrate deeper into the premium-end of the USA market. Welspun has also recently entered the Indian market for the first time with both a premium and mass market brand to capture a revival in domestic consumption. In addition, the company is targeting the e-commerce channel where it's seeing recent annual growth of 85% growth albeit off a low base. This has led to the share of revenues from e-commerce expanding from 3%to 6%.

These efforts have seen the business shift from generator of low-single digit revenue growth to the mid-teens – the company's long term target. Welspun's debt position was relatively high due to the development of its three facilities. The requirements for fixed assets has now diminished to front-end development of its value-added products. This requires smaller outlays with significantly higher asset turns of around 5x relative to the aggregated company level of 1.7x. This is highly accretive to the company's ROCE (allowing it to continue expanding beyond its current 14% level). Consequently Welspun's debt / equity is now 0.8x and we believe the company will be deleveraged over the next 24 to 36 months.

Textiles have historically been an environmentally impactful business. Welspun is not only an industry leader in terms of its market share but also in how it is addressing the sustainability of its operations. Their ESG report discloses 170 different metrics as targets for shareholders such as ourselves to hold them accountable to over the next ten years. For instance, the company aims to be carbon neutral and net water positive by 2030. It has already been reducing its carbon intensity by around ~2% a year and one of their two plants is already net positive in terms of water usage. The latter has been achieved by tying up with local municipalities to source sewage which is then treated and used for production with fresh water only being used for employee hydration. Beyond this they recycle over 1bn litres of rain water annually. 80% of their packaging is recycled and they aim to have their cotton to be 100% sustainably sourced by 2032 (currently 45%). As mentioned, India is the largest producer of raw cotton globally and as Welspun is India's largest exporter of home textile products, the environmental benefits of these initiatives and the best practices they can encourage amongst the company's peers are compelling.

It is not yet commonplace for small cap companies to have a Head of ESG but as part of our conversations with Welspun's, his claim that the company has the best sustainability standards in the textile industry is not made lightly. Anecdotally, he disclosed that their largest client, Walmart, is using them as a benchmark for their other suppliers to the extent that they have requested Welspun to engage with them on their environmental impact reduction aims.

As ESG investing becomes more mainstream, we believe that improving financial performance and these sustainability initiatives are a powerful combination for a re-rating of the company's shares. There has been some multiple expansion from 10x to 14x which is in part driven by the higher ROCE, dividend payouts, de-leveraging, and a recently initiated buyback programme achieved thusfar. We don't expect operating margins to expand from the current 20% level due to re-investment into brand building. However, were revenue growth to disappoint from our mid-teen base case and revert to single digits, we still believe that there is upside from a re-rating and steady earnings growth whilst the company becomes long-term debt free. Indeed, the fact that most B2B businesses in India with an ROCE of 14% trade at a price of 20x earnings is an indicator of how much safety we think there is in the current market valuation.

There are many ways to define an industry leader. Welspun earns that accolade in more ways than one. Our extensive research and due diligence gives us confidence that there is demonstrable evidence that it is well poised to build on its market share to take both its financial and sustainability performance to a higher level. All this whilst also being confident that we are sufficiently early on this journey to enjoy returns that accrue when the rest of the market wakes up to this.

The House of Ocean Dial Series is a collection of stock notes, podcasts, webinars, portfolio updates and investor trips to India. They are collated in the interests of offering our clients transparency and regular updates on our investment process and portfolio holdings with the added value of 'feet on the street'. HOODstock, HOODcast, HOODinars, HOODfolio and HOODcamp all fall under the House of Ocean Dial umbrella.

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