

EV Wonder

Stevie Wonder, the 25-time Grammy award winning, visually impaired musician once said, “Just because a man lacks the use of his eyes, doesn’t mean he lacks vision.” This can be paraphrased and understood in many similar ways, including that beauty is only skin deep, or that one shouldn’t judge a book by its cover, or even, what’s under the hood, could be good. That last one applies quite literally to the automobile sector. It’s practically impossible to tell by looking at a car today, what’s going on inside. Is it an Electric Vehicle (EV)? Is it a Plug-in Hybrid (PH)? Is it an Internal Combustion Engine (ICE)? Is it running on Hydrogen powered fuel cells (FCEV)? Or Compressed Natural Gas (CNG)? Unless of course, one of these labels is printed on the outside. India too is seeing an alphabet soup of passenger vehicle types.

So, what does the country’s domestic car market look like? Big picture, India only has about 1% of all vehicles globally, despite accounting for ~18% of the world’s population. India’s car ownership is a paltry 20 per 1000 people, compared to 160 for China, 800 for Europe and 900 for the US. Around 3.5 million cars are manufactured here each year, which is about one-tenth the number in China. Maruti Suzuki, the largest OEM (Original Equipment Manufacturer) commands a ~45% market share, followed by Hyundai, Tata Motors (TaMo), Mahindra & Mahindra (M&M) and others. The leader’s market share has been falling though, with the others catching up. But look past this headline number, and the war for dominance is on. Maruti has a near 85% market share in the CNG segment, M&M dominates the SUV space with ~60% share, while TaMo rules the EV space with close to 90% share. Is one segment more important than the others? It’s hard to say, as trends are evolving, but in fiscal 2022, nearly 50% of all cars sold were mid-SUVs. So under the hood, is not just good, but also misunderstood.

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Is there a demand for so many vehicles? Auto manufacturers are currently sitting on an all-time high order book of ~800k units. Waiting periods for some vehicles have stretched to over 6 months. Granted the global supply chain shock was a factor, but company managements tell us that the worst is likely behind us. The upcoming festive season - which is when most Indian companies across sectors clock ~35-40% of their annual sales - is expected to be the best in years, if not ever. Take the example of a high-end utility vehicle called the Scorpio-N. It sports a price tag of ~USD30k, which is certainly high-end for a country with a per-capita income of only ~USD 2k. Surprise, surprise then, that the company that launched this product saw 100k (a hundred thousand!) bookings in just 30 minutes - implying a top-line addition of a cool ~USD 3bn. To put this in perspective, the total SUV sales for the company in FY22 was 235k units. So, is there demand? It certainly seems so.

There is also the 2-wheeler (2W) space, which accounts for ~70% of all vehicles in the country and where India produces ~20 million bikes/scooters a year. Despite India being the world’s largest 2W market, the penetration is only ~100 out of 1000 people, compared to ~280 in Indonesia and ~300 in Thailand. The large listed Indian 2W players are Bajaj Auto, TVS Motors, Hero MotoCorp and Eicher Motors, each with their own niche and market segment focus. Eicher for instance is known (domestically and via exports) for its loud and stylishly premium “Bullet” 350cc+ motorcycles - somewhat a lower-priced cousin of the iconic Harley Davidson bikes in America. But the 2W category as a whole has struggled. With a rise in vehicle prices as well as petrol prices by ~40% over the last 4-5 years, FY22 volumes of 2Ws sold were ~36% below the prior peak of in FY19 of ~21m units.

Then there is the entire emerging world of Electric Vehicles. Keeping aside the debate on what actually powers electricity (fossil fuels or not), a shift towards electric mobility might do India good considering the high amount of petroleum imports and its adverse impact on the trade balance, forex reserves and of course environment. The govt. understands this, and hence is pushing for electric and hybrid adoption via its FAME schemes – Faster Adoption and Manufacturing of (Hybrid &) Electric vehicles. For instance, FAME-II provides a subsidy of ~35-40% of the cost of each e-2W. The govt. also offers tax breaks – the GST on EV cars is only 5% versus the 28% on ICE vehicles. Another example: the demand for e-buses was aggregated recently across five cities, and the world's largest tender of 5,450 e-buses was issued. This has led to record low prices with e-buses being operationally cheaper than diesel counterparts. The aim is then to aggregate demand for ~50,000 e-buses under Make in India provisions and drive a radical shift towards e-buses in all metros and cities.

Have EVs picked up in India? e-2W penetration is still less than 4% today, but a combination of govt. incentives, better charging infrastructure, and higher petrol prices can lead to sharp growth. A NITI Aayog (govt. think tank) [report](#) from June 2022 suggests that with a combination of technological improvement, reduced battery costs and incentives, India's e-2Ws should see ~80-90% penetration by 2031. A number of private equity funded startups (like Ola, Ather, Okinawa and Ampere to name a few) have mushroomed, smelling the opportunity. Ola's FutureFactory in the Indian state of Tamil Nadu is the largest e-2W plant in the world, with a capacity of 10 million scooters – so the word 'startup' is a bit of a misnomer. This competition has meant that the traditional 2W players have de-rated by 25-30% over the last 5 years, while EV startup valuations have risen despite miniscule volumes. Said incumbents aren't lamely taking it on the chin, but rather busy building new product roadmaps, strategically partnering with global tech leaders or even investing heavily into new facilities. For example, Hero MotoCorp not only has an in-house platform for e-2Ws called Vida, but also owns a 35% stake in Ather, and even runs a JV with Taiwanese battery swapping pioneer Gogoro.

Is the 4-Wheeler space easier to navigate? Not really. Remember the mention above about TaMo having a ~90% market share in electric cars? That monstrous-looking dominance is great, but it also masks the fact that EV penetration in 4Ws is not even 1%. Each month in India, ~300k cars are produced, of which less than ~5000 cars are EVs, and of which TaMo makes 90%. This is by no means bad, but even one other significant entrant into the space could see these market share numbers fall drastically. Companies realize this, and they are building up their EV credentials. Earlier this year, TaMo raised a billion dollars from PE major TPG exclusively for setting up an electric mobility subsidiary. M&M too raised \$250m from British International Investments for an EV subsidiary. Maruti the market leader in entry-level cars was ostracized by investors for the last many years because of its perceived lack of EV clarity. They too announced recently that the company's Japanese parent Suzuki was making a USD 1bn investment in the Indian state of

Gujarat to build an EV manufacturing plant. But as Maruti's Chairman noted in the company's annual report, "The per-capita income in India is ~USD 2,000, which is ~5% of what it is in Europe and Japan. This makes it difficult for many people to afford expensive cars. Because of the current technology and lack of charging infrastructure, electric cars are much more expensive than regular cars." Given this view is widely shared, one set of OEMs has gravitated towards hybrid powertrains - hybrid HEV (led by Toyota, Honda), plug in hybrid PHEV (by BYD, Geely) and extended range of PHEV i.e. EREV (by Li Auto). Maruti itself is set to launch mild hybrid vehicles, followed by strong hybrids.

As investors and custodians of capital, our question in this ever changing and complex landscape is: who will emerge victorious? Will the market crown the e2W startups? Or will the 2W incumbents manage to pivot successfully? Will hybrid cars be the next big thing? Or will it be BEVs or hydrogen fuel cell powered vehicles? Should one bet on the current market leader Maruti? Or should one prefer SUV leader M&M or EV leader TaMo?

A quick detour first, to Wonderland. No no, this is not a sly reference to lofty stock valuations, or even the title of this write-up, but the same Wonderland that Alice visited. When confronted with a fork in the road, Alice sought the advice of the pink-and-purple-striped always-grinning Cheshire cat. She asked which way she must go. To which the Cheshire cat replied, "It depends on where you want to get to". Alice said, "I don't much care where". "Then it doesn't matter which way you go," said the Cat. "— so long as I get somewhere," Alice added as an explanation. "Oh, you're sure to do that," said the Cat, "if you only walk long enough."

With so much evolving in the auto and mobility space, our high-concentration high-conviction portfolio only has 1 stock in the auto sector - Sona Comstar (SC) - and it is not an OEM. While we appreciate the immense growth potential of the Indian automotive market, we do not know which way the market will go.

Why Sona Comstar? SC is the fastest growing auto-ancillary company in India. Even during slowdowns like in FY12-16, where the industry grew at 1-2%, SC grew revenues at 11%. In FY17-22 when the industry grew at -0.8%, SC grew at 34%. The products SC manufactures - including differential gears and starter motors - are not just lowest-cost or technologically advanced, but also so sticky that the company has not lost a single client in the last 20 years. It is now a supplier to 7 of the world's top 10 car makers, 3 of the top 10 truck makers and 7 of the top 8 tractor makers. Typically, auto-ancs tend to have ~9-11% EBITDA margins, whereas SC's margins have been above 20%. SC's Return on Capital Employed or ROCE has been ~25%, compared to the industry average of ~10%, speaking to the competitive advantage the company enjoys and its ability to re-deploy capital well.

How about the risk of disruption? As alluded to previously, we don't know which way the industry will evolve, and so to our comfort, SC today caters to ICE vehicles also, hybrids also and BEVs too.

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Here's one example. The company makes differential gears and assemblies, which add up to about 50% of its revenues. These are very critical components in cars. They allow different wheels to rotate at different speeds, such as when turning a corner (where the outside tire would need to turn faster, due to differences in torque) while ensuring balance is maintained. EVs in general generate much more torque compared to ICEs, especially at lower RPMs, which is why a Tesla Roadster goes from 0 to 60 mph in just

1.9 seconds! As such, the more the torque generated by the car, the more the need for differential gears - typically 2x more than ICEs, and so if the future is electric, demand is likely to be strong. Within the

differential gears and assemblies market in India, SC has a healthy ~60% market share in cars, ~85% market share in CVs and ~80% market share in tractors. Despite this, it's share in the global differential gears market is only ~5%, providing much room for growth.

But such a company as you can imagine does not trade cheap. At a market-cap of ~USD 4bn, it's PE ratio today is ~90x. If you haven't fallen off your chair yet, then you might like to know that the PE ratio was ~180x a year ago, but EPS grew ~50% YoY. As part of our fundamental bottom-up investment philosophy, we build in a margin of safety for all our investments. Did we forget that here? Not at all, as we view valuations in conjunction with the company's future growth potential, and do not believe standalone PE ratios adequately capture the full picture. Our investment horizon is long. Many positions have been held for 7-8-9 years, and with a portfolio of only 20-25 companies, each position is expressed with conviction. This approach we believe will give investors the best platform to create wealth over time. With asset turns of ~2.5x, Sona Comstar can in our view potentially double revenues every three years from here-on. Having zero debt, healthy margins, high ROCE, as well as the highest exposure to global electrification trends (40% of revenues is from EVs) across all Indian listed auto-ancls means this company is probably more future ready than most.

For an EV revolution to take place in a country, ultra-critical would be the charging infrastructure on offer. How does India fare? There are ~3,000 publicly accessible chargers in India. To put this in context, China [reportedly](#) built 87,000 new public EV charging stations across the country in just the one month of May 2022, while the total number of charging stations is ~1.4m. So the gap is huge, but given the Indian gov't.'s focus, and the interest shown by various private companies and stakeholders, the gap can be bridged in due course. The requirement of chargers is estimated at 5-10% of vehicle population. Utilization levels for chargers in India is low at <5% as of now, but even in China, ~85% of charging stations lie idle. Two other reasons why EV penetration in India is (s)lower include:

- a) ~30% higher battery costs compared to global prices because of lack of domestic manufacturing. The govt. is remedying this through its Production Linked Incentive scheme, and
- b) Low availability of financing - as less than ~7% of all e-2Ws in India are financed, vis-a-vis ~80% financing in ICE 2Ws. Why is this? Because of the difficulty in estimating replacement value. If you buy an EV today with a battery range of 300 kms, and 12 months down the line, a new battery is developed with a range of 600 kms, how much should the older EV depreciate by? This is hard to estimate.

But India starting late and being behind the curve on EVs might be a good thing. How so? Exactly like India's technological advancements in payments and banking tech, which was made by leapfrogging legacy infrastructure (we wrote about this [last month here](#)). Given the very low penetration levels of cars, it is possible for an entire generation to adopt EVs or hybrids directly over the next decade without ever having owned or driven an ICE vehicle. If this happens at scale and at a lower carbon footprint, that would be an EV wonder.

***Note:** ASK's flagship concentrated ~20-25 stock India equity portfolio is tilted towards financials, consumption and manufacturing-beneficiary oriented businesses. Our portfolio is biased towards quality companies that can deliver strong earnings growth with exceptional capital efficiency.*

To learn more about ASK's investment strategies, please contact:

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