

December 2, 2021

Dear Clients and Colleagues:

Since the global COVID-19 pandemic began 17 months ago, we have seen a dizzying parade of investment themes (and memes) that have caught the imagination of investors big and small. From Electric Vehicles (EVs) to the latest canine-inspired crypto currency, and now NFTs (Non-Fungible Tokens) and the metaverse, where one can escape the harsh inflationary realities of post-pandemic life. At Global Alpha, we are not thematic investors, but we do rely on themes to offer tailwinds to companies that have been carefully vetted around our investment process.

Themes themselves can be broad-based and structural, or narrow and niche, fueled by the latest fad or trend. We tend to favour the former, which tends to last longer and influence a broad swath of the economy, cutting across sectors. Within emerging markets (EM) for example, a broad structural theme that is currently playing out is the increasing formalization of their economies. As per the International Monetary Fund (IMF), over 60% of the world's adult labour force participates in the informal economy and accounts for around 35% of the GDP of emerging economies.¹

Also, informality is not evenly spread across the EM world; Latin America and Africa have higher levels of informality in comparison to East Asia. Emerging markets with large informal sectors tend to underperform and punch much below their weight. Several countries within our EM universe have been actively trying to remedy the situation in order to increase their overall economic productivity, increase the size of their tax base, and lift the living standards of their populations. One country that has really stood out in its push towards greater formalization of its economy has been India.

In the last five years, India has enacted three key measures to push its economy towards greater formalization. Firstly, demonetization of Rs 1,000 and Rs 500 notes in 2016 forced many informal workers to join the formal work force. Secondly, the implementation of Goods and Sales Tax (GST) forced unregistered firms operating in the cash economy to get registered and enter the formal economy. Finally, the first two measures acted as a tailwind for the rapid adoption of digital payments via the Unified Payments Interface (UPI) platform rolled out by the government. The net result, as per

¹<https://www.imf.org/en/News/Articles/2021/07/28/na-072821-five-things-to-know-about-the-informal-economy>

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a recent report by the State Bank of India (SBI), is that the informal economy has now shrunk to 15-20% of GDP in 2020-2021, versus 52% of GDP in 2017-2018.²

This recent shift towards formalization is a generational change and is impacting every sector of the economy. For the discerning investor, it offers an opportunity to identify winners and losers of this massive shakeout that is leading to consolidation and an increase in market power of a select few companies. A great example of this consolidation is the luggage industry in India, which is estimated to be worth around US\$3 billion, of which only 25% is organized. The Indian luggage industry is projected to grow in the high teens, and this growth outlook is propelled by four interesting underlying trends.³

1. Indians are travelling more and are making on average three trips every year as air traffic grew in double digits up to 2018.⁴
2. There is a rise in brand consciousness and luggage is now seen as a fashion statement rather than a mere utilitarian product.
3. There is a higher spending on Indian weddings, where luggage is now included as part of the wedding trousseau.
4. Replacement cycles have been reduced, with Indians replacing their luggage in four to five years (vs 10 years earlier) and their backpacks in two years (vs three to four years earlier).⁵

VIP Industries (VIP IN)

For us, a clear beneficiary of this trend has been VIP Industries (a portfolio holding), which, along with Safari Industries (SII IN; not a portfolio holding) and Samsonite (1910 HK; a portfolio holding), control more than 90% of the organized luggage space.⁶ VIP, however, is the clear market leader with a 52%

²<https://theprint.in/ilanomics/how-indias-informal-economy-is-shrinking-and-why-thats-good-news-in-the-long-term/761659/>

³ Ambit Capital Research

⁴https://www.business-standard.com/article/pti-stories/domestic-passenger-traffic-growth-may-dip-to-six-year-low-icra-119121901445_1.html

⁵ Ambit Capital Research

⁶https://www.business-standard.com/article/markets/vip-safari-industries-luggage-stocks-will-take-a-long-time-to-get-going-120042801701_1.html

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market share, having been the number one brand in India for the last 50 years.⁷ VIP started in the 1970s, making briefcases for office goers, and the name VIP was meant to give its customers an aspirational tag. The company now makes hard and soft luggage, backpacks, and handbags.

With the entry of Samsonite in India, VIP was forced to rebrand and reinvent itself to cater to a younger and trendier demographic. The company decided to mimic Samsonite's own successful international turnaround by focusing on clearly segmenting their brands, expanding distribution, cutting costs, and spending heavily on branding. In addition to this, the company decided to switch from a promoter-led entity to hiring professional management.

The combination of these company-specific changes and macro tailwinds, coming from the shift to the organized sector, has led to remarkable results for VIP. If one were to look at their financial performance from 2016, which marked the acceleration of the shift towards formalization, up to the end of 2019, before the pandemic, we see that the company's EBITDA and net income has more than doubled. With zero debt, their return on invested capital (ROIC) grew from 19.5% in 2016 to 25% in 2019, as VIP decided to rely less on imports from China, and invest in their own manufacturing units in India and low-cost Bangladesh.

While the pandemic disrupted travel and led to a sharp drop in business at VIP, our discussions with management indicate that demand has rebounded sharply with pent up demand for travel and discretionary spending, such as weddings, leading to higher volumes. VIP intends to take advantage of the dislocations in Chinese manufacturing resulting from power outages by leveraging its new manufacturing capacities while launching new SKUs to capture the market share across segments. As the market and the Indian consumer slowly moves away from the unorganized market, we see VIP further consolidating its position as a market leader.

At Global Alpha, we remain committed to separating themes from memes and identifying winners who can clearly benefit from these once-in-a-lifetime shifts in emerging economies.

Have a nice day.

The Global Alpha team

⁷ <https://www.fortuneindia.com/enterprise/vip-industries-thinking-out-of-the-box/102467>

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