January 2016

INDIA

A view from the ground

THE VIEW THIS QUARTER:

- INDIA'S CHANGING FINANCIAL LANDSCAPE
- BALKRISHNA INDUSTRIES (BKT)

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OCEAN DIAL

THE COMPANY

OCEAN DIAL ASSET MANAGEMENT

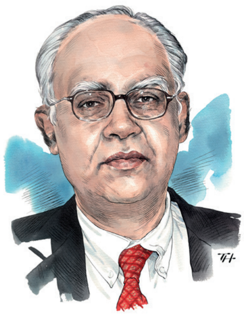
Ocean Dial Asset Management is a London based company with its primary focus on India. Owing to the nature and complexity of the Indian market, we firmly believe that local expertise is crucial to the long term performance of our funds and as such, we have a team of advisors on the ground in Mumbai.

We have an experienced management team with excellent contacts among those who matter in our chosen investment sectors.

It is the team's philosophy that in India, optimal returns will be generated over time by investing in companies that are well placed to benefit from the structural growth potential of the Indian economy, combined with the highest quality of management best able to exploit this opportunity.

David Cornell
Chief Investment Officer

David Cornell joined Ocean Dial in January 2010 from Henderson Global Investors. He is based in London, having been resident in Mumbai for three years until July 2013. He started his career in 1995 covering India for Robert Fleming Securities, ran the BDT Emerging Market Fund from 2004 to 2008 which compounded at over 25% per annum during his tenure and then co-managed New Star's Institutional Emerging Market Fund. He has a degree in English and History from the University of Durham and was in the British Army from 1991-1995.



Sanjoy Bhattacharyya
The Principal Advisor

Sanjoy Bhattacharyya has a career in the Indian capital markets that spans 25 years, initially as Head of Research at UBS Warburg Securities India, before becoming CIO of HDFC Asset Management. Latterly he joined New Vernon Advisory as a Partner before setting up Fortuna Capital to manage the Aristos Fund and domestic equities for a local fund manager. He has an MBA from the Indian Institute of Management, Ahmedabad.

Gaurav Narain
Head of Equities

Gaurav Narain has been immersed in the Indian equity markets for the previous 21 years. He has held senior positions as both a fund manager and an equities analyst in New Horizon Investments, ING Investment Management India and SG (Asia) Securities India. He holds a Masters degree in Finance and Control and a Bachelor of Economics degree from Delhi University.

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MACRO OVERVIEW

OUTLOOK

That 2016 has kicked off in the same vein as 2015 ended does not augur well, with concerns over the health of China's economy and further weakness in oil and commodity prices at the forefront of investors' minds. For as long as these themes persist, then pressure on Global Emerging Markets in terms of ongoing economic weakness and fund outflows will also persist.

India's strong macroeconomic outlook is key to the market's ongoing resilience in the face of this pressure. The better macro data is promulgated on the ongoing improvement of India's terms of trade, overall balance of payments, inflation and fiscal performance. Owing to the weakness of oil and gold, the import bill has collapsed and though this has been partially offset by continued pressure on exports, the impact is marginal given that the ratio of imports to exports is 2½ to 1. Barring any "grey swan event" (or worse) a current account deficit of 1-1.5% of GDP should be comfortably covered, preserving the country's healthy FX Reserves, providing support to the currency whilst keeping a lid on inflation, all valuable anchors in the current climate. Of course the Rupee is not immune to further market volatility, but India's currency fundamentals remain in good shape and this should serve investors well into the medium term.

An important additional benefit of lower oil is the preservation of the fiscal deficit through lower subsidy payments, and crucially, by giving the Government additional flexibility to increase duty on petroleum based products without incurring short term political cost. Tax revenues for the year ending March '16 will comfortably beat expectations and ensure the fiscal target is reached. The decision to cut diesel and petrol subsidies back in 2014 removed a structural impediment to the fiscal deficit, and since oil prices have continued falling the Government has followed this up by reducing the LNG subsidy, which is now distributed via the direct benefit transfer system. We understand that in February's budget the kerosene subsidy will also be distributed via a cash payment through this system, strengthening the fiscal position further and reinforcing the Government's credibility to reform using its executive power. It also raises the issue of a potential upgrade to the Sovereign rating.

The question arises therefore as to how will the Government react when the oil price reverses its current trend? In our conversations with relevant bureaucrats the official line is that the incremental duties that have been imposed on petroleum products into the falling oil price will be reduced, before there is any risk of reversing the subsidy removal. Keep in mind that oil was circa US$60 when subsidies were cut, so although the tax revenue windfall would wash away as oil rallied, there is some way to go before investors need to get twitchy on any policy reversal.

Equally crucial to preserving market confidence and currency stability will be the reappointment of Raghuram Rajan at the RBI. The Governor's first term ends in September and though we have no insight into the timing or the likelihood of his reappointment, this will become an issue for the market soon enough. Any uncertainty or delay around this will rattle the markets. Rajan has also been instrumental in reviving strong domestic interest in equities. This outcome is really a by-product of a successful strategy to target high real interest rates (forcing savings into financial assets), the ongoing scrutiny of the cash economy, and the persistent weakness in gold prices and real estate, for many years the avenue of choice for all surplus cash and savings. Thus domestic mutual funds have been substantial buyers of equities in 2015, more than offsetting the foreign outflows, providing valuable support to the market. As a base case for 2016, we should anticipate continued redemption pressure from GEM funds to continue to affect India, but similarly expect further domestic inflows, conceivably above and beyond 2015's numbers given ongoing "formalisation" of the India economy. This can provide a further pillar of support to India's equity story for 2016 and possibly beyond.

Though the economy will grow in the region of 7% for both FY16 and FY17, the much anticipated turn in the investment cycle and recovery in earnings remains elusive. Excess capacity, weak corporate balance sheets and a stressed public banking system are taking time to work through and this, combined with weaker growth globally, is extending the period to recovery. But pockets of capital investment are evident, particularly in roads, railways and energy (coal and renewables) and the benefits of this (and the second derivative) will continue to filter through. Furthermore benign inflation, a manageable fiscal environment and a stable currency should allow for further gradual cuts to interest rates. This in turn will support the viability of new investments, incrementally boosting economic activity. Urban consumption should get a lift from a 24% public sector pay increase. Although lower nominal growth is forcing investors to adjust to a "new normal" for top line at 15% as opposed to 25%, nonetheless the pressure on earnings downgrades should ease across the market as the impact of falling oil and lower commodity prices on corporate profitability falls away.

Equities across the board have got off to a poor start in 2016 with India closely correlated to global cues, whilst continuing to outperform its emerging peer group. The market continues the consolidation phase following the 2014 rally, and remains at the lower end of the 18 month trading range. On a medium to long term view we see this as an excellent opportunity to increase exposure to a strong structural growth story.

INDIA'S CHANGING FINANCIAL LANDSCAPE

A snapshot analysis of the Indian banking sector makes for grim reading. Public Sector Undertakings (PSUs) have 73% market share of assets[1] and are renowned for politically motivated lending as well as anachronistic systems and processes.

Legacy issues stemming from poor business practices in conjunction with the liquidity boom prior to the Global Financial Crisis, are now dominating the narrative of any analysis taking place today. Indeed, approximately 11.5% of assets in the entire system are "troubled" (4.0% non-performing and 7.5% restructured)[2], the majority of which originate from the public sector.

A compelling argument can be made that the domestic banking system has hitherto failed to serve its purpose of responsibly financing India's growth potential. Partly as a consequence of Indira Gandhi's nationalisation of the 14 largest banks in 1969, a cornucopia of burgeoning entrepreneurial talent across the country has faced a very high cost of capital - or worse - no access at all. Despite these failures a shake-up is underway. A meaningful re-capitalisation of the sector is unlikely due to fiscal constraints. However, under the leadership of Raghuram Rajan, the RBI is instigating changes which, coupled with the Government's aggressive drive for financial inclusion, cause us to believe that these problems are finally being addressed.

In a lecture in May 2014, Dr Rajan echoed this, stating that *"The banking sector is on the cusp of revolutionary change. Such a vision is not just a possibility, it is a necessity if we are to finance the enormous needs of the real economy."*[3] This piece will examine what these changes are and why we believe the Governor was not indulging in hyperbole by describing them as *"revolutionary"*.

When the USA made its transition into an economic superpower over the course of the nineteenth century, there was a rapid expansion of financial intermediation and banking which was a crucial facilitator of the industrialisation that the country experienced. In 1818 there were 338 banks in operation with total assets of U$160m and by 1914 there were nearly thirty thousand with US$27bn of total assets[4]. Chart 1 shows how India has been slow to act on this front since its economic renaissance in 1991. Only two new banks have been allowed to commence operations over 21 years. However, after a long wait, the RBI has reopened the sector over the last two years by issuing 23 licences to a new set of players. Two are for Universal Banks, ten for Small Finance Banks and eleven for Payment Banks. Whilst the increased number of institutions is good news for the wider economy, it is the latter two models that are of particular interest.

Small Finance Banks will aim to start providing basic banking to the bottom of the pyramid. According to Credit Suisse's India strategy team, there are approximately 5,500 listed companies and 900,000 registered companies. Beyond them, there are 58 million enterprises with an average employee count of 2.2. The new banks will target these enterprises who currently have no access to banking credit and consequently face a usurious cost of capital[5] with a lending portfolio, half of which will have to be made up of ticket sizes below INR2.5m (US$38,000). With the Government now aiming to pay all subsidies as cash transfers directly into recipient bank accounts, this allow banks to lend against this income stream thereby increasing the availability of credit at affordable rates. Furthermore, eight of the ten licences have been given to existing microfinance institutions ensuring that the drive is not being made from a standing start, and they will now be able to offer a wider range of services including raising deposits, thereby lowering their cost of funding.

It is unviable for the traditional bank branch model to reach every village in India primarily due to poor infrastructure. Nevertheless, the country has achieved connectivity through an impressive telecom network and is close to reaching full mobile phone penetration. The issuance of Payment Bank licences will aim to increase financial intermediation from this platform. They will target migrant labourers, low income households and small business by offering them the ability to deposit cash, transfer money,

As bank branches continue their decline in The West, India is transitioning away from an informal economy into a cashless society. Adoption of cutting edge technology will enable the country to undertake the same journey of financial expansion that the USA did in the nineteenth century, mentioned earlier, but do so at a faster pace.

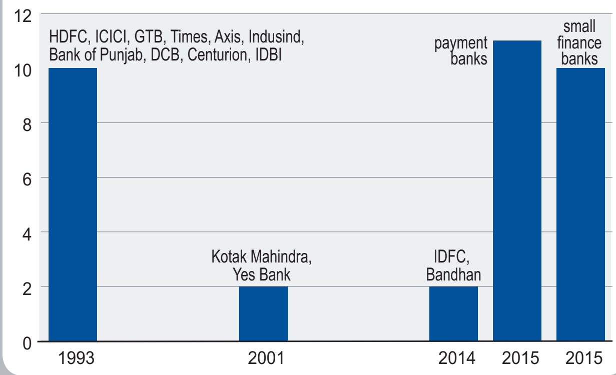
pay bills and make purchases – all through their mobile handset. No lending will be allowed and transaction fees will need to be kept low to attract customers. As such, licences have been issued to organisations with existing distribution reach and strong balance sheets. This includes telecom companies (Bharti Airtel, Vodafone, Idea) and industrial houses such as Reliance. Inspiration can be taken from Vodafone's M-Pesa in Kenya, through which approximately two thirds of the adult population now deposit money and make transactions.

Political sensitivities and labour union intransigence make outright privatisation of public sector banks unrealistic

These changes are a promising step towards increasing access to finance across the economy, and their effects will start to be felt as soon as operations commence. Over the longer term we believe their impact could radically change the make-up of the sector. Firstly, political sensitivities and labour union intransigence make outright privatisation of public sector banks unrealistic. Therefore an increase in the size of the banking sector will circumvent this by diluting the overall influence of PSUs. Make the pie bigger rather than worry about how it's divided up. This is similar to what happened with the telecom and airline industries where the state-owned MTNL, BSNL and Indian Airlines dominated the market until it was opened up to private competition. They have now become minnows in their respective fields, with consumers ending up as the ultimate winners through lower costs and greater choice.

Secondly, the focus on digital technology to expedite financial inclusion will enable India to leapfrog the bricks and mortar banking model that is entrenched in the developed world. As bank branches continue their decline

Chart 1: New banking licences



Source: RBI

The RBI has reopened the sector over the last two years by issuing 23 licences to a new set of players. Two are for Universal Banks, ten for Small Finance Banks and eleven for Payment Banks.

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The focus on digital technology to expedite financial inclusion will enable India to leapfrog the bricks and mortar banking model that is entrenched in the developed world

Most encouragingly in the short term however, is that these new licences are pushing the more dynamic incumbents to raise their game. Our discussions with management teams of universal banks revealed excitement rather than concern. Many claimed that they have already made headway in digital technology, by for instance investing to create their own e-wallets. They are also looking to add their expertise to the Payment Banking space. State Bank of India has taken a 30% stake in Reliance Industries' Payment Bank, whilst Kotak Mahindra Bank has done the same with a 20% stake in Bharti Airtel's. The deeper access to their customers will enable them to provide a better service as well as leverage on their lending.

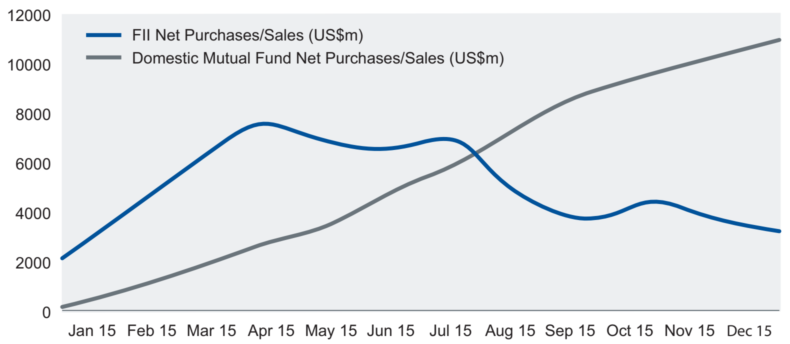
The changes discussed are unlikely to be of direct immediate benefit to the earnings profiles of the largest listed names in corporate India. As mentioned earlier however, there are 58 million unregistered enterprises whom employ on average 2.2 workers. These reforms aim to work their way from the bottom of the base where the scope for impact on the wider economy is most dramatic. This is especially so if each of these enterprises can more easily borrow to purchase a new piece of equipment or hire an extra worker. The numerous parties that constitute the driving force behind financial inclusion – from the Government and the RBI to large businesses and the new e-commerce industry – should ensure that the pace of change is "revolutionary" as Governor Rajan predicts. What one can be sure of is that the state of the banking landscape is set to look considerably different in five years' time compared to today.

1 Reserve Bank of India, Report of The Committee to Review Governance of Boards of Banks in India, May 2014
2 Kotak Institutional Equities Securities Research
3 Annual Day Lecture, Competition Commission of India, May 2014
4 Daron Acemoglu and James Robinson, Why Nations Fail, 2012
5 Annual lending rates in Rural India can range from anything between 30-60%. Source (India Infoline Ltd)

CHARTS & COMMENTARY

LAGGING INDICATORS

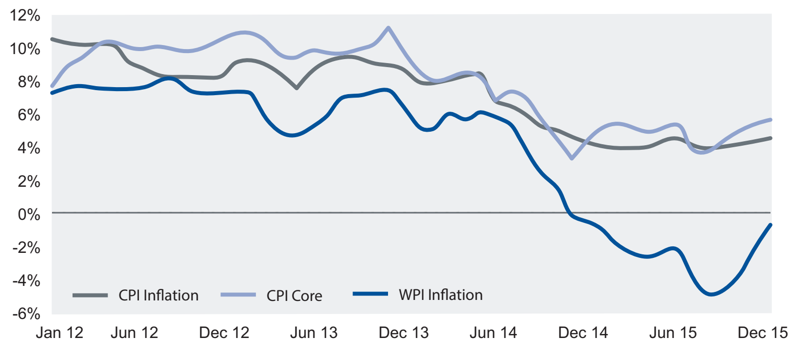
Chart 2: Net foreign portfolio vs domestic mutual fund listed equity flows



Source: RBI, IIFL Research

Mutual and pension fund interest in domestic listed equities played a vital role in supporting the market in 2015, offsetting the outflows from foreign investors that picked up mid-year. Ongoing scrutiny of the cash economy, combined with high real interest rates, weak real estate and gold prices are encouraging savers to diversify into financial investments. Domestic demand for equities could continue to play a decisive role in 2016 if trends continue.

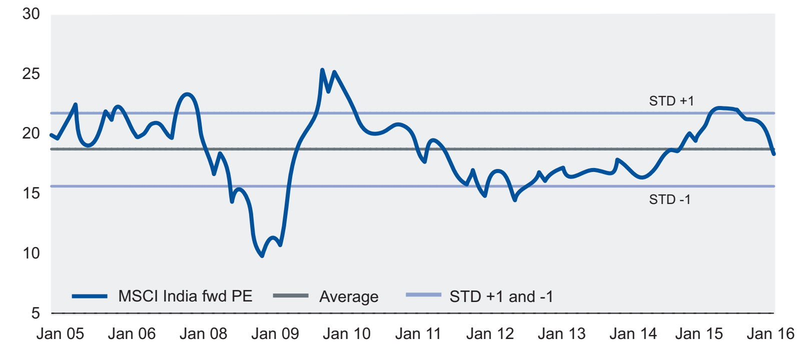
Chart 3: Inflation



Source: Bloomberg, IIFL Research

December clocked further deflation in WPI, reported at -0.73%. Fuel and manufactured product inflation prices continued to fall, offset by a 6.2% food price rise year over year. CPI also rose 5.6%, higher than forecast on account of similar food inputs, notably onions and pulses. More recent data suggests these prices have subsided in January, with no generalised spillover. Benign inflationary trends are expected to remain, with the RBI on course for further monetary easing this year, particularly if US Fed expectations ease.

Chart 4: Sensex TTM P/E valuation vs. history



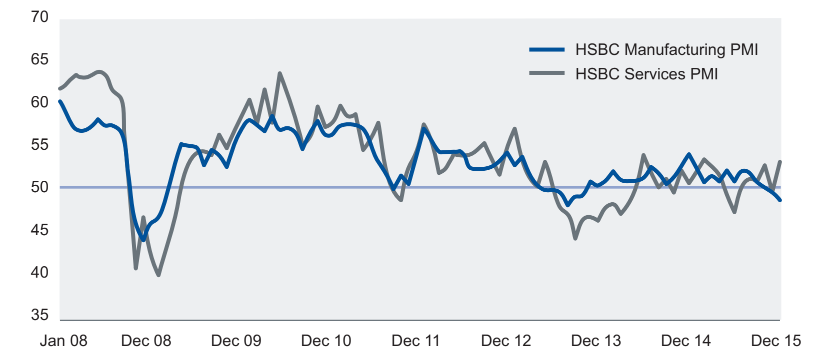
Source: Bloomberg

The market is currently trading at 18.3x trailing 12 month earnings. For the next 12 months the market trades on 15.9x price/earnings for expected growth of approximately 20%. 2016 earnings were continuously downgraded throughout the year due to ongoing commodity and oil price pressure and weak domestic banking and rural consumption. This year we see the pace of downgrades easing, but with potential further pressure to bear in public sector banks in particular.

CHARTS & COMMENTARY

LEADING INDICATORS

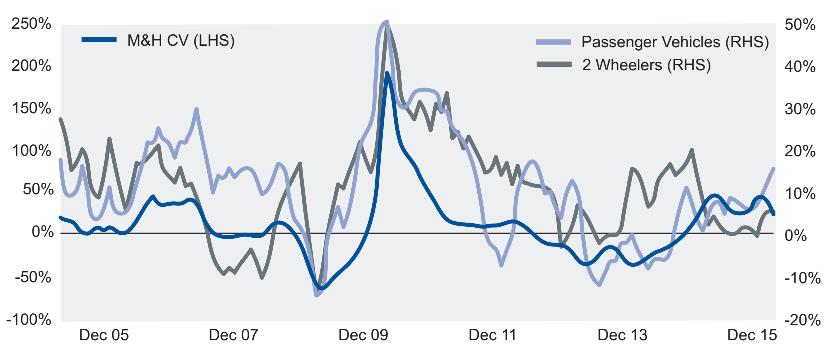
Chart 5: India HSBC PMI



Source: Markit Economics, IIFL Research

The new order to inventory ratio fell to a 28 month low, corroborated by CMIE data which indicated a decline in new project annoucements. Weak export data impacted by global trends, in combination with the changing outlook for the Chinese currency added to the overall weakness. Service data was up month over month.

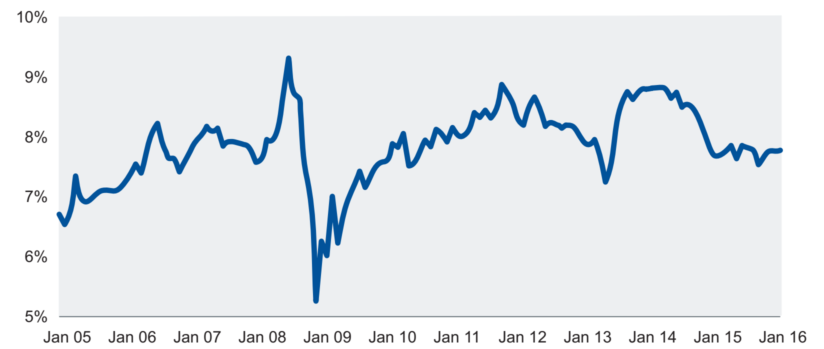
Chart 6: Auto sales growth (3MMA)



Source: CEIC, IIFL Research

Passenger car sales showed healthy growth of 8.5% for Dec (13% for the full year), demand moderated slightly towards year end and all growth was heavily focused on new models. Commercial vehicle industry sales remained strong on a demand pick up in medium duty trucks and new product launches. 2 wheeler sales remained soft in line with weak rural demand.

Chart 7: Government of India 10 year bond yield



Source: Bloomberg

10 year bond yields remain elevated. This is in spite of strong fiscal performance, benign inflationary trends, healthy FX reserves, and a weak oil price. There are market fears that the FY17 target (-3%) will come under pressure due to a public sector pay hike, State Electricity Board debt rescheduling and a tick up in oil, adding to the numbers. The impending Budget will look to address these concerns.

COMPANY FOCUS

BALKRISHNA INDUSTRIES

The Modi Government has placed much emphasis on increasing India's manufacturing capability over the next decade, setting a target to raise its overall contribution to GDP from 14% to 25%, creating employment opportunities and reducing India's dependence on imports. With that in mind this quarter's stock piece is focused on a company that already competes on the global stage using India as its manufacturing hub, benefitting from low cost skilled labour, thereby enabling it to win business from its global competition. The company has built a sustainable moat around its capability in a highly specialised market, and is dedicated to expanding market share off a low base. With a sustainable competitive advantage and an impressive track record, we expect profitable growth well into the next decade.

Balkrishna Industries is a company that the Ocean Dial team knows well, having followed it for some time before taking initial exposure in early 2013; position sizes were completed across the funds by mid-2014. The company is the principal business of the Siyaram Poddar Group and is a leading manufacturer of off-highway tires (OHT) for sale to the agriculture and industrial segments. Balkrishna's revenues are predominantly export driven; 50% is derived from Europe, 27% from the United States, circa 10% from Asia (including Australia), with the balance from India, a more recent initiative.

There are a number of compelling reasons to suggest that Balkrishna has built significant barriers to entry in its business model. OHTs represent just 10% of the global tyre market; within the segment revenues two thirds originate from the construction and mining segments (earthmovers, dumpers and loaders) whilst the balance one third evolves from the agriculture space, (tractor tyres front and rear). As such OHTs make up a small part of the overall business of the big global players such as Bridgestone, Michelin and Trelleborg who do not therefore consider this part of their overall business as "strategic" and whilst there are a few "pure-play" European players alongside Balkrishna such as Titan International and Mitas, in all there are limited players in this niche segment. Indeed a number of the global players have exited the OHT segment altogether believing that the high levels of customisation required combined with high capital costs (but a minor contribution to total revenues) makes the sector unattractive. This level of customisation has been built up over two decades and well demonstrated by over 2,200 SKUs. These are often manufactured in small batches using multiple moulds, offering varying degrees of soil compaction and surface gripping, making the product suite difficult for any company to easily replicate. Since new tractor or mining equipment "launches" often have different sized tyres, distributors have to source small quantities of tyres to meet the replacement demand; clearly there is an advantage in sourcing from one supplier. Moreover it takes the Chinese suppliers out of the market, who see the high volume standardised passenger car and commercial vehicle markets as better bets.

The investment argument is therefore strengthened by the less intensive competitive environment at this end of the market, reflected by the company's margins, historically ranging from 20-24% (currently at 28% due to the fall in commodity prices); this is despite selling at a discount to customers. The larger global competition tend to report margins in high single digit. Additionally, over 75% of Balkrishna's revenues are focused on the replacement market which is more defensive than selling to the OEMs directly, though more recently the latter have become an important contributor to overall revenues.

Balkrishna adopts a discounted pricing strategy to win market share from the

Having created a profitable and defendable business model Balkrishna's challenge is to broaden its reach to new geographies, expanding market share in both farm and industrial segments. The company is expected to sell circa 150,000 tonnes in FY16 providing a global market share of 3.5%, up from 1% five years ago.

competition using significantly lower labour costs to drive better deals for customers. The company's labour costs represent 4-5% of sales by comparison to the developed market peer group who pay up to 25-30%, the benefits of which are passed through to the customer in terms of lower prices. Raw material expenses, mainly natural rubber, represent approximately 45% of total costs which are passed through to the end user but with a lag. This helps to provide operating stability, a positive attribute for investors, as it allows margins to show resilience in periods of weak rubber pricing, (due to the delay in passing through lower costs), whilst in periods of higher raw material prices (also passed on with a lag thereby pressurising margins), stronger demand drives better volumes, facilitating operating leverage and supporting profits. In addition, as an export registered business, Balkrishna is exempt excise duty on imported rubber (20% on cost) giving it further strategic advantage in pricing, and although these are dollar denominated costs, the company's dollar revenues provide a natural hedge also safeguarding margins and at a structurally higher level to the global competition. And given the global players act as price setters but earn relatively lower returns on capital we are confident that pricing discipline across the industry will not be threatened by majors wishing to win back market share.

Balkrishna is exempt excise duty on imported rubber (20% on cost) giving it further strategic advantage in pricing

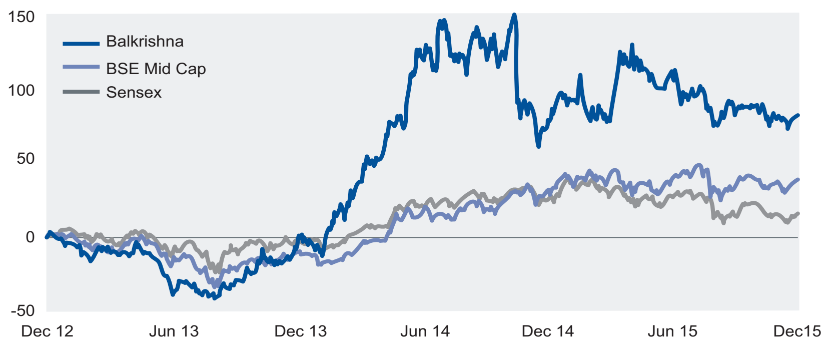
Though Balkrishna's returns on capital are higher than its competitors, the working capital cycle is adversely affected by the distance from factory to customer. This blocks capital, reducing asset turn and depressing potential returns. The company looks to offset this by only manufacturing against confirmed orders from its distributors, but also by incentivising these customers to carry inventory and manage the marketing spend. This is achieved by offering better margins (15% vs 7-8%) to the distributors than the competition.

A new 120,000 tonne facility has recently been completed and this is expected to be fully utilized by FY19 doubling existing capacity and facilitating the next leg of growth.

Having created a profitable and defendable business model Balkrishna's challenge is to broaden its reach to new geographies, expanding market share in both farm and industrial segments. The company is expected to sell circa 150,000 tonnes in FY16 providing a global market share of 3.5%, up from 1% five years ago. Of that approximately 75% is sold to the replacement or secondary market providing stability in periods of weaker growth; the balance is sold directly to the OEMs. A new 120,000 tonne facility has recently been completed and this is expected to be fully utilized by FY19 doubling existing capacity and facilitating the next leg of growth. This growth is expected to come from market share gains in the industrial and mining sectors in new geographies within Asia (Australia and India) and Europe (Russia and CIS). The contribution to revenues from OEMs is also expected to rise from 25% to 30% to better balance the current high contribution from the replacement market.

In the current environment of slower global growth and ongoing price pressure in commodities the demand outlook remains challenging. Volume growth has slowed across regions and particularly in the mining sector. This comes at a time when the new capacity is coming on stream enabling the company to improve market share despite a flat industry environment. The incremental increase in utilisation of the new capacity will be gradually phased in over the next few years as the demand environment picks up, initially via the restocking cycle and latterly by an improvement in demand. The company will also shift some manufacturing from its older facilities to the new plant, thus additionally improving efficiencies. Now the period of intense capital expenditure is over Balkrishna is expected to utilise the higher levels of cash generated from increased volumes to manage the higher interest and depreciation costs, as well as repay principal on the debt taken out to fund the expansion. This should lead to a reduction in balance sheet debt, an improvement in returns on invested capital, and a higher valuation rating on the company's share price.

Chart 8: Three year cumulative share price performance (US$)



Source: Bloomberg

MACRO OVERVIEW

ECONOMIC DATA

Change over	2009	2010	2011	2012	2013	2014	2015	Last Qtr. (Jun-Aug)	This Qtr. (Sep-Nov)
Real GDP % Annual Change	6.7%	8.6%	8.9%	6.7%	4.5%	4.7%			
Real GDP % Annual Change - new series					5.1%	6.9%	7.3%	7.0%	7.4%
Avg. IIP % Annual Change	2.9%	5.3%	8.3%	3.1%	1.2%	-0.1%	2.8%	4.9%	6.8%*
Exports % Annual Change	14%	-4%	40%	22%	-2%	5%	-1%	-16%	-22%
Imports % Annual Change	21%	-5%	28%	32%	0%	-8%	-1%	-11%	-26%
Current Account Deficit % of GDP	-2.3%	-2.8%	-2.7%	-4.3%	-4.8%	-1.7%	-1.7%	-1.2%	-1.1%
Interest Rates (Repo) (Avg.)	7.4%	4.8%	5.9%	8.0%	8.0%	7.5%	7.9%	7.3%	6.8%
10 year GOI Bond Yield (Avg.)	7.6%	7.2%	7.9%	8.4%	8.3%	8.6%	8.5%	8.1%	7.9%
FII Flows (US$bn) (CY)	+17.6	+29.3	-0.5	+24.5	+19.8	+16.2	+3.3	-2.7	-1.2
FDI Flows (US$bn) (CY)	+27.0	+21.0	+27.6	+22.8	+22.0	+28.8	+26.5	+6.3	+2.9**
INR vs. US$ (CY)	+3.7%	+4.0%	-18.9%	-2.8%	-13.0%	-2.3%	-4.7%	-4.0%	-0.8%
INR vs. GBP (CY)	-7.2%	+7.7%	-18.5%	-7.8%	-15.3%	+3.4%	0.2%	-4.6%	+1.9%

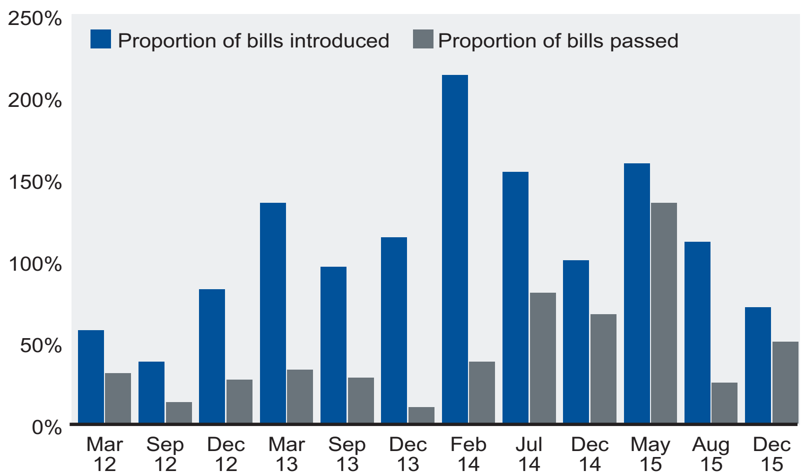
* Sep to Oct ** Sep only

Source: Bloomberg, DIPP – Govt. of India

GOVERNMENT SCORECARD

The Winter Session of Parliament was a disappointment both in terms of headline bills being passed and with regard to the absolute number of laws entering the statute book. This is primarily due to disruptions from opposition parties in the Upper House which only sat for 51% of the scheduled hours versus 98% for the Lower House.

Chart 9: Parliamentary speed and activity



Source: PRS Legislative Research

REGULATORY INFORMATION

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