July 2015

INDIA

A view from the ground

THE VIEW THIS QUARTER:

- POOR MONSOON? YOU CAN'T BE CIRRUS...
- COMPANY FOCUS: RAMKRISHNA FORGINGS

www.oceandial.com

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

It has been a tough quarter for Indian equities, but despite the recent weakness the market has held up well under the circumstances, suggesting that investors' conviction in the investment case remains intact, in the main.

Previously we highlighted concerns that stocks had run ahead of themselves, and therefore a period of consolidation was likely whilst corporate profitability recovered. We anticipate that this trend may continue in the near term as investors grapple with concerns both onshore and in a global context.

The period has witnessed a sharp spike in crude, a "melt up" in Chinese equities, and worries over the strength of the global recovery. Whilst this reduces investor appetite for India at the margin, in the short term, the overriding concern has been that corporate results substantiate the view that the real economy is not yet responding to the improved macroeconomic and political environment. The private sector remains reluctant to beef up fixed capital investments and revenue growth remains anaemic. Both credit demand and supply are weak, aggregate capacity utilisation is estimated to be somewhere in the mid-70% range implying there is slack in the economy, and the IPO market is moribund. The real cost of money remains circa 6.5% which is onerous considering the weakness in the economy, but the Reserve Bank of India (RBI) is reluctant to take the brakes off until the impact of the Monsoon on food inflation can be assessed. On a positive note, the initial rains have hitherto been adequate for the summer crop and the Government has announced only an aggregate 2.8% increase in Minimum Support prices of agricultural goods (a price floor to protect farmers). This should keep food inflationary pressures contained allowing the RBI scope to continue cutting interest rates later in the year.

On the politics front, sentiment was knocked following the revival of uncertainty around retrospective tax liabilities, this time on foreign portfolio investors, and namely the imposition of Minimum Alternate Tax of 20%. The recent back tracking by the Finance Minister plus clarifications and subsequent concessions suggest that this issue has now been recognised as a spectacular own goal which must be rectified, an outcome the market is certainly expecting. In Parliament the Government managed a productive session (best in five years), despite the negative press, where 23 bills received approval along with the promulgation of several ordinances. But it was the failure to get both the Goods and Services Tax or the amendments to the Land Acquisition Act through both houses that have rightly raised concerns. We understand that the former will pass in the next session, however amendments to the Land Acquisition Bill have proved much tougher with the BJP failing to build consensus effectively and leaving themselves vulnerable to opposition parties labelling them "anti-farmer". The passage of this bill in its current form, considered critical in addressing India's infrastructure deficit, is looking problematic this year as shortly the Government will need to win the State election in Bihar, to keep the broader agenda on track.

Given the dearth of private sector capital investment, a lot of emphasis is now being placed on the increase in public spending

Given the dearth of private sector capital investment, a lot of emphasis is now being placed on the increase in public spending; this is focused on roads and railways. Government data for April reveals a sharp pick up in spending (up 28% year on year), so we would expect this to filter through in better data in the months ahead, although it is hard to ascertain the extent to which public expenditure fillip will move the "growth needle". Anecdotally we hear that China Light and Power's (CLP) coal fired power plant in North India is now receiving sufficient coal stocks from Coal India after a dearth of supply. In its recent interaction with investors, Cummins India noted that "measures currently being taken by the Government for India's economic revival are generally positive for our domestic business and have started to show early signs of recovery in segments linked to infrastructure and defence spend."

Perhaps it is Modi's war against corruption that is the principal reason for the private sector's reluctance to invest

It is interesting that of all the industrial conglomerates that are openly reporting signs of life, (as far as we are aware) it is the subsidiaries of Cummins Inc. and CLP. Perhaps it is Modi's war against corruption that is the principal reason for the private sector's reluctance to invest; since the application and approval process has become transparent and rules based, successful "e-auctions" in coal and telecommunications being prime examples, doing business with the Government "old style" is off the table. Even those industrial families considered to be closest to the Prime Minister are finding access hard. The rules of the game have changed for the better but it is taking time for the players to adjust. The Government is tackling India's structural weaknesses root and branch. These changes may not bring instant gains to either foreign investors or the population as a whole, but in an environment with low inflation, lower interest rates, improved governance and steadily rising growth, the medium to long term outlook remains encouraging.

POOR MONSOON? YOU CAN'T BE CIRRUS…

The RBI's Governor, Raghuram Rajan, indicated in the June policy announcement that the prospect of lower interest rates was diminishing. Part of the reasoning behind this decision was a revised monsoon forecast by the India Meteorological Department (IMD) which suggested that there is a 66% probability of the impending rainfall being deficient. Dr Rajan commented: *"a conservative strategy would be to wait, especially for more certainty on both the monsoon outturn as well as the effects of the government's responses if the monsoon turns out to be weak"*

What is clear from this excerpt is that India is in a peculiarly unique position amongst the world's largest economies. A geographic phenomenon that occurs for four months every year requires cautious consideration not only from the country's Central Bank but also across multiple levels of the Central and State Governments. The IMD website itself quips that *"In 1950s and 1960s, [the] Indian budget was regarded as a gamble on the monsoon rains"*,[1] so much so that one of the three Parliamentary sessions that take place over a year is named after the rainy season. It drives sentiment as well as policy, and with India on the cusp of an economic recovery it is a timely opportunity to discuss its cause and effects.

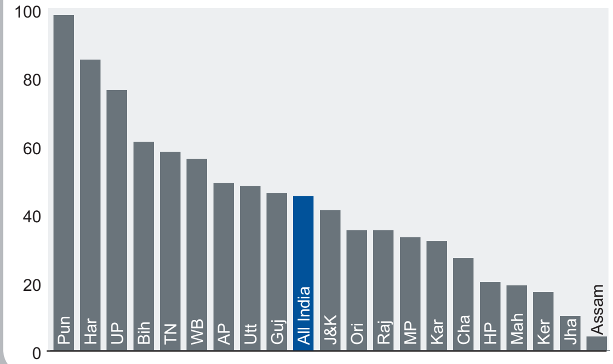
The heavy rainfall is caused by south westerly winds travelling from the higher temperatures of the equatorial region of the Indian Ocean towards the (cooler, post-winter) Eurasian landmass. It starts at the beginning of June hitting Kerala on the west coast, covering the whole country by mid-July and finishing towards the end of September.

The headline statistic to analyse the monsoon is the long period average (LPA) which takes a 50 year mean of cumulative rainfall each year. It currently sits at 887mm and a "normal monsoon" is classified as being between 96% and 104% of this number. Whilst a drought is 90% or below the LPA, anything under 96% is considered "below normal" and is viewed as harmful for the crop sowing season. Of greater importance is the dispersion of the rainfall around the country. The states across the northern belt of India are the top producers of cereals. Chart 1 shows that these states, with the exception of Rajasthan, have developed better irrigation coverage so are not as monsoon dependent. However the top fruit and vegetable producing states are located in the southern peninsula and are more vulnerable to drought conditions due to poorer irrigation and the inability to store excess supply in years of bumper rains[2]. These factors, in conjunction with the overall size of India, ensures measuring the impact of the monsoon on the wider economy is a challenge, and although agriculture constitutes only 14% to GDP, the monsoon still causes concern over inflation and growth.

Within India's CPI basket, food forms approximately 46% of the index of which cereals constitute 10% and fruit and vegetables are 9%. This explains the historic relationship between poor monsoons and higher inflation[3]. Over recent years the Government has improved its ability to limit the impact of higher food prices by improved accumulation and management of buffer stocks of cereals. Through the state owned Food Corporation of India, grains have recently been released to the market to prop up supply, whilst

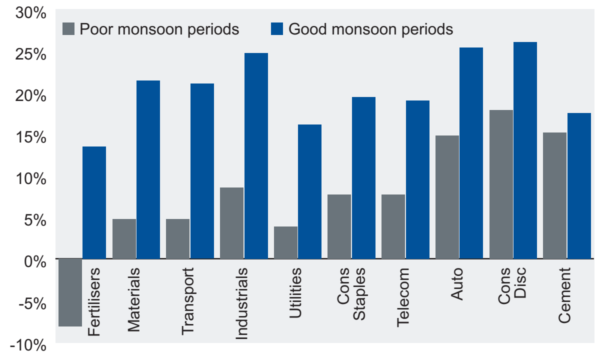
For 2015 the IMD has forecast deficient rainfall in the better irrigated Northern states that remain well stocked from a bumper crop in 2013, and a better level of rains in the fruit and vegetable producing regions further south. Furthermore, the Government has been importing pulses as a pre-emptive measure. Hence, should the IMD forecast become a reality, and the Government's handling of the subsequent shortage proves to be adequate, food inflation is likely to be more manageable for this year.

Chart 1: Irrigation coverage per state (% of total crop area)



Source: Directorate of Economics and Statistics, DAC (2011)

Chart 2: Historic impact of monsoons on sales growth



Source: I-Sec Rearch, Capital Line

enforcing a crackdown on hoarding to keep price rises in check. For 2015 the IMD has forecast deficient rainfall in the better irrigated Northern states that remain well stocked from a bumper crop in 2013, and a better level of rains in the fruit and vegetable producing regions further south. Furthermore the Government has been importing pulses as a pre-emptive measure. Hence, should the IMD forecast become a reality, and the Government's handling of the subsequent shortage proves to be adequate, food inflation is likely to be more manageable for this year. The main challenge from two successive years of below normal rain is a lower water table. If rains are again deficient next year, this could diminish the ability of even the well irrigated states to source water, thus emphasising the need for superior surplus grain management from the Government.

Over recent years the Government has improved its ability to limit the impact of higher food prices by improved accumulation and management of buffer stocks of cereals

Although agriculture has fallen as a percentage of GDP, rural India continues to employ approximately 47% of India's workforce[4] and Chart 2 shows that there is a clear relationship that dictates lower sales growth in the years when rains have been deficient.

There were two periods in the recent past of severe drought that demonstrate the damage of a poor monsoon could have on growth. In FY03, the agricultural component of GDP contracted by 7% and FMCG sales to rural India shrank by 8%. Following the drought in 2010 however agriculture actually grew by 1% and rural FMCG sales rose 21%, on account of the Government taking a more active role in providing additional subsidy support to rural communities. Likewise in 2014, lower rains coincided with FMCG sales holding up well, but larger ticket items such as cars and two-wheelers saw muted growth, and companies which have a greater proportion of demand stemming from rural India were more directly impacted. In addition rural consumption patterns have deviated away from agricultural productivity, and given the Government would appear better prepared to act in the worst case scenario, the impact of a sub-par monsoon still should limit the effect on demand. From an investment perspective, Government enforced "loan waivers" in the drought years have always negatively impacted asset books within the banking sector, but due to the challenges that arise from ascertaining the timing and dispersion of the rainfall, mitigating the investment risk is a difficult exercise.

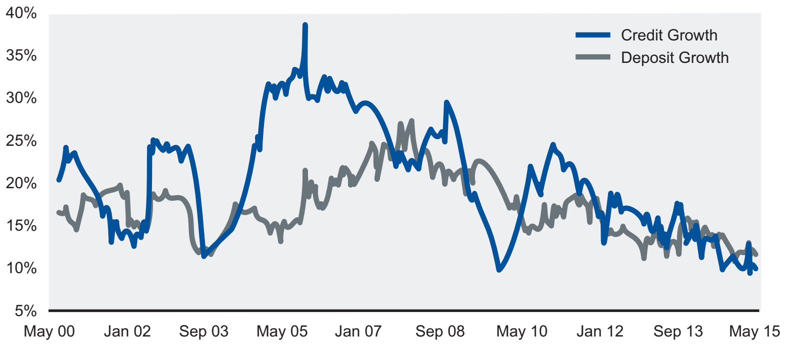
At a broader level it is encouraging that a poor monsoon no longer impacts growth and inflation as in the past. Nevertheless, as the RBI's recent policy announcement demonstrates, progress has been too slow. Although productivity growth measured by yields per hectare has compounded at 1.9% over the last decade at just 3,000kg (compared to 5,000kg/hectare in Indonesia and 6,000kg/hectare in China), India needs to catch up with its peer group. Irrigation coverage should be accelerated complimenting greater penetration of fertilisers, increased usage of hybrid seeds, mechanised tillers and tractors. The monsoon constitutes 80% of the country's annual rainfall and as such will always prove to be a risk. The extent to which it is mitigated going forwards will be a useful indicator for measuring India's ambition to mature into an advanced economy.

1 www.imd.gov.in/section/nhac/dynamic/history.html
2 I-Sec Research "Below-normal monsoon: Impact on growth likely to be moderate" June 2015, Ministry of Statistics and Programme Implementation
3 Ministry of Statistics and Programme Implementation, "Consumer Price Index: Changes in the Revised Series"
4 World Bank 2012, http://data.worldbank.org/indicator/SL.AGR.EMPL.ZS

CHARTS & COMMENTARY

LAGGING INDICATORS

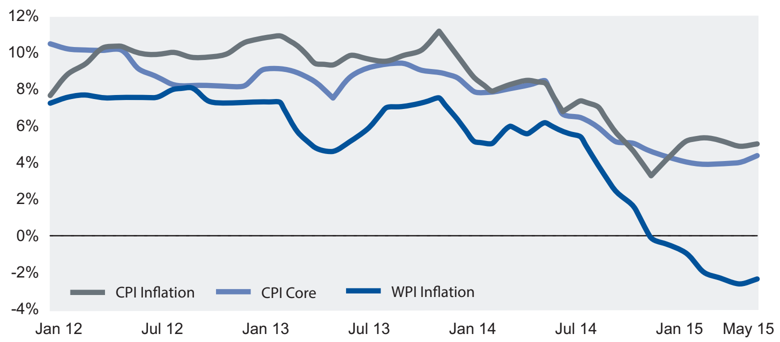
Chart 3: Deposit and credit growth



Source: RBI, IIFL Research

Both credit and deposit growth remain weak. Credit is both a demand and supply issue, where banks remain cautious lenders as they struggle with legacy lending issues and corporates remain reluctant to invest until profits improve and economic activity recovers. Banks are cutting lending rates quite sharply now, so demand is expected to recover. On the deposit side, the benefits of lower inflation on real rates of return are yet to lead to increased demand, but savers should respond in due course.

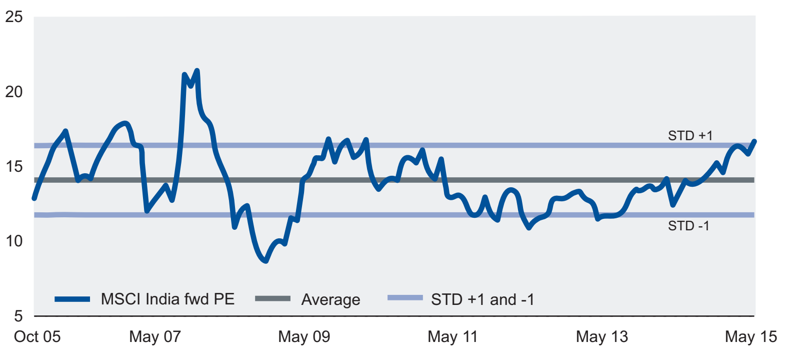
Chart 4: Inflation



Source: Bloomberg, IIFL Research

CPI remains well below the RBI's 6% target (end FY16), but near term expectations are for mild upward pressure predominantly due to the base effect. The RBI remains hawkish until the outcome of the monsoon rain is clearer and there is more certainty over the timing of a US rate rise. The Government has resisted the temptation to increase minimum support proces for key agricultural products which will cap food price inflation and increase pressure to cut interest rates.

Chart 5: MSCI India's forward PE valuation vs. history



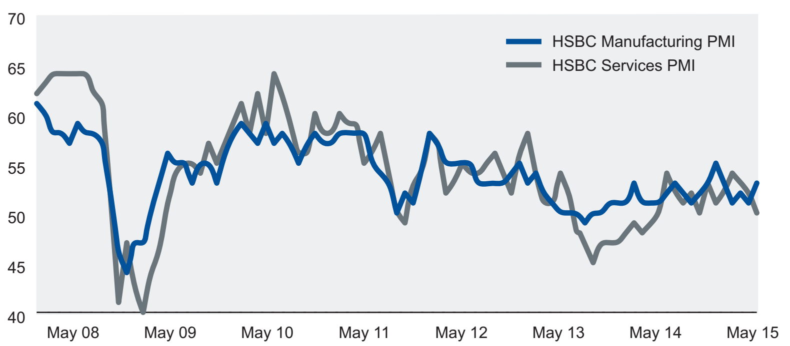
Source: Bloomberg

Earnings growth for the final quarter 2015 declined 12% y/y and showed just 3% growth for the full year, according to Ambit Capital. The extent of the weakness surprised investors. The collapse in inflation (WPI) has depressed sales growth, whilst there has been significant inventory losses based on falling oil and commodity prices. Relative FX strength has also played its role, and monetary policy remains tight. A pick up in investment spending is a critical component of an earnings recovery, and may yet be a few quarters away.

CHARTS & COMMENTARY

LEADING INDICATORS

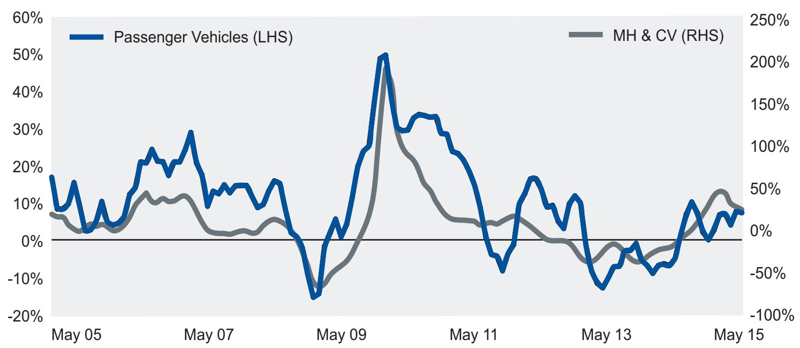
Chart 6: India HSBC PMI



Source: Markit Economics, IIFL Research

Index of Industrial Production (IIP) surprised positively in April, registering 4.1% growth versus consensus of 1.5%, driven by strength in capital goods, manufacturing and coal mining. IIP growth has now been positive for six consecutive months. Service sector gowth has been negatively impacted by the relative strength of the Indian Rupee and recent weaker actvity in developed markets.

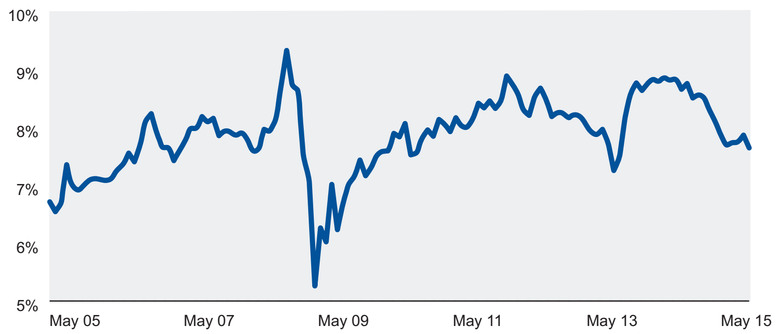
Chart 7: Auto sales growth (3MMA)



Source: CEIC, IIFL Research

The trend in sales growth for both commercial and passenger vehicles remains quite healthy, although the numbers are positively impacted by a low base effect. In passenger vehicles, it is the urban centres driving growth. Two wheeler sales, which is more reflective of rural demand however, still remains weak.

Chart 8: Government of India 10 year bond yield



Source: Bloomberg

The Government appears to be responding well to pressure from the RBI to keep inflationary pressure subdued. Recent hikes in minumum support prices for agriculatural products have been modest, and twin deficits are under control. To date the monsoon rain is ahead of long term averages, implying food prices will remain in check. We expect yields to fall further towards year end.

COMPANY FOCUS

RAMKRISHNA FORGINGS

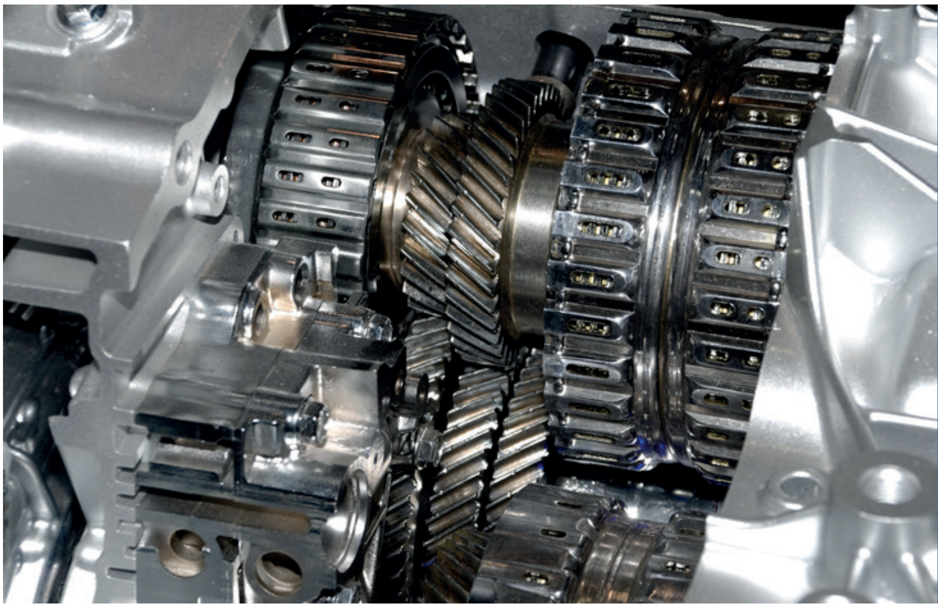
For some years now the auto components sector in India has competed globally led by companies such as Motherson Sumi and Bharat Forge, which between them supply ancillaries to virtually all the leading automobile manufacturers. India's auto ancillaries business has truly evolved onto the world's stage. The sector's competitive strength has arisen principally from a low cost manufacturing base and availability of skilled manpower. These attributes dovetailed neatly with their exposure to leading technology and manufacturing practices, introduced by global auto manufacturers who entered India in the early 1990s.

Within auto components, the forging sector holds promise. The difficult working environment and higher operating costs of the developed world naturally make countries like India attractive as a potential sourcing destination. With an installed capacity base of 3.75m tons, India's forging industry is large but even today the industry remains highly fragmented and disorganised. There are over 400 companies operational currently, but of those just eight have capacity of more than 75,000 tons. The principal reason behind this is the changing dynamic of the industry which has seen an increase in capital intensity at the expense of the workforce. Increased automation is a key differentiating factor between companies, as hammers are being replaced by presses and tool design now requires higher skilled manpower. These are the factors that have become critical to advancement; only a few Indian companies have been able to make the leap forward, and principally it's been those whose acquisition strategy in Europe has landed them access to big name OEM clients such as VW, Volvo and Daimler. Each "forger" though has followed its own area of focus and specialisation.

Ramkrishna Forgings is India's fourth largest auto component company

Of the key players, it is Bharat Forge that has focused on forgings for commercial vehicles, subsequently diversifying into other sectors such as the power and locomotive sectors. Whilst Amtek Auto, which has made 22 acquisitions at the last count, is focused on smaller forgings for the passenger vehicles segment. Mahindra CIE has combined its production to cater for both commercial and passenger vehicles.

Ramkrishna Forgings (RKF) is India's fourth largest auto component company specialising in manufacturing a wide variety of forged components for commercial vehicles in India and overseas. Though a relatively small player today, RKF has the ingredients to scale up significantly its operations with the potential to become a serious player in the global supply chain. The company benefits from an unusual but highly effective ownership/management model that is best described as a "professionally run family company." The founder and son play an active role in all customer interaction, product development as well as strategic direction whilst the professional management, all of whom have held senior positions in competing companies across the sector, ensure the smooth running of the business with a low employee turnover. We see this model as a core strength of the business. The company started life as a component supplier to Tata Motors (then the largest automobile manufacturer in India), before gradually moving up



India's forging industry is large but even today the industry remains highly fragmented and disorganised. There are over 400 companies operational currently, but of those just eight have capacity of more than 75,000 tons. The principal reason behind this is the changing dynamics of the industry which has seen an increase in capital intensity at the expense of the workforce.

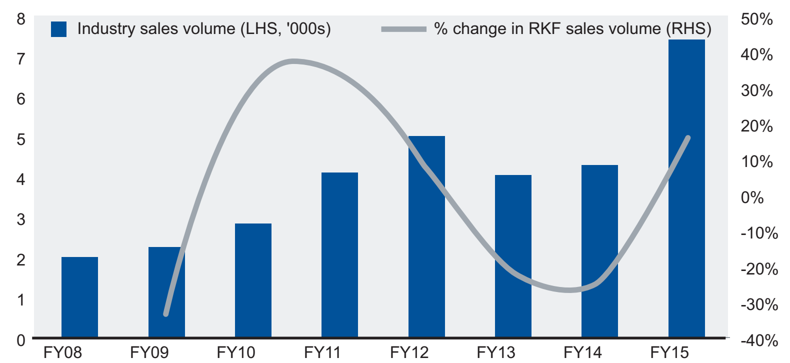
the value chain. 2008 saw the company undertake a US$20m expansion to set up a ring-rolling unit for manufacturing crown wheels, used in the chassis of a commercial vehicle. This was a fully automated plant from launch and marked a substantial jump in the evolution of the business, ensuring that the higher quality products provided the company with an entry into the global Tier 1 auto vendors. The breakthrough enabled the company's revenue growth to compound at 21% between FY08-15, occurring over a period of domestic medium & heavy commercial vehicle market decline of 2%. Importantly it also gave RKF a diversified client base as well as a healthy mix of domestic and export earnings, which currently stands at 50:50. Today RFK is a global leader in crown wheels and supplies to most OEMs through Tier 1 vendors like Meritor and Dana Corp.

Having established a strong client base, RKF is now poised to take its business to the next level. The company is close to commercialising a new US$110m plant for the manufacture of high end components such as axle beams, knuckles, stub axles and connecting rods. The salient feature of this project is the fully automatic 12,500 ton heavy press, custom ordered from SMS Meer in Germany with a two year delivery period. Once commercial production commences it will be able to produce a unit every 45 seconds. Additionally the project also includes other presses of 3,000, 4,500 and 6,000 ton capacities, some of which have already commenced production. These are new products for RFK, who will act as a second supplier to many customers in particular Tata Motors who committed to taking 25% of incremental production. The management is also marketing this strategy to its global OEMs, and has already closed a US$100m per annum order with Dana Corp for both crown wheels and heavy forgings. We understand they are close to finalising several other contracts with other vendors, including Volvo Brazil. What has helped RKF break in to these customers, even for heavier forgings, is their tool design capabilities. For example, they have designed as many as 1,600 different components for Dana Corp. They have also done breakthrough mould designs, leading to lower cycle time and consequently lower costs for the customer. That RKF had already been designing and supplying ring rolled products to these customers over several years gives those buyers comfort in the company's ability to maintain quality standards. The capacity expansion phase for the company is now largely over. Thus FY17 (commencing March 2016) will be the first year of operating at full capacity of 150,000 tons per annum, over double 2014 levels. At peak capacity the business has the potential to scale up revenues threefold from the current levels which will lead in time to a steady increase in margins from the current levels of 17%. RKF also has the added advantage of lower cost of power versus Bharat Forge (drawing power from a Tata group company) and close proximity to key raw material supplies. Bharat Forge, the market leader has by comparison standalone margins of 29% for its India operations. Hence the opportunity is large.

The key risk is execution. Although the company is professionally run, the size and scale of operations plus the need to maintain the highest quality standards will be challenging. In addition, the commercial vehicle production globally is a cyclical business, and although RKF survived the slowdown of FY11-14, the company is exposed to global factors. That said, in the last year automotive volumes have picked up and Indian companies have benefitted significantly, and with global car manufacturers setting up capacities in India to export to Asian and African markets, the demand for forging from Indian companies is set to grow.

The management forecasts revenues of circa US$300m by FY18 from the current run rate of US$115m, a CAGR of 39%. The combination of high end products, increased automation and a greater contribution from machining products, will also enable margins to expand, and thus profits are expected to compound in excess of 40% over the same period. On our estimates of US$265m revenues and 19% EBITDA margins for FY17, the stock trades at a PE multiple of 10.2x, and generates a return on capital employed of 13%.

Chart 9: RKF outperformance in M&HCVs in a tough environment



Source: Ocean Dial Asset Management, Bloomberg

MACRO OVERVIEW

ECONOMIC DATA

Change over	2009	2010	2011	2012	2013	2014	2015	Last Qtr. (Dec-Feb)	This Qtr. (Mar-May)
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%	6.6%	7.5%
Avg. IIP % Annual Change	2.9%	5.3%	8.3%	3.1%	1.2%	-0.1%	2.8%	3.8%	2.1%*
Exports % annual Change	14%	-4%	40%	22%	-2%	5%	-1%	-10%	-18%**
Imports % annual Change	21%	-5%	28%	32%	0%	-8%	-1%	-10%	-11%**
Current Account Deficit % of GDP	-2.3%	-2.8%	-2.7%	-4.3%	-4.8%	-1.7%	-1.4%		
Interest Rates (Repo) (Avg.)	7.4%	4.8%	5.9%	8.0%	8.0%	7.5%	7.9%	7.9%	7.5%
10 year GOI Bond Yield (Avg.)	7.6%	7.2%	7.9%	8.4%	8.3%	8.6%	8.5%	7.9%	7.9%
FII Flows (US$bn) (CY)	+17.6	+29.3	-0.5	+24.5	+19.8	+16.2	+7.1	+4.2	+2.8
FDI Flows (US$bn) (CY)	+26.8	+21.0	+31.9	+24.3	+28.2	+37.0	+12.0	+12.6	+3.2*
INR vs. US$ (CY)	+3.7%	+4.0%	-18.9%	-2.8%	-13.0%	-2.3%	-0.7%	+0.3%	-3.2%
INR vs. GBP (CY)	-7.2%	+7.7%	-18.5%	-7.8%	-15.3%	+3.4%	+0.8%	+2.0%	-2.5%

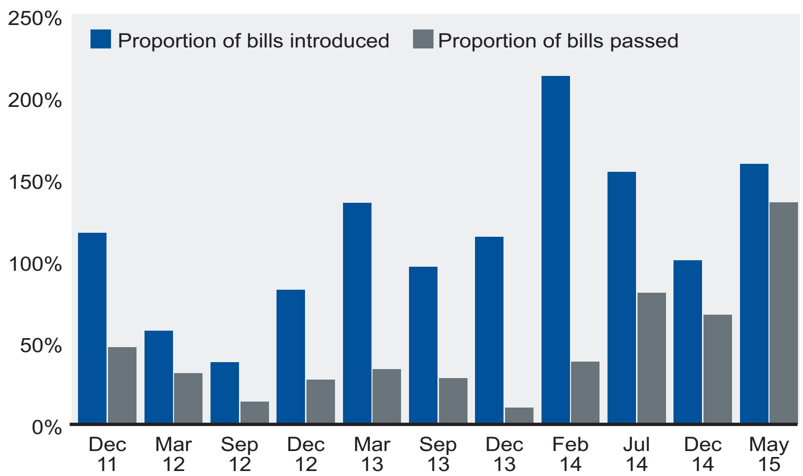
* March only ** March to April only

Source: Bloomberg

GOVERNMENT SCORECARD

The Budget Session of Parliament ran from 23 February to 13 May. It was a productive session; the Lok Sabha (Lower House) worked for 123% of the scheduled hours and the Rajya Sabha (Upper House) 101%. 27 Bills were introduced and 23 were passed by both Houses.

Chart 10: Parliamentary speed and activity



Source: PRS Legislative Research

REGULATORY INFORMATION

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