June 2016

INDIA

A view from the ground

THE VIEW THIS QUARTER:

- PUBLIC SECTOR BANKS - FROM INTENSIVE CARE TO REHAB
- AIA ENGINEERING - BALLS OF STEEL

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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

When interviewed in 2013, early in his term as Governor of the Reserve Bank of India, Raghuram Rajan repeatedly articulated that "there is no long run trade-off between growth and inflation." Neither lower interest rates, nor stimulus spending from the Government were seen by him as viable solutions to the inflationary rut that India was in.

Instead, emphasis was placed on the need to create a stable environment to facilitate a sustainable recovery in the economy. Not only did this indicate a newfound intent to tackle inflation head on, but it also sent a powerful signal to politicians that fiscal rectitude and supply side reform was needed before monetary policy could be loosened.

This approach has resulted in a positive medium term outlook for India today. Some stability has come from partial reforms and lower commodity prices, and has led to tentative signs of a recovery. From a political perspective, the BJP Government continues to deliver on its manifesto (albeit not without stumbling blocks). Prime Minister Modi's approval ratings remain high and State Elections in May saw his party make inroads (from a standing start) into West Bengal and Kerala, whilst most dramatically winning in Assam – historically a safe state for the Congress Party. The Budget Session of Parliament was productive (see Chart 9, pg10) and oversaw 24 bills passed by both Houses, including the Aadhar Bill; formalising the payment of subsidies as cash into bank accounts, the Bankruptcy Code; to tackle crony capitalism (more detail on page 4); and the Real Estate Bill; to create an independent regulator for a sector infamous for corruption. The passage of the Bankruptcy Code is arguably the biggest legislative breakthrough to date. It has the potential to meaningfully change the way business is conducted in India by creating a time-bound mechanism for insolvency resolution that is in line with global best practices. The corporate culture of promoters using their business as a vehicle for self-enrichment to the detriment of shareholders and lenders is now under attack. Banks will be better able to extract value from stressed companies, allowing asset recycling to improve, leading to more efficient allocation of capital in the economy as a whole.

In the immediate future, key macroeconomic indicators - low currency volatility, increasing foreign exchange reserves, lower inflation and interest rates, with fiscal and current account deficits in check - are creating a more positive business environment. Confidence in the reported book value of public sector banks is returning as the RBI's aggressive drive to force recognition of non-performing loans plays out. Through windfall indirect tax receipts from lower oil, the Government spent US$2.2bn building 6,000km of roads in FY16 (US$900m, 4,500km in FY15) with a target to build 10,000km in FY17. The railway network is also undergoing sizeable investment to bring logistics costs for Indian businesses down from approximately 13% towards the global average of 8%.

As such, there are pockets of the economy that are now showing signs of life. Cement production growth has moved into double digit territory for the first quarter of this year. Similarly, electricity demand and commercial vehicle sales have rebounded between February and April alongside improving volume growth in motorcycles.
One should caution however that the recovery is still fragile and momentum is still some way from reaching "escape velocity". Credit growth is muted and the reporting season for Q4FY16 (approximately 90% of announcements have been made) indicates that higher profits are not yet round the corner. Companies have managed to protect the bottom line over the last two years through an expansion of gross margins from lower input costs. This relief may now have run its course with the recent rally in global commodity prices such that a recovery in top line growth is required for the market to move to a higher plain.

The consensus forecast amongst meteorological bodies is for an above average monsoon this summer, which after three consecutive crop shortages should help keep food prices low and increase consumer confidence in Rural India (something that is perhaps already being reflected in motorcycle sales). Furthermore, the list of asset sales, both completed and underway, by leveraged companies is now growing, suggesting that the cleaning up process is underway to facilitate the next leg of the investment cycle. To expedite this, it is encouraging that the Government's "ease of doing business" drive under the Make in India campaign is resulting in higher Foreign Direct Investment. FY16 saw India receive US$54bn of FDI flows, a record level and 15% higher than the previous year's total of US$46bn.

Gross fixed capital formation growth averaged 13% between FY04-FY12 and since then the average has been 5%. Although the timing of when this will recover is uncertain, investors should be excited that coordinated policy action from the Government and RBI is being pushed to prevent the excesses of the previous boom happening in the future, thereby facilitating a more robust growth trajectory for the economy.
The direction of travel is sound, ensuring that India is a market that the global investment community will struggle to ignore going forwards.

PUBLIC SECTOR BANKS: FROM INTENSIVE CARE TO REHAB

The full impact felt by India's public banking system following the period of weak economic growth between 2010 and 2014, and the subsequent shallow recovery is only now being fully understood.

According to local broker Kotak Institutional Equities, consensus estimates for overall impaired loans in the banking system are in the range of 15%-18% of total assets, with forecasted equity written off at circa US$25bn.
The 27 public sector banks (PSB) in which the Government owns 51% or more account for approximately 74% of the total credit, yet the combined market capitalisation of PSBs has fallen to less than HDFC Bank, India's largest private sector player, which accounts for just 6.7% of credit outstanding.
This single statistic reflects the malaise in the banking system and the enormity of the test ahead.

Whilst the exact nature and extent of this banking crisis might vary at the margin from earlier episodes, the origins are as they always were. A poorly managed (and partially corrupt) public sector banking system owned (and therefore controlled) by the Government, repeatedly forced to deliver credit "unsuitably", backed by inadequate risk management processes and antiquated technology. Since yesteryear these structural flaws have been exploited by influential corporate honchos whose "willingness to repay" has often differed profoundly from their "ability to repay" (a certain liquor baron being a case in point), safe in the knowledge that the judicial system was equally incapable of restoring order. For their part, the public sector banks have also been "gaming the system", either by not fully recognising the extent of non-performing loans (NPLs) or by "ever-greening". This is a widely used practice by which the bank extends further credit to a corporate already in trouble, whereby the incremental loan not only masks the current asset quality issues, but also registers increased top line growth for the bank. Everyone's a winner, at least in theory.

So what's new?
The transformation underway is being led by two "outsiders" to the system, both instrumental in forcing change.

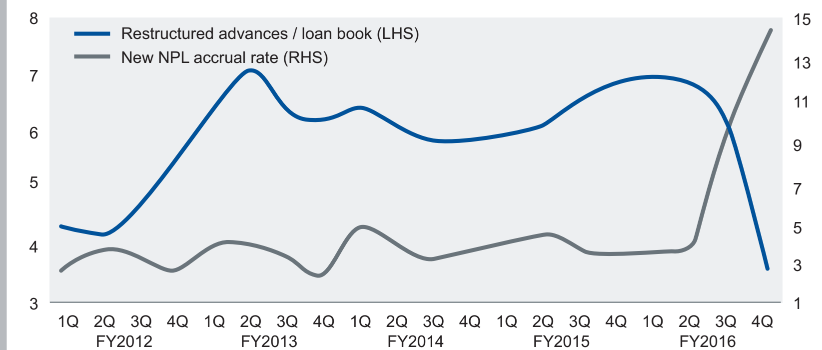
Raghuram Rajan, as Governor of the Reserve Bank, and an economist respected across financial markets globally, has repeatedly prioritised cleaning up the public banking system as a fundamental part of creating a sustainable recovery. Prime Minister Modi, also an "outsider" has a single minded focus to improve India's economic output, and clearly understands the role the banking system must play to realise his vision. As a "global citizen" Rajan has little to lose and serves no political master, as a pragmatist Modi is focusing his energy where he gets the biggest bang for his buck. It is highly refreshing to witness the RBI and the Finance Ministry working in tandem in this way as achieving success will take time and resolve, both in equal measure. As is often the case, the darkest hour is before the dawn.

A closer inspection of the resultant handling of the crisis by the Reserve Bank and the Finance Ministry give us good reason to believe that real progress in cleaning up the balance sheets of the PSBs and that wholesale reform is ongoing. After several false starts the RBI's Asset Quality Review, (AQR; a simultaneous audit of all banks), published a list of 150 companies that had, or were expected to default insisting that all banks classified these companies' loans as non performing, irrespective of repayment history, which typically varied across the lending consortium. This forced banks to acknowledge corporate defaulters unilaterally, even if the corporate had tactically "selected" which bank it had chosen to repay in any particular period. Banks were given two quarters to restate their books, effectively forcing a "kitchen sinking" process designed to expose the extent of the problem and thereby drawing a line under future uncertainty. This has largely been achieved.

The RBI's Asset Quality Review has highlighted the extent of problems in the corporate sector.

This Asset Quality Review has highlighted the extent of problems in the corporate sector. According to latest research from IIFL Securities the March 2016 quarterly results, (of which circa 90% of the numbers have been

collated) the NPLs of the public sector banking system increased by US$11bn, or 5.8% of total loans versus 4.2% in the previous quarter, clearly highlighting that the banks have responded to the RBI's demand to improve transparency. In tandem with the AQR, the regulator has introduced a policy of Strategic Debt Restructuring (SDR) which enables the banks to convert loans into equity and where appropriate take control of the company. In the Budget policies were introduced to "beef up" asset reconstruction companies with enhanced capital norms to facilitate the monetisation process of problem assets. More recently the Government has successfully passed a new bankruptcy law. The law will ensure time bound settlement of insolvency, enable faster turnaround of business and create a database of serial defaulters, all critical in resolving the current problems and laying the foundations for Modi's promise of improving the "ease of doing business" in India. The law gives power to the creditors to agree a revival plan within 180 days, with an additional grace period of a further 90. If no agreement is reached the firm will be automatically liquidated.



Source: IIFL

The above measures are having an impact. Intense pressure from the RBI on the banks is forcing a new approach. To date, 17 companies have being taken over by the banks, including high profile companies such as Alok Industries (textiles) and Monnet Ispat (steel), plus there has been a significant increase in the number of asset sale transactions, with many leveraged companies forced to sell performing assets in order to reduce debt, particularly evident in infrastructure assets such as roads and power. Intense media and public scrutiny is also forcing the banks to be more aggressive and preventing them from negotiating any "backdoor deals", best highlighted by the case of Kingfisher Airlines, whose promoter, Vijay Mallya, has been declared a wilful defaulter, forced to flee to England from where he is trying to negotiate a settlement against vastly emboldened banks' consortia.

We believe that the clean-up is just one part of the Government's longer term plans to break away from the historic model of an overly assertive public banking sector.

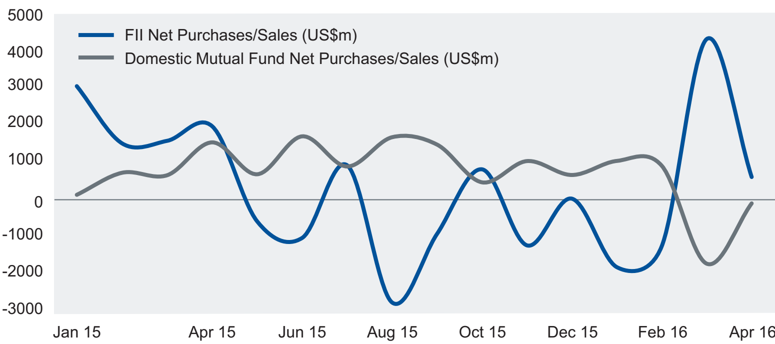
The deeper changes are the measures being incorporated to address the inefficiencies of PSBs. In August 2015, the Government announced a "root and branch" project to reform the public banking sector spearheaded by a newly formed independent body, the Bank Board Bureau (BBB). Initial reaction implied that the market saw this approach simply as old wine in a new bottle, but nine months in there is evidence to suggest policy makers are on the right track. Heading up the BBB is Vinod Rai, former Auditor General of India, with a well-earned reputation for promoting best practice and unearthing the irregularities that lead to the 2011 "Telecom Scam". Other independent members include the former Head of CRISIL (S&P's India arm) as well as the former MD of ICICI Bank. This board will be responsible for senior personnel appointments, where the focus is on appointing Managing Directors with a longer tenure, freedom to extend this beyond the current fixed two year window, whilst now reporting directly into the BBB, effectively removing the role of the bureaucrat and politician. This will allow new management teams the requisite time to implement fresh strategies, as opposed to the previous "merry go round model" of Chairman and MDs moved on often within two years, which has been behind much of the poor decision making of the past. Thus, for the first time Bank of Baroda has appointed a former Citi Banker as Managing Director and a former director of Infosys as its non-executive Chairman. In addition all of the Government's equity in the banks would also be consolidated under this entity with a medium term view to implement a recapitalisation process (selectively) alongside a consolidation process and/or strategic sales where appropriate.

The transformation of the sector is at an early stage and more time and transparency is required to consider it a credible investible proposition, but without doubt the changes are delivering a more transparent, reliable and competitive banking system.

CHARTS & COMMENTARY

LAGGING INDICATORS

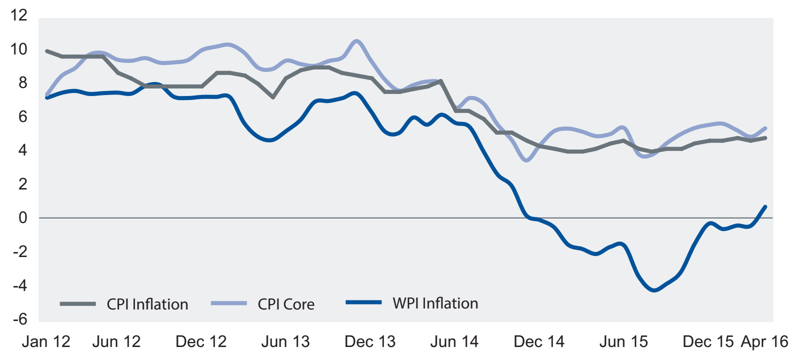
Chart 2: Net foreign portfolio vs domestic mutual fund listed equity flows



Source: For FII data - https://www.fpi.nsdl.co.in/web/Reports/Archive.aspx, for Domestic mutual funds - Bloomberg

Domestic mutual fund buying paused for breath following 12 months of strong flows. Whilst this was offset by a sharp rebound from FIIs in March in line with a recovery in "risk assets" generally, until sentiment towards Emerging Markets recovers, demand for Indian equities will be choppy. Ongoing flows from domestic buyers is critical for longer term support for the market.

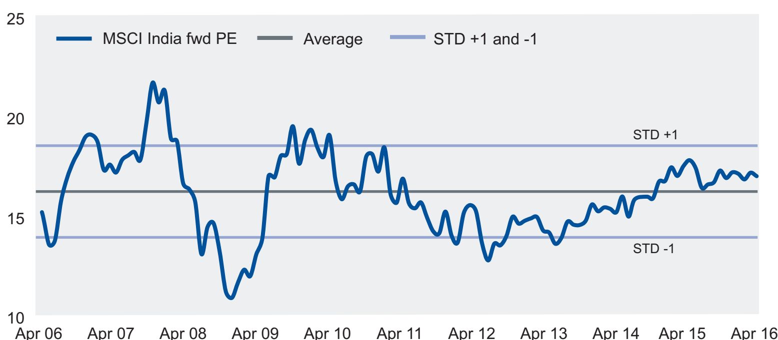
Chart 3: Inflation (%)



Source: Bloomberg, IIFL Research

Food constitutes 46% of the CPI basket and has thus far remained in check despite three consecutive poor crops. CPI rose from the 6 month low in March of 4.8% to 5.4% in April, but is likely to remain under the RBI target of 5% for the end of FY17. Should the forthcoming Monsoon rainfall meet expectations, this should give some further (but limited room) for monetary easing. WPI remains muted due to weak industrial activity, but has entered positive territory due to a recovery in commodities.

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



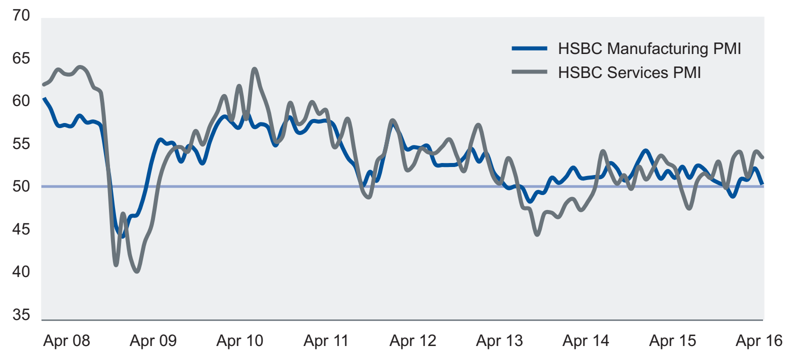
Source: Bloomberg

Valuations within the market remain polarised with consumer, industrial and health care related businesses trading at a premium, and infrastructure, utilities and commodities at a substantial discount. Consensus forecasts for FY17 predict double digit growth driven by automobiles, industrials as well as global cyclicals. At an aggregate level on a trailing basis the market appears fairly valued trading just above its 10 year average multiple.

CHARTS & COMMENTARY

LEADING INDICATORS

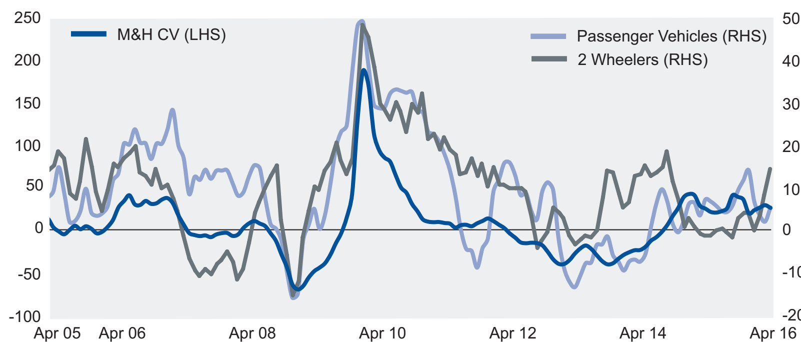
Chart 5: India HSBC PMI



Source: Markit Economics, IIFL Research

Composite PMI data fell in April from a 37 month high in March driven by slower increases in manufacturing and service data. The RBI's policy remains "accommodative" and inflation is low, suggesting further monetary easing is likely.

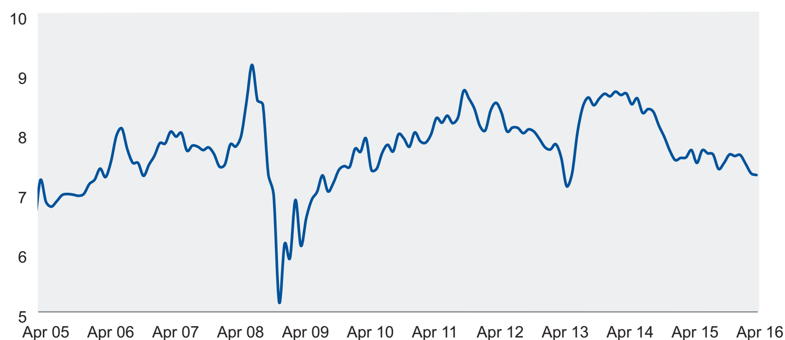
Chart 6: Auto sales growth (3MMA)



Source: CEIC, IIFL Research

Two wheeler sales have rebounded since February, potentially driven by positive expectations of the Monsoon from rural consumers as well as higher public sector salaries under the 7th pay commission. LCV sales have picked up indicating pockets of recovery in demand, whilst M&H CV monthly sales growth has been robust for one year.

Chart 7: Government of India 10 year bond yield (%)



Source: Bloomberg

The cost of capital remains high for corporate India. Real interest rates are positive and industrial credit growth remains sluggish. In the short run, the RBI will seek to ensure sufficient interest rate differentials to protect the currency from global volatility.

COMPANY FOCUS

AIA ENGINEERING

AIA Engineering (AIA) is a listed Indian midcap with a market capitalisation of US$1.4bn. The company started operations in 1979, manufacturing high chrome casting products for the cement industry in India. Since then it has become the second largest player globally, one step behind its erstwhile JV partner Maggotteaux from Belgium. Currently it has 90% of the local cement market and 40% of the global market (ex-China, which is highly fragmented). In the last 10 years the company has compounded revenues by 22% and net profits by 32%, consistently generating cash with returns on capital employed (ROCE) in excess of 20%. AIA's next phase of growth will originate from the mining industry which, like cement, will benefit from its highly specialised focus and robust technical advantages.

AIA manufactures chrome casted consumable grinding balls which are used to convert clinker into a fine powder, required in the process of making cement. The clinker is ground using a horizontal mill with a rotating drum, within which the grinding balls crush the clinker. AIA's success has evolved over time owing to the superior efficiency of its product, underpinned by an industry leading R&D process, developed internally by the Company's founder and largest shareholder over the last 35 years. Historically in cement, and as is still largely the case in the mining sector today, grinding balls were manufactured from a "forged media", or a scrap metal which is brittle and easily breakable, potentially clogging the mill and obstructing the process. The brittleness of the ball in the high impact environment of the mill also slowed down the procedure resulting in an inefficient outcome. Consumable grinding media would not usually be considered as a critical input, given it is just 1%-2% of total operating cost, but any failure can delay the end product, which gives it significance. Since the company's inception, AIA has been developing a "chrome plated" media ball to compete with the traditional forged product. This is a harder material and thus breaks less, is more resistant to corrosion and hence wears less, and after continuous use eventually dissolves into the clinker, ensuring the mill can operate on a continuous basis not needing to stop to extract broken forged media nor to reload. This is the great advantage that the costlier chrome alternative offers with a higher input cost more than offset by much improved productivity which the company estimates to be anywhere between 10%-50% of crushing costs. Although a seemingly a straightforward process, AIA manufactures chrome media on a bespoke basis not only for each customer, but for every plant as per the specification and requirement of individual manufacturing facilities. This is normally dependent on the quality of limestone (and how it reacts to the process) and intricacies of the customer's procedures which impacts the exact composition of the ferro-chrome and the extent of its heat treatment; this is what provides a uniquely customised experience. This customer centric involvement, based on a superior knowledge of the chemical process involved has led to significant productivity enhancement, and is what binds AIA to its customers. The outcome has been impressive market share gains and strong barriers to entry. Given AIA's positioning in the cement sector, it cannot meaningfully grow from here (though it will continue to benefit from volume demand). The company's future growth will arise from the market share gains it builds with the miners, in particular copper, gold, platinum, and iron ore. These form 80% of forecast demand for grinding media products. Within four to five years we expect the revenue share from mining to reach 65% from 52% today.

Remarkably, of the 3m tonnes of media balls that are consumed by the mining sector annually, just 10% consist of

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ferro-chome media, the remainder are still forged; this is the opportunity that presents itself to AIA today. More importantly perhaps is the timing of AIA's increased focus. Since the collapse of global commodity prices, mining companies industry-wide remain constantly under pressure to cut costs. Given that the grinding process forms a small percentage of operating costs, and within that even less so for the media, throughout the commodity boom years the miners never saw the rationale of ferro-chrome over forge. This current pressure to cut costs, combined with the forecast in ore grade decline (compelling higher production volumes for comparable ore quantity) is forcing the industry to switch attention to the productivity benefits of using chrome over forge. Here the largest player is Moly-cop of Chile, with a capacity of 1.4m tonnes per annum competing in both the primary and secondary grinding process. Currently AIA which has just 100,000 tonnes of capacity operates in purely the secondary segment using media of more than five inches in diameter and usually used in the crushing process of coarser ore. AIA has been undertaking pilot projects in the primary segment, with mines based in Chile (in Rio Tinto and Anglo American's smaller mines) with positive results to date on the basis that the chrome balls have been able to sustain high impact and the wear rates have been low. The conversion process for new customers will necessarily be slow as each product requires customisation at every mine. Any failure of grinding media can result in significant production loss, whatever the productivity benefits, meaning decisions of this magnitude take time. Looking forward this may affect AIA's working capital cycle in the build out phase. Additionally, although AIA centralises its manufacturing facilities in India, where manufacturing and employee costs are lower (4% of sales vs. 11-12% for Magotteaux/Moly-cop), it loses the benefits enjoyed by both Magotteaux and Moly-cop of providing lower freight costs and a closer relationship with the customer. And although the poor outlook for the mining sector is acting as a positive catalyst for AIA, one of the biggest risks facing the company is the potential credit risk emanating from this low price environment.

For AIA, the company's future growth will come from the mining sector's conversion to high chrome media. In order to cater for the anticipated increase in demand, AIA is increasing capacity from 260,000 tonnes to 440,000 tonnes (operational by FY19) which will impact returns on capital employed and profitability in the roll out phase. Additionally AIA has recently benefited not only from local currency weakness (likely to remain so), but also from falling raw material prices. Thus operating margins have increased significantly from an average of 24% (last 10 years) to 29% in FY16, which are forecast to revert back to long term averages in due course. Thus, although earnings growth will be mooted through the build out phase (whilst continuing to generate positive free cash flows), as the company utilises the capacity expansion, both profitability and returns on capital will trend upwards.

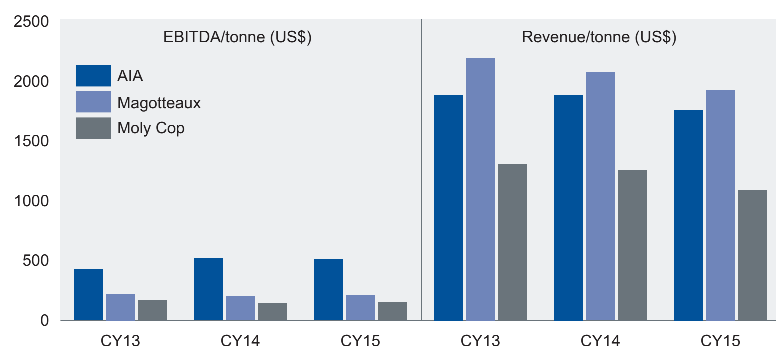
It is not only the longer term outlook that excites us however. As an investment opportunity AIA ticks a lot of boxes. The company has an historic track record of delivering impressive returns to shareholders. It is operating in a niche area of the market with limited competition, strong barriers to entry and industry leading product, supported by a research driven philosophy. This combination ably demonstrates that when local entrepreneurial talent successfully exploits the natural advantages India affords businesswise, global leadership in a niche industry and healthy future profit growth are achievable. The company is well on track to meet both challenges.

Liquidity (3m avg vol)	US$0.9m
Promoters' ownership	61.6%
FII ownership	27.6%

	FY17E	FY18E
P/E	22.7	20.8
ROCE	15.6%	15.7%
P/B	3.5	3.3
ROE	16.2%	16.4%

Source: Ocean Dial Asset Management, Bloomberg

Chart 8: AIA's superior margins (cement and mining)



Source: Ambit Capital

MACRO OVERVIEW

ECONOMIC DATA

Change Over	2010	2011	2012	2013	2014	2015	2016	Last Qtr. (Nov-Jan)	This Qtr. (Feb-Apr)
Real GDP % Annual Change	8.6%	8.9%	6.7%	4.5%	4.7%				
Real GDP % Annual Change - new series				5.1%	6.9%	7.3%		7.3%	
Avg. IIP % Annual Change	5.3%	8.3%	3.1%	1.2%	-0.1%	2.8%	2.5%	-1.9%	1.1%*
Exports % Annual Change	-4%	40%	22%	-2%	5%	-1%	-16%	-18%	-6%
Imports % Annual Change	-5%	28%	32%	0%	-8%	-1%	-15%	-16%	-17%
Current Account Deficit % of GDP	-2.8%	-2.7%	-4.3%	-4.8%	-1.7%	-1.3%		-1.1%	
Interest Rates (Repo) (Avg.)	4.8%	5.9%	8.0%	8.0%	7.5%	7.9%	7.0%	6.8%	6.7%
10 year GOI Bond Yield (Avg.)	7.2%	7.9%	8.4%	8.3%	8.6%	8.5%	8.0%	7.9%	7.9%
FII Flows (US$bn) (CY)	+29.3	-0.5	+24.5	+19.8	+16.2	+3.3	+1.8	-2.8	+3.5
FDI Flows (US$bn) (CY)	+21.0	+27.6	+22.8	+22.0	+28.8	+39.3	+10.6	+12.5	+5.6*
INR vs. US$ (CY)	+4.0%	-18.9%	-2.8%	-13.0%	-2.3%	-4.7%	-0.3%	-1.6%	+3.1%
INR vs. GBP (CY)	+7.7%	-18.5%	-7.8%	-15.3%	+3.4%	0.2%	+1.0%	+2.6%	-2.3%

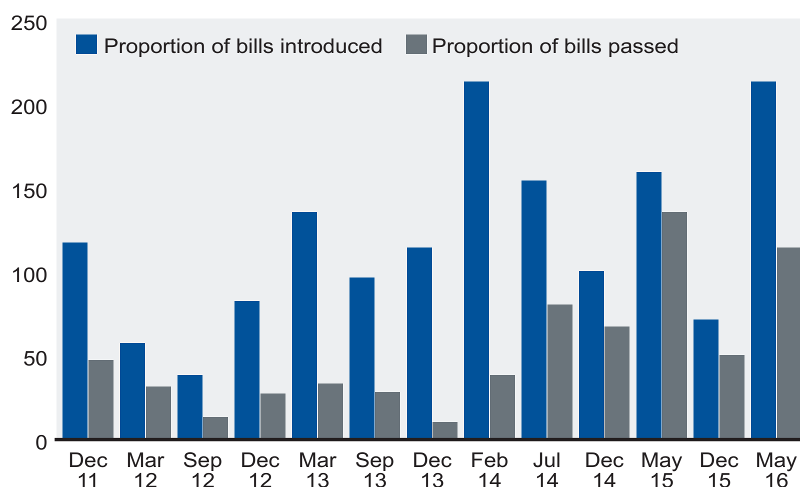
* Feb to Mar

Source: Bloomberg, DIPP – Govt. of India

GOVERNMENT SCORECARD

The Budget Session was considerably more productive than the Winter Session with the Lower House working for 121% of scheduled hours, and the Upper House for 91% (versus 98% and 51% previously). 24 bills were passed by both Houses. The dates for the Monsoon Session are yet to be confirmed but it usually takes place in July and August.

Chart 9: Parliamentary speed and activity



Source: PRS Legislative Research

REGULATORY INFORMATION

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