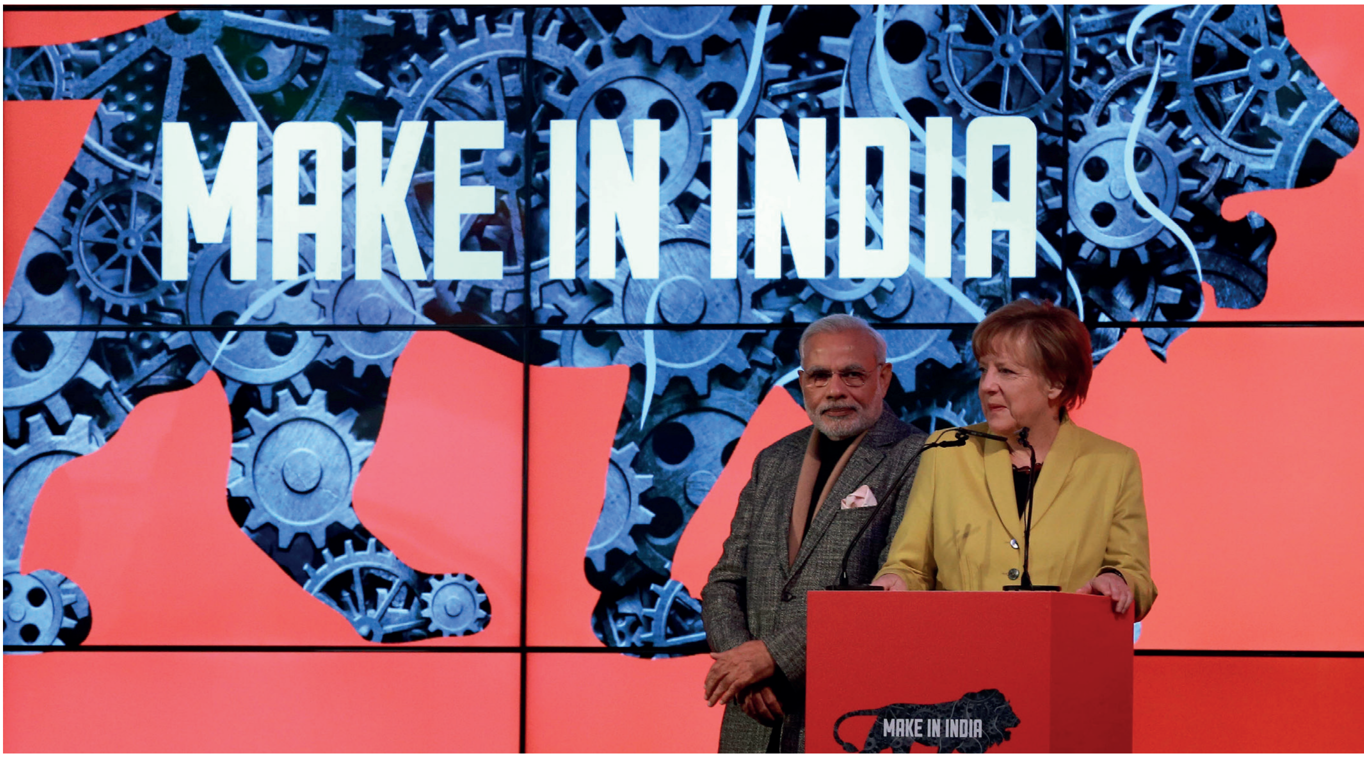
October 2015

INDIA

A view from the ground



THE VIEW THIS QUARTER:

- THE "MAKE IN INDIA" CAMPAIGN
- HINDUSTAN PETROLEUM CORPORATION LTD

www.oceandial.com

OCEAN DIAL

THE COMPANY

OCEAN DIAL ASSET MANAGEMENT

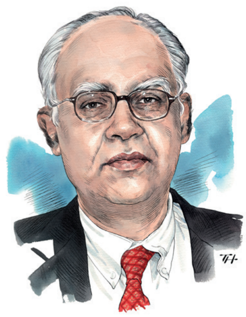
Ocean Dial Asset Management is a London based company with its primary focus on India. Owing to the nature and complexity of the Indian market, we firmly believe that local expertise is crucial to the long term performance of our funds and as such, we have a team of advisors on the ground in Mumbai.

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.

Amul Pandya
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MACRO OVERVIEW

OUTLOOK

Whilst the markets across the world have been weak this quarter, both Indian equities and the Rupee have continued to outperform their emerging peers, as investors perceive the risks relating to Chinese currency weakness and the expectation of US Fed raising rates as being greater elsewhere.

This is partially true as India's exposure to global trade is less relevant to its growth prospects than other emerging economies, and as a net importer it benefits considerably from lower commodity prices. But despite India's lower economic sensitivity to major shifts in the direction of global trade, it is not immune to major shifts in the direction of global capital flows. Should the "carry trade" meaningfully unwind as increases in developed market interest rates drain liquidity from riskier assets, then India will not escape.

Although the market has performed reasonably, the quarter was a non-event domestically. Activity on reforms has been slow with legislative approval of GST being pushed back to April 2017, and amendments to the Land Acquisition Act stymied in the Upper House. We have long argued that Modi is not a "big bang" reformer and therefore a lack of headline activity on reform should not be surprising, rather more it is helpful that the markets' expectation have been tempered. Behind the scenes structural changes are being implemented in critical areas. A more efficient system to manage subsidy payments to the poor, the curtailment of black money, the attitude towards crony capitalists, are all examples where solid progress is thus creating a more conducive business environment. The Government's U turn on retrospective application of a Minimum Alternate Tax is a welcome step to eradicating foreigners concern over retrospective tax liability.

Elsewhere the monsoon has been disappointing, despite a late burst of rain in September. The Government has successfully managed food stocks, thereby capping upward price pressure despite the poor rainfall, keeping a lid on inflation. On the long awaited question of a recovery in capital spending, the news is more positive. Although India's only driver of growth to date has been the Government, (recent fiscal numbers show it has front loaded 70% of its fiscal budget, driven by a 34% pick up in capital spending principally targeted towards roads and railways), the benefits of this expenditure should start to filter through to reported earnings, whilst also triggering a "crowding in" of the private sector.

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The hurdles of excess leverage, low demand for credit, excess capacity across various sectors, and structural changes in the relationship between the Government, the bureaucracy and the private sector are handicapping the resumption of the investment cycle, but in time these issues will be worked through, even though in lockstep with this current domestic "air pocket", the external environment now appears less conducive to growth. India is not immune from China issues or interest rates rises in the US. GDP forecasts for next financial year are currently being revised downwards, but the recent surprise cut in nominal interest rates by 0.5% to 6.75% and a concurrent commitment by the RBI to work with the Government to improve the process of monetary transmission, will support the market. The RBI's inflation outlook has also been cut, implying there is further room for additional easing, particularly in its assessment that global commodity prices are likely to stay lower for longer. Domestic savings continue to be reallocated away from real estate and gold in this high real interest rate environment into equities, market valuations have moderated somewhat, suggesting India remains an attractive investment destination. This is predicated on the rising GDP growth in a low inflation environment, improving macro-economic fundamentals alongside political stability working to a reformist agenda. The twin deficits of fiscal and current accounts are improving, the Reserve Bank has international credibility and the trust of the market, currency reserves are at all-time highs and foreign direct investment is gaining momentum suggesting India has the right ingredients for a stable currency. However in the event the Rupee weakens further, either as a consequence of further global volatility or on account of the increased interest rate differentials with the United States, the RBI will not stand in its way. It will want to protect both India's export competitiveness and its currency reserves. This currency weakness is the biggest risk facing equity investors currently.

In conclusion global markets appear to be at an inflection point as they continue to adjust to slower growth in China and the US interest rate cycle turns. However, in the main, current financial conditions should continue to be supportive of Indian equities. The global backdrop of robust growth in the world's largest economy combined with low interest rates low inflation and weak commodity prices globally, in tandem with a reform minded Government and a rising growth trajectory on the home front, provides confidence that India remains a good bet on both a relative and an absolute basis.

MAKE IN INDIA

The ultimate test for Narendra Modi as Prime Minister of the world's largest democracy is the creation of sufficient productive employment to cater for the 12 million Indians that join the working population every year.

This is a challenge that no Indian politician has ever been bold enough to address, and fundamental to its success is the "Make in India" campaign launched just 12 months ago. Its objective is to transform India into a global manufacturing centre by attracting foreign companies to construct industrial facilities across the country, thereby taking advantage of the abundant low cost work force and established democratic principles, raising economic activity and ensuring sustained long term growth.

This is a strategy that has been successfully developed in many Asian economies in the last 30 years, and Modi has set two targets to benchmark progress. The first is to increase manufacturing as a share of GDP from 16% to 25% by 2020. Second is for India to move from 142 (currently behind Uzbekistan and Sierra Leone) to above 50 (held by Qatar) in the World Bank "ease of doing business index".

Improving the "ease of doing business" has been a key pillar of change in government operations to date. Bureaucrats are now fully accountable and have been empowered to make quick decisions and to remove bottlenecks. There is better coordination among ministries, and all projects have identifiable targets and realistic timelines.

The Government has prioritised 25 industries as the pillars of the "Make in India" campaign.

Corporates we meet inform us that meetings with bureaucrats are easy to obtain, held on time, and are crisp and to the point. Better use of technology is a driver of these initiatives with many approval processes moving online, reducing government interface. A single point of contact and a single window clearance for all approvals are becoming more common. Online self-certification results in factory levels inspections becoming system based. This ensures speedier compliance, reduced red tape, greater transparency and crucially less room for exploitation.

In addition to improving bureaucratic procedure, progress has been made on the policy front too. Several new regulations have provided clarity in key resource based sectors such as mining and oil & gas. New and innovative funding channels have been created for roads and railways with longer term funding structures available from Life Insurance Corporation for Railways, and hybrid equity models for roads. In addition the Government has also prioritised 25 industries as the pillars of the "Make in India" campaign. These include sectors such as Consumer Electronics, Medical Equipment, Auto & Auto Ancillaries and Defence. In the latter, 75 local companies have already been granted licences since the new policy was implemented. In addition FDI limits have been increased in Defence, Railways, Insurance and Construction, and Modi himself has led the initiative with 26 foreign trips in the past year focusing on marketing India as an investment destination, with impressive results.

Mayasuni Son, Founder of Softbank, comments on his last trip to India.

"Last year, I had a meeting with the Prime Minister (Narendra) Modi in Tokyo. We talked about India and the opportunities there and he invited me to come to India. I came in October last year. From that visit, we (SoftBank) said we will make a $10 billion investment and I made a commitment for the next 10 years."

We read of several such interviews of CEO's who, post their meeting with Government officials, have expressed their intent to be a part of "Make in India". The CEO of Siemens AG, presently in India has already had four meetings with the Prime Minister over the past year, clearly reflecting the importance assumed by the Government. Another key tenet of the "Make in India" effort is the freedom the Centre is giving to the State Governments to drive the change, reflecting Modi's time as a Chief Minister of Gujarat. The States' share of centrally collected tax revenues has been increased and there is no longer Federal control on how that money is being spent.

The Centre is also encouraging best practice within States to be shared between States. Rajasthan's amendments to its labour laws (reducing the power of the Unions), ratified by the Centre are now being adopted elsewhere, as is the case with Tamil Nadu's recent Land Law amendment which reduces owner consent and social impact assessment requirements. This law is now being showcased elsewhere in the expectation that other States will adopt this approach. Indeed Modi has been deliberate in his attempts to encourage competition against each other to attract foreign investment. "Competitive Federalism" has become the buzzword, with many competing more aggressively with each other to attract investment. In recent weeks five States have taken out full page advertisements in business dailies highlighting the simplified process for getting approvals to attract investments.

As we write, the state of Tamil Nadu is hosting a conference for global investors, the Chief Minister of Uttar Pradesh is in Mumbai for a similar meeting with Industrialists, whilst the Chief Minister of Maharashtra is in Japan and his counterpart in Telangana is in China; the message is the same from all. "Make in India". Maharashtra recently "bagged" a US$5bn investment from Foxconn, their first outside of

China, as reported in the local press below.

"Seven meetings, two over dinner and one over lunch, a Chef borrowed from the Chinese consulate to prepare authentic Chinese cuisine, a gift of a Ganesha statue, plus a helping hand to secure passage for a divine idol through customs at Mumbai airport."

It's not all plain sailing however. Although in recent weeks the Minimum Alternate Tax on foreign portfolio investors has been satisfactorily resolved, the more contentious dispute involving potential outstanding tax liabilities on Vodafone, Cairn Energy and others remains in arbitration and as yet unresolved. It is encouraging to note that in two other disputes involving Vodafone which received a favorable verdict by the Bombay High Court, the Government has not appealed, implying a softening of the Government's position. However the ongoing uncertainty in a very public battle is steering potential investors away from India.

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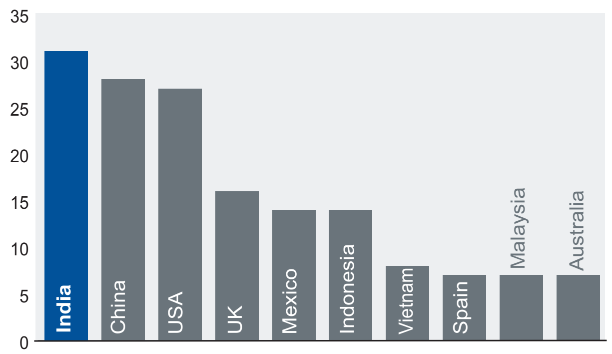
Mayasuni Son, Founder of Softbank

The Government has also acknowledged that India's "substructure" needs to develop rapidly if global investors are going to consider India as a realistic investment destination. Thus alongside the Make in India campaign are a variety of "mission mode projects", of which "Skill India" and "Digital India" are intrinsically linked to "Make in India". The former is a project to take internet connectivity to the core of the country, facilitating the delivery of critical services such as health and education across rural India. This is occurring in tandem with the transformation of 98 urban centres into "Smart Cities". These are areas prioritised for rapid development of affordable housing, functioning sanitation and electricity, transportation links, WiFi connectivity and so on. Here, States are competing to ensure these developments occur in their region, raising the competitive bar to a higher notch. "Skill India" recognises the need to prepare India's workforce for the opportunities that await them; the Central Government, working in conjunction with the States and the Private sector are funding schemes across a number of States (piloted by Rajasthan) whereby the corporate sector is incentivised by the Government to run training programmes for workers to become proficient in specific skill sets where there is a shortfall as identified by the corporate in question.

Chart 1: Top 10 FDI destinations - H1 2015 (Capex, US$bn)



Source: Financial Times, fDi Markets

FDI limits have been increased in Defence, Railways, Insurance and Construction, and Modi himself has led the initiative with 26 foreign trips in the past year.

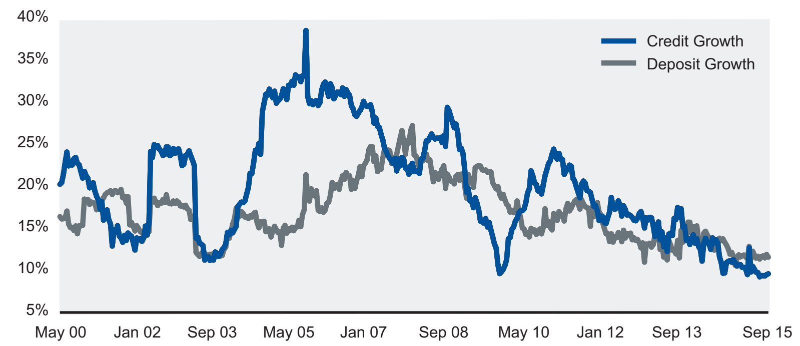
Inevitably these changes are also leading to disruptions as "interested" parties are set to lose out in the process of change. The old way of doing business, where the relationship between the Government and business were the key ingredients of success, is being reset and this is affecting the way both the political class as well as the private sector are behaving. In some cases, the project approval process is held up by officials, who in their zeal to not be seen as favouring any corporate, are over compensating, whilst in other cases the private sector has been reluctant to commit capital investment until they have a clearer understanding of the new rules. The Government's efforts to stymie the black economy is also having a crippling impact on future investment plans, particularly in the real estate sector. Elsewhere, the opposition parties too have been coming together to prevent critical legislation such as the New Land Bill or Goods & Service Tax from being passed in parliament. The fact that these reforms are hurting speaks of volumes for their success to date. The extent of the backlash is a worry however as to the extent that it may just derail the whole process.

To conclude, we believe that a lot has been achieved over the past year. Despite some setbacks and growth taking longer to revive, the intent of the Government remains clear. The process is ongoing with the Government already working on the next leg of reforms such as litigation policy, the bankruptcy codeand a new arbitration law. Corporate confidence is still high and we believe the changes being implemented today will in time take India to a structurally higher growth trajectory.

CHARTS & COMMENTARY

LAGGING INDICATORS

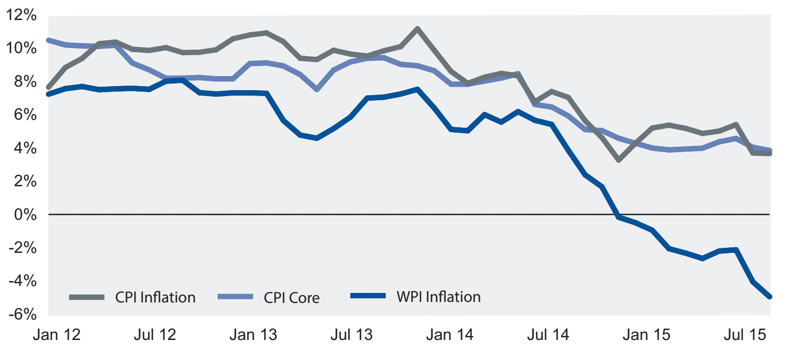
Chart 2: Deposit and credit growth



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.

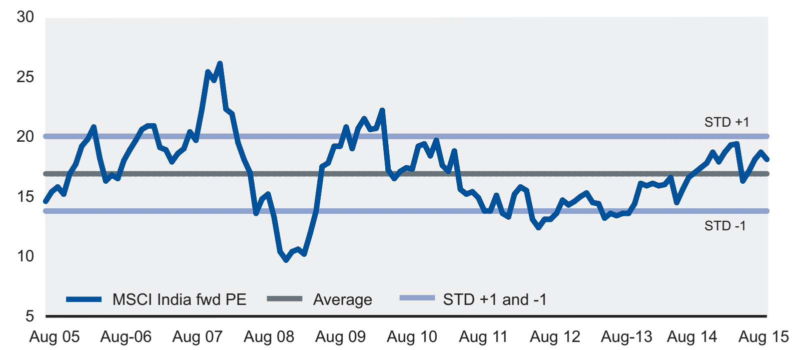
Chart 3: Inflation



Source: Bloomberg, IIFL Research

Inflation continues to surprise on the downside which is a big positive considering the Monsoon has been disappointing, (historically leading to upward pressure on food prices). The RBI has lowered its Jan '16 inflation target from 6% to 5.8% paving the way for a more aggressive 0.5% cut in interest rates than earlier thought. The RBI is targeting real rates between 1.5%-2% suggesting further room to cut, if the inflation trajectory stays on track.

Chart 4: MSCI India's forward PE valuation vs. history



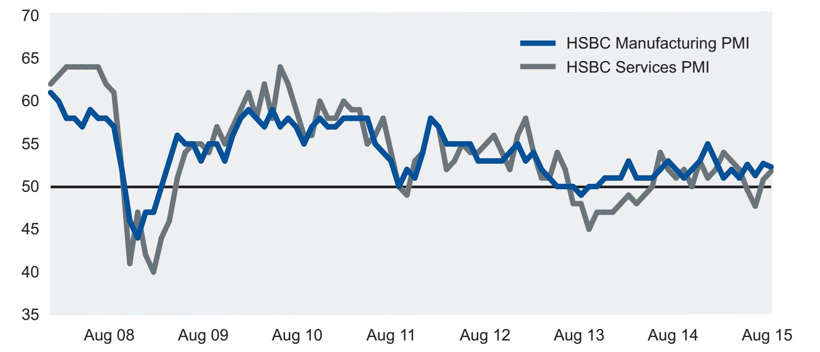
Source: Bloomberg

Valuations in India have moderated to somewhere close to the long term average as a result of weakness across Emerging Markets in general. This is creating a better entry point as macro economic data continues to improve, the political backdrop remains stable and supportive of growth. In addition there are genuine signs of an earnings recovery emerging.

CHARTS & COMMENTARY

LEADING INDICATORS

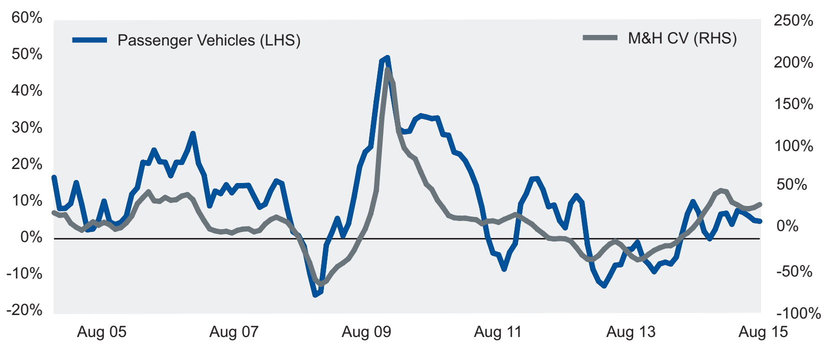
Chart 5: India HSBC PMI



Source: Markit Economics, IIFL Research

Manufacturing PMI data remains positive but stagnant. The domestic economic recovery is slow, hampered by over capacity and high real interest rates. Government spending has impacted positively and the private sector is expected to follow. A poor Monsoon will affect agricultural productivity and related sectors. Service sector PMI has recovered, but external environment is not supportive.

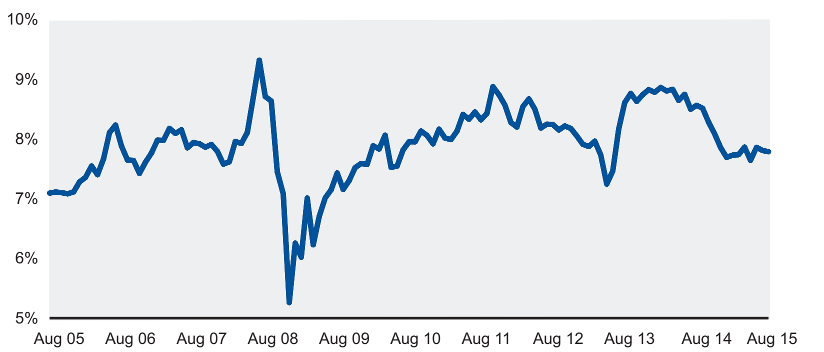
Chart 6: Auto sales growth (3MMA)



Source: CEIC, IIFL Research

M&H CV sales are healthy but off a low base, supported by "pre-buying" ahead of improved safety regulations. The outlook looks solid as lower fuel prices are driving fleet demand, mining projects are up and road building has been a priority. Auto demand to remain in single digits; sentiment is poor and rural wages are weak. Pent up demand however is substantial, following extended period of low growth. Interest rate cuts will support demand.

Chart 7: Government of India 10 year bond yield



Source: Bloomberg

In tandem with the interest rate cut to 6.75%, the RBI announced a phased increase in the limits of Government Bonds that can be bought by Foreign Portfolio Investors. An incremental US$18bn of Government Bonds and a further US$7.5bn of State Bonds will be made available by 2018. Easier monetary policy and increased liquidity should lead to lower yields, whilst increased flows will be currency supportive.

COMPANY FOCUS

HINDUSTAN PETROLEUM CORPORATION LTD

India has been a tough place to do business for oil marketing companies (OMCs). The reason for this chimes with those who are sceptical of the country's feasibility as an investment destination; namely a heavy handed approach from the State with regards to regulation.

Apart from a brief oasis in time between 2002 and 2004, successive Governments fixed the price at which OMCs could sell their products to the retail consumer as an untargeted form of subsidy. As the side effects of this policy damaged both the downstream industry and the Government's fiscal position, the issue of unwinding the subsidy system became a political football for the last Congress Government which struggled to gain cooperation for doing so from its more populist coalition partners.

The election of the BJP in May 2014, alongside a collapse in the oil price, has facilitated the new Government to allow free market pricing in diesel – the core component in the fuel subsidy bill. With petrol already de-regulated and a visible timeline to extend this to LPG and kerosene products, we believe this has opened up the sector to the inevitable challenges, but also opportunities that a more liberalised environment provides.

Prior to the de-regulation of diesel and petrol prices, the OMCs would initially bear the total losses incurred from difference between their permitted selling price to the consumer and their cost of refining or acquiring the fuel. Whilst they were subsequently able to recover one third of the losses from upstream providers and one third from the Government, there would usually be a considerable time lag before the Government paid its share. The removal of the fixed pricing mechanism has now taken away the need for OMCs to borrow large amounts of short term debt to fund their receivables in anticipation of the Government's pay out. Not only are companies now free to set their own prices and earn a margin in the process, but their losses suffered from their share of the subsidy have been removed and their working capital requirements have come down substantially.

From a stock picking perspective, the ability for the market players to control their own destiny has provided the chance to invest in companies that are set to enter an exciting period of earnings growth. HPCL is likely to be the greatest beneficiary of this.

The oil marketing space is dominated by three state owned companies – Indian Oil Corporation Ltd (IOCL), Bharat Petroleum Corporation Ltd (BPCL) and Hindustan Petroleum Corporation Ltd (HPCL) (in that order of market share of MMTPA volume sold; 53%, 24% and 22% respectively). All three companies have a strong and broadly similar presence in urban centres and highways. Due to the difficulty and cost of acquiring land for new outlets in these areas, this should provide a strong barrier to entry against private competition that is inevitably set to enter a more liberalised market.

Whilst being the smallest of the three players, HPCL appears to be best placed to capture the benefits of the new environment. It has 16mtpa of refining capacity produced at two plants located in Mumbai and Visakh (Andhra Pradesh) but retails 32mtpa to

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consumers, sourcing the balance fuel from Indian refiners who don't have a marketing presence. This gives it a superior marketing to refining ratio of 2x, in comparison to BPCL's of 1.6x and IOCL's of 1.4x. As the opportunity in this space lies away from refining and towards marketing, HPCL is geared most favourably towards this amongst its peer group.

The impact of price deregulation can be seen in the year on year improvement of HPCL's performance for FY15. Its accounts receivables came down 35% to US$0.7bn, providing considerable relief to its working capital funding requirements. As a consequence its total debt fell by 23% to US$6bn and its interest expense declined by 29%. The total debt to equity ratio now stands at 1.3 compared to 2.1 in FY14[1].

Going forwards, now that the Company has greater control of its destiny, its future prospects are considerably more positive, especially from the perspective of a minority shareholder. Its average annual capex spending over the past three years has been US$606m. Considering that free cashflow generation has stepped up from US$464m to US$1.9bn from FY14 to FY15 – whilst the Company has elected to maintain its dividend payout ratio of 30% - future expenditure can now be funded from internal accruals. This should allow automation at fuel pumps to be expedited (2,309 of 13,233 outlets are currently automated) as well as further refining capacity to be added without impacting the balance sheet.

The risk to the investment case is driven by a spike in the price of crude oil. Whilst the Finance Minister articulated in October 2014 that *"henceforth, like petrol, the price of diesel will be linked to the market"*, the Government's resolve in the face of political pressure to protect consumers from higher fuel prices would be tested. Indeed, in advance of a sizeable election in the state of Bihar to be fought in October, it appears that under pressure from the Government, OMCs have delayed raising prices at the pumps for their timetabled fortnightly revisions, despite a higher international oil price. As mentioned above, between 2002 and 2004 the last BJP led Government liberalised prices, but this was abandoned following a higher market level of oil.

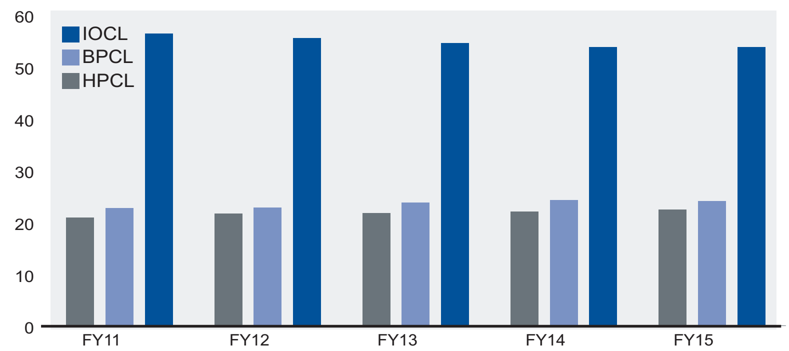
The election of the BJP in May 2014, alongside a collapse in the oil price, has facilitated the new Government to allow free market pricing in diesel – the core component in the fuel subsidy bill.

One can argue that the current Government has a greater mandate to resist clamour to repeat its mistake, and has also wisely increased fuel duties to provide a buffer to lower prices should oil revert upwards. US$80 per barrel is the price at which the Government initiated the removal of subsidies on diesel, so it is safe to assume that the market will remain relaxed about the prospect of a reversal, at least until oil returns to that level. Nevertheless it is clear that politics will continue to pose concerns until the Government builds up a track record of free pricing in environments of both higher and lower oil prices.

The explicit commitment to improving fiscal discipline made on numerous occasions by the BJP gives us comfort that untargeted fuel subsidies should be a thing of the past. As such, from a valuation perspective, HPCL is an attractive opportunity to partake in a newly liberalised regime. It trades at 6x forward EV/EBITDA[2], and Ocean Dial estimates a 50% expansion in EBITDA over the next two years. The Company offers most value relative to its two peers. Taking the Enterprise Value of the marketing business as a standalone entity the company trades on a Marketing EV/tonne basis of 6,713 compared to 9,841 for BPCL and 7,505 for IOCL.

The broad based nature of the retail outlet infrastructure should protect the business from new market entrants over the medium term, and here the growth opportunity is most compelling. This infrastructure, coupled with considerably lower debt obligations, and the ability of the Company to control marketing margins, should facilitate sizeable cash returns to shareholders over the medium term.

Chart 8: Market share: HPCL & BPCL gaining from IOCL



Source: Annual reports

1 Hindustan Petroleum Corporation Ltd Annual Report FY15. 2 Bloomberg

MACRO OVERVIEW

ECONOMIC DATA

Change over	2009	2010	2011	2012	2013	2014	2015	Last Qtr. (Mar-May)	This Qtr. (Jun-Aug)
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%	7.5%	7.0%
Avg. IIP % Annual Change	2.9%	5.3%	8.3%	3.1%	1.2%	-0.1%	2.8%	2.8%	4.3%*
Exports % annual Change	14%	-4%	40%	22%	-2%	5%	-1%	-19%	-16%
Imports % annual Change	21%	-5%	28%	32%	0%	-8%	-1%	-13%	-11%
Current Account Deficit % of GDP	-2.3%	-2.8%	-2.7%	-4.3%	-4.8%	-1.7%	-1.7%	-1.4%	-1.3%
Interest Rates (Repo) (Avg.)	7.4%	4.8%	5.9%	8.0%	8.0%	7.5%	7.9%	7.5%	7.3%
10 year GOI Bond Yield (Avg.)	7.6%	7.2%	7.9%	8.4%	8.3%	8.6%	8.5%	7.9%	8.1%
FII Flows (US$bn) (CY)	+17.6	+29.3	-0.5	+24.5	+19.8	+16.2	+4.5	+2.8	-2.7
FDI Flows (US$bn) (CY)	+26.8	+21.0	+27.6	+22.8	+22.0	+28.8	+19.4	+9.6	+2.1**
INR vs. US$ (CY)	+3.7%	+4.0%	-18.9%	-2.8%	-13.0%	-2.3%	-4.7%	-3.2%	-4.0%
INR vs. GBP (CY)	-7.2%	+7.7%	-18.5%	-7.8%	-15.3%	+3.4%	-3.8%	-2.5%	-4.6%

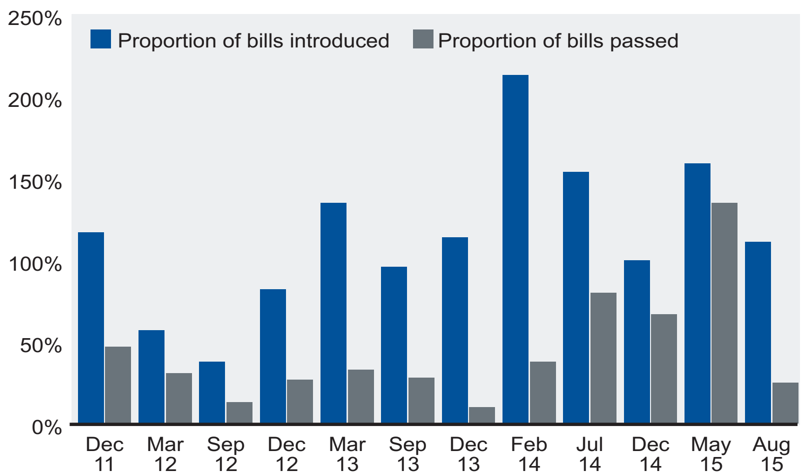
* June to July only ** June only

Source: Bloomberg

GOVERNMENT SCORECARD

The Monsoon Session of Parliament ran from 21 July to 13 August. It was an unproductive session due to opposition parties in both Lower and Upper Houses aggressively disrupting proceedings. The Lower House managed a few days of activity after the suspension of 25 MPs by the Speaker, but no significant business was conducted in the Upper House.

Chart 9: Parliamentary speed and activity



Source: PRS Legislative Research

REGULATORY INFORMATION

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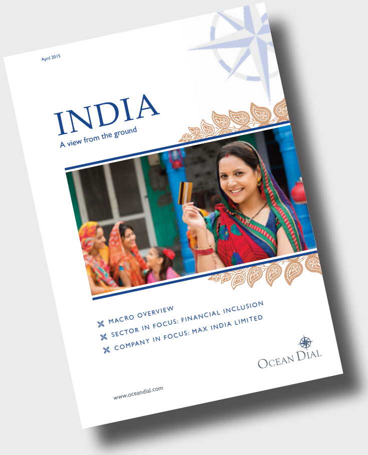

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