

# INDIA

A view from the ground



THE VIEW THIS QUARTER:

- ✕ GOODS AND SERVICES TAX: COMING OFF A LOW BASE
- ✕ KITEX GARMENTS LIMITED: GROWING UP QUICKLY

## 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

# INDIA'S ECONOMIC RECOVERY: A TWO LEGGED STOOL

An eventful quarter saw appetite for Emerging Markets resurface tentatively, buoyed by brighter prospects for growth, rare stability in both commodity prices and currencies, and compelling valuations. Barring sporadic upticks, since emerging markets have underperformed for over five years, further upside to incremental flows remain.

In this regard, India remains the “stand out market”, valuations aside, as confidence in the investment story rightly builds. Since the lows in February the market has rallied hard, but the rationale to stay invested is compelling.

The Government finally grabbed the opportunity to cajole the Goods and Services Tax Bill through the Upper House, thereby ensuring its passage into law. A transitional period now ensues with crucial issues still to resolve, but barring inevitable implementation risk, the move towards a more efficient tax structure and the potential economic benefits that will follow, is “in the bag”. Simply put, successful implementation will increase consumption, reduce tax leakage, and significantly enhance productivity, raising economic output as a one off, an estimated 0.9% - 1.7%. It should also embolden the Government to push ahead with further reform.

The recent appointment of Dr Urjit Patel as the new Governor of the Reserve Bank (RBI) demonstrates the Government's desire to preserve the continuity of monetary policy and foreign investor confidence. Dr Patel will oversee the implementation of the MPC (monetary policy committee) whose mandate is a five-year inflation target of 4% (+/- 2%). We are also encouraged by the appointment of three notable academics to the committee, who will act independently. In truth however, there is little to fear currently; the real test for Dr P will only present itself in more turbulent times which for now, seem a long way off. Indeed, since food price inflation has fallen dramatically, further (limited) cuts in interest rates are on the cards. (As we go to print, the Reserve Bank has announced a 0.25% interest rate cut to 6.25%).

Whilst positive for the market, easing headline rates further will do little to change the constraints to capital availability that still exist. Industrial credit is growing at a paltry 1% per annum; this is not just an indication of poor asset quality amongst the banks, but a lack of demand from infrastructure facing sectors. This is where the bulk of previous private sector investment emanated, suggesting that new sectors such as power transmission, roads, railways and irrigation will have to plug the gap.

But although there is little evidence of an investment recovery, “pre-conditions” are falling into place. The Financial Stability Review (FSR) highlighted that the number of corporates surveyed (from 4,000) and considered to be in “real” trouble (defined as having net debt to equity ratio in excess of 3x) has fallen from 19% to 14%. In addition, there has been a substantial increase in non-banking sources of credit, in particular the corporate bond market, now accounting for just under one third of total outstanding domestic debt, being the largest part of the incremental issuance in recent years. Capacity utilisation is picking up albeit gradually, inventory levels are coming down likewise, and corporate de-leveraging is much in evidence. When the next leg of demand does materialise the conditions will be set for the investment phase to follow. For now the recovery remains uneven.

If industrial credit demand is lacklustre, the opposite can be said of retail demand, growing at 19%. This is supporting a growing consumption cycle in urban India particularly, but it is hoped that rural consumers will

follow suit. As such Corporate India is gearing itself up for a pickup in consumption, justified by the recent 25% pay hike awarded to public sector workers, whilst rural India is expected to emerge from three years of dormancy, as farm incomes recover. Stocks across the board have moved in anticipation of this (and the passage of GST), suggesting that there is room for disappointment. The approaching Festival season may provide some of the answers.

In earlier reports we have focused on analysing underling trends in the economy and corporate profitability, both viewed as key bellwethers of the recovery. In truth not much has changed in either case. Underlying economic data confirms that the worst is behind us, but individual data points remain volatile and the signals vary. Corporate results share a similar trend, but with greater clarity. Sectors exposed to the global economy such as IT, oil and gas, component manufacturing (auto ancillaries for example) announced weak numbers in the main, whilst companies exposed to domestic India performed much better, though more as a consequence of cost savings rather than healthy top line growth. Public Sector banks appear to be past the worst, but further provisioning is expected in the quarters ahead.

Despite a run of good news much of which has been reflected in equity valuations, the India story remains on track. Turning points have been reached, both economic and political, confirming that both the reform agenda and the recovery are gaining momentum. As investors continue to re-examine the potential in emerging markets, India continues to deliver.



# GOODS AND SERVICES TAX: COMING OFF A LOW BASE

A consumption based tax (VAT) was first introduced by French economists in the 1950s. It was proposed as a levy on the manufacture, sale and consumption of goods and services at a national level and collected on the value added component at each stage of the supply chain.

The process was designed in tandem with a credit system which gives the benefit of an input tax credit (ITC) on the tax paid at previous stages, thereby putting the burden on the end consumer.

Since its creation, 160 of the world's 193 countries have followed the French and introduced a VAT styled system, Malaysia being the most recent, naming it, like many others, as a Goods and Services Tax (GST). After 10 long years of political squabbling India has finally achieved sufficient cross party support required for its own GST Bill to pass through both houses of parliament.

The rationale for adopting this more efficient tax system globally has been to facilitate greater levels of economic output (both domestic and export driven growth) as a consequence of better allocation of resources and greater investment. In the case of Canada (1991), GDP increased by some 2%, whereas India's National Council of Applied Economic Research (NCAER) back in 2008, calculated the impact would be between 0.9% - 1.7% of GDP, computed as the present value of the additional income discounted at a real interest rate of 3%. Given the current state of

India's tax regime, a multiplicity of Federal and State taxes over loaded with social policy goals and riddled with opportunities for exploitation, this feels like a serious underestimation. And whilst the transition process is likely to be a challenging period, the adoption of GST is a real "game changer" for India on numerous fronts, the real value of which will only be fully understood as the process evolves.

A cursory explanation of the drawbacks within the existing system will put into context the benefits of change. Currently the Revenue Department oversees a complex structure of local and federal taxes varying across boundaries and sectors overlaid with a plethora of exemptions, filed in person and in print. Unsurprisingly this is hard to administer, easy to avoid, and wide open to abuse. On top of that, the inefficiencies within the system ensures additional costs for business, guaranteeing a misallocation of limited resources. The principal weakness of the system is the cascading impact of paying tax on tax. For example, input credits are not available on interstate transactions and nor is credit on Central Sales Tax available on inputs purchased from

other States. These variations increase costs and ensure an uneven playing field for companies competing both inter-state and overseas. Additional costs are incurred in the physical act of getting goods "to market", suffered in the time taken, and the duties paid, to cross State and Union boundaries. The introduction of GST will generate gains for companies who can halve journey times, slash inventories and working capital needs, as well as ditching hard assets such as warehousing facilities, required for goods travelling interstate. Internal trade, accounting for circa 14% of GDP and growing faster than headline GDP, is an immediate winner, particularly for India. A World Bank study suggests that halving delays due to road blocks and other hindrances will cut logistic costs by 40%, with the majority of that coming as a consequence of GST.

Instigating input tax credits on capital goods will reduce purchasing costs by 12%-14% which will lead to higher levels of investment. As well as helping exports, GST will remove an implicit subsidy on imports, many of which are not subject to intermediate taxes. As well as minimising distortions and improving capital allocation decisions, GST will also enable easier compliance and thus better collection, plus in time it will formalise the unorganised sector, thus broadening the tax net. GST filing will be completed online using just two fully automated forms and fully attested using digital signatures. The process will be managed by a 21<sup>st</sup> Century VAT system for invoice matching and data sharing, involving 70 million tax registered parties and three billion "B2B" invoices monthly, across the country.

As always, the devil lies in the detail, and it will be the responsibility of the



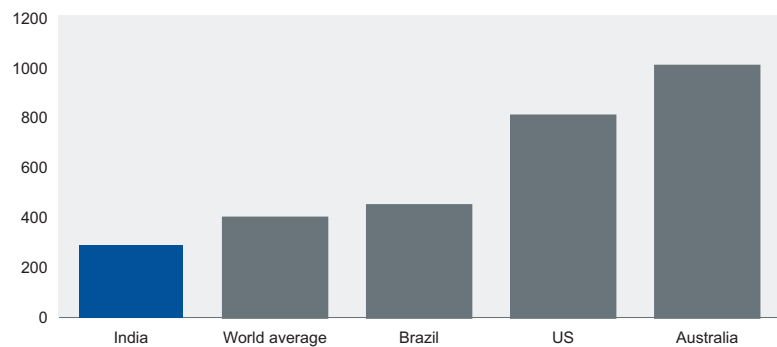
**India has finally achieved sufficient cross party support required for its own GST Bill to pass through both houses of parliament and into law.**

GST Council, chaired by the Finance Minister, to oversee implementation. The Government will work alongside the States to define critical factors; in particular, rates, thresholds, exemptions and dispute resolutions, all as yet to be decided. These issues, plus the training and “technology readiness” required makes April 2017 an ambitious target.

It is expected that the Council will base its decisions on recommendations made by the Government’s Chief Economic Adviser. The report stresses the Government’s overriding aims; “to protect revenues, simplify administration and encourage compliance, whilst avoiding inflationary pressure”, besides ensuring India’s tax rates stay within a “globally competitive range”. Key to avoiding an inflation spike, and thus maintaining popular support, will be the level at which the standard rate is set. Three rates are proposed. A lower rate of 12%, the standard rate at 18% and the “sin rate” of 40% which will cover luxury cars, tobacco etc. These are national rates, comprising of the sum of state level GST (SGST) and a central level (CGST), split in a proportion yet to be determined. In fulfilling its aim to protect revenues, the council will seek to find the “revenue neutral rate” (RNR) which will be the rate which preserves revenues at current levels, and will ideally be set close to the standard rate, likely to be 15%-15.5%.

In addition, the Council will set a minimum threshold below which no tax will be levied, plus agreement must be reached on the extent of products considered exempt, (many food items, for example) and other politically sensitive items. Currently there are over 300 exemptions at the Centre (at an estimated cost of 1.2% of GDP in foregone revenues), many of which are expected to be brought “back in”. There is a risk that, for political reasons, there is pressure to broaden the number of exemptions. Subramanian’s report

Chart 1: Average distance travelled by a truck (kms/day)



Source: Credit Suisse

stresses exemption cost will need to be offset by a higher RNR, and the inflationary consequences thereof.

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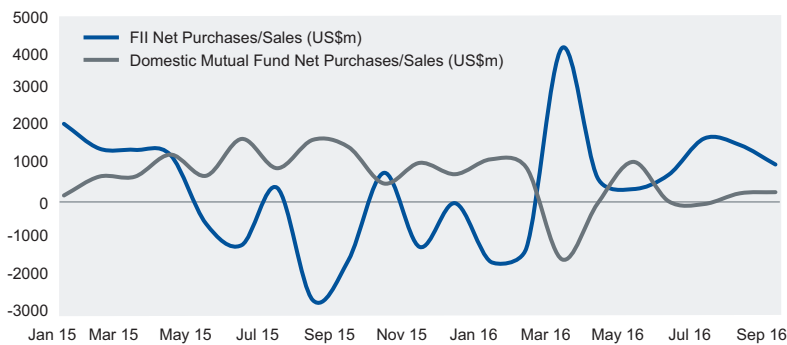
Not exempt, but excluded, are alcohol, petroleum products, electricity and real estate which will all remain the purview of State governments, understandably reluctant to share the spoils of such valuable receipts straight up. These make up approximately 25% of the taxable base, thereby significantly denting the full impact of GST in the first instance, but it is expected that once the States see the benefit of better compliance, it will motivate decision makers to bring all exclusions under the GST sphere. To date, the Government has been successful in working constructively with the States to managing their concerns in relation to foregone revenues, already protected for five years. However, effective implementation will depend on a transparent and reasonable dispute resolution and a compensation system which “engenders trust between all parties”, even if this results in revenue shortfall in the early days.

It’s clear that between now and April ‘17 there are some tough decisions to be made requiring ratification from all States, before implementation can move to the next level. It is well documented that the Government has been building the IT backbone since 2012, suggesting that roll out by April is realistic on that front, but there are also the challenges of training 60,000 revenue officials across the country and ensuring the States and companies have worked on changes in their own IT systems to manage the integration process. Implementing a new tax across 29 States and two Union territories will set a new global standard for tax collection in large Federal systems, but it is a suitably challenging task. To add to the risks there is a likelihood of a “pop” in inflation as prices immediately adjust to reflect new tax rates, before the benefit of free flowing ITCs effectively “offset” and there may equally be a negative impact on growth. After all, inventory levels are expected to fall, affecting production. But whether GST is ready to go by April 2017 and precisely what the near term impacts are is to miss the main point. It is the long term structural benefits to the country that investors should focus on, which to date are by no means fully recognised.

## CHARTS &amp; COMMENTARY

## LAGGING INDICATORS

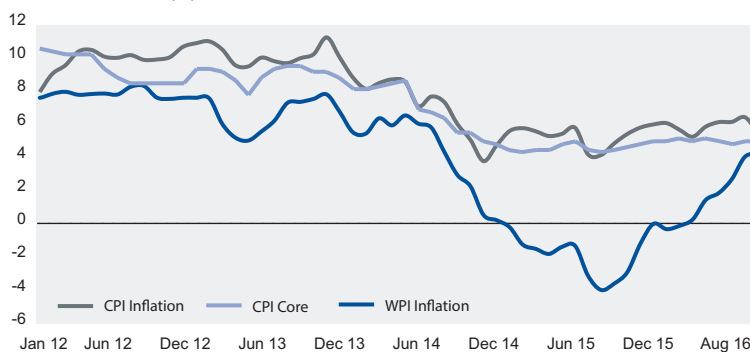
Chart 2: Net foreign portfolio vs domestic mutual fund listed equity flows



Source: For FII data - <https://www.fpi.nsdl.co.in/web/Reports/Archive.aspx>, for Domestic mutual funds - Bloomberg. Source: [www.fpi.nsdl.co.uk](http://www.fpi.nsdl.co.uk), Bloomberg, IIFL

Bloomberg data suggests September end was the tenth consecutive quarter of domestic mutual funds net buying of shares, as alternative assets such as gold and real estate stumble, and real interest rates remain positive. This has helped to spur small and mid cap valuations to a premium over large caps. Foreign fund flows are also healthy, reputedly ETF driven, as investors close underweight positions in Emerging Markets.

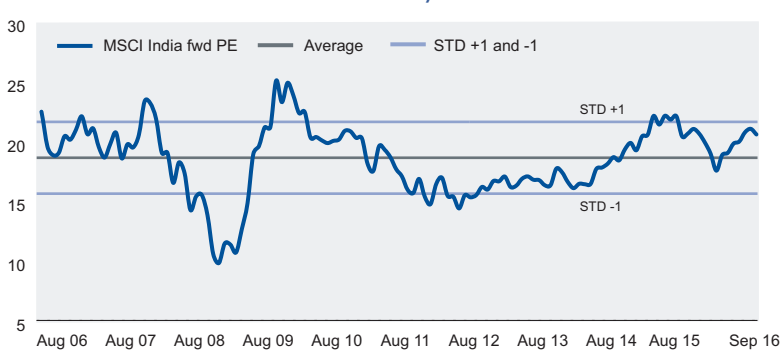
Chart 3: Inflation (%)



Source: Bloomberg, IIFL Research

Consumer Price Inflation (CPI) fell aggressively in August as a consequence of lower food prices (particularly pulses), enabling the newly formed MPC to cut nominal interest rates to 6.25%. Core inflation remains sticky, whilst WPI ticked up moderately as increased oil and commodity prices fed through. With real interest rates at 1.25% (CPI - Repo), we see little room for further rate cuts currently.

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



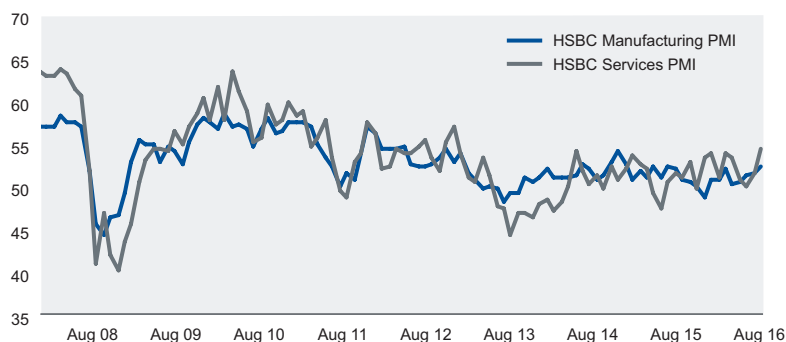
Source: Bloomberg

Trailing 12 month price/earnings have moderated fractionally, although the multiple remains elevated relative to history. Whilst the worst is passed, and there are limited signs of an improving demand in specific areas, a full scale recovery is not yet underway. Export related companies' earnings have come under pressure, due to a combination of weak end user demand and regulatory issues in particular areas.

## CHARTS &amp; COMMENTARY

## LEADING INDICATORS

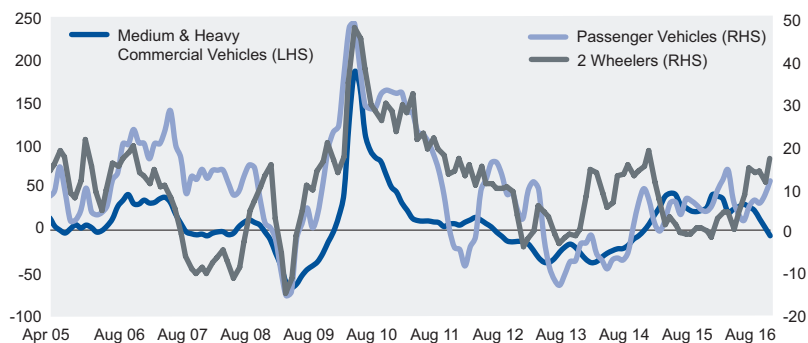
Chart 5: India HSBC PMI



Source: Markit Economics, IIFL Research

Composite PMI data has been improving of late with a real pickup in the services numbers giving a boost to the positive news flow. Inflation is steadily falling and scope for a potential further cut in interest rates could be a high priority on the newly appointed Governor of Finances' to do list.

Chart 6: Auto sales growth (3MMA)



Source: CEIC, IIFL Research

Cars and motorcycles saw sales volumes surge as secondary channels prepared for the "festival season" which traditionally sees elevated demand. Expectations are high as both pent up and fresh demand, crystallised by a healthy monsoon and recent public sector pay increases, combine. This has been further fueled by lower interest rates and oil prices. Commercial vehicle sales fell off the high base of 2015, where earlier changes to emission norms forced higher sales volumes.

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



Source: Bloomberg

10 year bond yields are currently at seven year lows, thus providing real benefits to wholesale funded entities through lower borrowing costs. Falling inflation, favourable liquidity provision from the Reserve Bank, and increased access for foreign buyers to Indian bonds should lead to lower yields yet, combined with additional spread compression. Weak demand for credit suggests monetary transmission is not yet fully effective.



## COMPANY FOCUS

# KITEX GARMENTS: GROWING UP QUICKLY

Kitex Garments, (estimated market cap. US\$300m), is a recent investee company for which we have high expectations. The company produces infant wear and exports 100% of its production, primarily to US and European markets.

Opportunities do exist in the domestic market, but for now overseas remains the focus. Kitex is unique in many ways, so much so that our initial impressions left us all rather perplexed. Firstly, it is Kerala based, which is a part of South India not considered particularly business friendly. Secondly, the company focuses solely on the infant wear segment (0-24 months). Finally, despite being in a relatively cyclical industry, the company has delivered positive revenue growth in all but one year for the past decade, whilst maintaining 35% operating margins, 25% returns on capital employed (ROCE) and net cash. Overall, an intriguing business model which well warranted a trip South.

After detailed analysis it became clear that the company has created a business model, not only with high barriers to entry, but also high switching costs and as a result, strong pricing power. When it set up shop in 1995, like many other apparel manufacturers Kitex produced an enormously wide range of garments. However when the 2001 global recession struck management woke up to the

fact that all product categories had witnessed sales declines of up to 60%, barring the infant garment segment, whose sales remained flat. This suggested infant wear was recession proof, or as near as. Henceforth since 2001, Kitex began to focus specifically on infant clothing, and by 2005 the company was exporting 95% of its production, with notable clients such as US based retailers, Gerber, Toys R Us and Jockey.

Producing infant wear for export presents unique challenges which Kitex has learnt well, giving it considerable advantages over the competition. In particular challenges around health and safety are paramount in the production process. For example, children tend to lick their clothes and so the use of “appropriate” substances in the production process is critical. With many dye components being chemical based, (80 mainly harmful compounds recognised), some manufactured infant wear can be unsafe, and as such the US authorities have already banned 12 such dyes from the production process. Here Kitex has been proactive,

removing all 80 highlighted chemicals from their process. Furthermore, it is now producing its own fabric in order to ensure it maintains absolute control of all chemicals used in the assembly process. This has built strong customer and brand loyalty, particularly as there are just a handful of companies globally able to meet the large volume requirements of US customers, without compromising on quality standards. This, therefore, provides an element of pricing power for the company.

Kitex has been able to differentiate itself from its competitors through the quality of its manufacturing process. Importantly, it pays its employees well above industry averages, a good first step and an important part of the customers “buying decision” when assessing emerging market clothing suppliers. An additional element of its manufacturing success has come as a consequence of the high standard of working conditions provided to all employees. In fact, management claims this has led to efficiency levels rising by up to 50%. When the original factory was built in 1995 air conditioning was



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installed, helped admittedly by the fact that Kerala has one of the lowest costs of power in the country. Nevertheless, this was “a first” for the time, and indeed 20 or so years later, we only know of one other factory producing clothing across India which is fully air conditioned. Moreover the company provides lodging facilities to all its female workforce inside the facility, and for the men, accommodation offsite. In addition the company provides healthcare and counselling facilities for all its employees, many of whom are not Kerala born, another reason perhaps that staff turnover is low. Consequently Kitex has neither union nor strike issues, whilst operating margins remain one of the highest within the industry. The adherence to both high quality production and safety standards has ensured that Kitex is able to capture a higher market share of the global client base, and fend off the competition from countries such as Bangladesh and Vietnam.

In the last decade Kitex compounded revenues at 17% per annum; looking ahead, the management is confident that over the next three years this can be “upped” to 20%. The key to this incremental growth will come from not only an expansion of the client base (recently added Walmart – through Sams club), but also increased market share in both US and Europe. The company is launching its own brand, “Little Star”, through e-commerce channels initially, and has also entered into a brand licensing agreement with new customers such as Lamaze International, where it will be the exclusive supplier of infant wear.

We see two main risks, the first being high client concentration. We believe that this is being addressed by the launch of “Little Star” and the addition of new clients, such as Walmart. Of greater concern is the existence a company called Kitex Children’s

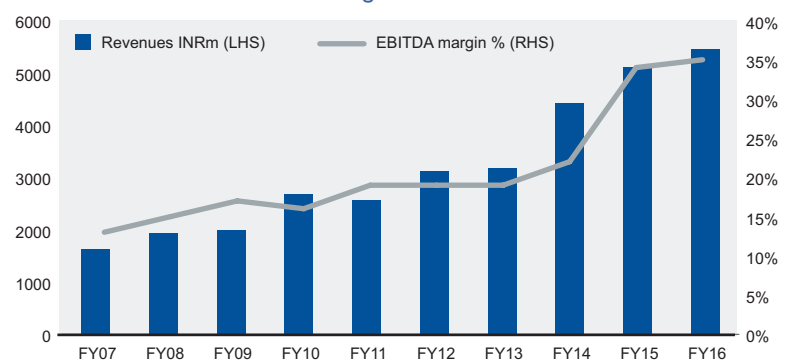
Wear Ltd (KCW), which is a private company, 100% owned by the Kitex promoters. Established in 2005, the company pursues identical lines of business, supplying infant wear to clients such as Carter’s, Mothercare and The Children’s Place. KCW was established by the Promoter using equity raised from mortgaging the family home. The purpose was to secure the additional debt, needed to fund the working capital requirements of the listed entity, whose balance sheet at that time was over stretched, (though no longer). Best practice, despite this conflict, is achieved through ensuring that all new clients are customers of the listed entity, whilst KCW continues to serve its existing or legacy customers only. Although the history behind KCW existence has some plausibility, the owners have rightly taken the decision to merge the two businesses, appointing Ernst and Young as a consultant. And in order to maintain full transparency it has been agreed that KCW will be listed first, before the businesses are merged, a process we expect to take 18-24 months. We can find no reason to doubt the promoters’ intentions in this respect, particularly as the listed entity has been given precedence, though clearly we will be monitoring the situation with great care.

To conclude, we believe Kitex is a hidden gem. It has operations on a global scale, a marquee client base and sufficient barriers to entry to maintain pricing. Most importantly, by following the highest standards of manufacturing practices and remaining the employer of choice in a labour intensive industry, Kitex has a great opportunity to expand further. Also, to its advantage, the new Government in India have been re-working the regulatory framework in efforts to maximise the employment generating capability of the textile sector. This, combined with favourable macroeconomics, suggest that 20% annual revenue over the next 4-5 years should not be difficult to achieve. At 13x FY18 PE, the valuations are compelling and a valuation rerating likely, subsequent to the merger of both businesses.

Liquidity (3m avg vol)	US\$0.94m	
Promoters’ ownership	54.20%	
FII ownership	5.20%	
	FY17E	FY18E
P/E	16.5	13.5
ROCE	26%	25%
P/B	4.7	3.5
ROE	32%	30%

Source: Ocean Dial Asset Management, Bloomberg

Chart 8: Revenues and EBITDA margin



Source: Ocean Dial

## MACRO OVERVIEW

## ECONOMIC DATA

Change Over	2010	2011	2012	2013	2014	2015	2016	Last Qtr: (Mar-May)	This Qtr: (Jun-Aug)
Real GDP % Annual Change	8.6%	8.9%	6.7%	4.5%	4.7%				
Real GDP % Annual Change - new series				5.6%	6.6%	7.2%	7.6%	7.9%	7.1%
Avg. IIP % Annual Change	5.3%	8.3%	3.1%	1.2%	-0.1%	2.8%	2.5%	0.0%	2.1%*
Exports % Annual Change	-4%	40%	22%	-2%	5%	-1%	-16%	-5%	-3%**
Imports % Annual Change	-5%	28%	32%	0%	-8%	-1%	-15%	-20%	-13%**
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%	6.6%	6.5%
10 year GOI Bond Yield (Avg.)	7.2%	7.9%	8.4%	8.3%	8.6%	8.5%	8.0%	7.8%	7.5%
FII Flows (US\$bn) (CY)	+29.3	-0.5	+24.5	+19.8	+16.2	+3.3	+6.1	+5.1	+3.9
FDI Flows (US\$bn) (CY)	+21.0	+27.6	+22.8	+22.0	+28.8	+39.3	+10.6	+2.5^	NA
INR vs. US\$ (CY)	+4.0%	-18.9%	-2.8%	-13.0%	-2.3%	-4.7%	-1.0%	+2.1%	+0.3%
INR vs. GBP (CY)	+7.7%	-18.5%	-7.8%	-15.3%	+3.4%	0.2%	+10.8%	-3.6%	+11.1%

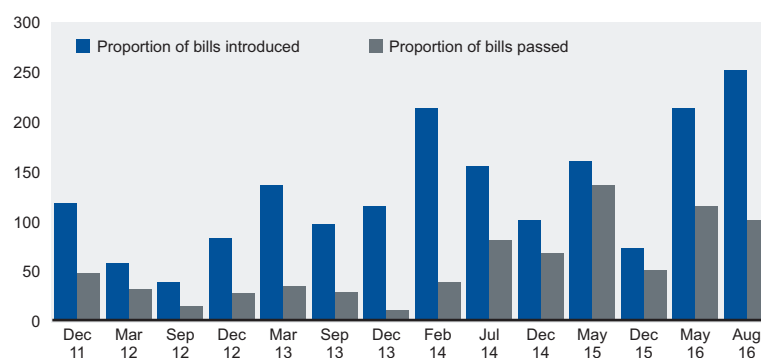
\* Jun 2016 \*\* Jun – July 2016 ^ March 2016

Source: Bloomberg, DIPP – Govt. of India

## GOVERNMENT SCORECARD

During the monsoon session, Rajya Sabha met for 96% and Lok Sabha for 101% of their scheduled time. Before this Session, since May 2014, Rajya Sabha had met for 76% of its scheduled time and Lok Sabha for 102%.

Chart 9: Parliamentary speed and activity



Source: PRS Legislative Research

# REGULATORY INFORMATION

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