India: a view from the ground

Ocean Dial Asset Management Briefing 5

June 2012

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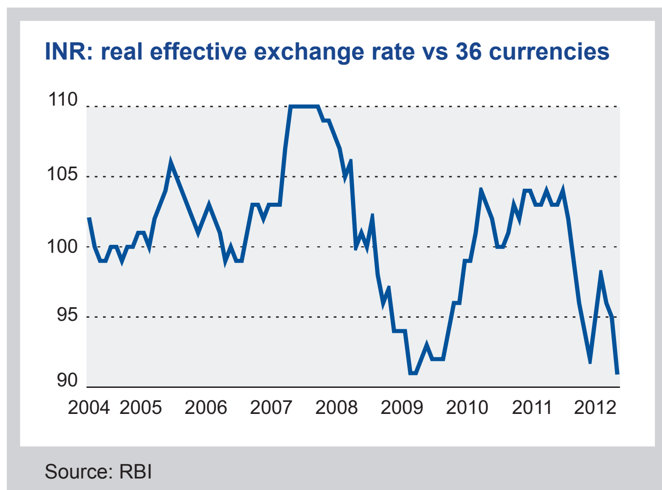
Outlook

The highlight of the quarter to May 2012 was the steep 14.5% depreciation in the Indian Rupee (INR) vs. the US Dollar (USD). The manifestation of India's economic imbalances is via the currency and the fall in the INR vs. USD is an excellent example of this. The imbalances are magnified at times of global market stress because of India's dependence on foreign capital to fund the nation's overdraft, and this stress feeds on itself as anyone and everyone with USD risk rushes to buy protection. The Central Bank makes noises about intervening to reduce volatility and on occasion they step up to buy Rupees, but the truth is they are powerless, which is why sensibly they do not sell much of their hard earned (and limited) foreign exchange reserves. It is a fruitless exercise given that the global market for the Rupee trades roughly USD70bn a day, whereas the RBI has been intervening on average USD2-10bn a month. Given also that the bond market is effectively closed to foreigners there is no natural stabilising factor for the currency. In liberalised markets, if the currency is oversold it is easy to take exposure via a Treasury Bill or Gilt, which helps to re-right the listing ship. India does not have this self-correcting mechanism; the only meaningful way to take on currency risk is via an equity linked product. Hence the Rupee can be expected to overshoot both on the downside and indeed on the upside.

The chart below highlights the extent to which the Real Effective Exchange Rate (REER) looks oversold relative to its history, which suggests some comfort but does mean that the Rupee cannot fall further from here. The reality is that given the recent fall in the price of oil, and a significant slowdown in the pace of gold imports, the current account should be tracking better than the market is expecting (implying a stronger, not a weaker Rupee).



Source: RBI

Looking longer term, India has not struggled to attract sufficient foreign capital to fund its current account (average long term inflows at 3.2% GDP), and such is the increased participation of the private sector it should not really face a problem today. The reason for such a sizeable fall in the Rupee therefore, does not boil down to the numbers, but more the negative message that foreign investors are receiving from the government. Recent announcements relating to tax upheaval on both foreign direct investment and portfolio investments has combined to create an atmosphere of uncertainty and unpredictability for all investors. In current global market conditions, foreign players do not need too many reasons to opt out. After a surge of money in at the start of the year, since the Budget (when these issues were first raised) inflows have quite literally dried up.

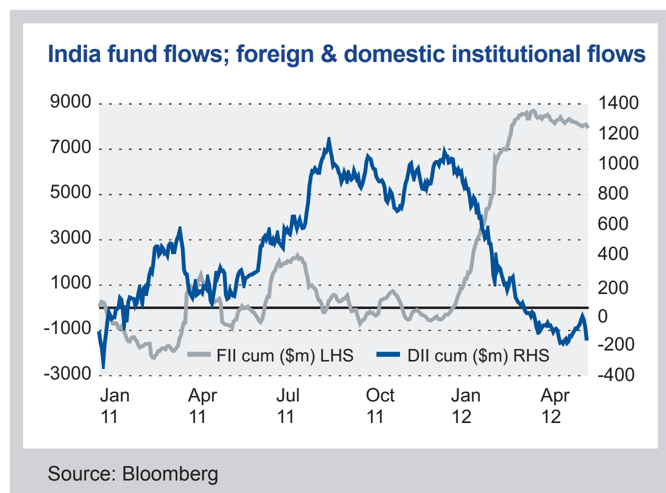
There are plenty of other reasons why the market is not attracting fresh money. "Risk assets" themselves are not in vogue given the European meltdown, and though the government in India would like to lay the blame squarely at the feet of Europe's politicians, the truth is that the mismanagement of the economy in India is the real cause. GDP growth continues to slow, as can be seen from the chart below. The 5.3% figure for Q4 2012 registers the lowest quarterly growth for nine years, with all components contributing to the weak number. Overall, FY12 grew at 6.5% and the outlook for the current financial year looks bleak at best with consensus forecasts at 6.5%.

Source: Bloomberg

Headline inflation is sticky and the imported cost component is rising as a result of a weaker Rupee. The high fiscal deficit will not improve unless growth in fiscal revenues pick up (not a realistic forecast) or expenditure cuts are made. Here there is some hope either through a reduction in the oil subsidy burden or a decline in other transfers to the poor, most probably in ways the central government does not have to share the benefits with the regional states. Given a lack of prior form though, the market needs to see signs of action rather than the succession of low expectations which so far, have consistently failed to be met.

The big unanswered question for us therefore is, given all the

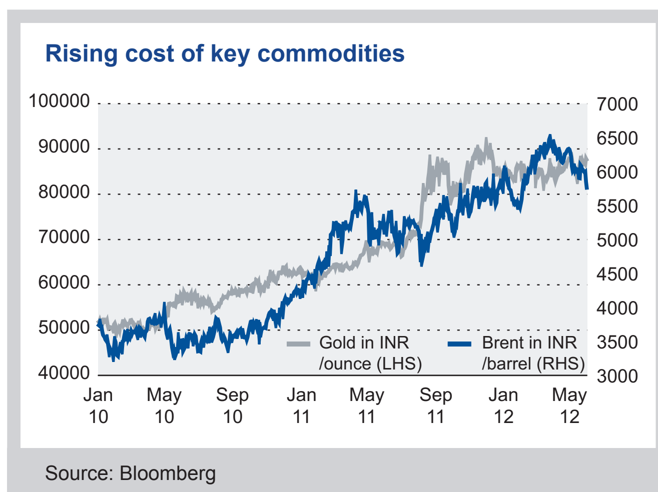
relentless negative news flow, how is it that investors haven't sold India? Since the beginning of May, USD235m has left India, whilst USD4.1bn of foreign institutional money has left Korea. So in spite of the terrible news flow that India has endured, the USD8bn that was sucked in via the LTRO-prompted liquidity rush at the end of 2011 has stayed put. We have scratched our heads but can find no convincing reason why this money hasn't departed from whence it came. We would be feeling happier if there had been some outflows as market sentiment is weak, the undertone is anxious and indices are still some way from the 2009 lows. Europe, as we are all aware could be on the brink of pulling markets much lower.



Source: Bloomberg

Looking ahead

We shall leave aside the question of Europe because there is no value to add in this report. Nevertheless one ought to mention that, in conversations with a number of current and prospective clients recently, many saw the Emerging Markets as a far better way of playing "better news in Europe" than by playing Europe itself, assuming that is the way the coin falls. The thinking was such that even if European politicians do come to their senses, the recession and the balance sheet deleveraging would not vanish, nor would the implementation risk of closer fiscal integration. Emerging Markets on the other hand, and in particular India, are a peripheral and better quality way of playing the "risk on" trade. India stands out from the pack in this regard because of the rolling over of raw material and oil prices, and its cheap valuations. The chart below shows the extent to which oil has fallen in local currency terms, and given global "headwinds", not least in China, it is possible to believe that these prices may continue to moderate, or even stop rising. The oil futures curve has also shifted from backwardation (USD100 at the short end, USD92, 5 years out) to almost flat across 5 years at USD85.



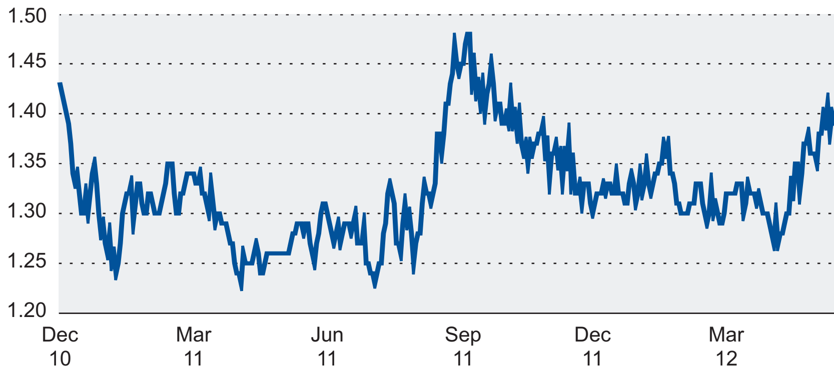
Source: Bloomberg

The reason we believe that oil is pivotal to the India investment argument is that a falling oil price is India's "get out of jail" free card. The fiscal deficit is largely a function of the high cost of imported oil, as is the current account, both of which have contributed to the weakness of the Rupee. The weak currency in turn is importing inflation, and that along with the high fiscal deficit is restricting the Reserve Bank of India (RBI) from looser monetary policy. So even without any real shift in government policy, (a negative factor well priced in), the macroeconomics can turn from a viscous circle into a virtuous cycle.

Recent comments from the RBI have already hinted that the oil price fall is increasing their options and allowing them a little more "wiggle room". This scenario would be a positive driver of equities in India, prompting upward revisions to earnings and a possible rerating as inflation fears eased at the margin. But it can only be a temporary relief for the market. The political agenda continues in its failure to deliver any boost to the business sector or to the market. There is lots of talk of renewed vigour within the bureaucracy, changes to the coalition makeup which might strengthen Congress' hand. Indeed diesel price deregulation and FDI in both aviation and multi format retail are returning to the headlines as a genuine possibility. This is just a half of what could be achieved, but as yet, nothing has come to fruition, and as such, we expect growth to weaken further from here as corporates remain on the back foot, consumers retrench and the government argues amongst itself.

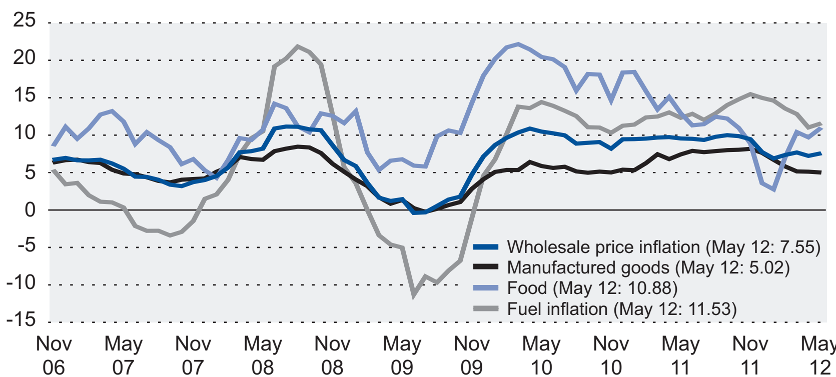
Macro overview

Charts and commentary



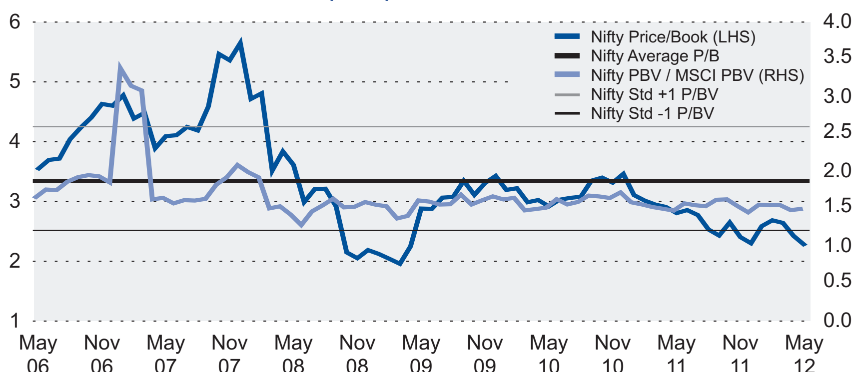
India has recovered some of its underperformance over Asian markets. The fall in global commodity prices, particularly crude and some stability to the Rupee at lower levels are key drivers behind the outperformance.

Source: Bloomberg



Inflation continues to remain above comfort levels, limiting the Central Bank's ability to lower rates. Food inflation has reversed from its declining trend and appears to be more structural in nature, while the recent increase in minimum support prices will put further pressure on food inflation. The commodity price decline is being partly offset by the Rupee depreciation.

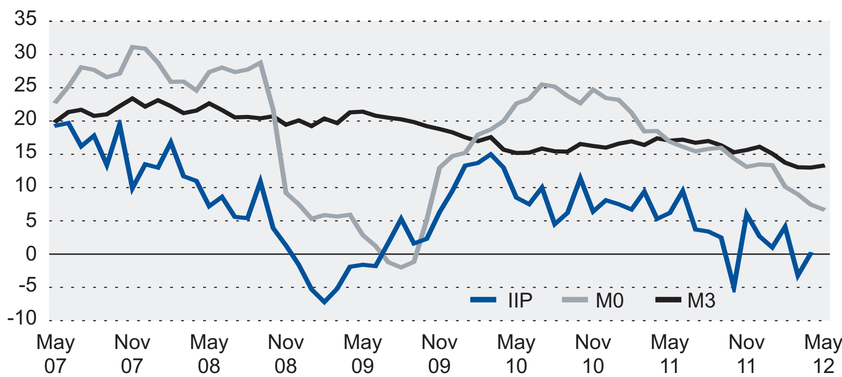
Source: Bloomberg



Trailing price to book multiple reflects an attractive entry point from a long term perspective. The current Indian multiple continues to be below its long term average, though still at a premium over other Emerging Markets (justified by higher, but declining ROEs and growth prospect)

Source: Bloomberg

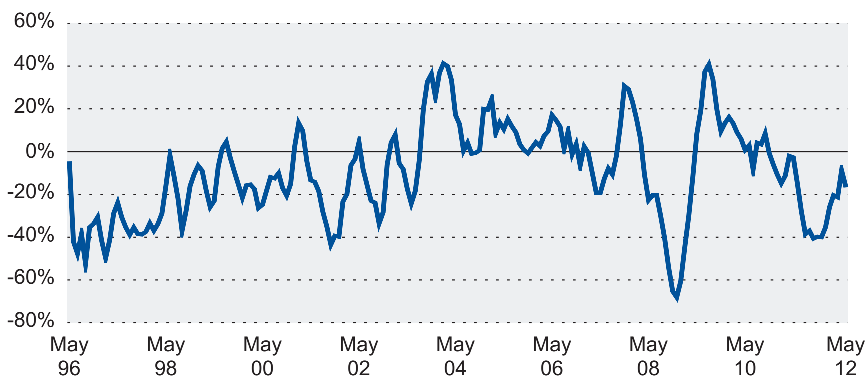
India's Index of Industrial Production (IIP), M0 and M3 (Money Supply)



The 'policy paralysis' of the central government is taking a toll on economic growth with IIP growth being close to zero for the month of April. Further, the declining liquidity trend continues in spite of the Central Bank's efforts to inject money in the system through Open Market Operations. The high inflation is eating away into the savings and leading to muted deposit growth.

Source: Bloomberg

MSCI India Earnings Revision Index



The pace of downgrades has reduced post the declaration of FY12 results for corporates, but absolutes are still negative. Upgrades would come only after some positive action from the government. We are still some way away from an upgrade cycle.

Source: Religare

Indian 10 Year Bond Yield

Yields are down from the recent peak following a rate cut in April 2012, but still remain sticky above 8%. The large fiscal deficit, coupled with few signs of inflation abating are likely to keep yield above 8% levels. Falling bond yields are essential for a revival of the capex cycle which is badly needed.

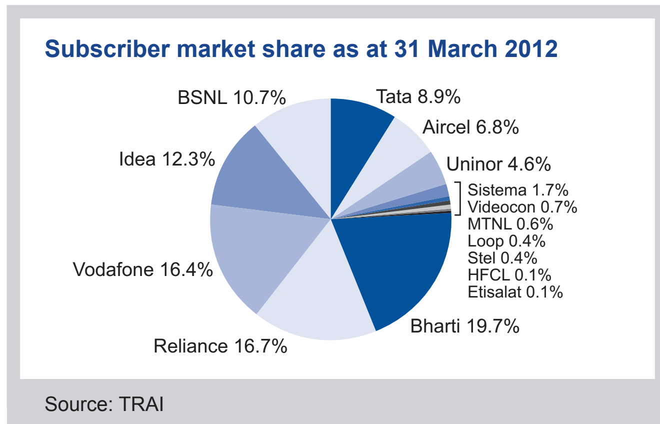
Source: Bloomberg

Sector in focus

Telecommunications

Any keen observer of India's economic woes and recent disappointing stock market performance will know that investor sentiment has been poisoned by relentless publicity around corruption at the highest echelons of politics, bureaucracy and industry. In the eye of the storm for the last 18 months or so has been the telecom sector. In 2011 it came to light that back in 2006, the then Telecom Minister and his cronies had been selling licences for 2G spectrum to the highest bidders on a first come first served basis at an estimated loss to the public purse of USD32bn. The aftershocks of this scam are still being felt as the Supreme Court has recently cancelled all these licenses and are forcing companies to rebid, most certainly at higher rates.

To add to the pain, the regulatory authorities are recommending that companies must re-bid for spectrum already acquired, as well as suggesting future spectrum costs (for 3G and 4G) should be sold at valuations on a per-subscriber basis, far in excess of global averages. To cap it all, this is an intensely competitive market with 15 players in the game, so pricing power is weak (India has the lowest calling charges in the world).



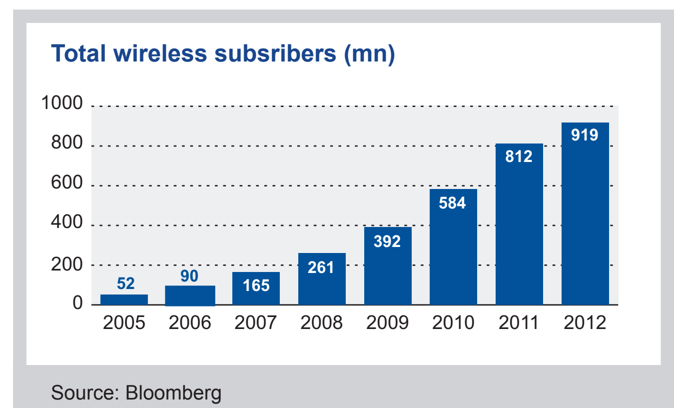
Source: TRAI

So is this all about to change, and if so what will it mean for the survivors?

It is important to take a step back and look at the industry potential and the opportunities for growth. After all, this storm will pass and not even the Indian authorities are likely to regulate the sector out of existence.

India is the third largest mobile telephony market in the world by volume of calls, and the sector has witnessed extraordinarily rapid growth in the last 10 years, with subscriber growth compounding at roughly 70% per annum.

The speed and scale to which these companies have had to grow to cope with insatiable demand is a real testament to the quality of the management of the leading players. Just think about the geographical spread and remoteness of the infrastructure that has been built: the advertising, the marketing and the billing systems that have been established in quick time. The delivery of a successful telecom platform for 900m subscribers in just ten years is a remarkable achievement. An added plus is that the quality of the technical equipment in India matches the best in the world, given how recent the scale up has been. At 74%, penetration levels are low by global standards, but in the rural areas of India it is just 37%. This suggests that handset growth and voice usage levels still have many years of growth to enjoy.



Source: Bloomberg

In developed markets we have become accustomed to the handset as being the delivery system for much of our day to day life, to such an extent that it has become our second skin. It is just a matter of time before it delivers similar levels of functionality to an Indian subscriber as it does to a Westerner.

The handset will be the way in which rural India connects to the outside world. Today data usage represents just 14% of service revenues for Indian telecom companies as opposed to 32% in China and 42% in Indonesia. The government too is recognising the importance of wireless communication in the delivery of e-health, e-education and other important services in its desire to build inclusive growth for all Indians. This suggests they understand that companies must be allowed to generate a reasonable return on their investment to be sufficiently incentivised to expand the reach of the network to all of India.

What is most exciting for us as investors in India is that as a result of all the corruption, mismanagement and excessive competition, wonderful buying opportunities are emerging. Some of the weaker players are packing up and going home, and so the market is beginning to consolidate, from 15 players to an estimated 6 or 7. Of those, it is already clear who the winners are likely to be. Although we have some time to wait before the regulatory fog clears, stock prices are already reflecting a lot of the pain.

Company in focus

Idea Cellular Ltd

Market capitalisation June 2012: INR245bn (USD4.3bn)

In India's rapidly growing, yet highly competitive telecom space, we believe Idea Cellular (Idea hereinafter) is one of the clear long term winners. Idea is also the only pure play India centric telecom company in the listed space.

With a subscriber base of 113 million (12% market share), Idea is India's fourth-largest mobile operator in number of subscribers, but the third largest by revenue market share at 15%. It is part of the Aditya Birla Group with 46% ownership and Axiata, Malaysia (the foreign partner has a 20% stake). Over the last four years, Idea has been the fastest growing Indian mobile operator, such that in FY12, its revenue growth of 26% was nearly double the wireless industry growth rate.

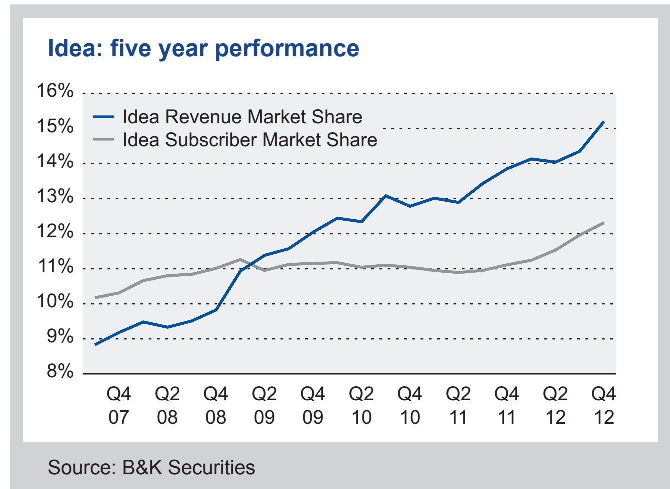
The telecom sector is the only sector in India which has achieved global scale – three of the top ten companies globally are Indian. With a population of 1.2bn people, India's wireless telecom subscriber base of 900mn is the second largest after China. Yet, this base grew at 20% in 2011 and we still see volume and pricing growth over the next decade. This is because the sector is being viewed, both as a necessity by users, and as a key infrastructure for integrating the economy.

In India telecom penetration is 74% (urban penetration 161%; rural penetration 37%). Idea has focused on rural India where penetration has been low. It has the highest Rural/Urban revenue subscriber mix at 52.9% compared to 40.6% for Bharti, India's largest telecom company. Thus Idea is a key beneficiary of rising rural incomes.

Though the telecom industry is highly competitive, only the top four private sector players (Bharti Airtel, Vodafone, Idea and Reliance Telecom) are profitable. Moreover, within these it is the first three which have the balance sheet strength to generate free cash flows.

Idea's performance over the last five years has been impressive. Not only has it consistently improved both its subscriber market share and revenue market share, but the quality of subscriber has also improved substantially. Its active subscriber base as a percentage of total subscribers is the best in the industry at 93% compared to 74% for the entire industry.

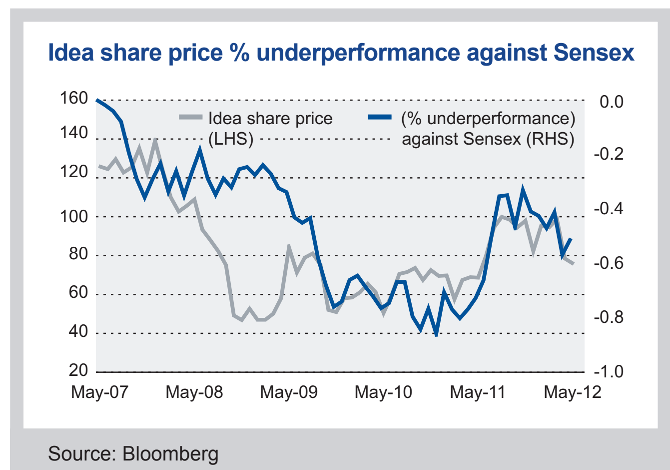
One of the key issues facing most companies in the telecom sector has been the high level of investment necessary to build scale. As a result leverage levels are high, and though the subscriber base is expanding, low tariff levels have led to extended break-even periods and constant cash burn. Idea has surpassed this phase. Its capex is declining and with revenue growth above industry average, operating leverage has begun to kick-in. After three years of declining margins, operating margins in FY12 increased 150bps to 26%, with significant scope for further expansion in the coming years. The company also turned free cash flow positive in the last quarter of FY12.



Source: B&K Securities

On account of the regulatory uncertainty, telecom stocks have taken a significant beating and are currently trading at a 20-30% discount to their last two year average EV/EBITDA, despite improving underlying business fundamentals. Idea is currently trading at 6.3x one year forward EV/EBITDA compared to a two year average of 8x.

While it is difficult to make a call on how regulations will pan out, we believe that Idea, with among the best business models and a strong management team, should emerge as one of the winners



Source: Bloomberg

Macro overview

Economic data

Change over	2009	2010	2011	2012	Last Qtr.	This Qtr.
Real GDP % annual change (FY)	6.7%	8.4%	8.4%	6.5%	5.3%	N.A
Avg. IIP % annual change (FY)*	2.9%	5.3%	8.3%	3.0%	2.6%	-1.6%**
Exports % annual change (FY)	14.0%	-4.0%	40.0%	21.0%	6.0%	-2.0%
Fiscal deficit % of GDP (Central Govt.) (FY)	6.0%	6.5%	4.9%	5.9%	Citi Est for FY13: 5.5%	
Inflation (WPI) monthly (avg.) (FY)	8.1%	3.9%	9.6%	8.8%	7.3%	7.5%
Inflation (CPI) (avg.) (FY)	9.1%	12.3%	10.5%	8.4%	6.5%	9.4%
Money supply (M3) (avg. (FY))	20.5%	19.4%	15.9%	15.9%	15.2%	13.3%
Interest rates (Repo) (avg.) (FY)	7.4%	4.8%	5.9%	8.0%	8.5%	8.2%
10 year GOI bond yield (avg.) (FY)	7.6%	7.2%	7.9%	8.4%	8.4%	8.5%
FII flows ($bn) (CY)	+17.6	+29.3	-0.6	+8.5	+7.1	+1.1
INR vs. USD (CY)	+3.7%	+4.0%	-18.9%	-5.9%	+6.2%	-15.3%
INR vs. GBP (CY)	-7.2%	+7.7%	-18.5%	-6.4%	+4.1%	-12.1%
MSCI GEM ($) (CY)	+74.0%	+16.0%	-20.0%	-1.0%	+16.3%	-16.0%
MSCI Asia ($) (CY)	+68.0%	+17.0%	-19.0%	+2.0%	+17.8%	-13.0%
Sensex (INR) (CY)	+81.0%	+17.0%	-25.0%	+5.0%	+10.1%	-8.6%
S&P India ($) (CY)	+73.0%	+17.0%	-41.0%	+2.0%	+21.1%	-22.3%
BSE Midcap (INR) (CY)	+108.0%	+16.0%	-34.0%	+15.0%	+13.5%	-7.5%

Last quarter: December 2011 - February 2012
This quarter: March - May 2012

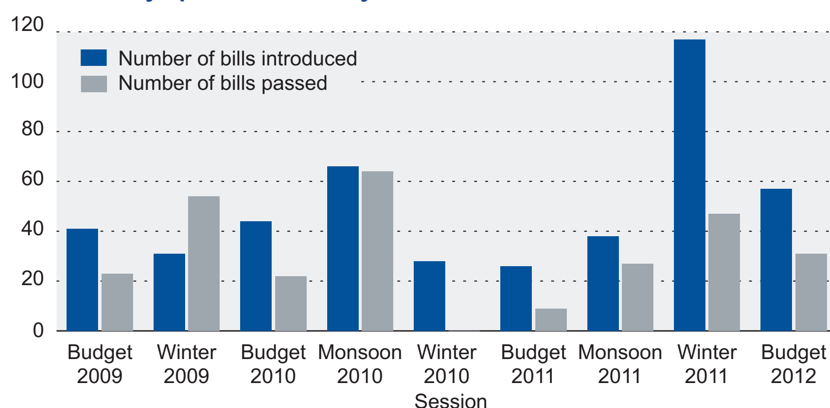
*New base 2004-05
**March - April

Macro overview

Events to watch out for

Event	Timeline	Comments
Parliament in Session	July-Aug 2012	This session will see the election of a new President of India for a period of 5 years (2012-2017). Following this, there is a possibility of a Cabinet reshuffle and a new Finance Minister. We expect government to speed up the pace of reforms and take key pending decisions on various sectors.
Petroleum products price hike	Post July 2012	Prices of administered products: diesel, LPG and kerosene are expected to be raised to rein in subsidy levels. While the crude price has fallen, sharp INR depreciation has reduced the positive effect of fall in crude by a significant margin.
Monetary policy	31st July 2012	RBI's focus on inflation and management of liquidity through OMOs means the interest rate cut will take effect once inflation falls significantly and there are some meaningful policy decisions by government to revive growth. While RBI has acknowledged growth slowdown, it believes that interest rates are not the source of the problem.
Disinvestment	April 12 - March 13	The government is planning to raise USD6bn through sale of 15 public sector units in FY13. However, looking at the past records in last few years, the figure looks an ambitious target.
Regulation for FIIs in the fixed income markets	CY 2012	We continue to expect further liberalisation of the fixed income markets over the year as the government is keen to diversify its revenue raising sources. This will underpin the currency and support markets.
Monsoon progress	June - Sept 12	Weak pre-monsoon rains have depleted the water resources at reservoir level (18% vs. 24% last year). The start to the monsoon in key agri-states has been weak as well, prompting a delay in agri sowing, thus affecting crop production. The Meteorological Department has however predicted a normal rainfall this year.

Parliamentary speed and activity



Source: PRS legislative Research

General information

The Company

Ocean Dial Asset Management Limited is a London based and FSA regulated fund management business whose primary focus is on India. The fund management team in London is supported by a well knit and experienced group of professionals at Ocean Dial Advisers Private Limited, Mumbai who provide analytical research and non-binding investment advice.

The Principal Advisor

David Cornell joined the Group in January 2010, initially in London, and is now resident in Mumbai. 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.

Fund performance

Ocean Dial Asset Management Limited is the manager of India Capital Growth Fund Limited. For specific detail on the fund please refer to the website www.indiacapitalgrowth.com.

Contact details

Amul Pandya
Sales & Marketing Manager

Ocean Dial Asset Management Limited
Cayzer House, 30 Buckingham Gate, London, SW1E 6NN

D +44 20 7802 8907
M +44 7554 000 201

Email amulp@oceandial.com
Twitter @OceanDial

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Ocean Dial Asset Management Limited
Cayzer House, 30 Buckingham Gate, London SW1E 6NN

T +44 20 7802 8900
F +44 20 7802 8909

www.oceandial.com