

RECENT DEVELOPMENTS IN INDIA AND FUTURE EXPECTATIONS

What's changed?

- i. After a two year hiatus, the government has recently announced some capital market friendly reforms.
- ii. The immediate threat of a sovereign downgrade, provoking a further collapse in the Indian Rupee (INR) appears to have passed, although it is not off the table.
- iii. Asset quality concerns in the banking sector have eased, though problems remain.
- iv. Analysts' downgrades of corporate earnings have stopped after 20 months.
- v. Concerns regarding additional inflation arising from a poor monsoon have dissipated.

The impact has been impressive with the market hitting a 17 month high and the currency rallying hard. Citigroup forecasts an overshoot to INR48 to USD1, based on certain assumptions.

The shift in sentiment has come from a slew of "reform" announcements.

- i. FDI limits raised in retail and aviation, with the expectation of more to come (insurance, pensions).
- ii. A reduction in the subsidy on diesel and a cap on subsidised LPG gas eased concerns over the rising fiscal deficit.
- iii. Restructuring of the State Electricity Boards' balance sheets, easing pressure on the banking sector's non-performing loans.
- iv. Capital market and tax reforms encouraging further foreign fund flows into both debt and equity.

How has the government achieved this after 2 years of policy stagnation?

- i. They have neutralised troublesome coalition partners who were disrupting progress.
- ii. The government had its back against the wall, with the prime minister coming under direct attack as being ineffective even by the international press.
- iii. All political parties and corporate India's interests appear to be aligned as the campaign to replenish political party election coffers gets underway. This is a typical pre-election cycle.

What is next? We think further policy momentum by the government is possible.

- i. A renewed commitment to fiscal reform (both on the revenue and expenditure sides).
- ii. An attempt to divest public sector assets (circa USD10bn), buoyed by a resurgent stock market.
- iii. Efforts to stimulate GDP growth by fast tracking a mass of delayed projects and kick starting the investment cycle.
- iv. An easing cycle, as inflation finally moderates.
- v. Further capital market and tax reforms.

If upheld, the market has reached an inflection point, further gains are likely. Also;

- i. In India there is a high correlation between a rising market and a pickup in fixed capital formation.
- ii. There is historically only a 3-6 month time lag between the market's recovery and renewed private sector capex. If this correlation reoccurs, it will lead to earnings upgrades and a re-rating story.
- iii. Subdued global oil and hard commodity prices, combined with a stable (or stronger) FX will impact corporate profitability positively, as the benefit of fixed price contracts come into play.
- iv. Lower rates will take further pressure off the banks and encourage fresh investment.

Risks to the downside;

- i. If the momentum diminishes the glow may fade rapidly. Recent reforms do not address the bottlenecks which have impacted the investment cycle and caused the earnings slowdown.
- ii. Time is limited. October is the window of opportunity before the state election cycle gets underway and parliament reconvenes.

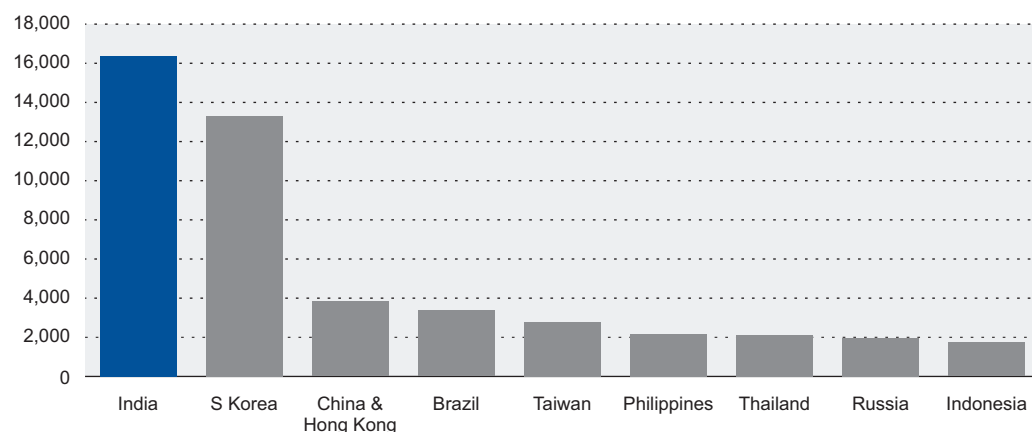
RECENT DEVELOPMENTS IN INDIA AND FUTURE EXPECTATIONS (CONTINUED)

- iii. So called “big bang” reforms such as land acquisition laws, labour reform, and service tax overhaul may fail to pass in the next session, causing a sentiment setback.
- iv. Corporate India’s confidence is fundamental to restarting an investment cycle; all are waiting and watching currently; easier credit will not be enough.
- v. The political scales are balanced currently but the equilibrium is so poised that sentiment can easily reverse.
- vi. The 2014 election cycle is imminent with a predictable market assessment of the negative consequences.
- vii. The market has run ahead of itself in the short term and India is still trapped in a high inflation, low growth environment with an ineffective and corrupt government.
- viii. Alongside the public sector sale of assets, there is a vast pipeline of private sector equity raising which the market will need to absorb.

Risks to the upside;

- i. Despite recent fund flows (see chart below), investor sentiment (hence allocation) remains low.
- ii. Recent strong performance will force global investors to re-assess this market and if it continues upwards they will be forced in. Anecdotally Ocean Dial is seeing a lot of interest.
- iii. The same applies to local investors who have been consistent sellers and are underperforming.
- iv. GDP growth may have bottomed and the interest rate cycle may have peaked.
- v. Minority governments in India have historically had a good track record on reform.
- vi. Market is expensive but on depressed earnings. An upgrade cycle will fuel a lower multiple and a re-rating; a double kicker.
- vii. QE in the West will continue to drive risk appetite. India is the market to play currently.
- viii. Potential upside:
 - a. If one was to attribute a 17x (average multiple over medium term) to the market;
 - b. Factor in earnings growth of just 9% for next year;
 - c. There is over 20% upside from current levels, excluding any further currency appreciation or possible upgrades.

YTD (30 September) Foreign Institutional Investments in Equities (USDm net)



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