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.

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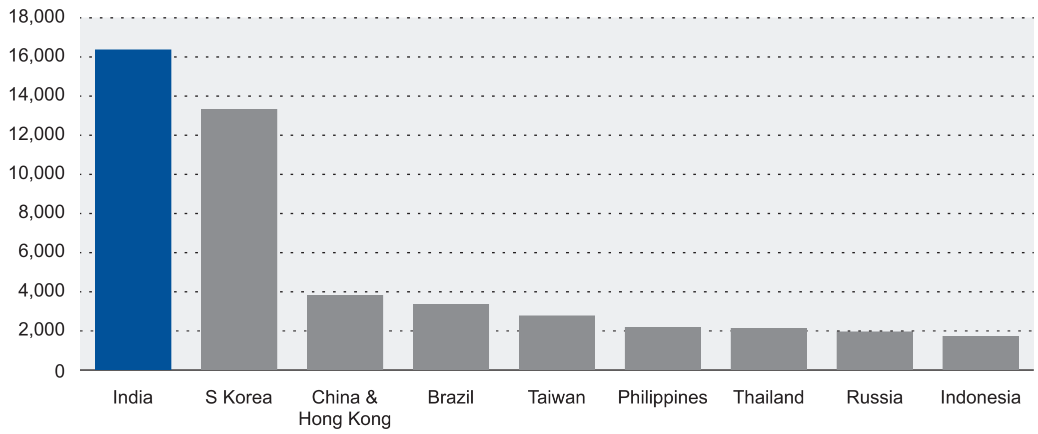
RECENT DEVELOPMENTS IN INDIA AND FUTURE EXPECTATIONS (CONTINUED)

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 rerating; 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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