INDIA – SCORING SINGLES ON A TRICKY PITCH

As we bring 2015 to a close Global Emerging Markets (GEM) find themselves under intense pressure. Battered from the West by uncertainty surrounding the impact of rate hikes in the United States, from the East by ongoing weakness in Chinese output and the concomitant pressure bearing down on the Renminbi, from the South by sense of impending doom that hangs over Brazil, and the potential contagion risks that might ensue. At the heart of the storm is ongoing weakness in oil and commodity prices, as investors grapple with this either as a function of weakening global demand or years of excess supply compounded by technologically driven improvements in oil extraction. At the risk of sounding ever more clichéd, these are tough times indeed. Caught up in this perfect storm but to an extent less directly impacted, sits India.

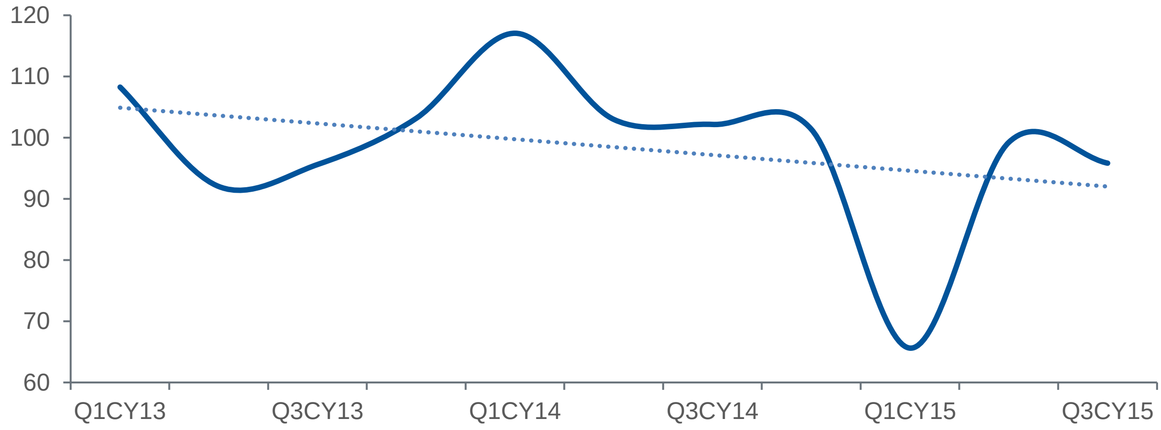
Ocean Dial's recent week long investor trip to India crossed three cities, meeting with senior management of listed and unlisted companies (including one plant visit), senior bureaucrats across various Ministries and several journalists and news editors. The notes below highlight details of all the issues raised, but the overriding conclusion drawn from the meetings is that India is on a path to change. That path is not straight, nor easy to navigate, but it's there nonetheless, and evidence is visible on multiple fronts. This reform agenda, combined with political stability and an economy that benefits from the ongoing shift in the global terms of trade give the market an edge over a broad range of alternatives.

Barring any global shocks we continue to argue that the downside risk is limited. This is owing to strong macro-economic outlook for the country, high real interest rates (encouraging savings into financial assets and stability in the currency) and the expectation of reform orientated growth. Upside risk looks greater in our view. The poor sentiment surrounding Emerging Markets is predicated on weak Chinese growth, soft oil and commodity prices and a stronger US Dollar as the US Fed normalises rates. India is a beneficiary of lower commodities and is not materially affected by China's near term growth outlook. On the latter point we ascribe to the view that the tightening process in the States will be measured, and to a larger extent has already been factored into the dollar through steady appreciation over a basket of emerging market currencies over the last two years. We believe this paves the way for some relief to GEM equities in the aftermath of a Fed hike. In that case, the upward trend in Indian equities should reassert itself as investors opt for quality over value within the asset class, and the time effect of 12 months of sideways trading falls out of the current steep valuations. India currently has the former "in spades". The market's strong relative performance throughout this tumultuous period for GEM equities is testament to that. In addition, domestic sentiment is just too bearish. This is in part to do with global issues, but also over the market's frustration over Modi's ability to deliver on reform, and the lack of visibility on a recovery in corporate earnings. Recent meetings in India point to plenty of encouraging signs, detailed in this report.

Earnings; stuck in a rut

There has been little to cheer about in recent months with investor concern mounting across a variety of market sensitive issues. The ongoing insipid performance of corporate earnings and specifically in sectors related to the global economy has caused further downgrades in cyclical sectors; particularly in commodity related sectors such as steel, cement, base metals, plus oil and gas and index heavyweight Tata Motors in particular, whose business is significantly exposed to China. On the one hand although India's economy is relatively well protected from these shifting global sands (due to a heavy domestic bias to its GDP makeup), the main board index constituents are overly weighted towards companies which generate earnings offshore, thereby over emphasising the negative impact.

Chart 1: NSE 50 aggregate EPS Q1CY13 – Q3CY15

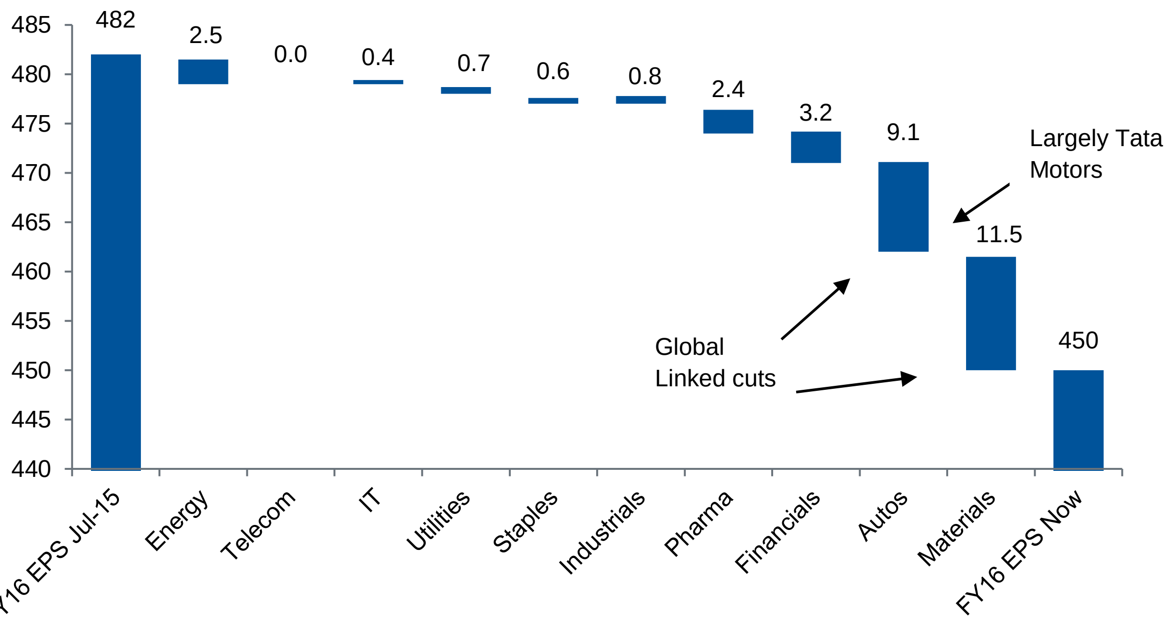


Source: Credit Suisse

Note; In Q1CY15 (last quarter FY15), there were two big exceptional items in metals companies Vedanta and Tata Steel

This is concealing a more resilient domestic economy (itself of greater significance to the overall India investment argument) which, though not yet firing on all cylinders remains robust both on a standalone basis and relative to the peer group.

Chart 2: Change in FY16 Nifty EPS since July 2015



Source: Credit Suisse

Banking Sector under pressure

Here too however the situation is not stress-free, not only as a consequence of renewed global uncertainties, but also due to the extent of the vast economic overhaul currently in train, the first round effects of which will not necessarily be positive. As recent meetings in Mumbai confirmed, concern is in the banking sector where credit quality shows little sign of improvement and the pressure on banks' balance sheets in relation to poor asset quality may yet worsen, in part, due to these global issues but also as a consequence of well documented infrastructure woes. The majority of the stress lies with the public sector banks that face the twin hurdles of absorbing heavy loan losses and the additional Basel 3 capital requirements, whilst also acting as the principal credit conduit of the economy. These glitches are causing short term headwinds to growth via a subdued credit channel and longer term concerns over the banks' ability to finance India's future growth at full potential. However, there is a commitment (already underway) to refinance those PSU Banks that are considered "worth saving", in tandem with the selective introduction of private sector professionals at the highest level to implement structural change. Additionally a proposal has been tabled to transfer the debts of the State Electricity Boards (SEBs) from the public sector banks to State Governments' balance sheets thereby removing a substantial portion of banks' bad loans, and thus easing lending constraints. Easing the financial stress will enable SEBs to purchase power from the generating companies sufficient to meet demand rather than pure affordability, or rather lack of it.

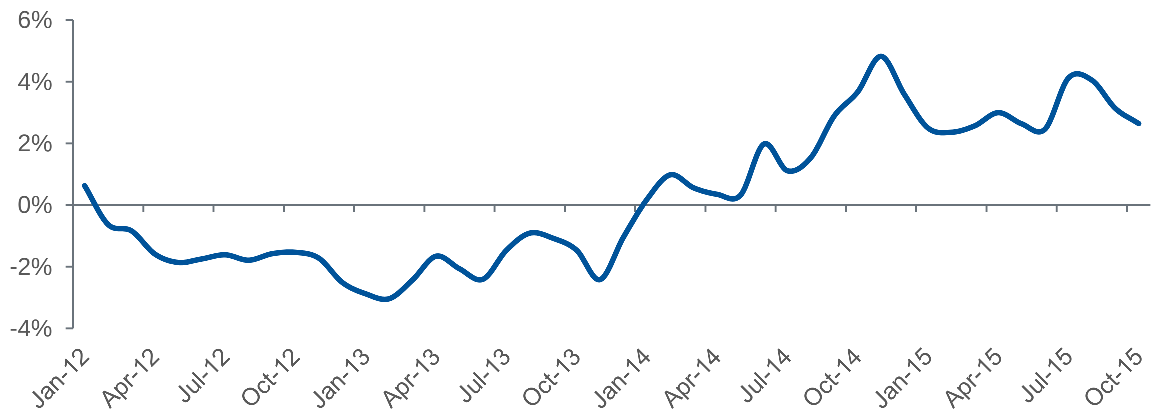
New channels to fund Infrastructure

In tandem with the RBI, civil servants have been actively pursuing alternative channels to facilitate financing of the infrastructure sector. A National Infrastructure Fund has been established in which the Government will take a 49% equity stake with the intention to provide longer term funding for key infrastructure assets. The first raise target is $US7bn with the balance expected from Sovereign Wealth Funds and global Pension Funds. Though the initial quantum isn't earth shattering, this is a major "step up" to the extent that the bureaucracy is creating practical solutions to address the shortfall in infrastructure investment. Elsewhere the Government has sanctioned the raising of Rupee denominated bonds offshore for certain public sector companies such as Railways Corporation of India, introducing a deeper funding avenue for Indian infrastructure.

High real rates hampering the recovery

Despite lower nominal interest rates, lower fuel prices and (seemingly) robust consumer confidence, signs of a recovery in either consumption or manufacturing are fragile. Domestic facing companies are experiencing lacklustre revenue growth, part whittled away by deflationary pressure, part by excess manufacturing capacity (Chinese dumping steel) and part by the weak consumption activity in tandem with high real rates. Although nominal interest rates have been lowered (now at 6.75%), real interest rates remain high for a country where GDP growth has slowed so dramatically. In our meeting with the Reserve Bank, although officials stressed an unwillingness to give up easily on the inflation battle so ably won, the Governor's recent rhetoric points to a "growth bias" and thus we do expect nominal rates to fall further, providing additional support. Positive real interest rates in the region of 1.5% - 2% are the likely target.

Chart 3: India 10 year G-Sec real yield



Source: Bloomberg

Leading economic indicators suggest signs of a recovery. IIP growth in October 2015 was recorded at 9.8% year over year as against 3.8% in September 2015. The strong growth is largely accounted for by the low base effect of last year's negative number as IIP growth in October 2014 was recorded at a 30-month low of -2.7% year over year, but it is encouraging to see strong growth in capital goods output pointing towards a recovery in overall investment. There will be a correction in November's data, but the aggregation of two month's data should confirm a modest economic recovery is underway.

In an extended meeting with Bharat Forge (core business manufacturing auto components for domestic and export markets) senior management confirmed the plant was operating at just 65% capacity utilisation due to sluggish demand across the group. Nevertheless they were clearly upbeat about the future, anticipating a meaningful recovery in domestic demand for which they expressed full commitment. Subsequently we learnt on the grapevine that a UK based manufacturer of heavy plant machinery for construction (40% of global revenues from India) has experienced "blow out" sales numbers in October and November, and are now, internally at least, calling this the turning point in India. Interestingly this good news out of India is not being replicated in other Asian economies (for them at least) where we understand that sales continue to deteriorate at an alarming rate.

Supply side reform in Agriculture and Consumer banking

For the rural consumer times have become harder. Their wallet is no longer replete with hand-outs from the Government and this, combined with consecutive Monsoon disappointments, has resulted in weak spending; we are cautious of an imminent recovery here, but are monitoring efforts by the Government to improve supply side constraints. Focused attention has been on attacking the cartelisation of food stocks, removing minimum support prices, and re-setting the clearing mechanism away from the controlled market towards demand/supply dynamics. We understand that this is already changing the planting programmes of farmers wishing to benefit from free market pricing. The 7th Pay Commission's[1] recent confirmation of a 24% increase in salaries for the public sector will bring a genuine boost to urban based consumption, and bodes well for companies with appropriate exposure. And whilst this is good news on one hand, it has at the same time raised the eyebrows of the economic wonks that highlight a likely 0.65% impact on the fiscal deficit for next year, and question the Government's ability to stick to its deficit target whilst maintaining "pump priming" policies. In far reaching efforts to lower the cost of capital, the RBI has recently issued 21 new banking licences, (a big "step up" from the eleven licences issued between 1989 and 2005[2]), boosting "financial inclusion", and a crucial pillar of Modi's strategy to raise economic output at the base of the pyramid. New licence holders will be a combination of "payment banks" and small "finance" banks. The former will team up with telecom providers, technology partners, and large conglomerates to collect deposits (no loans sanctioned currently), whilst the latter will function along similar lines to the commercial banks but with conditions imposed on loan size and exposure limits, designed to cater to small business in rural and urban India. Both will use top notch technology to reach out to a broader customer base, extending the bankable base, disrupting the dominance of the traditional banking model, and lowering the cost of capital for SMEs. 99% of India now has access to a bank account which will stimulate growth over time.

Political news flow is expected to recover. State level reform momentum is building

The disappointing economic and corporate performance this year has been mirrored by political frustrations. Modi remains in transition mode from Chief Minister to Prime Minister, or as one informed critic explained, "Modi is stepping up from CEO of an SME to CEO of an MNC". Top of the list of objections is the thumping defeat the BJP took in Bihar's State elections. Theories abound as to the cause, but the reality was that the opposition successfully held together a coalition which made winning as a single party hard. Although Modi's party won the largest number of votes and with increased share,

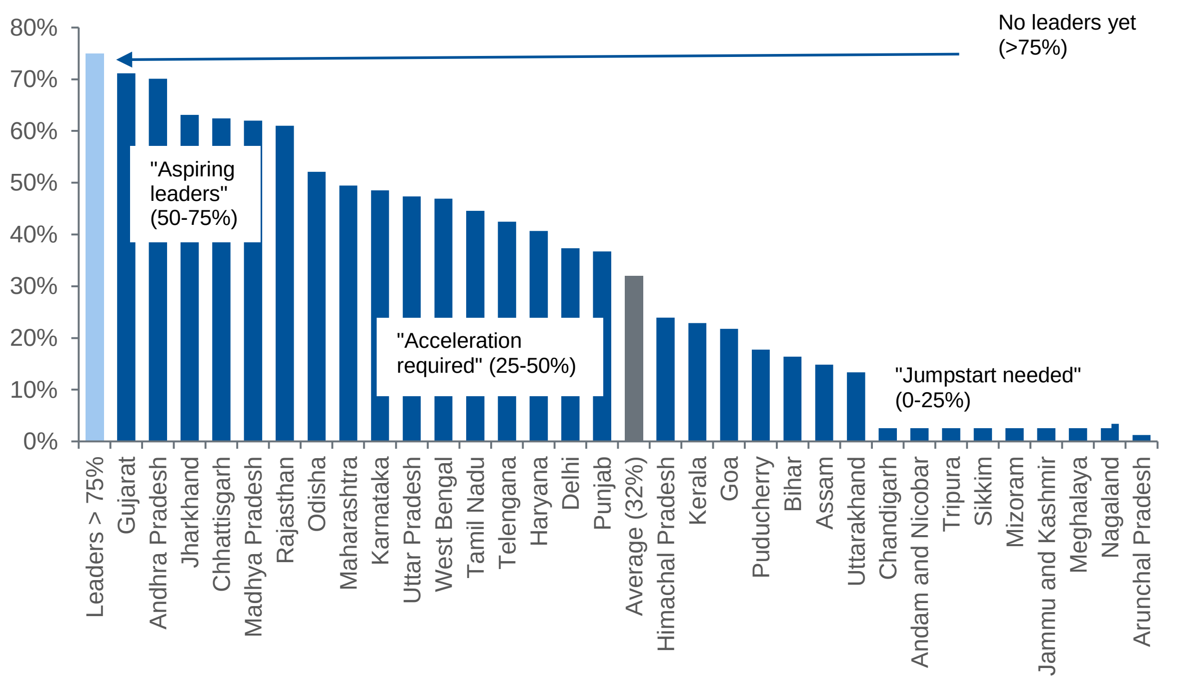
[1] Source: http://www.oneindia.com/feature/seventh-pay-commission-salary-hike-govt-employees-know-all-about-pay-commissions-1861371.html

[2] Source: Batlivala & Karani Securities India Pvt. Ltd.

was not enough. The Government will need to figure out a way of combatting this threat in the future, especially with more economically relevant State elections due in 2016. The leadership responded quickly to this defeat, reinforcing its narrative on economic reform by announcing an increase in foreign direct investment limits in 15 sectors and reiterating its intention to work with the Congress Party to ensure the Winter Session of Parliament is productive. This is a controversial topic. It has been well documented that Modi's Government has failed to deliver much on headline reform, particularly the passage of the Goods and Services Tax Bill, badly damaging investor confidence. His acolytes are quick to blame the Congress Party for pursuing obstructive politics, in part true, but this is a fruitless argument however as India's political process does not yet differentiate between issues of national importance and parochial politics; in opposition the BJP were no better. Modi has grasped this constraint and is working around it to keep the reform agenda on track. Thus in more progressive States, laws concerning labour, land and tax reform are bypassing Federal legislation, allowing Chief Ministers (CMs) to pursue their own reform agendas with the approval of the Government in Delhi. To build on this momentum a "98 point plan" to improve the "ease of doing business" at State level has been published by the Centre[3] with World Bank support. This provides input for CM's on concerted action required to encourage business to operate under easier conditions. This programme has gained traction in the last twelve months thanks to the political commitment of State and Central bureaucrats working in tandem. Reforms relate to starting a business, resolving insolvency, enforcing contracts and trading across borders. Streamlining technology to process online payments for taxes, self-certification, and environmental clearance have also been included. The first set of results, covering the period January to June 2015, has been released, ranking States by their success so far. Quoting from the World Bank report;

"The results of the assessment indicate that the States have wholeheartedly embraced the challenge placed upon them to focus on further streamlining the regulatory burden on business in India. The study provides a good benchmark for initiating work towards facilitating ease of doing business."

Chart 4: State level ease of doing business performance



Source: Government of India

[3] Source: http://www.doingbusiness.org/Reports/Subnational-Reports/~/media/giawb/doing%20business/documents/profiles/country/IND.pdf

This initiative should be highly effective. Public naming and shaming is already forcing better performance. Successful reform in one State can quickly be adopted in another, whilst the competitive intensity will raise the bar for all. Local TV and print media have seen a significant spike in the demand for advertising capacity from State Governments wishing to attract more business. The real winner is Modi, as the sum of the improved parts should catapult India up the World Bank's country wide "ease of doing business index" which by itself will rebuild investor confidence in India. For all this, the PM can take the credit. But despite finding ways to work around obstructive politics, Parliament must be made to function better, and BJP's tactic to date of riding roughshod over the Congress Party has failed. A more inclusive approach is required and the current Winter Session of Parliament will be a test to see if the BJP can adopt a more conciliatory approach. Both the GST Bill and the Bankruptcy Bill are in play, and both outcomes will be important drivers of sentiment for the market. "Backroom news" on GST is encouraging insomuch that Modi recently met with Sonia and Rahul suggesting compromises are being made on both sides to ensure safe passage, though it is wise to remain sceptical on this issue. The Bankruptcy Bill should also pass, and this too will be a big step forward. Loosely based on US Chapter 11 it will hand more power to the Banks to foreclose, it will enable banks to exchange debt for equity stakes in failing businesses, and will ensure India entrepreneurs of questionable integrity are not easily let off the hook. Successful passage into law will encourage future potential investors to consider India as a credible investment destination.

The market has sobered up as investors' expectations retune to disappointing headline news and relentless pressure on the broader emerging market asset class. We have long argued that progress on reform will never happen at the pace investors expect, nor will it happen in boxes that the market can readily tick, particularly in the current global climate; 2015 has demonstrated this amply. Stepping back from market noise and reflecting on the leanings of this recent trip a couple of key issues have become clear. Firstly, India's leaders have acknowledged the country has long lagged its Asian peers on economic reform, and the process of addressing these legacy issues is underway; the signs are promising. No longer is the onset of a crisis required to stimulate innovative and productive policy. In Modi and Rajan India has leadership that demonstrates a strong instinct for development whilst displaying sufficient will to enforce structural change. More importantly perhaps is the realisation that success is no longer solely dependent on those at the top of the tree. Political leadership at a State level is gaining the confidence to enforce change at lower levels which is vital to deliver more consistent growth across a broader base. There is enough positive data to suggest a narrow economic recovery is underway and this, combined with the steady progress on reform augurs well for future stock market returns.

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2015 – A SNAPSHOT

January	RBI cut interest rates for first time under Rajan. 100bps cut to 6.75% since then
February	Transparent *e-auction* of 15 coal blocks. ~US$1bn across 29 mines raised to date
	Government's first full Budget (click for note outlining reforms here)
March	Insurance Bill increasing FDI limit in insurance to 49% passed
	Mines and Minerals Amendment Bill and Coal Bill passed
	2015 telecom spectrum auctioned raising a record US$18bn
April	Indian Revenue Service claims for a retrospective imposition of MAT
May	Form for the incorporation of a new company reduced from eight pages to one
June	E-Tourist Visa on Arrival extended to 113 countries (including UK)
	RBI empowered banks to take 51% stake in companies with serial NPAs
July	US$11bn capital infusion to PSU banks
August	Finance Ministry accepted Shah Committee report to drop MAT claim
	Foxconn committed US$5bn of FDI, aims to employ 1m Indians by 2020
September	India revealed as highest recipient of FDI in H1 ahead of China (source pg 5)
	RBI issued 10 small finance banks licences, 21 licences issued since April 2014
	Financial Inclusion drive 1 year in; 185m new bank accounts, US$3.7bn deposits
October	BJP resoundingly loses Bihar state election against the *Grand Alliance*
	Vodafone successful in Bombay High Court case, tax authorities have not appealed
November	US$2.6bn tie-up; GE / Indian Railways, includes a new plant facility in Bihar
	The 7th Pay Commission announced an overall increase in public sector pay of 23.6%
December	Japan announced US$15bn project for Mumbai - Ahmedabad bullet rail link

TO WATCH OUT FOR IN EARLY 2016

MPC	Final RBI meeting for FY16 is due on 2 February. Subsequent dates to be confirmed
Parliament	Budget Session usually sits from the end of February to the start of May
Budget	Traditionally delivered by the Finance Minister on the last Saturday of February
Elections	Five state elections due in May - June; Tamil Nadu, West Bengal, Kerala, Puducherry, Assam