India as the Cycle Turns

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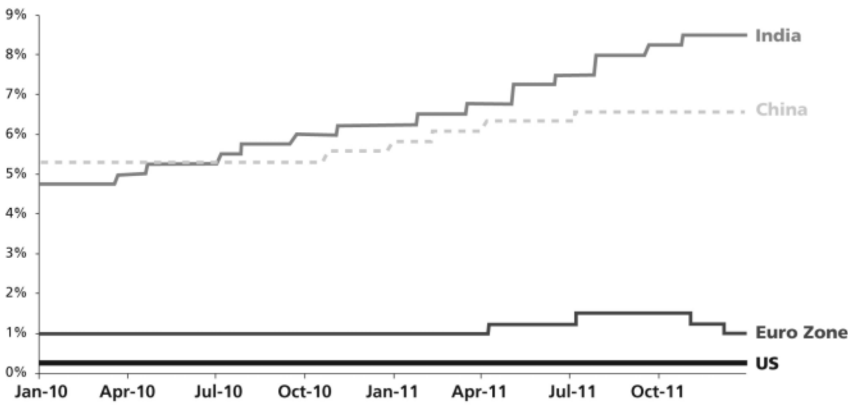
Figure 1 **Policy Rate Movements**

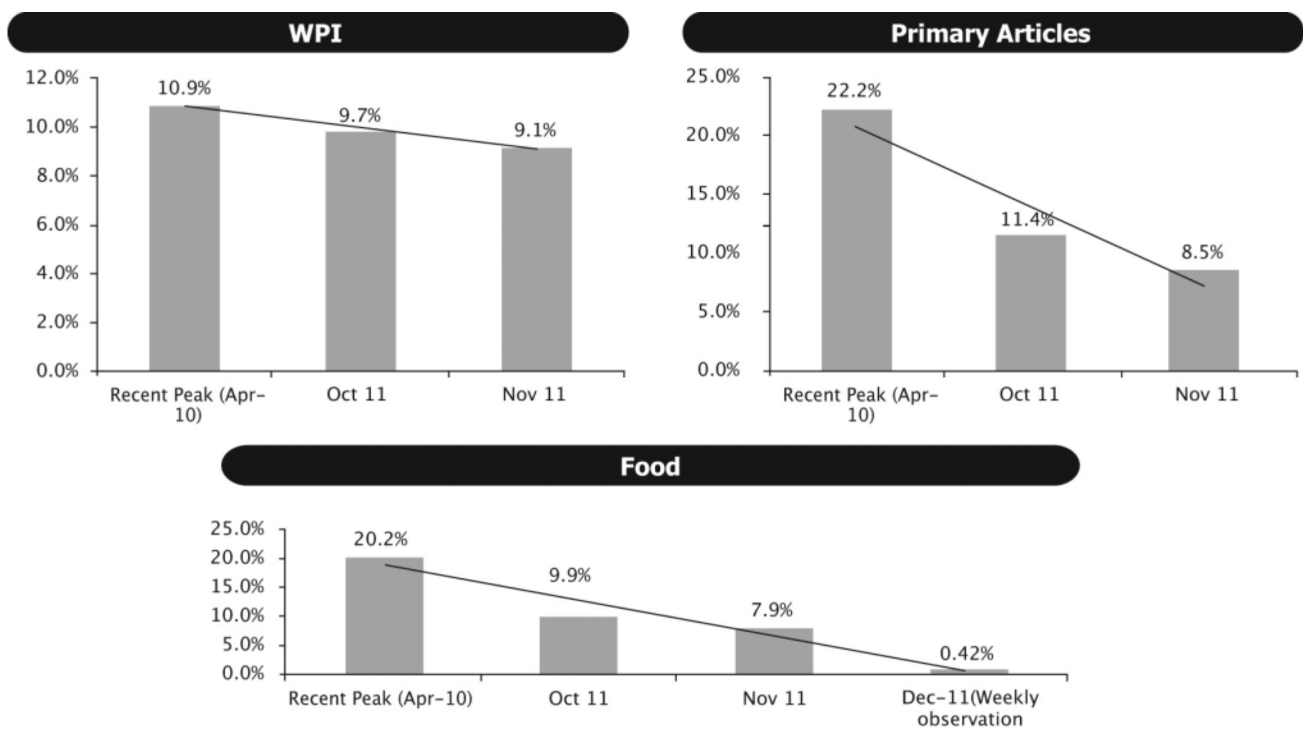


Source: Bloomberg

Tight money is tough medicine. The RBI, India's central bank, has raised rates thirteen times in the past 24 months to combat inflation –a total of 425 bps, the most aggressive move of any monetary authority in the world, including China's [Figure 1]. While this leaves India well positioned if a global crisis hits, it has had the unpleasant (though expected and desired) impact of slowing economic growth. In 2010, real GDP growth was 9.4%, while consensus expectations are down to about 7% for the current financial year. Expansion in credit moderated to 18% and corporate earnings grew at an annualized rate of 12% in the most recent quarter, down from projections of 17% at the start of the year. The economic impact has spilled over into the political realm, with widespread criticism of the government and street protests against corruption.

Against this backdrop, 2011 was a very painful year for the Indian equity market. The large cap index fell 25% and the sharp depreciation of the rupee toward the end of the year left the Sensex down nearly 40% in U.S. dollar terms.

Figure 2 **Indian Inflation Rates**



Source: Office of the Economic Adviser

INFLATION AND THE TURNING OF THE RATE CYCLE

So, what is the state of the Indian market as we enter 2012? Elevated inflation, the cause of the RBI's rate hikes and a prominent source of investor concern, is now easing [Figure 2]. Wholesale inflation had hovered around 10% for most of 2010 and 2011, but fell to 9.1% in November, down 72 bps from the previous month. Inflation in primary articles fell to 8.5%, a fall of 300bps from the prior month and far off from peak levels of 20%. Particularly important from an economic and political perspective, food inflation, which had been as high as 20%, has fallen to a four-year low of 0.42%. Manufacturing activity has been promising — the December 2011 PMI came in at 54.2, the highest level since June and the sharpest monthly rise since April 2009.

Falling inflation will allow the central bank to ease interest rates in the months ahead. The RBI's most recent policy review said that "from this point on, monetary policy actions are likely to reverse the cycle". This is as clear a forward looking statement as a central bank will ordinarily give, but RBI Governor Mr. D. Subbarao dispelled any doubt in a follow-up interview saying, "from here on, we could expect [a] reversal of monetary tightening… the balance between growth and inflation will shift in 2012."

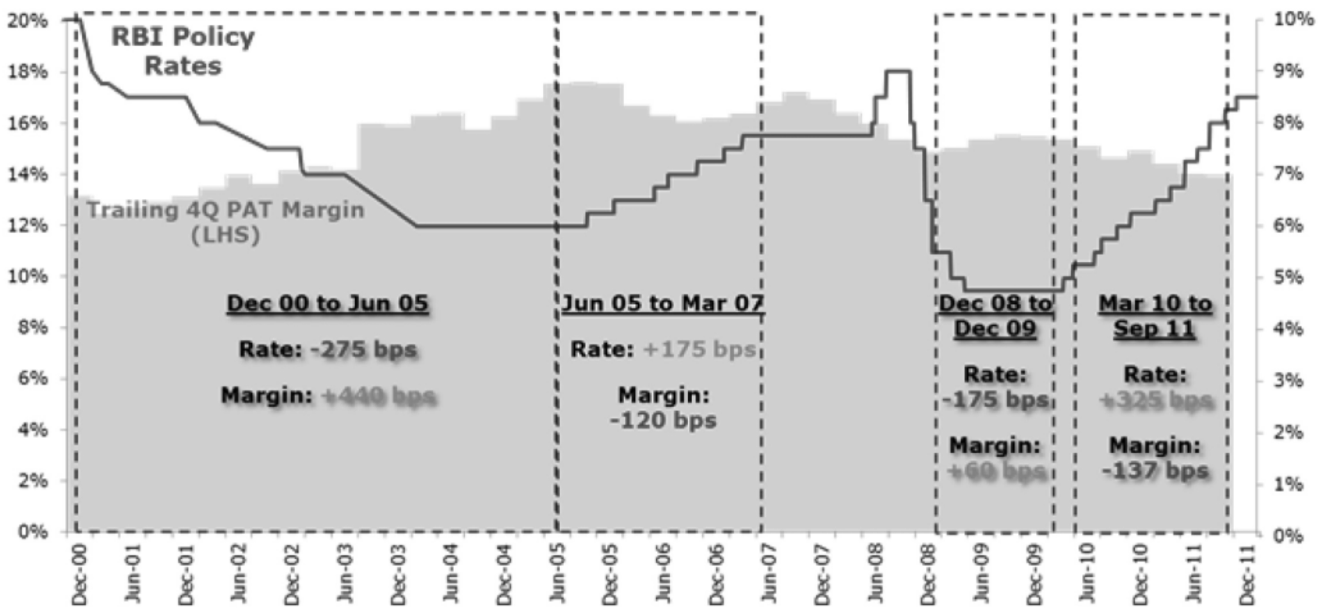
While falling rates could trigger capital outflows and a weakening of the rupee, a number of factors suggest that this is unlikely to be the case in India. There's relatively little danger of hot money capital outflows on account of lower yields since foreign inflows into the equity and debt markets have been muted in recent months: There was $8B in net foreign investment into the equity and debt market in 2011 compared to a combined $39B in 2010. More broadly, the slowing pace of India's economic growth is already well understood by the market and a turn in the rate cycle is unlikely to be interpreted as a bellwether of economic weakness.

The immediate positive impact of lowered interest rates will be towards boosting growth, though with a lag. Lower rates and easier liquidity will aid delayed infrastructure investment and discretionary consumption. In a recent survey in a leading newspaper, 67% of potential home buyers said they were waiting for home loan rates to come down before they make a purchase. Lower rates will also ease the interest burden of Indian companies, though most have little debt in any case.

Most importantly, lower interest costs and falling inflation will aid corporate margins [Figure 3]. The recent rate hikes have been the fastest and largest increase in interest rates in more than a decade and the impact of easing is likely to be especially pronounced.

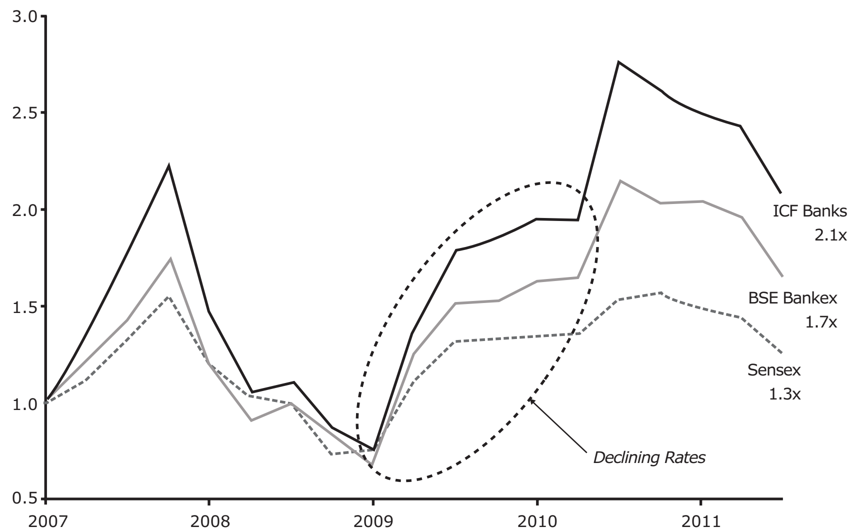
While falling interest rates are positive for the equity markets as a whole, they are especially positive for rate-sensitive sectors such as banks and capital goods [Figure 4]. While banks typically see their stock prices decline during periods of rising interest rates, this is in stark contrast with how well their fundamentals have held up during these periods. For example, the past year has clearly been quite difficult for financial stocks, but the banks in the India Capital Fund portfolio have seen strikingly robust growth, high ROEs, strong asset quality and expanding net interest margins [Figure 5 and 6].

Figure 3 **Corporate Margins vs. Interest Rates**



Note: Corporate PAT margin has been calculated for Sensex constituents
Source: ENAM, Bloomberg

Figure 4 **Indexed Share Price**



Source: Bloomberg

Figure 5 **Change in Policy Rates vs. Spreads for India Capital Fund (ICF) Banks and Sector**

	Change in Rate/Margin (Mar'10 – Sep'11)
Change in Repo Rate	+325 bps
ICF Banks	+136 bps
Banking Sector excl. ICF Banks	–14 bps

Note: ICF banks are value-weighted; banks in the banking sector are market-cap-weighted
Source: ENAM, Bloomberg, company reports

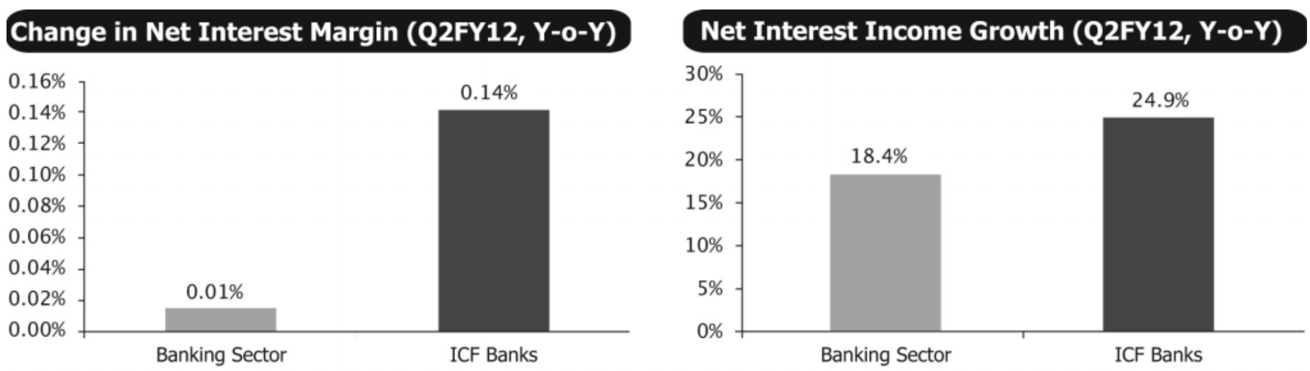
Banks and financials have been one of the factors driving the Fund's 325bps outperformance vs. the USD SENSEX since inception in 1994. This is due in part to the Fund's overweight to the banking sector, which has structurally outperformed and also because the banks in the portfolio have significantly outperformed their peers. We think these banks are particularly well-placed going forward — fundamentally, on an operating basis and cyclically, due to an imminent turn in the interest rate cycle. We discuss South Indian Bank, one of the Fund's top holdings, in the box on the following page.

WHERE IS THE RUPEE GOING?

From August 2011 onwards, the INR, like several emerging markets currencies, depreciated amidst an overall investor flight-to-safety to the USD. The INR was further impacted as the central bank publicly stated (on November 8, 2011) that it would not intervene in the currency market since its primary interest was in managing liquidity and controlling inflation, leaving the INR open to increased speculation.

As inflation eased, the central bank has had room to take a more aggressive stance, starting with a number of targeted measures to increase the supply of dollars. Then, on December 15, the RBI announced

Figure 6 **Bank Operating Performance in Q3 CY2011**



Note: ICF banks are value-weighted; banks in the banking sector are market-cap-weighted
Source: ENAM, Bloomberg, company reports

SOUTH INDIAN BANK

South Indian Bank (SIB) is based in Thrissur, Kerala. Founded in 1929, it is an 'old generation' private sector bank, the moniker used to differentiate it from younger and more recent entrants to the private sector banking space whose polish and high visibility at overseas conferences have attracted a great deal of interest from foreign investors. While SIB may lack the profile of its younger peers — from Mumbai, it's a flight plus a two hour drive over sometimes rough roads to reach SIB's corporate office — today it is a modern, fast growing and extremely well-managed bank and represents one of the India Capital Fund's top holdings.

SIB is in part a turnaround story. In 2005 when the Fund first invested, asset quality was weak and the quality of earnings was poor, with the bank making losses in their core business — the only thing holding the bank up was money earned through treasury trading operations. This all changed with new management led by Dr. V A Joseph and the bank saw a steady improvement in fundamentals over the next six years.

Today, the bank is among industry leaders in terms of operational metrics. Its asset quality is very healthy with net non-performing loans of 0.3% and among the lowest risk-weighted assets in the industry. Return ratios have improved steadily with an ROE of 18% and an ROA of 1% as of March 2011. It is one of the few banks with a near-zero asset-liability mismatch. Through the rising interest rate environment starting January 2010, the bank's net interest margins have been remarkably steady. The new management has an established record of meeting and outperforming its guidance and the bank is on track to grow its business to Rs. 75 B by March 2013, a 50% increase over March 2011.

But the bank's remarkable turnaround to some extent obscures several structural advantages that we think will be of even greater long-term value. For example, SIB's home state of Kerala sends the largest number of expatriate workers to the Persian Gulf of any region in India. These workers repatriate a large portion of their earnings back to India through special overseas depositor accounts which serve as a sticky and low-cost source of funding for the bank. Overall, nearly 80% of the bank's total liabilities are current and savings accounts (CASA) and retail deposits, which carry a lower and less volatile funding cost than alternate funding sources of wholesale or bulk deposits.

Another advantage is the longstanding practice in South India of keeping wealth in the form of gold jewelry. The bank offers a product which lends against this used household jewelry. For the borrower, this allows them to deploy their wealth as a true financial asset, borrowing against it at a far lower rate than through a pawn shop. For the lender, gold lending is a high margin product, with yields around 15% compared to approximately 11% for other lines of lending. The collateral remains in the bank's vault so non-performing loans approach zero and collection costs are effectively nil. SIB is a leading player in this business with gold loans representing almost 25% of its total loan book.

The bank's network of 641 branches is the fourth largest amongst all private sector banks. This matters since the central bank in India typically rations out bank licenses. SIB trades at a fraction of the market cap of the top three banks by branch network, while none of the global giants have even a hundred branches in the country.

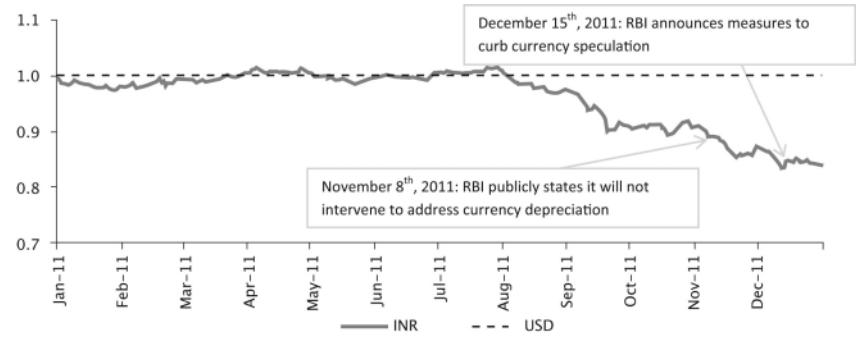
While SIB has outperformed the index by more than 2X over the time the fund has held it, it still trades at 1x forward book and 6x forward earnings, very much at the lower end of private sector bank valuations, leaving a great deal of room for continued share price appreciation on the back of continued earnings growth. Our view is that some of the best banks in India are not necessarily the best known or the most popular and are best identified through detailed bottom-up analysis as we have done with SIB and the other banks in the portfolio. We believe this approach will continue to drive performance in the years ahead.

a series of actions to curb excessive speculation in the Indian currency. The specific moves were highly technical, including restricting the rebooking of forward forex contracts and reducing overnight position limits, but the net effect has been to eliminate the arbitrage between the onshore and offshore forex market, sharply restricting currency speculation by Indian companies and banks under the guise of normal treasury operations. The focus was tightly targeted at the trades employed by speculators, while leaving normal means of currency hedging intact. Importantly, compared to the heavy cost of defending the INR through direct intervention, these measures have had zero fiscal cost and do not add to the balance sheet of the central bank.

The combined effect of the RBI's actions has been pronounced [Figure 7]. From November 8 to December 15, the INR depreciated by 8% against the USD. Post the announcement on December 15, the currency has traded approximately flat, with the currency futures market seeing a marked reduction in volumes. According to one broker's estimates, the on-shore OTC USDINR market volumes are down 50% post the RBI announcement.

While it is difficult to say exactly where the rupee will settle, the RBI's actions have stabilized the currency, albeit at near historically low levels. The past decade has seen a strong correlation between the rupee and the domestic equity markets — barring one year, each upswing in the market has been accompanied by an appreciating rupee. If history does indeed repeat itself, structural positive improvements to India's macro-economic environment should likely be met with a positive turn in the Indian equity market and an appreciation in the rupee. With the rupee close to all-time lows against the dollar, any reversion towards the mean would be an added benefit to the medium-term investor.

Figure 7 **USD/INR Movement**



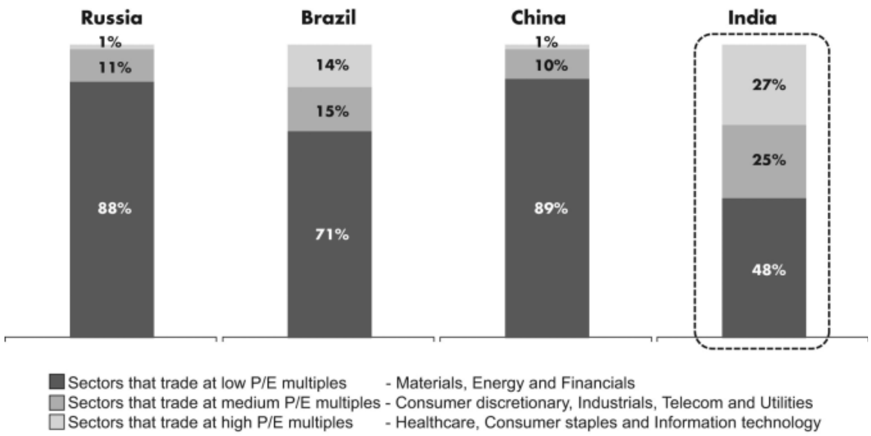
Source: Bloomberg

LOOKING AHEAD

Setting aside the sharp and recent currency discount available to dollar investors, the Indian market is also cheap on its own terms, trading at about 12x 1-year forward earnings compared to its fifteen year historical average of 15x. It is even cheaper given the fundamental difference in the composition of the index compared to the other BRICs, which are composed substantially of lower P/E multiple stocks, very much unlike India [Figure 8]. The India Capital Fund is trading at a further substantial discount to the Sensex [Figures 9 and 10].

Looking beyond the immediate impact of falling interest rates, there are a number of structural features about the Indian markets that are attractive to a long-term investor. We highlighted some of them when we wrote for the Gloom, Boom, Doom Report back in November 2010. Perhaps the most attractive is the fact that India is a domestically-focused, consumption-driven economy with a long runway for growth. Credit/GDP and credit/capita is low and penetration of banking services is lower still. Nearly a quarter of the adult population is unbanked and penetration of mortgages and credit cards is a fraction of that of China and the US. India also has a very favorable

Figure 8 **Index Composition by Sector**



Source: Bloomberg

Figure 9 Index and India Capital Fund Trailing P/E

Portfolio vs Sensex – P/E ratio	
Particulars	**Trailing (FY11)**
Sensex	14.6x
India Capital Fund	7.9x

Notes:
1. Portfolio Trailing P/E ratio has been computed by dividing the aggregate value of all companies in the ICF portfolio by aggregte trailing PAT of constituent companies
2. Sensex Trailing P/E ratio has been computed by dividing aggregate market-cap of Sensex companies by the aggregate trailing PAT
3. Prices as of 12/30/2011

Source: Prowess, Bloomberg

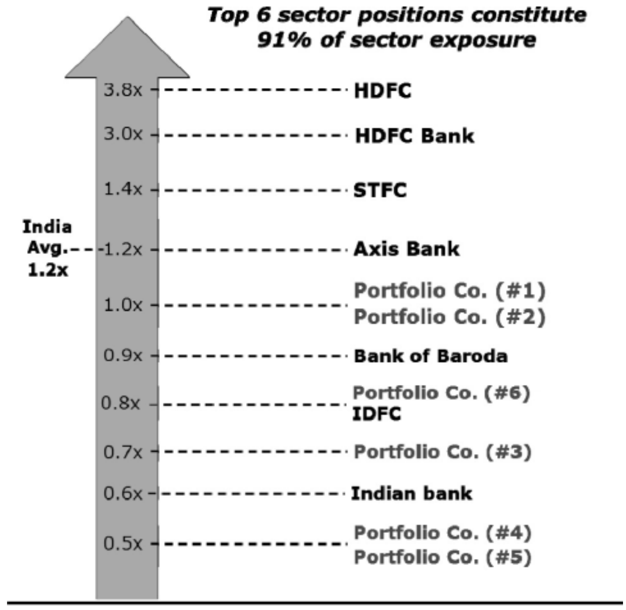
demographic profile — it will add more workers than any other country in the world over this decade.

The question on an investor's mind might well be 'is now a good time to invest in India?' As the cycle turns, we believe it is.

India Capital Management has since 1994 built among the longest and best track records among foreign investors in India. We focus exclusively on Indian public equities and we apply a fundamental, long-term investment approach, together with detailed primary research and a proprietary database of investment opportunities.

The India Capital Fund has been nominated for numerous industry awards, including nominations in five of the past eight years for AsiaHedge's Single Country Fund of the Year, which the fund won in 2005. In 2011, the Fund was voted Best India Fund by Eurekahedge and IAIR awarded India Capital Management the Excellence in Alternative Investment Hedge Section: Mid Size/Asian Funds. In 2010, the Fund was voted 'Best Absolute Return Fund' by Hedgeweek and in the same year, Bloomberg ranked the Fund in 7th position among the world's top-performing mid-size hedge funds.

Figure 10 **Banking and Financial Services Valuations**



Source: ENAM, IDFC-SSKI, Bloomberg

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