Ist July' 2015

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M O N T H L Y V I E W

FROM THE FUND MANAGER DESK

Lost in transmission

For unschooled mortals, there could be nothing boring like RBI policy action. Yet, the glamour around it never seems to subside. On the eve of every monetary policy, without exception, mercury levels meteorically rise in the media. Rate action takes the center stage and debates around it dominate the pink papers. Every word and utterance of RBI governor get dissected frantically for cues on future direction. It was no different in this cycle with all monetary policy events attracting hyped up attention.

But what has surprised seasoned pundits is that the impact of these policy actions have rarely lived up to the initial hype , going by their effects on what matters materially to the real economy i.e. lending rates . RBI had cut repo rates by 25 bps (basis points, each basis point refers to one hundredth of percentage) three times in the last one year. Yet, lending rates by banks have barely budged. Even bond markets which normally transmits the cuts quickly, have remained stubborn after the initial enthusiasm. There is not more than 20 bps (max) reduction in the banking system while about 40 to 50 bps response in the bond market.

Where is the dichotomy and why is so much hype around RBI monetary event that has no material impact on the lending rates. What many in the market fail to understand is that RBI policy actions merely act as a signaling mechanism and much of what happens to the final interest rates is determined by what transpires in the transmission channel. Banks and bond markets form the big part of the so called transmission channel. While rate actions quickly travel thro bond markets, banking channel is a high density medium with high transmission losses. Banks with their high reliance on long-duration fixed deposits for its source of funding can hardly transmit the rates without re-pricing the FDs (happens on maturity). Unlike developed countries where bond markets are deep and mature, much of the credit flow in the economy happens thro' banking channel in India and hence the inefficacy of RBI policy actions.

As per the data released by SEBI for 2011, banking loans constituted over 38% of the GDP while corporate bond market shared less than 10%. In developed countries, this ratio is highly skewed towards corporate bond markets. As per the chart shown below (World Bank data for 2012), corporate debt as a percent of GDP was over 90% for US and even for countries like Korea, it was near 60%. No surprise that the rate transmission is much faster in US and in other developed countries.

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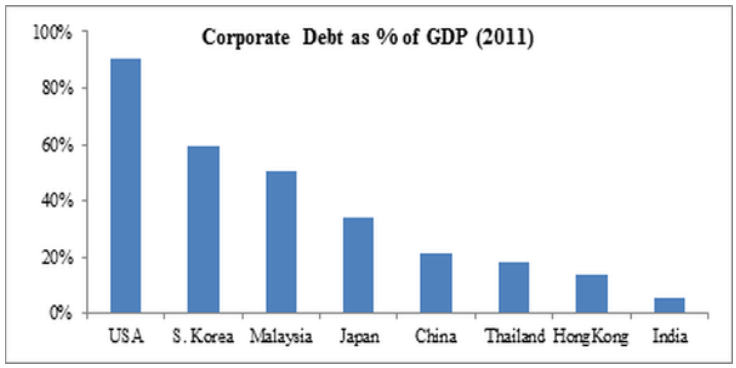

Indian bond markets are far less mature and lot more shallow than many would admit. Low level of financial sophistication of Indian households is one of the primary reasons for this, besides less developed financial intermediaries and debt markets. Less than 5% of household savings are in financial markets whereas physical savings (gold and real estate) grab a much bigger share. Our current political administration has recognized this and taken on the challenge of developing the bond markets. Govt's recent plans to shift bond market regulatory powers from RBI to SEBI are in this direction. This move is part of a major overhaul of the financial system that aims to deepen bond markets by increasing the participation of retail investors and improve the transmission of monetary policy.

It is going to be a long haul before India can reform its bond markets and become the hot choice for global investors. Until then, transmission tantrums will continue to taunt the RBI. You know what to expect when the news channels flash headlines like "home loan EMI to fall" post the next RBI rate action.

Happy Value Investing!!!

ArunaGiri. N

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CORPORATE DEVELOPMENTS

- **GVK Power and Infrastructure Ltd** would likely list its airports arm through an **initial public offering** (IPO). The IPO proceeds, which media reports estimate at Rs.30-35 Bn, would be utilized to trim debt that has been choking the firm's cash flow.

- **Tech Mahindra Ltd** is setting up a new unit to sharpen its focus on winning contracts in the healthcare industry. The unit, to be called nth dimension, has won an IT services project worth about 60 million pounds ($94.48 million) from Britain-based healthcare company CircleHealth.

- **Texmaco Rail and Engineering Ltd** will merge **Kalindee Rail Nirman (Engineers) Ltd** with itself after acquiring a controlling stake in the firm that makes railways infrastructure including signaling and telecommunications through an open offer.

- **Hindustan Unilever Ltd** (HUL), India's largest maker of consumer products, is in advanced discussions with **Mosons Extractions Pvt. Ltd** to buy the **Indulekha** brand of hair care products, including an ayurvedic hair grooming oil and shampoo, for around Rs.5 Bn, according to informed sources.

- **L&T** is finally getting ready to list his IT arm **L&T Infotech** this year to unlock value for the parent and attract top quality talent. L&T is planning to raise between Rs 16-18 bn from investors by diluting around 10-12% of the company, thereby eyeing a valuation of as much as $3 billion, said officials in the know.

- **Emami Ltd** has raised around Rs. 9 bn debt to partially fund the Rs. 16.51 bn acquisition of Kesh King hair-care branded products from Sanjev Juneja of **SBS Biotech**. This is the biggest deal for Emami so far. Earlier, it hadacquired the controlling stake in Zandu Pharmaceuticals for around Rs. 7 bn.

- **Ricoh India Ltd** has announced plans to invest up to Rs. 5 bn in expansion and adding new products and services. Ricoh has launched a fully integrated cloud-enabled healthcare solution

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named 'Picasso' which enables easy portability of medical data. The investments to be made would be through internal accruals.

- **Cipla Ltd** is planning to enter Latin America and Eastern Europe to tap into growing demand for generic drugs in emerging markets.

- **Reliance Communications** (RCOM) and Russian conglomerate **Sistema** are in exclusive talks to merge their Indian telecom businesses through a stock swap that may lead to the first major consolidation in the intensely competitive sector since 2009.

MACRO NEWS

- **The Indian Meteorological Department** (IMD) has forecast less than normal precipitation over the next two months and advised the agriculture ministry to keep ready a contingency plan. Rainfall could be deficient by 8- 10% in July and August respectively.

- A whopping Rs.530 bn exposure of Indian banks to seven **state electricity boards** (SEBs) has a "very high probability" of turning into nonperforming assets (NPAs) in the quarter ending September, the **Reserve Bank of India** (RBI) said in its Financial Stability Report.

- **Indian Railways** has tied up funds for the next two years for its ambitious modernization program. Union minister for railways Suresh Prabhu conveyed to institutional investors the government would be spending Rs 8.50 tn ($125 billion) over the next five years to modernize Indian Railways.

- Credit in the banking system continues to grow at a tepid pace. **Bank credit grew** 9.75 per cent at the end of June 12 as compared to the same period a year ago. Bank deposits at the end of June 12 grew 11.7 per cent, as compared to the same period a year earlier.

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- **The government** is likely to take the bank investment company (BIC) route - an omnibus holding company model proposed by the **P J Nayak committee** set up to review governance in banks - to meet the capital infusion requirement in public sector banks (PSBs)**.**

- **The Securities and Exchange Board of India** (Sebi) is working on a framework to facilitate foreign portfolio investor (FPI) participation in the commodities market. The only concern could be raised is by the Reserve Bank of India (RBI) but sources indicate that RBI has already given an in principle go ahead to the proposal**.**

- In an effort to protect the domestic steel industry from surging Chinese imports, the **Finance Ministry** has hiked the duty imposed on various categories of steel**.**

- **Merchandise exports** fell for the sixth straight month in May, plunging 20.19 per cent to $22.34 billion, compared with $28 billion in the corresponding period last year, owing to weak global demand and a fall in crude oil prices. Exports had declined 13.96 per cent in April and 21.06 per cent in March**.**

- Deflationary pressure continued for the sixth month in a row with inflation dropping to a new low of (-) 2.65 per cent in April, mainly on account of decline in prices of fuel and manufactured items even as foodprices increased. Inflation, as measured on the **Wholesale Price Index** (WPI), has been in the negative zone since November, 2014. In April last year, it was 5.55 per cent**.**

- **Retirement fund body** EPFO will start investing in stock markets from July as part of its plan to put in as much as Rs 5,000 crore in **exchange traded funds** (ETFs) by the end of this fiscal. FPFO has planned to invest 5 per cent of the incremental deposits in ETFs during this fiscal, EPFO is expected to get about Rs 1 lakh crore (Rs 1 trillion) as incremental deposit during the current financial year**.**

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FUNDS FLOW DATA

Data as on 27th June 2015		
FUNDS FLOW DATA (Rs in Cr)		
Category	***MTD***	***YTD***
FII	(3950)	43763
Mutual Funds	7781	30326
Total	**3831**	**74089**

DEBT & FOREX MARKET

Data as on 27th June 2015			
Debt / Forex Market			
Category	***Day***	***1 mnth***	***3 Mnths***
10 Yr Yield	7.8	7.7	7.8
Re / US $	63.60	64.00	62.70

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MARKET VIEW*.

Structural Shift...

Amid the lackluster FII flows, languishing market, regressive political environment and muted recovery, Investors should not lose sight of the larger structural shift that is underway. Coming years will see a tectonic shift in the Indian household's savings and investment pattern. The long awaited move from gold and real estate into equities may just about to begin. All signs are there for that. With gold losing its glitter (gold in bear cycle) and real estate saddled with unsold inventory, outlook for these asset classes look bleak. Some estimates suggest that real estate sector is stuck with 3 to 4 years of inventory in the residential market nationally. The recovery, if any in real estate is a long time away and the adjustment process will be slow and painful.

Add to this the government's (and RBI's) renewed thrust to push up financial savings by staying steadfast on containing inflation to audacious goal of sub-4% (at CPI level) by FY17 (thereby incentivizing financial savers with higher real interest rate) , by deepening debt markets and by breaking the backbone of parallel economy thro' anti-money laundering bill , gold monetizing schemes , GST reforms (more tax compliance) etc , the shift to financial savings can gather momentum over time. If the recent surge in retail flows into domestic mutual funds is anything to go by, early signs of such a trend are already.

From this perspective, the ongoing correction in equities is a brilliant opportunity to build long-term positions to gain from this shift as well as from much delayed, not denied India story. Substantial value has emerged in the market with many stocks in the broader space correcting to near one year lows. Not a bad time to start nibbling especially when Chinese stock bubble is bursting, though in short-term, markets will continue to dance to the tunes of Greek exit fears, monsoon risks and elusive earnings.

We stay away from giving market outlook (except reporting the consensus view) as we believe that the short-term market movements are function of innumerable rational and irrational parameters and hence any attempt to predict the next market move would be a futile exercise. Hence, we would like to qualify the above consensus view on outlook with a clear caution that TrustLine does not have any specific view on the outlook and does not necessarily subscribe to that.

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VALUE EXTRACTS

- In this section of the newsletter, we attach an extract / write-up that we believe can add value to the readers from the "***VALUE INVESTMENT***" point of view or others that offer interesting perspective.
- Enclosed section carries an interesting article titled "**A week in India"** by Akash Prakash of Amansa**.**

"An investment said to have an 80% chance of success sounds far more attractive than one with a 20% chance of failure. The mind can't easily recognize that they are the same".

-**Daniel Kahneman**

Akash Prakash: A week in India

The government has a plan to turn around the economy

I had the privilege of spending four days in India over the past fortnight as part of an investment tour organized by Morgan Stanley. Two days as part of their annual India conference and two as one of the participants of a chief information officer (CIO) tour. We met policymakers, industrialists and independent experts.

I must say I went back from the trip more positive. There was a clear sense of direction and purpose to what the government wanted to achieve. Yes, things were taking longer than one wished; yes, one wanted more radical reforms - but there was a plan to turn around the economy and it was in the midst of execution.

Some specific points of interest:

There is a sense that in sectors like rail, roads, coal, power transmission and renewables investment has begun to pick up, led by the government. Money is being released and the government knows it will have to front-run private investment. The railways look likely to be a big driver of public investment - a sensible minister, access to long-term funds and a slew of bankable projects. Expect to see quick movement here, not just in the dedicated freight corridors but in line doubling, rolling stock, new lines for last mile connectivity, etc.

Roads are getting on track. Officials feel confident that more than 10,000 km would be ordered and over 6,000 km built in 2015-16 (compared with 4,000 km in 2014-15). Of the 80 road projects stuck when the National Democratic Alliance (NDA) took over, only 20 remain, with 16 projects being taken over by the National Highways Authority of India (NHAI) and many being cancelled and re-tendered. Having moved to more engineering, procurement and construction (EPC)-based project awards and stricter norms for project readiness before being put to bid, orders in this regime will translate far more quickly into actual construction.

There remains an intense focus on improving the ease of doing business. We heard discussions on how many approvals had moved online, how states had started competing to make things easier for companies and on further simplifications being planned. There has already been more movement on labour laws in the last 12 months than in the previous 20 years. There seemed to be a genuine game plan to improve India's poor rankings on these metrics.

The power panel highlighted solar and transmission as two areas of real excitement. There seems to be a large pipeline of projects in both areas, with investor interest and the policy framework in place. Within nine months, the southern grid will be connected to the national grid, releasing 4,000 Mw of stranded power from surplus areas and allowing true decentralization of generation. Distribution remains the Achilles heel of the sector, with no solution in sight. The panelists were not willing to hazard a guess on when this holy cow will be tackled.

In a fascinating presentation, one learnt of the huge opportunity in lending to the informal sector. The presentation made the point that even in urban India, most small enterprises and the poor had no access to formal credit due to lack of documentation. The new Reserve Bank of India (RBI) guidelines for small banks had opened up the field for professionally run microfinance. One can expect to see interesting new business models develop here, giving investors an opportunity to participate.

Poor corporate profitability: The leverage in the system, a sharp decline in inflation, rupee strength and steep cuts in government spending has all combined to decimate corporate balance sheets. With both inflation

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stabilizing and the government in far better control of the fisc, these pressures should begin to ease. There may be some fiscal buffers in the Budget; this could be a positive surprise and all departments are being encouraged to spend. Corporate profits are at decade lows, regression to the mean is inevitable.

Public sector banks: This was every investor's favorite bear argument for India. The approach seemed to be that it was pointless to simply recapitalizing the banks in their current form. We need to first fix the governance problem in public sector banks and then give them capital, so that the current non-performing assets (NPA) mess is not repeated. Efforts are underway to bring in high-quality chairmen, with some of the names doing the rounds being quite impressive. Next will be new chief executives. It will take time to get in the type of candidates needed. Attempts to fix the boards are also underway. There was also a view that many of the public sector banks could unlock value and capital through real estate, by monetizing non-core assets and by simply sweating their balance sheets better. Capital will ultimately be provided to these banks, the government understands that there is no alternative - but they have 18-24 months and want to push on improving the governance of these institutions in the time they have. My own sense is that non-voting shares and consolidation will be part of the answer.

The free lunch for corporate India is coming to an end. The days of promoters keeping all the upside and the banks the downside are over. The RBI and the government are seemingly united on this, with the new strategic restructuring guidelines an important tool in the hands of banks to go after difficult borrowers. Expect a renewed thrust on asset sales by leveraged companies. Many companies have been caught off guard by the lack of bailouts and are complaining loudly. It is taking time for them to adjust to the new rules of business and the end of crony capitalism. This change will drastically improve the productivity of capital in the long term.

There was tremendous excitement around start-ups and new business models. Almost 40 per cent of Indian Institute of Technology and Indian Institute of Management grads are now either joining a start-up or starting one themselves. The funding ecosystem has seemingly also now come into place. The incumbents in India, across sectors, seem determined to drive the digital transformation; they do not want to be disinter mediated like in the West.

Real estate has seemingly never seen a worse slowdown in both prices and the velocity of transactions. This has created stress on all inputs to this sector, be it cement, steel or labour. With the crackdown on black money here to stay, the pressure here will only intensify.

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Top level corruption has reduced drastically, not so at lower levels, but it is an improvement and the beginning of a journey.

Obviously there are short-term challenges to markets and the economy. Rural India and consumption more broadly are in stress, earnings will still take time to improve. The government continues to lack depth and talent beyond a handful of strong individuals. Corporations still seem to pine for bailouts. The RBI seems more hawkish than needed. Markets are over-owned and not cheap.

The prime minister is also not instinctively a free-market person; he still seems to believe in the power of the government to deliver, rather than in market-based solutions. Politics make passage of key reforms not a given. The improvements in both policy and economy have been slower than we all had hoped for.

Markets could easily correct in the coming months or days. We seem to be stuck in a trading range, breaking out of which will be difficult. There is no need to chase markets.

However, whenever markets correct, it is, to my mind, a buying opportunity. The long-term direction is clear - economic growth will continue to accelerate, earnings improve, and inflation and rates remain subdued.

Keep an eye on the long term; markets will keep correcting and throwing up opportunities.

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-Akash Prakash

(Amansa Capital – Fund Manager)

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About TrustLine

TrustLine Holdings (Pvt) Ltd. is a leading Chennai based equity research and portfolio management firm. Over the years we, at TrustLine, have gained rich domain expertise by focusing and specializing in Portfolio Management Services (PMS) . Unlike our competition, we are a boutique firm focused only on PMS . This sets us apart and gives us a unique competitive advantage in the PMS space. At TrustLine, we believe, the quality of "Research" is fundamental to delivering out-sized returns. When research is complemented by contrarian investment approach, the rewards can be dis-proportional. These two form the foundation of our investment choices and stock selection in our core PMS business. Our disciplined practice of this "Value Investment" principles have enabled us to deliver significant out-performance over bench-mark indices over last six years and that bears testimony to our deep research and stock picking skills .

TrustLine products include:

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- *Intrinsic* Floater (Arbitrage Fund)
- *Intrinsic* FloaterPlus (Risk Arbitrage Fund)

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