Cohesion India Best Ideas Fund

Quarterly Report

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Spike Hughes, Founder and CEO

(T): +44 20 7399 6718
(M): +44 7920 888200
(E): spike@cohesioninvestments.com
(W): www.cohesioninvestments.com

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A Reliance Capital Company

Quarterly Newsletter

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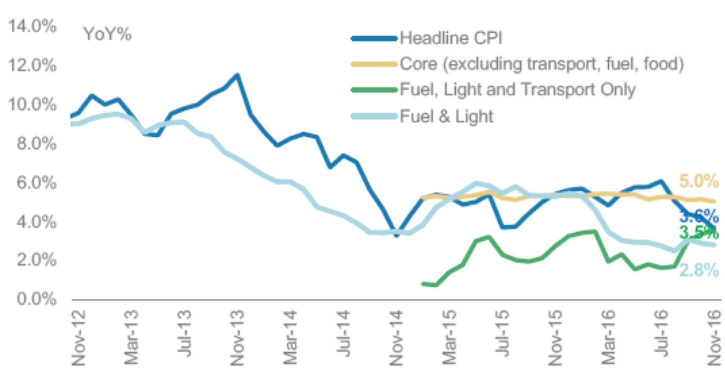
Economic Update

The last quarter has been a very eventful one globally and specifically for India. At the beginning of October, the RBI announced a rate cut of 25bps. In November, Donald Trump won the US Presidential Election and PM Modi announced the bold reform of Demonetisation, then in December, the US Fed announced an anticipated rate hike. This rate hike led to a surge in 10-Year US treasury yields by 90bps and the strengthening of the US Dollar. As a result, most of the emerging markets saw outflows and a price correction. The Indian equities market also saw outflows of around USD4.4bn and as a result, MSCI India (USD) fell 8.2% during the quarter. On the other hand, FDI inflows rose to an all-time high of USD60bn for the trailing 12 months ending September 2016. CPI inflation declined to a 2-year low of 3.6% YoY, principally due to lower food inflation. Indian 10-Year yields fell by 26bps in the quarter as a result of the rate cut, benign inflation and ample liquidity within the banks. Current Account Deficit is in a very comfortable zone of less than 1%.

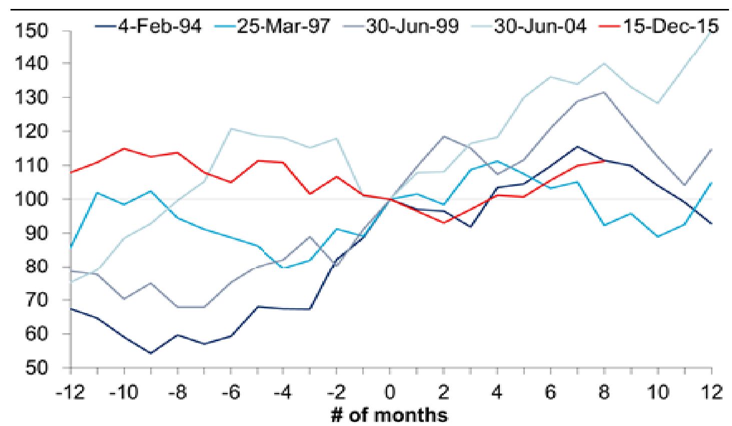


Source: CEIC, Morgan Stanley Research

Fed Rate hike and its impact

The US Fed hiked rates by 25bps in December, as expected, but also surprised markets with an additional rate increase in its median 'dot-plot' projection, raising the total number of hikes in 2017 to three. The implied 'hawkish' stance pushed USD/yields higher. Any USD strengthening due to the rate hikes pose a risk to flows into the emerging markets. Historically, India has done well in past periods of US Fed hikes, but Indian equities also have a negative correlation with USD.

Performance of the Indian Market following various Fed hikes



The graph refers to the performance of the Indian market (BSE Sensex) before and after the Fed rate hike. The value of the index is rebased to 100 on each of the various rate hike dates.

Source: Bloomberg ,Citi Research

Whilst a strong dollar could adversely impact FII inflows into Indian equities, strong inflows into domestic mutual funds have emerged as a support for domestic equities – strong inflows into DMFs persisted through November 2016, which recorded the second-highest monthly inflow in the past seven years. The strong inflow trends into domestic mutual funds could persist going forward given that 1) with domestic bond yields compressing sharply, the earnings yield gap for the domestic investor looks attractive, 2) demonetisation should provide further support to the ongoing trend of reallocation of household savings towards financial assets.

Despite the US rate hike and dollar strengthening, INR has been one of the best performing currencies amongst the EM countries. The main reason is a benign Current Account Deficit, all-time high Forex reserves and stable corporate earnings growth outlook.

Demonetisation - Glass half empty or half full?

The biggest point of discussion for most of us in the last 2 months has been "Demonetisation". PM Modi announced earlier in November that INR 500 and 1000 denomination notes will cease to be legal tender with immediate effect, barring a few emergency transactions and new notes of INR 2000 and INR 500 will be issued. This measure was aimed at addressing the problems of black money, corruption and terrorism. From an economic perspective, 86.4% of notes in circulation (amounting to USD220bn – as of March 2016) ceased to be legal tender. As a result, the country saw huge queues outside banks for people to deposit the old notes and withdraw new ones. The ATMs were not calibrated for the new notes and were shut for a while. Most Indians were of the view that the government has taken a bold step for the long-term benefit of the country and were happy to bear the short-term pain in return. Now the biggest question in everyone's mind is its impact on the economy and whether it has been able to achieve the desired results. We will try to address these points in the next few paragraphs.

Demonetisation has led to disruption in the economy in the short-term, where 80% of transactions were in cash. We are taking a few anecdotal examples from various industries to get a sense of the impact on the industry. MSIL is the largest passenger vehicle company in India and its bookings were down 20% YoY in November but are up 7% YoY in the first 22 days of December. This 7% growth is in line with the rate usually expected in December. Rural retail vehicles sales for MSIL are up 18% in the first 22 days of December vs. ~11% growth from April-November 2016. This shows that the impact of a good monsoon is now becoming visible in actual sales. Two-wheeler sales have improved from an initial decline of 50-60%, though still 20-30% lower. Cement volumes are now down 25-30% vs. an initial 35-60% decline, with prices down 4-8%. Marico and Britannia management have suggested that the wholesale channel seems to have recovered in the key markets of West and South India, whilst it is still struggling to come to terms with cash requirements in North and East India. Most of the NBFC's are receiving their payments on time. From this evidence, we understand that the impact was huge in the first few days due to a liquidity crunch but is now gradually returning to normality, though some industries are recovering faster than others. The total area under cultivation for winter crops rose by 6% YoY in the week ending 23rd December, showing that the rural impact has been very limited. This was mainly driven by the government's effort for credit availability and relaxed cash rules for farmers. Quantifying the impact of demonetisation on the GDP, the Reserve Bank of India (RBI) has stated that the negative impact of demonetisation on the GDP will be -15bps for FY17 resulting in 7.1% growth in it's monetary policy review. This GDP growth is still the highest amongst all the major emerging and developed economies of the world.

When will the cash flow normalise?

As of the end of December, almost USD 213bn of the demonetised USD 226bn is back in the banking system. Banks distributed around USD 87bn of new bank notes from 10th November to 19th December. If we assume 60% of the currency demand is for transactions and the rest is sitting idle, then by the end of January 2017 the cash situation should normalise. Anecdotally, for last week of December, the banks have been almost empty.

If most of the money has already come back in the banks, then where is the black money?

We believe that most of the money coming back into the banking system doesn't mean everything was clean. Rather, the larger transactions will attract scrutiny by the tax authorities who have already started acting on this. They have also announced a tax evasion amnesty scheme where after paying 50% tax, the wealth holder can come out clean, but those who still don't declare will face the law of the land. Also, the GDP of the unreported economy is expected to become a part of the reported economy. India's low tax/GDP ratio (18%) should go up as more people start paying taxes. Already, the tax collection is up 13.6% YoY.

Is it politically negative for BJP?

Since demonetisation, BJP has won the civic pools held in the state of Maharashtra, Gujarat and Chandigarh. Therefore, it seems positive for BJP but the big one is the state elections in March 2017 for 5 states including the all important state of Uttar Pradesh(UP), which shall be the litmus test.

To conclude, we believe this exercise will reinforce the confidence amongst people of the government's effort and will to clean up the system and instil fear into a section of society who don't have any respect for the law of land. Historically, two of the key things that have held India back have been corruption and the cash-driven black economy. Mr Modi masterfully tried to address both of these in a very unique way which was unprecedented. Over 230mn new bank accounts have been opened under Jan Dhan Yojna so far. Aadhar card already has 1bn people registered and has become the bedrock of all government subsidies. The push for GST and digital economy will change the way every single individual and business transacts in this country. Together, these reforms combined with demonetisation, have the potential to be game changing for the country.

We also believe that the government has followed a carrot and stick approach, where the stick has been delivered and now we should expect some carrots in the form of tax cuts in the coming budget. As we write, PM Modi has already announced some carrots for the bottom of the pyramid in his New Year Eve speech. The major focus is on low cost housing, medium and small enterprises, senior citizens and women welfare. Under this scheme, housing loans of less than Rs0.9m (USD 13,500) will get a 4% interest subsidy and housing loans of less than Rs1.2m (USD 17,500) will get a 3% interest subsidy. This should be a big positive for housing finance companies (especially those with low ticket sizes) and should also support cement demand. Pregnant women opting for institutional (in hospital) delivery will receive INR 6,000 (USD 90) directly into the bank account through the DBT route. Funding for these schemes should come from the gains in tax collections and other one-time gains for the Government from demonetisation.

Portfolio Overview

We have around 89% of the fund deployed into 20 stocks at the end of the quarter, thereby completing one full year of our portfolio. We used the opportunity of the dip in the market to deploy some of our cash into existing holdings. We also booked profit in one expensive FMCG company and replaced it with a large life insurance company. We also replaced one non-performing private sector bank with another one where the valuations were more attractive. By the end of December, there was a big dip in the price of one of our pharmaceutical holdings due to some observations by USFDA. We have had a long-standing relationship with this company for last 12 years and still feel comfortable with the management and the business. In fact, we are in the process of adding more exposure in to this company during this dip. The details of the new company we have added are explained below.

Fourth largest private life insurance company

A combination of healthy GDP growth, favourable demographics, increasing preference for financial savings and underpenetrated protection insurance will support growth in India's life insurance sector. The industry in annualised-new-premium-equivalent (APE) terms is expected to grow 13%-15% CAGR over the next three years. The insurance penetration is still very low at 2.6% vs. the global average of 3.5%. This company has emerged as a benchmark for the life insurance industry in India across several dimensions including 1) High quality of business - best persistency and high proportion of long tenure policies, 2) Strong distribution - high performance bancassurance and agency channels, 3) Strong and tenured management, and 4) Focus on long-term savings and protection products. Its superior cost management capabilities also set it apart. This company is merging with another large and well-respected entity to create the country's largest private life insurance company in the next 12 months. This will result in margin expansion due to cost synergies and larger distribution channels. The combined entity will have 3 of the top 6 private banks in its distribution channel. The company currently trades at 17.6x VNB multiple on FY18E basis, which is reasonable given its growth potential and high return ratios (RoEV ~18%) and offers good upside.

Q2 FY17 results review

Metal companies reported positive top-line growth in Q2FY17 after 7 consecutive quarters of contraction. This was due to improved prices as well as better volume growth owing to the implementation of the minimum import price. In domestic consumption, there appears to be a big divergence between discretionary consumption and staples. Discretionary, such as autos, paints, media, etc. continued to post robust top-line growth, while staples continue to disappoint with subdued single-digit growth despite a good monsoon and bumper sowing. Both PSU and private banks reported healthy growth owing to better NIMs and lower bond yields, which resulted in higher treasury gains. Nifty top-line growth improved to 6% vs. 2% YoY and PAT grew 7.3%. PAT growth was negated by the NPA provisioning for PSU Banks.

Outlook

TO WATCH: We need to watch Q3 and Q4 FY17 results to factually understand the impact of demonetisation on the corporate world. Following OPEC/Non-OPEC production cut announcements, crude prices have jumped 15% over the past month to USD54/bbl. We need to monitor this move closely as every dollar rise in crude increases India's trade deficit by USD1bn. We also need to keep a watch on the impact of the US rate hike, the stronger US dollar and the continued outflows from emerging markets. State Elections in 5 states including UP in Q4 FY17 are important for the BJP government at the centre. The annual budget announcement in February could provide further positive fiscal news.

OPTIMISTIC: Currently, Sensex is trading at around 15.7x FY18e PE and expected earnings growth is forecast at a very strong 23% for FY18e while our portfolio earnings are expected grow at 35%+ for FY18e, giving us full comfort in our investments. The portfolio will continue to invest in very high quality, steady growth companies, which have strong competitive advantages

Fundamentally, we believe that the recent positive introduction of GST and Demonetisation, once bedded in, will provide a significant boost to India's robust structural growth story and its credibility on a global stage.

Wishing you a very happy and prosperous new year.

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