Cohesion
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RELIANCE

Cohesion India Best Ideas

Quarterly Report
July 2016

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Quarterly Newsletter

Cohesion India Best Ideas Fund

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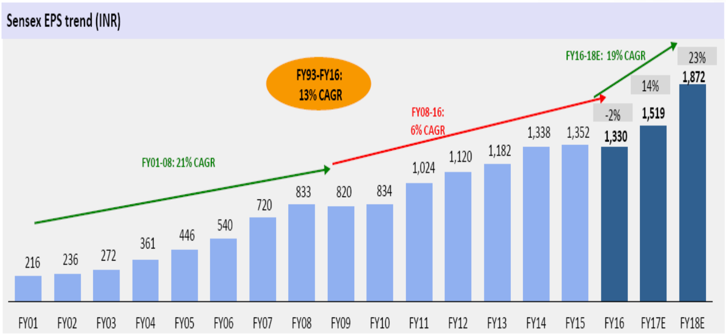
Economic Update

June 16 was a strong quarter for equities across markets and India was no different. Continuing from the momentum built in March we started the quarter on a strong note and added further strength once forecasts of normal monsoon rains came in. Helped by continued global and local inflows market sentiments remained buoyant till we saw the big events of "Rexit" and "Brexit" in June. While this lead to initial hiccups, investors seem to have taken the events in their stride and Indian equities have recouped the losses to hit fresh CY16 highs. In USD terms MSCI India gained 3.3% for the quarter and is now up 0.3% YTD.

Reserve Bank of India (RBI) governor Raghuram Rajan's decision not to seek a second term was a big surprise event and dubbed in India as "Rexit". Rajan's report card as the RBI governor has been record -breaking on the 'macroeconomic management' front, tremendous on the 'engendering competition' front, and highly effective on the 'banking supervision' front. There were some concerns by the investor community regarding his departure and potential impact for INR. However, we believe an institution is always bigger than an individual and the RBI has always been an independent institution led by highly qualified governors and their team. We also believe that any new governor won't discard his successful policies. Additionally, INR has remained steady since this news and is also supported by strong macro.

The UK has voted to leave the European Union dubbed as "Brexit". This will have profound implications for UK and significant impact on EU. However the direct impact of Brexit on India is limited from the trade channel. India's goods and services imports from UK are 0.7% of GDP while exports to UK are 0.8% of GDP. With inflows into EMs under pressure, it is likely that inflows into India may be lower to that extent. MSCI USD Index was down 2.8% on the Brexit day after recovering from 5.1% intraday fall. Whilst a general risk-off scenario in the global markets might not be helpful to INR, we are not concerned about INR, given that India's FX reserves are now much higher than in 2013 and the macro fundamentals – especially with respect to inflation, fiscal and current account deficit are much better placed. We also believe that in the medium term investors will seek India as a market offering superior returns to developed markets, especially as an alternative to UK and Europe. Equity market movement will be specific to sectors and stocks. Those having direct linkages to foreign business may be impacted, while those having more domestic orientation are likely to do better.

The big positive event in the last quarter was the earnings recovery where aggregate non-financials adjusted 4Q FY earnings growth for the Nifty companies which came in at a healthy 12%. The current expectation is a 15 -20% earnings growth in both FY17 and FY18. Cement volumes have picked up and so have steel volumes in the last 3-4 months reflecting a pickup in infrastructure related activity. Commercial vehicles volumes have also picked up. Retail loan growth, petrol consumption, air passengers flown, Naukri and Monster job indices, and consumer durables production have shown an improving trend over the last four months, indicating a pick-up in discretionary consumption.



Source: MOSL

Recently the Union Cabinet approved pay hikes for its staff and this move will add around USD 13bn in the pockets of these people. This is likely to have a big impact on the discretionary consumption such as automobiles, travel & tourism, education, lifestyle, leisure & recreation, medical services and consumer banking/ financial services.

2 years of Modi Government Achievements

In May 2016 Modi government completed its 2 years in power and hence it is interesting to look back and review their performance so far. We believe considering the limitation of a democratic setup, the government so far has done a fairly good job across most departments. They implemented Direct Benefit Transfer (DBT) via a biometric backed card (Aadhar card) and this has led to significant savings across several government welfare schemes, including USD 4bn in PDS, LPG distribution and MNREGS. The gridlock in the coal mining and utilities sector which was one of the biggest pain points is now resolved thanks to the e-auction of coal mines. The three rounds of auctions till now will earn USD 60bn for the states over next 30 years . Discoms have around USD 9bn losses every year and accumulated debt of USD 63bn. The government introduced a financial restructuring scheme UDAY (Ujwal Discom Assruance Yojana) to turn around sick power distribution utilities and post implementation India will take a big step in making the power utilities more efficient and ensure power to all. It is expected to save USD 26bn by FY19e.

With a view to bringing in financial inclusion for the rural and poor section of the society and to ensure access to financial services, namely Banking, Savings & Deposit Accounts, Remittance, Credit, Insurance, Pension in an affordable manner, "Jan Dhan Yojana" (PMJDY) was launched by the government. Under this scheme 221 mn bank account have been opened with deposits of USD 5.8bn. Road construction in India has accelerated to an all-time high pace of 25 kilometres per day, Vs previous high of 3km/day achieved in 2012. They aim to get to 30km/day in the next 6 months.

Taxation uncertainty has been addressed, ease of doing business has improved and the bankruptcy bill has been passed by the government. India currently has multiple laws to deal with insolvency, which leads to significant delays in winding up a company while this bill will make it easier to wind up a failing business and recover debts.

The government has also increased Foreign Direct Investment (FDI) in various sectors including 100% in defence, 100% in aviation, 100% in broadcasting carriage, 74% in pharmaceutical, 100% in trading of food products. A 100% FDI in defence will create a win-win situation for the country's defence forces, local industries and international OEMs. It will ensure availability of cutting edge technologies for the defence forces, boost local manufacturing in India and provide assured returns for international OEMs. The move will also enhance overall R&D to develop and deploy solutions catering specifically to the country's security needs. 100% FDI in food trading is to boost the food processing sector in the country where only 10% of the produce is processed and a big chunk is wasted every year.

To assuage the impact of crop failures on the farmers the government has brought in a crop insurance scheme with a premium as low as 2%. They expect 50% farmers to join the scheme in the next 2 years. This would be a big step in minimizing the impact of a failed monsoon on the rural sector. This is the first time in India's history that such a scheme has been implemented.

Portfolio Overview

As we discovered more opportunities to invest in the last quarter we kept on deploying the available cash and gradually increased the exposure to around 84% from 70% at the end of previous quarter. The main theme of our investment remains the same domestic economic recovery and consumption. The majority of our portfolio holdings remain the same except we booked profit in two large financial holdings and exited one industrial holding, as we were unable to build a meaningful position in it. Amongst the new entrants are India's largest beer company and another name is India's leading commodity exchange. Also we are looking to invest in a midcap financial services company. Below, we give a more detailed perspective of our additions.

Largest Beer Company: 65% of India's population is below 35 years of age. Social acceptance to drinking and that too with responsibility has increased. This company sold off 151 mn cases in FY16 and had more than 50% market share. Its volume growth for the last two years was muted on account of adverse state regulations and category slowdown. Though regulatory risks remain, the worst seems to be behind and we expect volume growth to improve led by the recovery in urban demand and benign tax increases by state governments in the current year. Over the last ten years its volumes have grown by 13% CAGR against industry growth of 12%. The premium segment in India currently has a small 3% share as against 10% share in China and more than 6% in rest of Asia but is growing faster. The company is growing much better than the industry in those segments and also plans to introduce flavoured beers. Margin expansion is expected based on economies of scale, introduction of light weight bottles, savings in supply chain costs from new breweries and improving production efficiencies. This should help it in growing its PAT by 35% CAGR for next 2 years.

Commodity Exchange: The Company has more than 84% market share in India's commodity trading. It offers a platform for 26 commodities across 4 segments – Precious Metals, Metal, Energy and Agri-commodities. It had no Managing Director over the last two years, post its ownership restructuring, leading to absence of leadership to drive the growth. The appointment of a new MD in June'16 has filled this vacuum. Introduction of options in commodity trading will be allowed which should widen the market size for commodity trading. The company will also look to introduce currency derivatives, weather derivatives and other new products to its platform. This business has high operating leverage with more than 70% of the costs being fixed. Hence growth in top line coming from newer products and participants, will translate into higher growth in profitability. We expect the company to grow its PAT by 16%-18% CAGR for next 2 years.

Outlook

We believe this global uncertainty is an exciting time to invest in India as during these times we can make outsized returns especially with India undergoing a cyclical recovery. Any adverse global news flow could be partly cushioned by upcoming domestic impulses to growth such as good monsoons, a likely easing of monetary policy, GST getting passed and pick-up in earnings growth in FY17. If we look at the period between 2003 and 2008, in six years earnings tripled for the whole of corporate India and no one expected that in 2002 and the same can happen this time after 5 years of subdued earnings growth. We believe in a world starved of growth, India will stand out. This should attract the tremendous amount of money sitting on the sidelines to be invested. The Portfolio will continue to invest in very high quality, steady growth companies, which have strong competitive advantages.

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