

India Notes

GDP growth hits 8.9% in Q2

India's gross domestic product (GDP) grew by 8.9% in the July to September quarter, rekindling the debate on whether the Reserve Bank of India (RBI) will continue with its monetary tightening policy to cool inflation, which has shown signs of easing in recent weeks. The better-than-expected growth was driven by a robust farm output that grew by 4.4% during the quarter, up from 0.9% in the corresponding period a year ago. All eyes are now on the RBI which will present the next policy review on December 16. Industry captains said any further rise in interest rates could adversely affect the growth momentum. Manufacturing sector has grown by 9.8% during July to September as compared with 13% in previous quarter.

India Food Inflation Eases Sharply

India's food inflation rate eased sharply in the week ended Nov. 20, slipping into a single digit for the first time since May 2009, raising expectations of a further decline of the still red-hot prices, which would ease pressure on the central bank to tighten monetary policy more. The food inflation rate based on the wholesale price index decelerated to 8.60% year-on-year from 10.15% recorded for the week to Nov.

Real Estate Sector being pulled in multiple directions

India is experiencing strong GDP growth- driving uptake of commercial and retail space and prompting end-users to buy residential property. Liquidity conditions are very favorable. However, recent memories of the boom of 2007 (followed by 2008's crisis) give rise to some skepticism. Note that residential prices in parts of Mumbai and the NCR are now higher than the 2007 peak despite a drop in affordability and hence volumes. On the other hand, some markets such as Bangalore are seeing an improvement in volumes even as prices inch up. In some areas in NCR suburbs, speculators have driven volumes to more than twice the historic high of 2007. These liquidity-driven phenomena are unlikely to sustain beyond the next 6-12 months.

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Economy & Markets

GDP growth hits 8.9% in Q2

The new gross domestic product (GDP) numbers released by the government on Tuesday show that the Indian economy continues to maintain its growth momentum despite a tough global environment. At 8.9% for a second quarter in a row, the economy is growing near its trend rate. Fears of overheating seem to be overdone right now despite intolerably high inflation and rising asset prices. The Indian economy seems set to close the year with economic growth of between 8.5% and 9%.

Despite the overall pretty picture, there are two underlying trends that deserve closer attention. First, the revival in farm output this summer from its drought-induced trough in 2009 has pushed up GDP in the second quarter. Farm output has grown at the fastest rate in 11 quarters. Maintaining this growth rate is almost impossible given the long-term stagnation in agricultural productivity. A lot will depend on non-farm output trends after the winter crop is harvested.

Meanwhile, manufacturing growth has slowed and has also been volatile in recent months. There have been problems with the way the index of industrial production is calculated, but that is the best indicator we have for now. The wild swings in factory output every month have been a worry for some time now. Indian manufacturing growth has slipped from 13% in the first quarter to 9.8% in the second quarter; not reason enough to hit the panic button, but surely something to keep a close watch on.

Second, the GDP numbers show that private sector demand continues to pick up. A huge increase in government spending had supported economic activity in the crisis months of late 2008 and early 2009, but the private sector has now stepped in to pick up the slack in domestic demand that could have arisen as the government tries to cut its fiscal deficit.

Yet, private consumer demand seems to be doing better than private investment demand. High frequency data on dispatches of cement bags, new telecom subscribers, car sales and airline bookings suggest that consumer spending continues to be robust. The revival in farm output should help boost rural demand as well.

Economic growth seems to be well balanced at this juncture, with private consumption, government consumption and fixed capital formation growing at close to double-digit levels. Interest rates are close to neutral levels (though the short-term money market is gasping for cash). Inflation seems to have peaked. These factors could put India in a sweet spot, especially if corporate investment accelerates and the world economy does not serve up another shock.

India's Food Inflation Eases Sharply

India's food inflation rate eased sharply in the week ended Nov. 20, slipping into a single digit for the first time since May 2009, raising expectations of a further decline of the still red-hot prices, which would ease pressure on the central bank to tighten monetary policy more. The food inflation rate based on the wholesale price index decelerated to 8.60% year-on-year from 10.15% recorded for the week to Nov. 13, but the index rose 0.2% to 180.5 from the previous week as milk and onions became more expensive. Food inflation is the primary culprit driving up overall prices in Asia's third-largest economy, but as summer-sown crops enter the market boosting staple supplies, the number is showing signs of easing. A recent burst of unexpected showers in some parts of the country will also help winter-sown crop and may further pull down prices. Analysts expect the downtrend in food prices to lift pressure off the Reserve Bank of India, which has raised key policy rates six times in 2010 to keep prices on a leash. India's inflation was 8.58% year-on-year in October, compared with 8.62% in September. The RBI expects inflation to ease to 5.5% by March.

HSBC India Services Purchasing Managers' Index (PMI) jumps in November

Indian service sector activity picked up pace in November and businesses are more optimistic about the future. The pick-up in activity was led by new business and it helped raise hiring. However, both input costs and prices charged are going north, highlighting the need for RBI to return to the stage and resume tightening in early 2011.

HSBC's India PMI for service sector activity jumped in November (60.1 vs. 56.2 in October), continuing the pickup in momentum since the deceleration in Q3. New business came in faster (57.7 vs. 53.3 in October), supported by a general improvement in market conditions and a higher volume of new customers. With the manufacturing PMI also picking up handsomely in November, as we saw on Wednesday, the composite index rose (61.3 vs. 58.4 in October), confirming that that the broader economy is on a firm footing.

The uptick in activity encouraged businesses to hire at a faster pace (51.9 vs. 51.4 in October), which together with an improvement in productivity (according to anecdotal evidence) helped to marginally reduce outstanding business (49.6 vs. 48.4 in October). Input prices climbed on a sequential basis and at an accelerated pace (54.9 vs. 53.8 in October) led by higher staffing costs. Prices charged also rose following last month's decline (52.8 vs. 49.4 in October). Looking ahead, businesses are more optimistic about the outlook (71.4 vs. 68.8 in October), citing improvements in the global economic conditions and the good quality of services offered.

With service sector activity still in expansionary territory and employment rising, there is clear evidence that domestic demand in India is buoyant. Moreover, the rising optimism about the outlook points to well-supported activity in the months ahead. This support will come from the favorable labor market conditions (both employment and wages), the monsoon dividend in terms of higher agricultural output and incomes, and the still highly accommodative monetary policy stance. Together with the corporate sector's need to expand capacity through investment, the loose monetary conditions are expected to support credit growth and financial intermediation more generally. Furthermore, services will benefit from the strong momentum in

manufacturing sector.

Bottom line: Activity in services is buoyant and supportive of job growth. Strong domestic demand will provide further impetus, but elevated food prices and demand-led inflation pressures are expected to keep RBI on its toes. Expect a resumption of the tightening cycle early next year.

India's infrastructure growth rebounds in October

October industrial production recorded a double-digit growth at 10.8% compared to 4.4% on a month-on-month basis. This was way above the street expectation. April-October IIP is at 10.3% against 6.9% year-on-year. Experts believe most of the growth is a reflection of the previous month's (September) festive activities. In addition there is a significant base rate impact. According to an Analyst poll, October IIP was seen at 8.83% compared to actual of 4.4%. There are several positive factors in October that has pushed the numbers higher. Last year October was not very strong, so that base effect has helped. Auto sales number too was strong in October than September, a jump of 9%.

Auto Sector volume growth to remain robust

Volume growth should remain robust, driven by strong economic recovery, improved financing conditions and new product launches by existing and new global players. This coupled with strong exports would support strong volumes. The volume guidance provided by automakers indicates a favorable environment for FY11.

EBITDA margins to moderate, but remain above historical average

Continued volume growth will give the industry pricing power and support high operating leverage. Moreover, leading companies have undertaken cost reduction and productivity improvement programs, which will dilute the impact of raw material cost inflation, thereby supporting higher margins. Besides, ramping up operations in tax-free zones like Uttaranchal will help to counter cost pressure through lower tax burden.

Real Estate

Commercial property: Revival underway

The IT/ITeS sector accounts for 70-75% of the commercial property demand. Financial services in Mumbai and Delhi make up the bulk of the rest. Rents fell dramatically from late 2007 to 1H09 driven by the broader economic downturn, specifically in the financial services and IT/ITeS sectors.

Market trends suggest a pickup in hiring in major cities such as Mumbai, Delhi/ NCR and Bangalore. Financial services firms (concentrated in Mumbai and some areas of Delhi) have started hiring in the last three quarters, while IT/ITeS companies have started hiring and announced major employee addition plans in the last 6 months. These are leading indicators of a pickup in leasing activity for commercial property in the next 3-6 months in the financial services and IT/ITeS sectors. The supply of upcoming/half-finished commercial buildings is likely to cap rents for 12 months but they may start inching up by the second half of 2011.

Residential property: Luxury housing back in vogue

The first half of 2009 saw developers cut prices by 25-30% and start to concentrate on the mid-income residential property. This implied lower prices, lower unit sizes, and no frills. The central bank reversed four years of tightening through a cut in policy rates (Repo) and the cash reserve ratio (CRR). Sales of mid-income residential property surprised positively as consumers took advantage of improved affordability, especially in the NCR. Prices in general moved up by 10-15% from the bottom seen in early 2009. In areas such as Mumbai, the lack of supply has led to price increases, in some cases by 10-20% beyond the 2007 peak. Delhi and Gurgaon markets also have seen appreciation of 25-30% in prices since the bottom seen last year due to strong demand. Prices in NCR will remain stable from here on, while Mumbai prices could soften a bit as volumes have started dipping post sharp increase in prices in last 12 months.

But in South India and other Tier 2 & 3 locations price increase continues to be moderate, with volumes seeing good traction.

Retail property: Some rays of hope Massive store roll-out plans by domestic and foreign retailers led to a flurry of supply in 2005-07. However, it also led to skyrocketing rentals till supply actually hit the market. The market, therefore, saw rents fall dramatically, driven by a high base effect, oversupply, and the downturn in the economy. The pace at which rents were falling has reduced, but they remain under pressure due to weak volumes. As retailers move back into expansion mode, we are seeing volumes pick up in some areas such as Mumbai and select micro markets. Rents have started to stabilize, and we expect continued improvement in demand in 2011.

Sector being pulled in multiple directions

India is experiencing strong GDP growth- driving uptake of commercial and retail space and prompting end-users to buy residential property. Liquidity conditions are very favourable. However, recent memories of the boom of 2007 (followed by 2008's crisis) give rise to some scepticism. Note that residential prices in parts of Mumbai and the NCR are now higher than the 2007 peak despite a drop in affordability and hence volumes. On the other hand, some markets such as Bangalore are seeing an improvement in volumes even as prices inch up. In some areas in NCR suburbs, speculators have driven volumes to more than twice the historic high of 2007. These liquidity-driven phenomena are unlikely to sustain beyond the next 6-12 months. The sector also faces multiple headwinds. Sector-specific policy tightening may be stronger than 2006/07 since speculators refuse to back off easily, having seen a V-shaped residential price recovery. As other sources of liquidity the market expects a flood of paper. A bulk of the increase in sector market cap and float in the next 12 months is likely to be added by fresh issuances and performance of stocks focussed on favourable market segments.