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Investor Update
January,2010

India Notes

India: Rebalancing in 2010

The overarching story in India this year is that of re-leveraging and the return of risk-taking, as a combination of easy capital and capacity shortages work to create an ideal platform for the investment cycle to take off. Growth is likely to accelerate as a pick-up in industrial investment is fortified by a policy push on infrastructure. Meanwhile, the government, stretched by the rising fiscal deficit might not be able to actively deploy capital should potentially move away from slack fiscal policy and share risk-taking with the private sector through increased public-private partnerships.

Equity Markets: the Way forward?

After two extreme years, 2008 and 2009, the Indian market is now trading at a premium to historical valuations, and looking for fresh triggers to decide the direction of its next move. Going forward, the market direction will be decided by the interplay of a new cycle in three aspects: (1) Earnings growth, (2) Capital raising, (3) Policy reforms.

Real Estate Locational Recovery in Residential; Commercial still lags behind

In spite of all the talk about demand recovery in the residential segment, Mumbai and NCR are the only two regions among the top six regions to have shown a significant recovery in transaction volumes. Bangalore and Chennai's residential markets are still struggling to pick themselves out of the slowdown. Until all major regions of India show volumes higher than the current levels, one cannot call it a satisfactory recovery. If volumes do not move up from current levels, concerns about the cash flow situation of developers should rise again, given that the restructured debt repayments would be commencing in FY11. In such a scenario, developers should not be looking to increase prices as it could hurt sales.

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Contact Us

Yatra Capital Limited
43/45 La Motte Street
St. Helier
Jersey JE4 8SD
Email: info@yatracapital.com
Website: www.yatracapital.com

Gavin Wilkins
Tel: +44 (0)1534 702 815
Fax: +44 (0)1534 702 870
Email: Gavin.Wilkins@minerva-trust.com

Investment Advisor

SAFFRONCAPITAL ADVISORS

Saffron Capital Advisors Limited
Suite 2004
Level 2, Alexander House
35 Cybercity
Mauritius

Ajoy Veer Kapoor
Vijay Ganesh
Tel: +230 4034384
Fax: +230 4673100
Email: vganesh@saffroncapitaladvisors.mu
ajoyveerkapoor@saffronadvisors.mu
Website: www.saffronadvisors.com

Economy & Markets

Macro Economic Policy

The over-arching story in India this year will be the return of risk-taking in the system, as a combination of easy capital and shortages in capacity work to create an ideal platform for the investment cycle to take off. Growth will accelerate as an autonomous pick-up in industrial investment will be fortified by a policy push on infrastructure.

This year is expected to be one of rebalancing: 1) of growth as investment makes a comeback after being on the backburner in FY09; 2) of a move away from an ultra expansionary fiscal policy as the government attempts to fix its finances and as economic buoyancy boosts revenues; 3) of a reversal of loose monetary stance as excessive liquidity is reined in followed by policy tightening, and; 4) finally and most importantly, of risk-taking as growth in investment resumes in earnest after a hiatus following the crisis in mid-2008. But, every path has its puddle. Early on this path to risk-taking and growth lies the proverbial puddle in the guise of a quick rise in inflation, which when it elicits a response by the central bank, could cause a market correction

Capacity shortages are back

The most important driver of capex is demand visibility. Analysts believe that indications of a significant tightness of capacity are now visible in the Indian economy. Capacity utilisation in the manufacturing sector rose to a high of 82.5% in FY08, the highest in nine years. The IIP numbers for November also suggest that on the back of increase in the demand visibility there is a significant uptick in the manufacturing activity as well.

In the past few months that firm signs of a demand recovery have become evident. Firstly there is a major acceleration in industrial growth, even on a pre-crisis base, as manufacturing responds to growing demand.

Second, despite strong domestic production growth, non-oil imports have started rising sharply, suggesting a spill-over of demand onto imports. Analysts believe that the capacity shortages of FY08, which were masked by the fall in demand in FY09, are back to the fore again, creating conditions for a revival of industrial capex in India.

A major side-effect of the pick-up in capex this year will be a rise in capital flows into the country as poor disintermediation of savings — underdeveloped long-end corporate bond market and a comparatively low level of savings through the equity route — has implied increasing capital inflows into the country to finance long term capex projects. This has implications for both monetary policy and the rupee.

India witnessing a surge in Capital Flows

India attracted net foreign capital of $23.6 billion in July-September 2009 quarter, over three times that in the corresponding quarter last year, recently released data shows. Concerns over capital flows have, however, not yet acquired any urgency because of the muted inflows in the first quarter. The capital flows in the first half of the current fiscal was only $29.6 billion.

However, if the trend for the July -September 2009 quarter persists, capital flows could become an issue sooner than later. Net foreign direct investment in the April-September 2009-10 period was $14.1 billion, marginally higher than the $13.9 billion in the corresponding period last year and almost on a par with that for 2007-08 when the country saw record capital flows of $106 billion and monetary management became difficult. The RBI had to take selective steps to check the flow of foreign funds into the country. Portfolio investment in the same period was $18 billion, against $27.4 billion for the entire 2007-08. Capital flows would have been much higher had the slowdown not affected external commercial borrowings, which were a meager $745 million, against $22.6 billion for the fiscal 2007-08.

India IIP Growth Surges Again

India's industrial output in November grew at an annual rate of 11.7 per cent, up from the October figures of 10.3 per cent. Industrial production growth numbers stood at 2.5 per cent in November 2008.

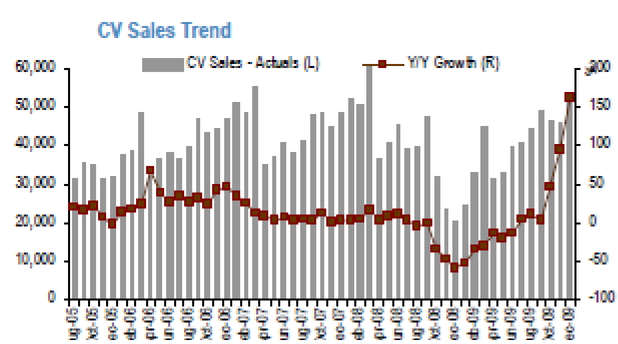
On the sectoral growth in November, manufacturing saw a growth of 12.7 per cent as against 2.7 per cent rise in November 2008. The mining sector grew at 3.3 per cent. Consumer goods production was higher at 11.1 per cent vs 9.4 per cent in the year-ago period. The consumer durables growth in November 2009 stood at 37.3 per cent as against 0.3 per cent in November 2008. Electricity production rose by 6 per cent vs 2.2 per cent.

The IIP growth in the April-November period was at 7.6 per cent as against 4.1 per cent in the year-ago period.

The jump in consumer durables growth is significant but there are doubts about its sustainability. The jump could be due to a pent-up demand. After the big jump in the IIP data, the bond yields spiked, with market participants seeing strong signals that the RBI would hike rates. Analysts expect it to be a difficult call to predict whether RBI would hike rates at this juncture to hurt the recovery process in the economy. It is expected that the RBI is likely to suck some liquidity out of the system, rather than hike rates.

Auto Sales continue to be robust

Passenger car sales were up 48% yoy; two wheeler sales were up 60% yoy and commercial vehicle sales were up 162% yoy. While unit sales growth was off a low base (as sales had sharply corected in Dec'08 given the global credit crises), robust sales over the traditionally weak December has surprised and has been driven by healthy retail demand.



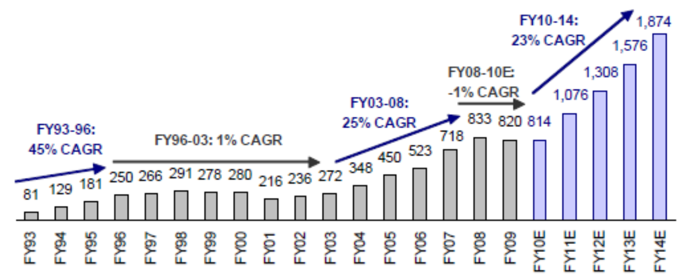
	Dec-09	Nov-09	Dec-08	YoY %	MoM %
Commercial Vehicles					
M&H Commercial Vehicles	26,118	21,178	8,379	211.7	23.3
Light Commercial Vehicles	27,110	24,514	11,894	127.9	10.6
Total Commercial Vehicles	**53,228**	**45,692**	**20,273**	**162.6**	**16.5**
Cars & Utility Vehicles					
Passenger Cars	167,190	186,110	117,888	41.8	-10.2
Multi Utility Vehicles	21,989	20,808	10,096	117.8	5.7
Total Cars & Utility Vehicles	**189,179**	**206,918**	**127,984**	**47.8**	**-8.6**
Two Wheelers					
Scooters	130,254	129,144	91,368	42.6	0.9
Motorcycles	702,964	729,419	424,818	65.5	-3.6
Mopeds	48,575	50,649	35,872	35.4	-4.1
Total Two Wheelers	**881,793**	**909,212**	**552,058**	**59.7**	**-3.0**
Three Wheelers	**53,373**	**58,408**	**35,630**	**49.8**	**-8.6**
Total	**1,177,573**	**1,220,230**	**735,945**	**60.0**	**-3.5**

Source: SIAM

New cycle of earnings growth

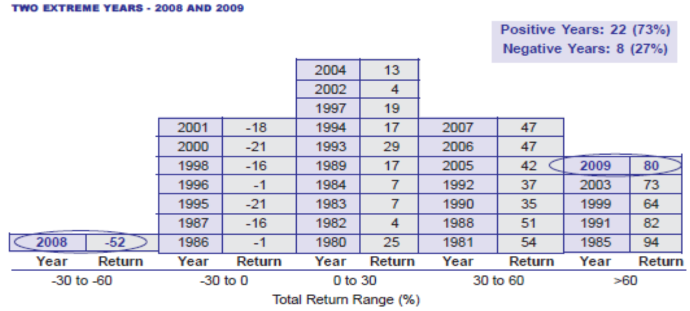
In the last 18 years, the Indian markets have witnessed four distinct earnings cycles. Analysts expect Sensex EPS CAGR of 23% through FY14 - a high front-ended growth of 32% in FY11 followed by 20% CAGR FY11-14.

SENSEX EPS: THE FIFTH GROWTH CYCLE BEGINS



Source: MOSL

TWO EXTREME YEARS - 2008 AND 2009



Note: Returns for calendar years

Source: Bloomberg/MOSL

India's Bonds Gain as Yields Near 15-Month High Lure Investors

India's 10-year bonds gained the most this week as yields near the highest levels since October 2008 attracted investors. The yield on the benchmark note climbed yesterday on speculation a pickup in industrial output and China's decision to rein in bank lending will spur the Reserve Bank of India to raise borrowing costs to curb inflation. The central bank is scheduled to review its monetary policy at a Jan. 29 meeting. India's cost of selling 10-year debt climbed by a record 2.3 percentage points in 2009.

Real Estate Markets

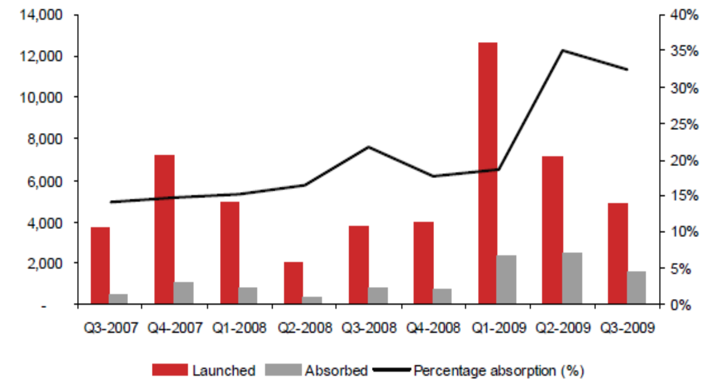
Residential demand and inventory

In spite of all the talk about demand recovery in the residential segment, Mumbai and NCR are the only two regions among the top six regions to have shown a significant recovery in transaction volumes. Bangalore and Chennai's residential markets are still struggling to pick themselves out of the slowdown, while Hyderabad and Kolkata continue to suffer. Until all major regions of India show volumes higher than the current levels, one cannot call it a satisfactory recovery. If volumes do not move up from current levels, concerns about the cash flow situation of developers would increase yet again, given that debt repayments would be coming up in FY11. In such a scenario, developers should not be looking to increase prices as it could hurt sales.

On the flip side, residential inventory across all regions, except Hyderabad and Noida, have shown large and constant declines which have the potential to support prices at current levels. Thus, analysts see a period of price consolidation of at least six months in most markets. The inventory decline is because the pace and size of new launches have come down over the past 18 months as developers focussed on existing projects.

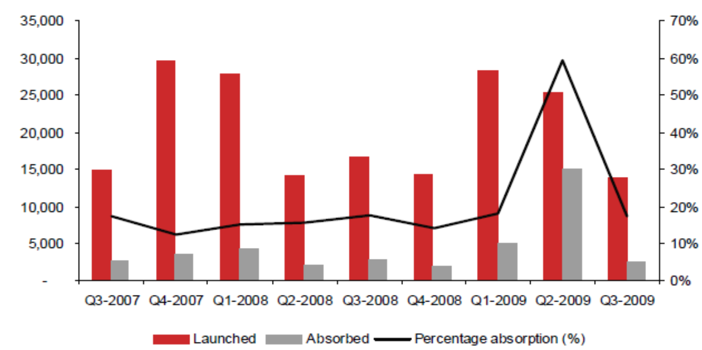
An interesting factor that was in terms of the average size of apartments sold. In CY09, cities which have witnessed a quick bounce-back from lows have seen a reduction in the average size of apartments, whereas regions such as Bangalore and Kolkata have not witnessed any significant reduction in apartment sizes. This indicates that the reduction in prices from their peak has not been sufficient and hence buyers have had to compromise on the living area. Unfortunately, a trend of increasing apartment sizes has begun again in the past two to three months.

Percentage of new launches absorbed every quarter in the INR0-1.5mn per unit segment



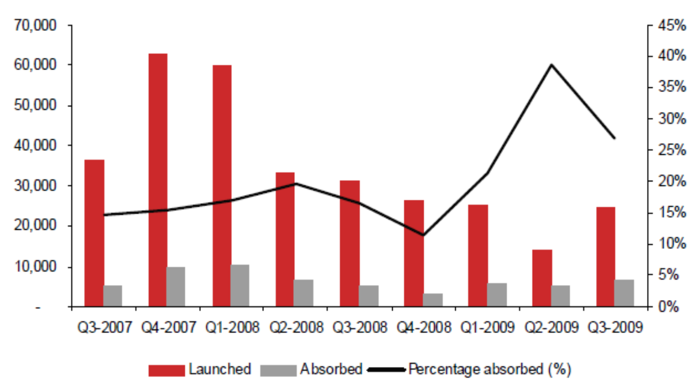
Source: Propequity, Nomura research

Percentage of new launches absorbed every quarter in the INR1.5-3mn per unit segment



Source: Propequity, Nomura research

Percentage of new launches absorbed every quarter in the INR3mn-plus per unit segment



Source: Propequity, Nomura research

Commercial Property

As per PropEquity, there is an estimated 62.3 mn sq. ft of leasable commercial space is likely to get completed in CY2010E and 45.6 mn sq. ft in CY2011E across Mumbai, NCR, Bangalore, Pune, Chennai and Hyderabad with potential absorption significantly below these levels. This will likely result in (1) larger vacancies and (2) project completion delays, thus pushing back supply creation. Demand trends indicate pick up in commercial activity in 3QCY09 but the absorption levels remain at sub-50%, thus increasing the quantum of inventory. As per Cushman and Wakefield data, it is expected that the weakest commercial absorption will happen in NCR where absorption levels were below 25% while Mumbai and Bangalore were relatively better placed as far as commercial demand is concerned.

Reasons for supply overhang: As at end-FY2008, total IT employees were 2 mn and various companies were expanding facilities based on 25% plus projected growth in employees. Thus, commercial construction took place with potential incremental employees of 1.1 mn in FY2008-10E while actual employee accretion is 40% of projected demand. These projects assumed a 18-24 month construction cycle. Significantly lower-than-estimated employee growth has led to a substantial amount of unfinished commercial projects. Some planned commercial projects have been converted into residential projects by developers, others have slowed down.

Increasing competition: Increasing competition is also expected even as demand supply dynamics don't look very favorable. More IT companies are likely to use projects developed by group real estate companies. A case in example is Tata Realty which is developing IT SEZs at 8 locations all over India – Hinjewadi, Trivandrum, Kochi, Ahmadabad, Hyderabad, Kolkata, Nagpur and Mangalore where Tata Consultancy Services (TCS) will likely be the anchor tenant to take advantage of economies of scale.

Supply of 62.3 mn sq. ft of leasable commercial space in CY2010E
Supply and absorption data from PropEquity, CY2010-CY2012E

	CY2010E	CY2011E	CY2012E	Total
	Supply	Supply	Supply	Supply
Lease				
Pune	6.0	4.6	1.0	11.6
NCR	12.2	7.1	12.3	31.7
Mumbai	9.3	7.1	6.2	22.6
Hyderabad	13.6	5.9	7.3	26.8
Bangalore	9.6	5.2	3.2	18.0
Chennai	11.6	15.6	6.0	33.2
Total	**62.3**	**45.6**	**35.9**	**143.9**
Sale				
Pune	2.1	0.9	0.0	3.1
NCR	8.6	6.5	9.8	24.8
Mumbai	7.9	4.1	1.2	13.3
Hyderabad	0.3	2.5	0.0	2.8
Bangalore	0.1	0.6	0.0	0.7
Chennai	1.4	0.0	0.0	1.4
Total	**20.4**	**14.6**	**11.0**	**46.1**

Source: PropEquity, Kotak Institutional Equities

The residential markets are seeing potential recoveries and there are increasing enquiries in the commercial space. This bodes well for the real estate markets in 2010.

Growth in IT/ITes to drive commercial demand
Estimation of commercial area required, FY2010-11E, March fiscal year-ends

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009E	2010E	2011E
IT employees (in '000)												
IT, Engineering and R&D, Software product exports	110	162	170	205	296	390	513	690	860	946	993	1,093
IT-enabled services exports	42	70	106	180	216	316	415	553	700	812	893	1,027
Domestic sector	132	198	246	285	318	352	365	378	450	518	585	672
Total	**284**	**430**	**522**	**670**	**830**	**1,058**	**1,293**	**1,621**	**2,010**	**2,276**	**2,471**	**2,792**
Addition space required (mn sq. ft)												
Total space required in India (assuming 100 sq. ft/ employee)		15	9	15	16	23	24	33	39	27	20	32
IT space required (assuming 33% built to suit)		10	6	10	11	15	16	22	26	18	13	21
Other commercial space		6	4	7	7	10	10	15	18	15	12	12
Total commercial space required		**16**	**10**	**16**	**18**	**25**	**26**	**36**	**44**	**32**	**25**	**33**
Growth rate in employee additions(%)												
IT, Engineering and R&D, Software product exports		47	5	21	44	32	32	35	25	10	5	10
IT enabled services Exports		67	51	70	20	46	31	33	27	16	10	15
Domestic sector		50	24	16	12	11	4	4	19	15	13	15
Total		**51**	**21**	**28**	**24**	**27**	**22**	**25**	**24**	**13**	**9**	**13**

Source: Kotak Institutional Equities