

India Notes

Monetary recalibration in process

The Reserve Bank of India increased key interest rates by 25 basis points with immediate effect in order to curb increasing inflation, which could make housing and auto loans more expensive. It increased the repo and reverse repo rates by 25 basis points (bps), to 5.5% and 4% respectively, as part of its "calibrated exit from the expansionary monetary policy", which was part of the stimulus package introduced by the government at the height of the global financial crisis.

FDI in May up 5.6% to USD 2.21 bn

India's foreign direct investment in May 2010 rose by 5.6 per cent to USD 2.21 billion, against USD 2.09 billion in May 2009, reversing the decline in the previous two months. The inflows in the first two months of FY 2010-11 were, however, down by about one per cent at USD 4.39 billion. Economists have predicted that the inflows are likely to remain healthy but there could be some volatility given the global scenario, particularly the European events.

Real Estate revival gains strength

During the past two months, volumes have been varied across markets. The Mumbai market has shown a decline on low affordability levels and fewer project launches. Southern India, particularly Bengaluru and Chennai, is witnessing better absorption levels due to strong demand led by the IT sector. In Northern India, the Gurgaon market has outshone others with strong volumes from both, investors and end-users.

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Economy & Markets

RBI hikes key rates to check inflation

The Reserve Bank of India (RBI), India's central bank has increased policy rates three weeks before the scheduled monetary policy review meeting on the July 27. The RBI raised both the repo and the reverse repo rates by 25 bps to 5.5% and 4% respectively. RBI observed that this was done in light of the evolving macroeconomic scenario. Analysts had expected the central bank to wait until the meeting and then hike the rates by 50bps. With the surprise 25 bps move, however, it looks increasingly likely that the central bank will only deliver a 25 bps hike at the end of the month.

So far, the RBI has mainly tightened monetary policy by mopping up excess liquidity from the banking system through 100 bps increases in reserve ratios. Further, the repo rate and reverse repo rate had also been increased by 75 bps, but with little or no pass-through to higher lending rates. Indications from banks, following the most recent RBI move, suggest that lending rates on a broad basis could continue to remain at current levels.

The rationale for rate hikes from the RBI can be summed-up as being driven by strong underlying growth momentum and worrying developments on the inflation front. On Wholesale Price Index (WPI) inflation, the central bank noted that the rise in core inflation (non-food manufacturing) from -0.4% in November 2009 to 6.6% in May 2010 is indicative of inflation impacting all sectors of the economy with demand side pressures becoming more evident. Recent increases in the administered prices of fuel are expected to push-up WPI inflation in the short term. As a result, there is a risk that inflation expectations may become unhinged.

RBI expects this hike to contain inflation and anchor inflation expectations, while not hurting the recovery process.

Analysts have been highlighting the urgent need for the RBI to cool domestic demand, not just to contain demand-pull inflation, but also to stem the deterioration in the trade balance.

The 25 bps rate increase is a step in this direction. The forecast is for a further hike of 125 bps in policy rates over the next 12 months.

Bottom line: About time. Policy rates needed to go up in India, and there is still a long way to go. There seems no reduction in inflation for the government to let down their guard. At the end of the month, another 25 bps increase in policy rates are expected and so are many more rate hikes beyond that.

Base rate comes into effect

Last month the Indian Banking system moved from Benchmark Prime Lending Rates (BPLR) lending system to the base rate lending system. RBI's directions on having a base rate i.e. the minimum rate below which banks cannot lend with effect from July 1, was largely aimed at bringing parity between different classes of borrowers and discourage discounted lending by banks to blue-chip customers, mostly large corporate houses. Almost all the banks have announced their respective base rates, which range between 7.0-8.75 per cent. This means they would have to lend at a rate equal to or above these base rates. In the previous regime, the banks' interest rates were linked to their Benchmark Prime Lending Rates decided by them from time to time.

The markets do not see any immediate impact on corporate or retail lending by both these measures. The moves were largely expected and the current cost of debt took into account the announcements.

IIP beats the most optimistic estimate ...

The Index of Industrial Production (IIP) increased to 17.6% Y-o-Y in April, growing noticeably higher than expectations. The number comes in against a growth of ~13.9% in the previous month and ~1.1% a year ago. While there was growth across sectors, it was the stellar growth in capital goods which stole the show. Growth in capital goods came in at ~73% versus -5.9% in April 2009 and ~28% in March 2010. Consumer goods also registered a healthy growth of 14.5%, driven by 37% growth in consumer durables.

... momentum accelerates further; but moderation ahead

The momentum, which IIP has gathered during FY10 on the back of timely stimulus injection and credit availability, has metamorphosed into solid growth, driven by increasing end-demand. Further, lead indicators such as the Purchasing Managers Index remain strong. However, the current superlative growth in capital goods is certainly one-off. Moreover, intermediate goods, which typically exhibit a 2-4 month lead period over IIP, is turning a tad softer. Taking all such indicators and the base effect dynamics into account, we believe, IIP should come down to high single digits by June. The balance months of FY11 would exhibit somewhat slower (yet strong) growth. However, this should not be mistaken for a slowdown. Rather, over the next six months IIP growth would consolidate around a more steady-state, realistic, and sustainable path.

FY10 Current Account Deficit Widens to Record High, but Capital Flows Sustain

Similar to trends in the previous quarter, rising imports (both oil and non-oil) resulted in the trade deficit widening to €24.5bn in Q4FY10. Invisibles (software and remittances), which normally see an uptrend in the Q4, decelerated due to outflows on account of business services. Encouragingly, the other components of invisibles remained strong. This resulted in the current account deficit widening to € 10bn vs. € 9bn in the previous quarter. Capital flows led by FDI, FII and loans rose to € 12.7 bn resulting in the overall balance of payments coming in at € 1.7bn in 4QFY10.

INR appreciation story remains but pace remains a question: Despite a Current Account Deficit (CAD) of € 27.6 bn, analysts maintain their view of a steadily appreciating currency with the rupee at Rs59.42/Euro by Mar11, given: (a) the underlying growth story – GDP of 8.4% in FY11E with forex reserves at € 217bn, (b) imports are primarily led by industrial/capital goods, (c) capital flows are led by relatively more stable FDI flows and (d) flows are more than sufficient to finance the CAD.

Oil price reforms in India, positive for fiscal balance and PSU/OMCs

The Empowered Group of Ministers (EGoM) decided recently to market-link the prices of petrol and diesel (eventually) at both the refinery gate and the retail level leading to increase in petrol price by €0.06/lit. However, diesel price has initially been increased by €0.03/lit with further increases to be made by the oil marketing companies only in consultation with the Petroleum Ministry without giving any timeline for the same. The EGoM has also, increased the price of domestic LPG by €0.6/cylinder and Public Distribution System Kerosene by €0.05/lit while deciding to continue with the subsidies on these fuels. Based on FY11 YTD average crude and product prices and the increased fuel prices, we estimate gross under-recoveries to be €8.96bn.

Monsoon Covers Entire India

India's south-west monsoon rains have covered the entire country, about 10 days earlier than the normal date, according to the country's weather office. Monsoon rains in India between June 1 and July 5 were 13% below the long-term average, the weather body said. Despite a deficiency in rainfall so far, the weather department expects rains to be 102% of the long-term average during the June-September monsoon season.

Analysts are not unduly perturbed with the monsoon performance till date because (a) June seems to be structurally prone to below normal rainfall due to significant changes in weather patterns, (b) June rainfall in itself accounts for non-material share of the total rainfall in the monsoon period at around 10-12% and (c) Normally, sowing in crop critical areas begins in the first fortnight of July, hence a weak June may not necessarily imply a weak overall monsoon as good precipitation in July-Sep can more than compensate for the June weakness.

Domestic Demand Going Strong

Domestic consumption not showing any sign of letting up

While global headwinds have impacted market sentiment and risk appetite, Indian consumption has remained relatively insulated. This could be due to (a) lower real economic exposure to the troubled Eurozone area and (b) rising disposable personal incomes across rural and urban India.

Auto Sales Going Strong

Auto sales continued with their good run: Rising industrial activity, robust freight volumes and base effect underpin the continued sharp growth in commercial vehicle (CV) volumes. Medium and heavy commercial vehicle (MHCV)

volumes grew 88% yoy in May-10 and 95% YTD, while light commercial vehicles (LCV) have grown 38% and 40%, respectively. Four wheeler volume sales have grown 35% YTD, driven by a spate of successful new car launches (Fiat Figo, Chevrolet Beat and Volkswagen Polo). Two-wheelers have shown relatively lower overall volume growth at 29% for May-10 and 25% YTD.

HDFC's loan disbursement growth in 4QFY10- highest in past four years

The growth rates in HDFC's mortgage approvals and disbursements, is also indicative of an undercurrent of strong consumption propensity reflecting in demand for housing. The yoy growth in 4QFY10 disbursement at 36% is probably amongst the highest over past four to five years. Similarly, the growth in approvals has also reached an elevated trajectory (latest reading at 27% and Q3FY10 reading at 32%) after having fallen off sharply in 3QFY09 in the aftermath of Lehman crisis.

Airline traffic sustains at multiyear high levels

Domestic airline traffic also seems to be holding up impressively at very high levels with the passenger flown and passenger km flown metrics sustaining at ~25-30% 3-month moving average growth level over past six months. In fact the latest available datapoints suggests that the growth levels are the highest in at least >3 years.

Real Estate

Market Stabilisation Phase

After the euphoria of 2007, the crash of 2008 and the sharp recovery of 2009, it is expected that 2010 will be year of stability for the India property sector, with: 1) residential demand remaining at FY10 levels in FY11, 2) office leasing demand showing gradual improvement, but not enough to bring down the over-supply or pull up rentals, 3) the retail sector expected to recover only in H2FY11, 4) execution starting to pick up pace and 5) an uncertain interest rate regime, along with a large number of developers looking to raise equity but not able to generate enough demand.

Homes – demand to be region-specific

Demand for housing increased substantially over FY10 mainly in Mumbai and NCR, but with prices having moved up by 35% and 15%-20% YoY respectively, we believe demand is likely to remain flat in FY11. Looking at current trends across the regions, it is expected that stable to slow growth in volumes and stable prices in CY10. On the positive side, Mumbai and Bangalore are two cities where inventory has declined significantly, thus providing support to prices.

Office space – fewer lessees than lessors

The office space segment has become the new hope of the real estate sector in the past six months, as there is growing evidence of a strengthening economy and an improving corporate environment, especially within the crucial IT sector. With the improving economy and better environment for the IT/ITeS industry, we expect corporates to expand and hence expect leasing to improve from the CY09 level of 23mn sq ft to about 35mn sq ft in CY10/FY11. The data shows that leasing continuously improved on a quarter on quarter basis in CY09

Even then, with existing oversupply of at least 42mn sqft and another 40-45mn sqft expected to be completed in CY10, analysts do not expect average rentals to move up meaningfully from here in CY10. The qualification here is that projects that are well constructed, well located and reasonably priced will likely see the benefits of the improved leasing environment earlier, enabling them to charge a premium later.

Execution – building up to the tall task

Project execution has picked up across the board, especially with regards to projects that were stalled due to a lack of funds and buyers during the credit crunch. Developers have started ramping up and are more focused on getting projects back on track to ensure delivery and get the cashflow wheels moving. While execution currently seems to be proceeding at a level pace, developers have to scale up their capabilities significantly on this front to avoid any meaningful delays, which would stall their cashflows and hinder their ability to service their debt. Large developers, such as DLF and Unitech, are optimistic about being able to expand their capabilities to successfully work on 50mn sq ft at a time to be delivered over a three to four year period, on a sustained basis. The key constraint in ensuring higher execution capability is the ability to get approvals in a timely manner and the availability of skilled workforce. However, the necessary condition would be to ensure sales to genuine buyers who would be the source of construction funds, rather than speculators looking at short term gains.

Policy moves – interestingly non-stressful

The Reserve Bank of India (RBI) has started tightening the monetary regime, and analysts expects policy rates to move up by a further 125bps until March 2011. This hike may not affect the physical market significantly as a 10- 11% increase in incomes is enough to compensate for the same. Also, GDP growth is more important in terms of determining property demand in India rather than mortgage rates. The key issue of concern is property-sector-specific measures that the Reserve Bank of India may adopt if it sees property prices or bank debt to developers moving up unreasonably.

These measures would act as a signal to banks to reduce lending to the sector, and would increase the stress on the balance sheet of developers. This could force them to cut prices to increase volumes and cashflows or even enter into distressed asset sales. However, in the near term, these strict measures are not envisaged.

The implementation of IFRS accounting and reporting standards from FY12 onwards will also put the focus of investors mainly on execution apart from sales.

New listings – flood turns into a trickle Since September 2009, 15 companies in the property sector have filed documents for a public issue to raise approximately €3.16bn worth of equity, leading to fears of an oversupply of paper in the sector and possible underperformance of the existing listed stocks in the sector. However, over the past seven months, only five companies have managed successful issues, raising about €471mn between them as investor interest has been limited in the face of high valuations. It is expected that the going will remain tough for the remaining nine companies, and not all will be able to generate the required demand. There could yet be an impact on existing stocks from any large listings which may be offered at a substantial discount to listed peers

Real estate sector is more organised now, putting pressure on supply As of June 2010, €29bn (Rs1.7 tn) was invested in real estate sector from diverse sources such as bank lending, Private Equity funds and equity raising by companies. The developers now face additional pressure of catering to expectations of different investors with different investment horizons and return expectations. Banks and Private Equity investors have relatively shorter investment time horizon and focus more on cash flows and earnings growth, which was not the developers' focus previously. As a result, developers now have little choice in delaying development or controlling supply in pursuit of higher margins.