

India Notes

RBI announces its policy... Tightens up on Real Estate

The Reserve Bank of India (RBI) lifted both the repo rate and reverse repo rates by 25bps to 6.25% and 5.25% respectively, thereby maintaining the Liquidity Adjustments Facility corridor at 100bps. The CRR was left unchanged, as expected. Although, the overall action was more aggressive than expected, the accompanying statement was much milder, with RBI acknowledging that "likelihood of further rate hike in immediate future is low". Containing inflation and anchoring inflation expectations without hurting growth was the key motivation behind the policy move. The objective of ensuring financial stability also played on the minds of policymakers. The central bank imposed stringent norms on housing loans by commercial banks such as increasing the risk weights, higher provisioning for teaser rate loans, among others.

Private Equity Deal Value Slips 27% in Oct '10 To \$326M

The private equity investment activity reached its lowest in October for this calendar year, with deal value declining by 27% to € 236 million (USD 326 million) as compared to € 323 million (USD 447million) in October 2009, according to VCCEdge. Though the number of deals remained nearly the same, the deal value slipped because of lack of big-ticket deals in October 2010. The largest deal during the month was Kohlberg Kravis Roberts & Co's € 36 million (USD 49 million) investment in IPO-bound Avantha Power & Infrastructure Ltd for a 9% stake. But the overall PE deal value is set to more than double as the first 10 months of 2010 have seen transactions worth € 5.5 billion (USD 7.57 billion) as compared to € 3.2 billion (USD 4.4billion) in the whole of 2009.

Credit policy - Increase in provisioning norms are surprising...but not all that bad

The central banks imposed stringent norms on housing loans by commercial banks such as increasing the risk weights, higher provisioning for teaser rate loans, among others. Increase in provisioning norms and Loan to Value caps aims to cool off pricing specifically at the higher end of the market.

Investor Update November, 2010

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Economy & Markets

Key Features of the Policy

RBI has hiked the repo and reverse repo rate by 25bps to 6.25% and 5.25%, respectively. RBI has also stated that the near-term (3-months) possibility of rate hike is low. All the macro economic projections for FY11 have been maintained. Although RBI's intent is to keep liquidity in the tighter mode, however, current levels are extreme and should improve in a few weeks' time as a result of government spending and refunds from the Coal India IPO. Banks may not hike the deposit and lending rates post the rate hike, however, RBI is of the view that the transmission mechanism is still not complete and deposit rates should increase, going ahead.

Overall, RBI's policy statement reflects comfort on the macro economic environment and primary risks exist in the form of domestic inflation and global economic recovery. The global economy is expected to remain weak till the first half of 2011, implying that the exports pick-up from these levels may remain arrested, thus limiting the GDP upside. Based on the current economic situation and projected trajectory, RBI seems to be through with the rate hikes in the current financial year. In case the food inflation remains stubborn, as in the past and commodity inflation spirals, led by the fund flows arising from QEII, RBI may have to change its stance. Going ahead, RBI is likely to keep a closer vigil on the asset prices and capital flows and derive policy measures accordingly.

RBI Monetary Policy Update

The Reserve Bank of India (RBI) in its second quarter Monetary Policy Review dated November 2, 2010, has proposed the introduction of following key changes in respect of housing loans given by commercial banks:

- The loan-to-value (LTV) ratio in respect of housing loans should not exceed 80%.
- The risk weight for residential housing loans of ₹ 121,700 (INR 7.5 mn) and above (irrespective of the LTV ratio) will be increased to 125% from 100%.

- The RBI has raised concerns on 'teaser rate' housing loans as it is of the view that many banks at the time of initial loan appraisal do not take into account the borrower's repaying capacity at normal lending rates. Hence, the central bank has proposed to increase the standard asset provisioning by commercial banks for all such loans to 2%.

Impact: The proposed changes are a reflection of RBI's increasing concern on rising asset prices in India (particularly in tier I cities such as Mumbai and Gurgaon)

Purchasing power for high ticket size houses reduces: LTV ratio being capped at 80% effectively reduces the purchasing power of a home buyer with respect to homes with a ticket size in excess of INR 5 mn and above essentially the premium segment. With a home buyer having to cough up additional 5-10% equity for buying a house, he may have to delay his purchase decision, leading to a fall in incremental sale volumes.

Increased risk provisioning to make housing loans more expensive: According to our banking analysts, the proposed increase in risk provisioning for high ticket size loans and 'teaser rate' loans may lead to a ~50bps increase in housing loan rates, which will directly impact affordability.

10/90 scheme at risk: In the face of rising residential prices, many developers across the country are offering a 10/90 scheme wherein the home buyer pays ~10% upfront and the balance 90% on possession. With LTV capped at 80%, such schemes are at risk of being discontinued. Developers who focus primarily on the premium housing segment may be impacted negatively in terms of volumes. Going forward, a key monitorable will be developers' response to the proposed changes in terms of product pricing, ticket size, and incentives offered to buyers.

Rupee: On a Stronger Footing Post RBI Rate Hike

The Indian rupee commenced higher on Wednesday, 03 November and continued to advance further to regain its two year peaks lost since mid October. The domestic currency opened at Rs. 44.31 per dollar and hit an intra day high at 44.24 propped up by a waning US dollar and strong start to the domestic share market.

Rupee rebounded to its 25 month peak in intra day trades to around 44.24, a level that was mislaid since the Coal India IPO took away funds from the secondary markets. Now the foreign funds are seen reversing its recent trends and have are making a slow comeback into the domestic markets. Moreover, the RBI rate hikes that drove capital inflows and helped the rupee reach peak since mid September monetary policy is once again likely to be the key factor to bring funds back into the domestic arena.

The stock markets had a spectacular rally last week and closed at an all-time high level. The main trigger for the market rally was the US Federal Reserve's announcement of € 435 billion (USD 600 billion) in quantitative easing to provide a boost to the US economy. Analysts believe that a sizeable part of this quantitative easing will flow into emerging markets as part of hedge fund and foreign institutional investor (FII) investments.

Foreign institutional investors (FIIs) infused a record € 4.63 billion (USD 6.4 billion) in October, accounting for nearly one-fourth of the total inflows came in stock market so far this year. As per the data available with capital market regulator Securities and Exchange Board of India , overseas fund houses were the net buyer of Indian equities worth € 5.65 billion (USD 6.42 billion) during the current month, the highest amount pumped in by the FIIs in any single month.

With this heavy inflow in just one month, the total net investment by FIIs on the local stocks now stands at € 21.82 billion (USD 24.79 billion), the highest in a single year. Finance minister Pranab Mukherjee reiterated the government's commitment to continue with the liberal foreign investment regime while ruling out any immediate need to restrict FII participation in stock markets. India is the only country which recently enhanced FII investment limits in debt while Brazil and

Domestic Demand Going Strong

Indian Auto posts record sales. Festive Sales continue to create new records

Automakers posted record sales in October, with the festive season drawing more customers to showrooms and dealers also stocking up to meet demand. Maruti Suzuki India, TVS Motor Co, Tata Motors, Hero Honda Motors, Mahindra & Mahindra. Toyota Kirloskar Motor, Ford India, Hyundai Motor India and General Motors India — all posted higher sales in the month.

Maruti posted a 39% jump in sales to 118,908 vehicles (85,415 vehicles). Despatches in October were the highest in a month, beating the previous high of 108,006 units in September and making the October the fifth month ever when sales in any month crossed the 100,000 mark. This October, even domestic sales breached the hundred thousand unit sales for the first time ever at 107,555 units (71,551 units).

India Equity Markets Shine

Food inflation eased for a third week in late October 2010, the latest government data showed. The food price index in the year to 23 October rose 12.85% compared with 13.75% rise in the previous week, as the prices of vegetables and pulses fell. Fuel inflation for the same period was at 10.67%, slowing from 11.25% the prior week.

The Q2 September 2010 corporate results have been encouraging. The combined net profit of a total of 1932 firms surged 38.8% to € 13.12 billion (USD 18.5 billion) on 18.4% growth in sales to € 95.4 billion (USD 134 billion) in Q2 September 2010 over Q2 September 2009.

India's services sector expanded last month at a faster rate than in September 2010, bringing an end to a 3-month decline in the key business activity index, a survey showed on Wednesday, 3 November 2010. The manufacturing sector expanded in October 2010 at a much faster pace than in September 2010, supported by strong output and a sharp rise in new business, a purchasing managers' index (PMI) showed on Monday, 1 November 2010.

India's exports rise 23.2% in Sept. 2010

The trade gap for the month under review stood at € 8 billion (USD 9.12 billion) versus € 11.5 billion (USD 13 billion) in the previous month. It was at € 6.1 billion (USD 6.9 billion) in the same month last year. India's exports in September jumped by 23.2% from a year earlier to € 15.86 billion (USD 18.02 billion) while imports rose 26.1% to € 23.9 billion (USD 27.14 billion).

Exports were up 17.2% in Rupee terms during September 2010 while imports were up 9.9% in Rupee terms. Oil imports during September 2010 were up 14.4% at € 6.6 billion (USD 7.5 billion) while non-oil imports rose 31.2% to € 17.3 billion (USD 19.7 billion). Cumulatively, exports during April-September have grown by 28% to € 19.24 billion (USD 103.7 billion) while imports during the same period are up nearly 30% at € 146.7 billion (USD 166.5 billion). Trade deficit for the first six months of the current fiscal year has been estimated at € 55.30 billion (USD 62.8 billion) as against the deficit of € 41.5 billion (USD 47.2 billion) during April-September 2009-10

Infrastructure: Investment pegged at \$1,025 bn

The Planning Commission has projected that investment in infrastructure would almost double at €902 billion (USD 1025 billion) in the 12th Plan, compared to € 452 billion (USD 514 billion) in the 11th Plan. Of the €902 billion (USD 1025 billion), 50 per cent is expected to come from private sector, whose investment has been 36 per cent in the 11th Plan. Gajendra Haldea, advisor to the deputy chairman of the Planning Commission, at a conference said debt mobilisation posed a serious problem. He explained nearly €220 billion (USD 250 billion) of debt was required for both public and private sectors during 11th Plan. "Infrastructure projects require long-term debt. Commercial banks lend for the medium term as their asset-liability mismatch prevents them from undertaking long-term commitments. Thus, the Planning Commission has suggested launching debt financing, where in-debt fund will be set up," he said. The fund would cover road, railways, port, Metro rail and airport projects that provide for a compulsory buyout by the authority granting the concession. It would also cover power and other projects.

Real Estate

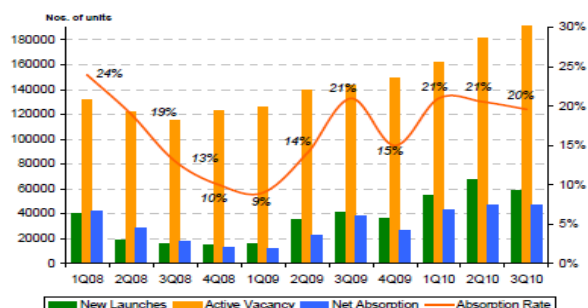
Recovery taking myriad contours

JLL REIS released 3Q10 data for the top seven metros, which displayed varied performances. Gurgaon, Chennai and Kolkata were strong, Pune and Bangalore remain good but trending down, Hyderabad is trending up but remains weak, Mumbai slowed sharply and Noida remains enigmatic. The overall market remains healthy, as underlined by momentum in new launches and new sales, resulting in sequentially flattish and high quarterly absorption rate of 20% (21% in 2Q10).

Key takeaways: 1) 3Q10 data should be seen in the context of continuing property price increases (surpassing 2007 peaks in several metros). 2) Volumes appear to be sustaining (but not accelerating) price increases in most markets except Mumbai. 3) New sales are measuring 80-85% of new launches for the last three quarters, keeping the overall inventory of unsold (and under construction) units in check. 4) An overall absorption rate of 20% implies roughly 4-5 quarters of inventory (versus 16 quarters required from start to delivery), implying limited oversupply risk. 5) Noida is the key contributor (70-75%) to the rise in the overall unsold inventory over the last four quarters.

Developers appear to be concentrating on the margins (i.e., price increases) and losing focus on asset turnover (i.e., volumes) in a rather early phase of a multi-year structural growth story. Mumbai is a prime example, wherein the demand is clearly resisting price increases (new sales halved in 3Q over 2Q). It appears that developers have started giving 10-15% soft discounts (EMI waiver, across table talk) to move sales.

Pan-India: Residential Demand-Supply Trend



NAV downgrade cycle turning as visibility improves

The Analyst community has started seeing a turnaround in the NAV downgrade cycle on the basis of improving fundamentals and visibility amongst Indian Developers. Analysts see stability in most parameters that help derive the NAV and believe that the NAV cycle is poised for a turnaround. NAV can be defined as a function of land bank (quality as well as quantity), initial selling prices, capitalization rates, construction costs, land bank phasing and WACC and each of these parameters has been very volatile over the past three years. Below is an analysis on the evolution of various parameters over the next 6 quarters below:

Selling prices: Residential prices after seeing 25%-30% correction during end-CY2008 have sharply recovered in Mumbai/Gurgaon and have shown signs of uptick in other geographies. Commercial prices have also seen 20% correction from peak in early 2008 and are showing signs of bottoming out. Analysts have assumed a reasonable 5% growth in selling prices, which is arguably lower than inflation in the near term.

Capitalization (Cap Rates): Most Analysts model post-tax cap rate of 9% for the commercial segment and 10% for retail real estate. Implied cap rates from REITs traded in Singapore are in the 5%-9% range. They believe cap rates in India would be linked to alternative saving instruments such as FDs and government bonds with suitable risk premium. Cap rate assumptions indicate a risk premium of 400-500 bp.

Construction costs: Analysts estimate construction costs to grow at a 5% per annum, in line with our growth rate for selling prices. They find these reasonable as most of them see near term weakness in cement prices. However, any sharp rise in construction costs on account of higher steel/cement prices could be a key downside risk to NAV estimates

Land bank phasing: Most companies have started including land banks which are either fully paid for or have limited outstanding. Phasing forecasts have become more accurate recently as more data points are now available on execution.

WACC: Upward trend for interest rates will likely be balanced by lower risk perception for real estate companies.

Most Analysts have assumed a WACC of 14% with cost of equity at 15% and cost of debt at 13%.

NAVs are most sensitive to selling prices and thus P/NAV multiples could expand if there are expectations of faster growth. Growth opportunities in the real estate sector are linked to the direction of GDP growth, as higher growth provides more avenues for reinvestment. Well-managed companies with a track record of profitable reinvestment and good near-term execution visibility could potentially justify a premium to NAVs. Companies having balance sheet strength could look for adding projects and are thus likely to trade at better multiples. Further the fund raising pipeline for the sector could have an impact on near term P/NAV multiples.

Real estate is a capital intensive sector and more than ten companies are planning to raise funds over the medium term, which cumulatively amount to US\$4 bn. In addition, existing companies with large promoter holdings may opt for secondary fund raising to pursue growth. Moreover, private equity investors may look at opportunities to reduce stake as they generally tend to have a limited investment time horizon. Indian real estate companies have raised about US\$10 bn over the past four years including almost US\$2 bn in the past 12 months.

Residential robust; Inventory at 3-yr low, absorption has picked up Residential absorption has picked up to 25,000-30,000 units in the past 4 months as compared with an average of about 20,000 units in 2009 for the 15 Indian cities in the residential segment. Residential inventory is currently at less than 10 months of absorption and at a 3-year low.

Commercial absorption picking up, but inventory still very high While absorption has picked up from averaging about 1.88 mn sq ft per month in 1H2009 to about 2.52 mn sq ft per month in 1H2010 for the seven key Indian cities in the commercial segment. While absorption momentum remains robust, about 40 months of inventory currently remains vacant. This is largely due to expectations of increased IT and ITES demand for office space not materializing in 2008 due to a fall in number of net employee additions as a result of the financial crisis.