

## India Notes

The Global Financial crisis has had an impact on India but with its strong domestic consumption and renewed interest from Foreign Institutional Investors the economy has shown resilience with 6% GDP growth in 2HFY09. Consumer demand has picked up, but a weak monsoon and inflationary pressures will limit further surprises. Although new corporate investments are on hold, enabling conditions are in place for an upturn which, along with a full-fledged global recovery, should drive the economy positively over the next few quarters.

Compared with its peers, India has proved to be relatively resilient to the global economic downturn with near 6% GDP growth, versus an average of -2.3% regionally. While structural factors such as higher domestic orientation and high savings rates provided the base, aggressive policy actions aided the revival of the domestic economy. Thanks to a relatively healthy banking sector, the Reserve Bank of India's (RBI) sharp cuts in interest rates and liquidity-support measures have translated into improved credit availability and a 1-2 ppt fall in lending rates. With fiscal policy actions focusing on improving affordability and adding wealth to lower-income rural households, overall consumption spending has witnessed traction. Industrial output data suggest that more sectors are recovering; in June 2009, when industrial production grew 7.8% YoY, 12 out of 17 subsectors reported positive growth, versus five in January 2009.

The near 20% rainfall deficit during the 2009 monsoon has adversely impacted the sowing of key crops, which will impact agricultural output by 5-10% this year. Although agriculture accounts for only 17% of GDP now, the fall in FY10 agriculture GDP will dampen the buoyancy in rural demand that has been visible over the past few years. Inflationary pressures are also building up, as reflected in the double-digit consumer price inflation.

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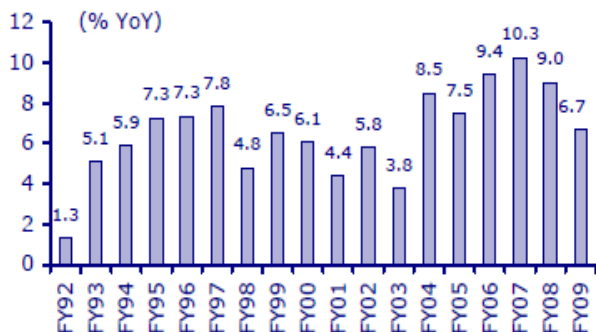
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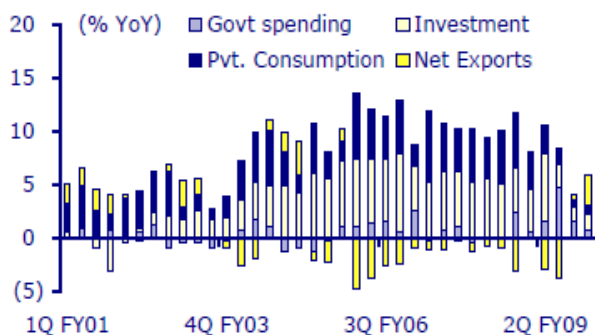
## Economy & Markets

After five years of strong growth, signals that India's credit-driven growth had peaked started to become evident from late 2007. While the Indian economy appeared to be insulated from the US-led global downturn even in 1HFY09, by October 2008, with a collapse in exports, a freeze in external credit and rising capital outflows, domestic growth momentum was under pressure; 3QFY09 GDP growth came out at 5.8%, versus 7.7% in 2Q, with growth for the Industry component of GDP falling to 2%, after 25 quarters of +6% growth. Thus, for the fiscal year ended March 2009, real GDP growth was 6.7%, versus 9% in March 2008 and an 8.8% average for the five-year period between FY04-08. The deceleration was driven by a sharp fall in discretionary consumption and investment, which had been on an upswing since FY04.

## GDP growth



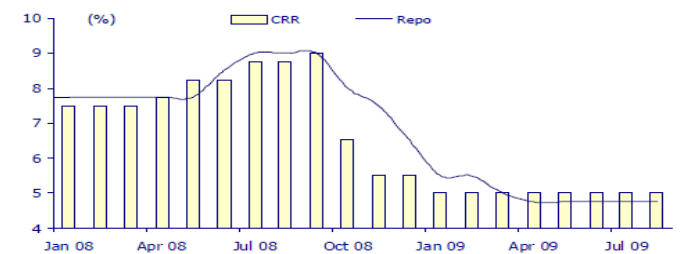
## Breakdown of GDP growth



Source: Reserve Bank of India (RBI), CLSA Asia-Pacific Markets

While structural factors - namely low exposure to global trade and capital flows as well as penetration upside for basic goods and services – underpin India's resilience, an aggressive monetary policy response and ongoing and new fiscal stimuli were key to the early revival. The cautious monetary-policy stance that prevailed until mid-2008 provided room for significant liquidity infusion and aggressive rate cuts. Given the well-capitalised, largely state owned banking system, transmission of monetary stimuli to the real economy was relatively quick, even in the backdrop of high risk aversion.

## Aggressive monetary policy actions

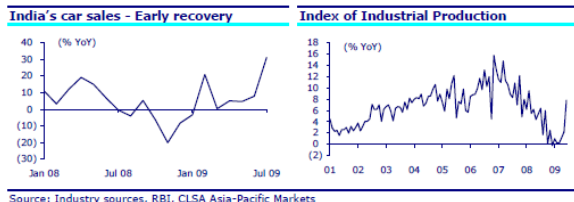


Source: RBI, CLSA Asia-Pacific Markets

While India did not announce any mega fiscal stimulus package - given the constraints imposed by a consolidated budget deficit of about 10% of GDP - measures such as cuts in excise duty (up to 6ppts) were effective in reviving consumer demand. The boost to consumer incomes from the pay hike for government employees and the ramp-up of the National Rural Employment Guarantee Scheme (NREGS) also helped. In 3QFY09, government spending accounted for as much as 4.9ppts of reported GDP growth.

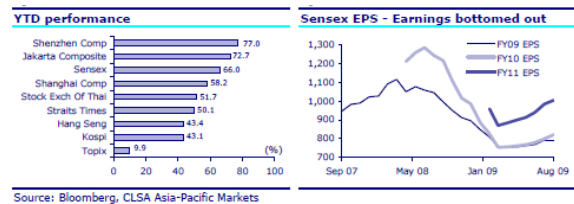
## Recovery clearly visible

The recovery in consumer demand first reflected in a pickup in auto sales from December 2008, as the combination of lower taxes, reduced financing costs, fuel-price cuts and producer/dealer discounts resulted in significantly improved affordability. This was followed by an increase of demand in consumer durables (YoY growth output has been 6-16% ahead of the broader Index of Industrial Production since February 2009) and by June 2009, when IIP growth was a strong 7.8% YoY, 12 out of 17 sub-groups were reporting positive growth, versus five in January 2009.



## Equity markets have taken notice

The visible resilience of growth in India has translated into big outperformance for the Sensex, though this could also be partly a result of the surprise outcome in the 2009 election. Recent economic indicators and strong 1QFY10 results have led to a 9% upgrade in the Sensex's FY10CL EPS from the February-2009 low, but clearly the market's 75% re-rating during this period reflects expectations that the upturn will gather momentum in coming months.



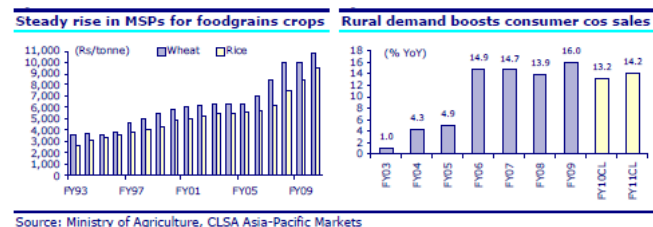
## Consumption outlook - Mixed

While a recovery in domestic consumer demand is clearly evident, prospects for the acceleration of this trend over the next few quarters do not appear bright. The adverse impact of the poor agricultural crops on rural demand, inflationary pressure and the bottoming out of interest rates will offset the benefits of an uptick in hiring and the increased government payouts. The full impact of the failed monsoon yet to be seen, the risk is on the downside.

## Failed monsoon - Taking the shine off the rural India story

Rural demand has been buoyant over the past two to three years, as good monsoons, strong policy support for agriculturists and step-up in government spending on rural India have boosted consumer incomes/wealth.

The government has provided significant increases in the minimum support prices (MSP) for key crops over each of the past few years, pushed banks to raise the availability of low-cost credit to agriculture and waived US\$14bn of farm loans in early 2008. It has also stepped up outlay for the NREGs to US\$8bn (versus US\$2.5-3.3bn prior to FY09) to cover 45m households. Strong rural demand has been evident in healthy growth of products and services with a significant share in rural markets, especially consumer staples and new mobile connections.



## Automotive sales shine

During the month, the passenger car segment and two-wheeler segment reported a neck-to-neck growth of 25.6% and 25.1% in domestic markets respectively. Overall automobile sales volume rose by handsome 21.6% with the domestic sales rising by 24.3% and the exports by 6.1%.

**Passenger vehicles:** Domestic car sales in August 2009 reported robust growth of 25.6% and the exports rose by 37.5%, whereas utility vehicle (UV) and multi-purpose vehicle (MPV) sales grew by 11.6% in the domestic market.

**Commercial vehicles:** CV sales reported second month of positive growth with the domestic sales growing by 18.5%. However CV exports continued to be subdued with 37.3% year-on-year (y-o-y) decline.

**Two-wheelers:** The two-wheeler segment performed well in the month with the domestic sales growing by 25.1% yoy.

	Domestic sales			Exports		
	August'09	yoy(%)	YTD(%)	August'09	yoy(%)	YTD(%)
Cars	120,669	25.6	13.5	40,901	37.5	39.1
UV/MPVs	31,431	11.6	6.9	444	15.3	-47.6
<b>Commercial vehicles:</b>	<b>40,624</b>	<b>18.5</b>	<b>-2.2</b>	<b>3,442</b>	<b>-37.3</b>	<b>-38.3</b>
M&HCV	17,345	4	-23.5	1,633	-3.8	-5.9
LCV	23,279	32.2	21.8	1,809	-52.3	-54.6
<b>Two wheelers:</b>	<b>776,777</b>	<b>25.1</b>	<b>17.7</b>	<b>89,856</b>	<b>-1.9</b>	<b>-3.4</b>
Scooters	118,694	23.1	20.5	2,196	-13.2	1.5
Motorcycles	611,173	25.9	17.1	87,405	-0.8	-3
Mopeds	46,878	31.4	24.6	255	-72.9	-61.3
Electric	32	-99.1	-76.6	0	0	0
<b>Three wheelers</b>	<b>39,201</b>	<b>22.8</b>	<b>12.1</b>	<b>14,677</b>	<b>8.3</b>	<b>-7.1</b>

## Inflationary pressure rising

Although inflation has been off the headlines due to the fragile state of the global economy and the (0.21%) YoY inflation rate registered for the benchmark wholesale price index (WPI), consumers are still facing an upward push in living costs. Consumer price inflation (CPI) is running at 10%, reflecting the rise in prices of food articles; with prices likely to remain high due to reduced output, discretionary spending of lower income consumers is likely to contract. The bottoming-out of borrowing costs will weigh on growth of durables sales.

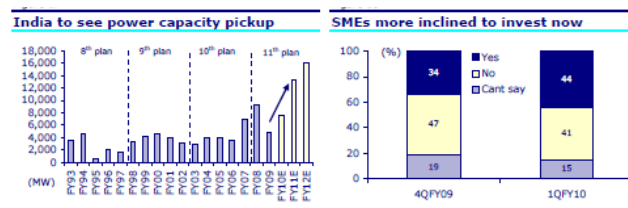
## Employment - The silver lining

While the monsoon failure is clearly an overhang on consumption growth over the next few quarters, we see positive indicators as well. The Naukri JobSpeak Index, run by India's largest job portal, has been rising for two months in a row and is up 9% from its low. There is anecdotal evidence of hiring in sectors that were hit by the downturn, including real estate and financial services. IT services companies are looking to restart hiring soon, given improved utilisation levels and signals on a demand recovery; most companies surprised positively in 1QFY10.

## Investment & Capex cycle picking up

Catalysts for a pickup in the investment cycle are in place and expect a visible upturn in the next two to three quarters. Improved demand conditions and reduced borrowing costs have given a boost to projects' internal rate of return (IRRs), while better credit availability and supportive equity markets have eased financial constraints. In addition, the effect of stimulus measures announced in late 2008/early 2009 will start to come through, with a new administration now firmly in place and residual policy bottlenecks getting addressed. State governments have yet to step up their spending on planned expenditure, based on the relaxed borrowing limit (4% of Gross State Domestic Product GSDP) allowed by the government.

Banks also have room to leverage refinancing facilities to the extent of US\$8bn from the India Infrastructure Company (IIFCL), as announced in the budget. Two infrastructure sectors where we expect a visible pickup in activity are roads and power. The government plans to award more than 40 road projects, worth some US\$10bn, over the next year; with IRRs looking better due to cost restructuring, front-ending of viability gap support and lower borrowing costs, we expect a healthy takeup from developers. Likewise, for the power sector, the commencement of the process for bulk ordering of 22x660MW supercritical sets suggests a pickup in capex. Corporate capex intentions, too, appear to be building up; 44% of the SMEs now expect to spend on equipment in 2009 - 10ppts higher since the 4QFY09 survey.



Source: Central Electricity Authority (CEA), CLSA Asia-Pacific Markets

## Property - On the up

Indian property stocks have risen 2-3x from their lows but are still 65-80% down from their peaks. A severe downturn in the property market saw residential property prices declining 25% from peak in 2007 and office rentals falling by 30- 40%. A decline in prices and interest rates has triggered a revival in the residential-property market, though an oversupply-hit office market awaits a hiring recovery in the outsourcing industry.

Meanwhile, developers have sold assets and raised equities, declining leverage across the sector. With continued traction in residential sales volumes and first signs of a price recovery, developers have started land purchases.

### Strong volumes driving residential market

A more than 2.5x rise in property prices between 2003-07, coupled with a rise in mortgage rate of 450bps had dried up transaction volumes in 2008. Developers took aggressive price cuts of 25-35% in early 2009, which have revived demand. Further, a 300bps decline in mortgage rates since the 2008 peak has boosted housing affordability, which we estimate to be near its best level, last seen in 2003-04. Volume recovery, though sharp, has been largely limited to the affordable segment as speculative sales and luxury housing is taking more time to recover. Recently, prices have again started rising, with an average of 10% recovery in housing prices witnessed from their bottom.

### Weak IT demand, oversupply has hit office rentals hard

While the residential segment has recovered, the office segment is yet to see either a recovery in volumes or in prices. 2008 witnessed an increase in office-space supply of 40% YoY, even as demand remained the same as 2007 levels. Again, 1HCY09 has witnessed an oversupply with the absorption of just 45% of the supply. Persistent oversupply has led to a rise in vacancy rates above 10%. Rents are now down 30-40% across cities. Encouragingly, the past couple of months have seen more companies looking to expand their India-related hiring even as bulk (50%+) demand from the IT outsourcing industry remains weak.

Retail rents fell 30-50% from peak as several retailers were forced to abandon their expansion plans following the credit crunch. However, retail sales are now on track resulting in a pickup in transaction volumes for premium location properties.

### De-levered balance sheets laying foundation for next upturn

Developers spent aggressively on acquiring land as well as building commercial properties in 2007-08, which led to gearing levels for bulk of companies to go above 100%. But the situation has improved with successful fund raisings and asset sales of some US\$3.0bn since March 2009, leading to average leverage declining to a comfortable 0.5x. Confidence on residential volumes and an uptick in property prices have revived purchases of high-value land by developers.

Land market in India is showing signs of revival—in the past month, land deals worth over US\$1 billion were announced. Developers' appetite for land has increased, given easier financing conditions and availability of prime land parcels. Increase in both off-takes and end unit prices are improving developer's confidence to buy new land.

Recent land acquisitions

Developer	Land (acres)	Deal Size (US\$MM)	Location
DLF	350	360	Sec 42, 53 and 54, Gurgaon, NCR
IBREL	4	290	Nariman Point
HDIL	100	60	Kandivali, Mumbai
DB Group (Dynamix Balwas)	7	125	Crown Mill, Prabhadevi, Mumbai
Lotha	10	145	Finlay Mills, Lower Parel, Mumbai
Hiranandani	135	167	Bangalore, Chennai, Hyderabad

Source: News reports (The Economic Times, Business Standard).

### Residential

Sales volumes in the residential segment have picked up meaningfully in 2Q09 after a muted 4Q08/1Q09. Increasing focus on affordable housing has resulted in the launch of several mid income housing projects in 2Q09 primarily in suburban locations of metro cities. While absorption rates in mid income launches have been quite strong, incrementally luxury segment too is witnessing healthy sales activity.

Volume recovery in the residential segment has primarily been driven by improved affordability on the back of aggressive price cuts and reduction in mortgage rate. Residential prices after witnessing a sharp downward trend (down 25%-35% from peak) have now stopped falling and have shown signs of increase (5%) in the past few weeks. Going ahead, the demand is expected to remain firm and further pick up strongly in 4QCY09 as the festive season approaches (Diwali is traditionally a home buying season in India) and developers continue to offer projects at attractive price points.

Key highlights were: 1) revival seen in volumes with new launches and enquiries on the rise; 2) brokers/developers suggest prices have bottomed out; a few expect a 5-10% move up closer to the festive season (Oct'09) when most launches are planned; 3) construction activity has picked up on pre-sold/leased projects.

## **Commercial Office**

Commercial real estate has borne the brunt of a global slowdown given its substantial dependence on the IT sector. Rentals for office space have already corrected by 30- 40% from their peak levels on the back of slow demand and leasing activity. Vacancy rates across key markets have already reached above 10% and are likely to increase further given the primarily from domestic corporates.

Further, transaction activity too has improved marginally compared to 4Q08/1Q09, but the same was confined to small deals. Investment yields have started to stabilize after witnessing an increase of 100-150bps over the last one year. While demand for office space could start to recover towards the end of the year when the reported increase in enquiries translate into actual leases, however rentals are expected to remain under pressure due to huge near-term supply.

According to JLL, close to 52msf of supply (42msf in 2008) is expected to be come up across India in 2009 as against 25msf (35msf in 2008) of estimated absorption. Amongst key markets, Bangalore is relatively better placed primarily due to the healthy pre-commitments (>75%) in upcoming projects in 2009. NCR is expected to witness the sharp rise in vacancy levels (~30%) as only small amount of the upcoming supply (in 2009) has been leased so far.

## **Retail**

Retail rents have already corrected by 30%-40% across key markets as new supply continues to outstrip the absorption levels in most markets. Demand remained subdued over the last quarter and few micro markets witnessed further store closures and renegotiation of earlier lease commitments. However, incrementally most large retailers (Pantaloons, Shoppers Stop) are guiding to improving sales trends. According to JLL, close to 17msf of supply (8msf in 2008) is expected to come up across markets in 2009 compared to only 7msf (6msf in 2008) of absorption estimated for 2009. Demand slowdown coupled with significant supply pipeline is expected to increase the vacancy rates sharply to ~25% by 2009 end. This will continue to exert further downward pressure on rentals and the trend is unlikely to reverse until late 2010. Retailers and developers are looking at revenue share models for leases against a fixed rent structure.

## **Outlook**

The outlook for the residential sector is strong as demand returns whereas the expectations of recovery for demand in commercial space is expected as business sentiments improve. The entire retail industry is reworking its business model transition to revenue share models is inevitable where the performance of the stores will determine the rentals they pay