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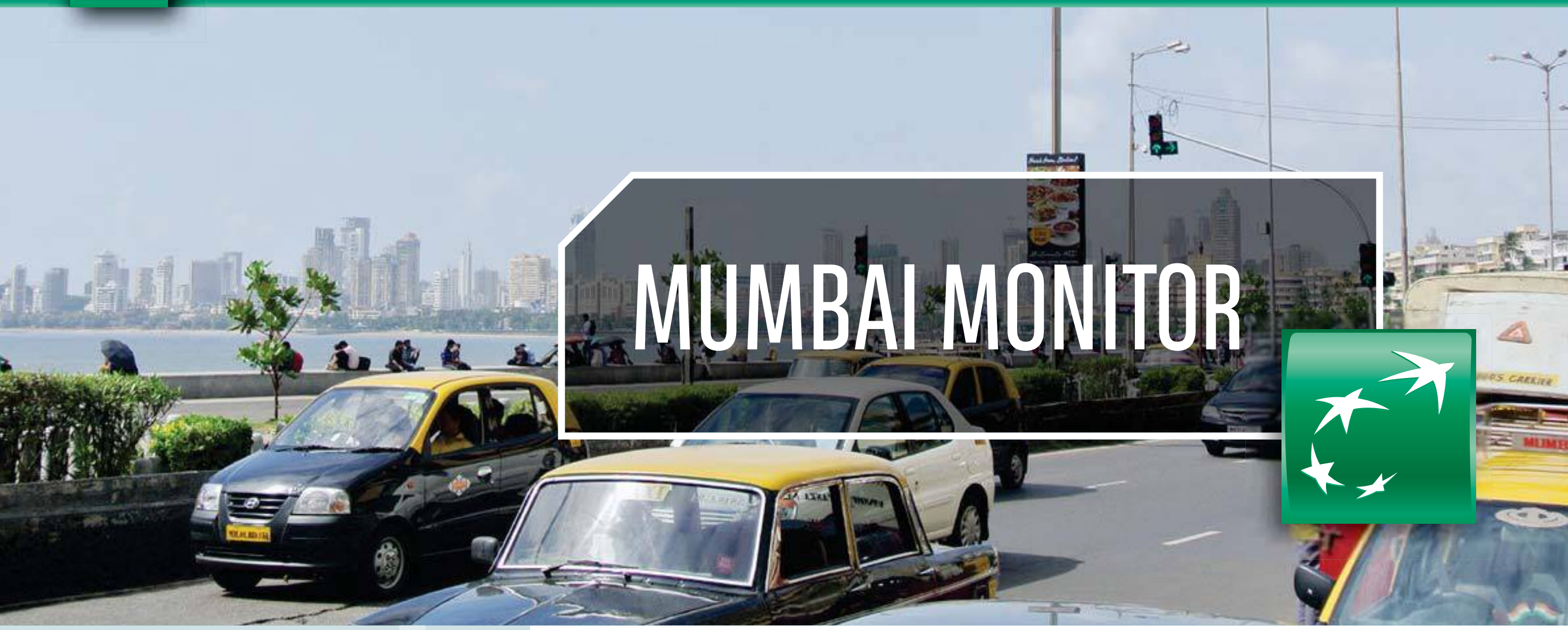


MUMBAI MONITOR

CONTENT

QUARTERLY REVIEW: LEGISLATIVE ROADBLOCKS AND UNCERTAINTIES WEIGH ON FINANCIAL MARKET

After correcting by 6.22% in USD terms in April, the MSCI India 10/40 (NR) index recorded positive returns in May and June to end the quarter down by 3.35% in USD terms. The Indian rupee (INR) depreciated by 2.03% against the US dollar over the same period.

GDP growth for the first quarter of 2015 was above expectations at 7.5% YoY. However, gross value added (GVA), which tends to better reflect growth dynamics, increased more mildly at 6.1% YoY. For the full fiscal year ending in March 2015 (FY 2015), GDP growth accelerated from 6.9% in FY 2014 to 7.3%, despite poor monsoons and sluggish consumption trends.

Similar to what happened during the winter session of parliament, the government failed to make much headway during the budget session due to reluctant opposition parties and the lack of a government majority in the Upper House. Key bills such as the Goods and Services Tax (GST) Bill and the Land Acquisition Bill have been referred to committees for further consideration before being examined again during the monsoon session of parliament.

The uncertainty surrounding the applicability of the Minimum Alternate Tax (MAT) to foreign investors was a hot topic this quarter. The government set up the Shah committee to consult on the issue with the various stakeholders and make recommendations.

CPI inflation remained stable over the quarter. In May the CPI stood at 5.0%, up from 4.9% in April. Core CPI inflation picked up to 4.4% from 4.0% in April, but remains within the Reserve Bank of India's (RBI) comfort range. The trade deficit narrowed for the second consecutive month in May to USD 10.4 billion. Exports stayed weak in May, while non-oil, non-gold imports contracted for the first time in 13 months. Industrial output for April improved to a healthy 6.1% in line with recent industrial production trends.

As expected, the RBI cut the repo rate by 25bp to 7.25% during its monetary policy meeting on 2 June. The central bank highlighted that further monetary policy action would be data-contingent, given the upside risks to inflation depending on potentially poor monsoons, the efficiency of the government's policy response, geopolitical risks to oil prices and external volatility impacting the exchange rate.

1. RBI: Reserve Bank of India, India's central bank

QUARTERLY OUTLOOK: POSITIVE STRUCTURAL DEVELOPMENTS TO SUPPORT GROWTH RECOVERY

While external shocks and potential 'risk-off' behaviour by international investors may affect equity markets including India, we believe India is well prepared and we expect its equity market to be primarily driven by domestic developments as the economy gradually recovers towards a higher growth rate.

Indeed, India's macroeconomic stability has greatly improved over the last two years. The Indian rupee has been very stable since its recovery in September 2013. CPI inflation has fallen significantly, from a peak of above 11% in November 2013 to 5.4% in June 2015, which is below the RBI's target of 6% by January 2016. The current account is also under control: from 4.7% in FY 2013 it has been reduced to 1.4% in FY 2015. Lastly, the rupee's strength has enabled the central bank to increase its FX reserves, which have moved from a low of USD 249 billion in November 2013 to USD 360 billion as of June 2015. This represents more than nine months of export cover, which should allow the RBI to defend the rupee should it come under pressure.

While real GDP growth has continued its upward trend, nominal GDP growth has slowed sharply on the back of falling inflation. This is putting pressure on corporate revenues and earnings growth. Some of the indicators that reflect demand and industrial activity are weak, including imports (excluding oil and gold), electricity generation, cement production and two–wheeler vehicle sales. Nevertheless, certain indicators are showing signs of bottoming out, including industrial production in which capital goods and consumer goods are recovering. Tax collection growth has improved from 9% in FY 2015 to 13% over April-May 2015. Domestic airline traffic is up 23% year-on-year (YoY) and M&HCV (Medium & Heavy Commercial Vehicles) sales are robust at above 20% YoY growth, albeit from a low base. Overall, falling inflation remains a structural boon for the economy, but is having a collateral impact on short-term growth.

We continue to expect growth indicators to improve, anchored by higher government spending and higher real incomes thanks to falling inflation. In April-May 2015, the government spent 13% of the FY 2016 budget, driven by non-plan expenditure at 9%, while plan expenditure accounted for 4%. Impressively, capital spending growth within plan expenditure stood at +32%. Roads and construction, which have seen the largest spending, have the biggest multiplier impact on the economy and employment intensity. We expect development on a number of measures to be keenly watched. Within legislative reforms, the government will try to pass the Goods and Services Tax (GST) and Land Acquisition bills in the monsoon session of the parliament. It may also extend the direct benefit transfer schemes to a wider range of subsidised products.

Investor focus has been on policy action by the central government. However, in the areas of land and labour, the federal government has granted India's states the freedom to implement reforms. Rajasthan and Madhya Pradesh have already changed their labour laws, while Gujarat, Andhra Pradesh and Telangana are acquiring land banks for future industrial use. The federal government's proposed ranking of states based on their 'ease of doing business' is expected to prompt more reforms. Central to all of these changes is the political need to create jobs. Following the FY 2016 Budget, India's states are set to receive a bigger share of the federal government's tax revenue, giving them an opportunity to handle a wider range of development projects.

Since the positive impact of the structurally positive developments highlighted above is gradual, we expect the earnings growth recovery to be incremental as well. While the market may appear expensive at current valuation of 17x 12-month forward P/E for the MSCI India as of end of June, we believe investors can benefit from an approach focusing on identifying companies with superior and sustainable earnings growth, strong management and reasonable market valuations. ■

Bloomberg is the source for all data in this article, as of end-June 2015.

Do you agree that earnings growth recovery will be gradual?
Email us your thoughts.

Alexander Chaikin / Shutterstock.com

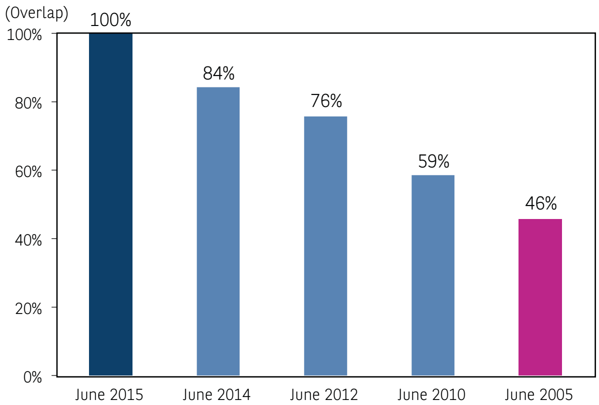
EVOLVING TOP LEAGUE OFFERS ACTIVE INVESTORS STOCK-PICKING OPPORTUNITIES

India is known for substantial family-controlled conglomerates such as Tata group, Mukesh Ambani's Reliance group, KM Birla's Aditya Birla or Sunil Mittal's Barti Enterprises, which include some of its largest listed companies. As of January 2015, listed companies from the top-10 conglomerates amounted to more than 20% of the Bombay Stock Exchange's total market capitalisation[2]. What few people know, however, is that the list of largest companies has seen relatively high rotation over the years, with a healthy number of emerging, fast-growth companies declining businesses.

India's top league: changing faster than you may think

From the top-50 companies by market capitalisation in 1990, less than a quarter (12) was still in the top-50 in 2014[3]. By comparison, in the US – usually seen as an entrepreneurial economy – no fewer than 20 of the top-50 companies in 1990 managed to retain their spot in 2014. This higher churn in India reflects the arrival of consumer and services sectors such as information technology and pharmaceuticals, as well as the fast-moving dynamics of this emerging economy, in which traditional, established businesses face growing competition from players aiming for the top rankings.

Healthy rotation: more than half of MSCI India index constituents have changed in the last 10 years



Source: MSCI, FactSet, July 2015

Looking at the MSCI India index, which is the benchmark for most international investors investing in India, this rotation can also be observed. As of end of June 2015, only 32 out of the 70 constituents were already in the index 10 years ago, meaning that more than half are companies that over the last 10 years have taken over from the incumbents[4]. In the quarter to end-June 2015 alone, no fewer than eight companies entered the MSCI India index, while three left.

Highlighting stock selection opportunities

For investors, such changes represent attractive stock-picking opportunities, for example, by focusing on those index members which can be expected to remain among the top Indian stocks of tomorrow. Most interestingly, those investors who are able to identify the smaller, fast-growing off-benchmark companies that stand to gain market share and emerge as leaders in their sectors could own the top Indian companies of tomorrow. ■

Do you agree that the high rotation of top companies in India offers attractive opportunities to investors?
Share your thoughts with us.

2. Source: BSE, Capitaline, as of 28 January 2015
3. Source: Capitaline, Bloomberg, 2014
4. Source: MSCI, June 2015

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RBI[5] POLICY STANCE: WATCH & WAIT MODE!

In 2013, when there were first signs of the US Federal Reserve (the Fed) tapering its quantitative easing, India was one of the economies to bear the brunt: the Indian rupee lost 23% over the three months from June to August. India's current account deficit was high at that time due to high crude oil prices and gold imports, funding of which was massively dependent on foreign capital inflows. Also, inflation had been high for some years, Forex reserves were low and growth was slowing. The central bank had to resort to liquidity tightening. Since then, under the current governor, the RBI has done a commendable job in taking various measures designed to make India more resilient to the Fed's likely rate hike and other global factors that can cause volatility. The Indian rupee has been one of the best performing currencies in 2014. With market volatility again at large, mainly due to the Greek debt situation, India and the RBI are better prepared this time with a stronger currency, higher Forex reserves and a low current account deficit.

Keeping track of inflation targets

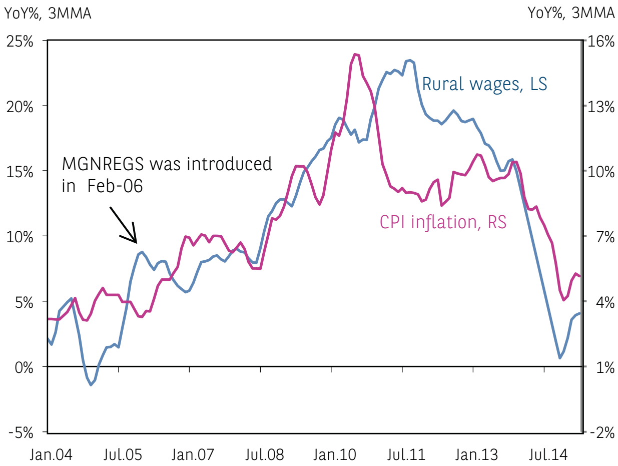
Moving to the current policy stance, the RBI cut rates in the latest bi-monthly policy meeting in early June but the bank actually sounded more hawkish in its statement, which led to bond yields tightening by 20bp in June 2015. The RBI is now more data-driven and objective in its approach to achieving its inflation target. The new monetary policy clearly positions tracking and targeting inflation as the RBI's primary responsibility. The central bank has set itself a target of 6% inflation by January 2016 and 4% +/-2% inflation for the medium term. In its latest bi-monthly policy statement, the RBI slightly revised its January 2016 inflation forecast upwards to 6%. While inflation may turn out to be lower than that, even if it does hit 6%, the RBI would have achieved its target for the current fiscal year. However, the long term target of 4% is a bigger challenge.

Inflation drivers

The factors that have or are likely to impact inflation and the RBI's policy stance are crude oil prices, this summer's monsoons, the government's policy in the event of sub-par monsoons, wage inflation, minimum support prices, a hike of the service tax and external influences including the Fed's rate hikes.

- **Crude oil prices:** After the collapse late in 2014, crude oil prices rebounded by almost 30% in the first half of 2015. However, indications are that prices may stabilise at around the current USD 60. This would be positive for inflation as average crude oil price for the fiscal year ending in March 2015 (FY 2015) was around USD 85.
- **Monsoons:** While the India Meteorological department (IMD) has predicted 7% below-normal monsoons for the year, the monsoons have been good in June and below normal in July so far. As of the end of the first week of July, cumulative rains were below normal by 4%[6]. July being the sowing month, it is crucial that the country receives normal rainfall in the remaining weeks of the month.
- **Policy reaction:** The RBI believes that the storage of enough seeds and fertilisers, the release of food stocks and more efficient food supply chains – including imports and reducing hoarding –should also help curtail inflation. As seen in early 2000s, adequate measures can help policy makers control inflation even during a poor monsoon. If they demonstrate that again, inflation could be brought under control.
- **Minimum support prices:** The high increase in minimum support prices has been one of the contributors to inflation in the past few years. Despite the upcoming state elections, the central government has avoided being populist and has increased minimum support prices by only 3%. This bodes well for inflation.
- **Rural wage growth**: While rural wage growth had increased between 2006 and 2011, it has since fallen sharply from its peak. Inflation tends to have a high correlation with rural wages (see chart).

Rural wage growth: a key driver of CPI inflation



Source: CEIC, Macquarie research, July 2015

- Pushing back of normalisation of **US monetary policy**, i.e. increase in Fed rates has been helpful and provided room for rate cuts
- Increase in **service tax** from 12.36% to 14% in this year's Union Budget will also add to inflation.

Growth pick up and investment cycle

On the growth front, the central bank has acknowledged weak demand and excess capacity and has downgraded FY 2016 real GVA growth to 7.6% (from 7.8%)[7].

5. RBI: Reserve Bank of India, India's central bank
6. Source: India Meteorological Department weekly weather report dated 8 July 2015
7. Source: RBI Monetary policy, June 2015

Rate cuts alone might not be enough to revive the investment cycle. As mentioned above, the government's measures to contain inflation and revive growth through public spending, the fast-tracking of stalled projects and job creation are designed to improve sentiment and should lead to higher consumption and better capacity utilisation, eventually motivating the private sector to invest more capital. At that point, lower interest rates and the banks' willingness and ability to fund such capital expenditure become important.

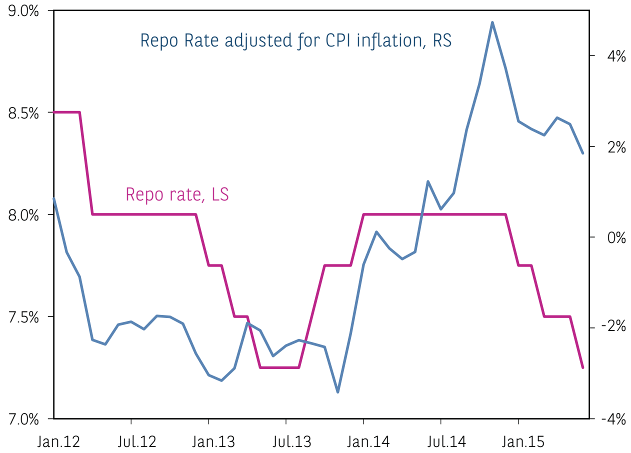
Public sector banks need to address their asset quality issues and more capital to clean up their balance sheet and support the investment cycle revival. Alongside this, the government needs to revive public spending, mainly on infrastructure development, so as to improve investment sentiment. While some indicators such as commercial vehicle sales have picked up considerably in the last year, others such as industrial production and new capex projects have picked up only slightly.

Real rate in comfort zone; room for further cuts

The RBI is targeting a real interest rate of 1.5%-2%. It has cut interest rates by 25bp three times so far this calendar year, bringing the repo rate down from 8% to 7.25%. Should the consumer price index remain at 5%-5.5% by the end of the current fiscal year, real rates would be in the range of 1.75%-2.25%, providing room for further cuts. So further RBI action is likely to be dependent on how the monsoons progress, as well as on government action to contain inflation through better food management policies, and on a conducive external environment.

Do you think India is better positioned now than it was in 2013 to deal with a Fed rate hike and global volatility?
Email us your thoughts.

Real rates are now anchored in positive territory



Source: CEIC, Macquarie Research, July 2015

Gradual transmission of rates

Banks need to pass on the recent rate cuts, but so far their transmission – and even their adoption – of the RBI's last three rate cuts has been slow. Banks are in a dilemma as deposits are only slowly re-priced, whereas assets are immediately re-priced when the base rate is cut. Banks' credit costs due to rising asset quality issues have further limited their ability to cut base rates. However, we should see gradual transmission over the coming quarters as deposits re-price.

Conclusion

Evaluating the overall state of the economy, the RBI has front-loaded its rate cuts and may now wait for further data before deciding on any additional cuts. However, should inflation undershoot the RBI's revised estimates, we may well see further cuts even in the current fiscal year. ■

INDIA'S COAL SECTOR – IT'S HOT

Commercial coal mining in India started back in 1774 when the East India Company began to extract coal from the Raniganj coalfield along the Western bank of river Damodar in what is now West Bengal. Later, the introduction of steam locomotives in 1853 gave a fillip to the sector. Within a short time span, production rose to an annual average of 1 million metric tonnes (mt) and the country was producing 6.12 million mt by 1900.

When India gained its independence in 1948, annual production was some 30 million mt.

The government saw the need to expand coal production output to take care of the growing needs of the economy. It set up the National Coal Development Corporation (NCDC) in 1956 with the collieries owned by the railways as its nucleus. This was the first major step towards the planned development of the industry. The Singareni Collieries Company Ltd (SCCL), which had already been in operation since 1945, was also moved to the public sector unit under the control of the government of Andhra Pradesh in 1956. India thus had two state-run coal companies in the fifties.

During the 1950s and 1960s, unscientific mining practices adopted by private mining companies coupled with poor working conditions became a matter of concern for the government, resulting in the decision to nationalise all private coal mines. This was done in two phases, the first with the coking coal mines in 1971-72 and then with the non-coking coal mines in 1973 with the enactment of the Coal Mines (Nationalisation) Act.

The industry today

As at 1 April 2014, India's coal reserves stood at 301.56 billion metric tonnes, of which 125.9 billion is proven and 142.5 billion indicated. Around 88% of this is non-coking or thermal grade, which is used in power plants. The rest of it is coking grade, mainly used in steel blast furnaces.

Through a programme of sustained investment and the use of modern technology, India's annual coal production has grown from 70 million mt at the time of nationalisation to around 600 million mt in FY 2015 (April 2014 to March 2015). This makes India the world's third largest coal producer after China and the USA. The growth in coal production in the last 10 years is shown in Chart 1.

Coal India Ltd and its subsidiaries produced 494 million mt of coal in FY 2015, making it the largest coal producing company in the world. Singareni Coalfields accounted for 52.6 million mt of the total. The rest was contributed by various captive miners (producers mining coal via government licences for own uses) allocated to thermal power plants and steel manufacturers.

Despite the huge reserves and growth in coal production during five decades since nationalisation, India today is in a new situation: it has to supplement domestic production with coal imports. Clearly, supplies have lagged demand in a country that is short of other energy resources such as petroleum and natural gas. In India, coal meets around 52% of primary commercial energy needs against an average of 29% elsewhere in the world. Around 66% of India's power generation is also coal based. In addition, on account of a myriad of factors in recent years, the performance of both the public sector companies has been unsatisfactory. Coal India, for example, has seen production growth of just 3.8% year-on-year (YoY) between FY 2008 and FY 2015.

In FY 2015, India's coal imports stood at around 224 million metric tonnes or 37% of total production. As seen in Chart 2, coal imports have risen sharply since FY 2010.

Chart 2 - India coal imports in mn MT

Coal	FY10	FY11	FY12	FY13	FY14	FY15
Total Import	**75.6**	**70.4**	**105.2**	**140.6**	**168.4**	**224.0**

Source: Government of India, 2015

Chart 1 - India's coal production in mn MT

Year	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15E	CAGR (%)
Non-Coking	422.6	457.9	487.6	483.1	488.3	504.8	508.9	539.0	3.5
Coking	34.5	34.8	44.4	49.5	51.7	51.6	56.8	60.7	8.4
Total	**457.1**	**492.8**	**532.0**	**532.7**	**540.0**	**556.4**	**565.8**	**599.7**	**4.0**

Source: Government of India, 2015

So what does the future hold?

If India's annual GDP were to grow at 7% to 7.5%, the country's energy demand would need only steady growth. Given the current reserves at India's disposal and favourable cost dynamics, coal will continue to be a significant contributor to this growth.

The current government has acknowledged this by fixing an annual coal production target of 1 billion metric tonnes by Coal India in FY 2020, meaning production is slated to double in the next five years.

Having set a target, the government has started by setting up a favourable policy environment for the sector. As part of this endeavour, it has brought the department of coal, power and renewable energy under a single ministry for effective coordination and to minimise procedural delays. Secondly, the processing of the environmental and forestry approvals required before opening new coal mines has been fast-tracked. An online coal project monitoring portal has been set up by the ministry to regularly keep track of projects under way.

The railway ministry has also taken it upon itself to complete three key track-laying projects within the next two to three years. This will be crucial for transportation once Coal India's production reaches a level of 600 million mt and more. These projects will be realised via a special purpose vehicle (SPV) or a joint venture company involving Coal India, Indian Railways and the provincial government relevant to the project being implemented.

While the Ministry has identified what it can do to help Coal India reach its target, much can be done at the company's end too. Two areas needing immediate attention are: a) augmenting and modernising the current heavy earth-moving machinery fleet and b) investing in transportation infrastructure. In the last six months, the company has made some progress on both these fronts. Tenders for purchasing 190 tonne dumpers, 460-850 horse power bulldozers and 42 shovels have been submitted. We expect these to be finalised by the end of this year. This will allow the company to crank up production growth in the years ahead. Secondly, the company has also decided to buy 5 000 bulk rail wagons to overcome the occasional shortage of wagons from Indian Railways wagons.

The government's efforts have started to bear fruit, with Coal India posting a 12% and 8% YoY growth in production and dispatches respectively in the April-June 2015 quarter. If everything begins to fall into place, we should see this trend continue in the future, too.

Do you think Coal India will be able to reach its annual coal production target of 1 billion mt by FY 2020?
Share your views with us now.

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