The State of the Economy - A Perspective

November 5, 2013

Premchand C
Executive Director

Recap from Coimbatore Meeting: We had concluded that recovery of the Indian economy is contingent on four underlying factors playing out – lets see how these are faring

Assumptions underpinning economic recovery – Recap

Economic recovery is contingent upon favorable policies and responsible governance

- **Good monsoon will significantly boost the rural economy**
- **CAD is likely to improve as global commodity prices fall more rapidly than currency depreciation**
- **The pace of reforms has picked up and must not slow down due to election year pressures**
- **Favourable interest rate revisions are critical for sustained recovery and policy rethink is essential on inflation**

Source: Avalon Consulting Research and Analysis

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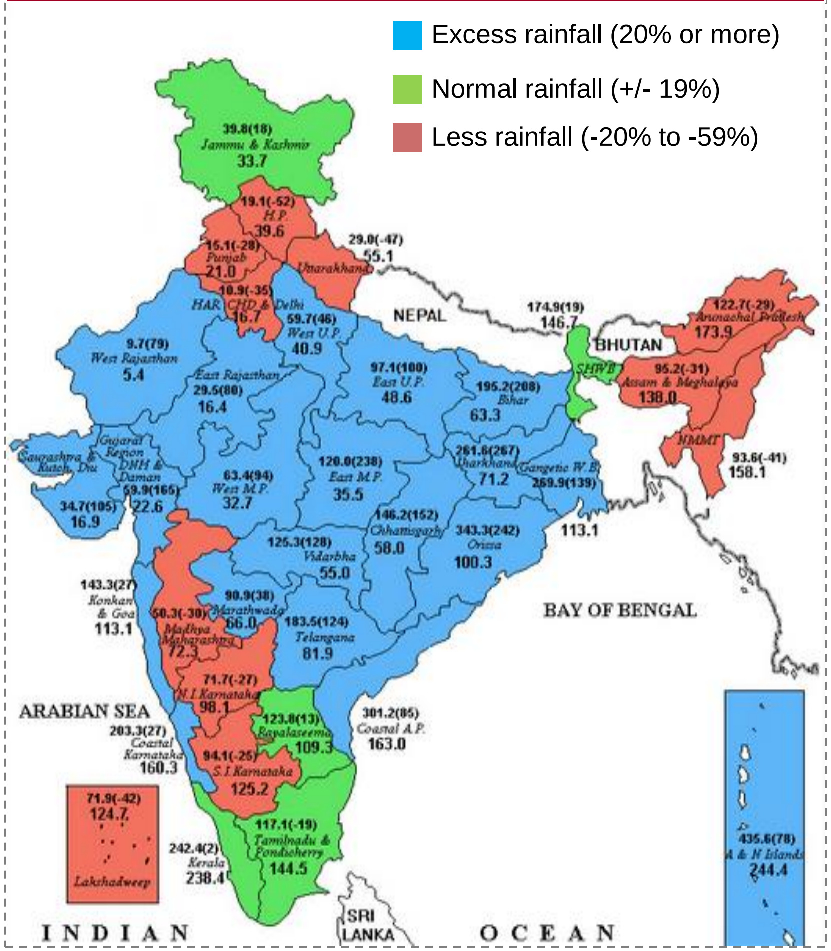
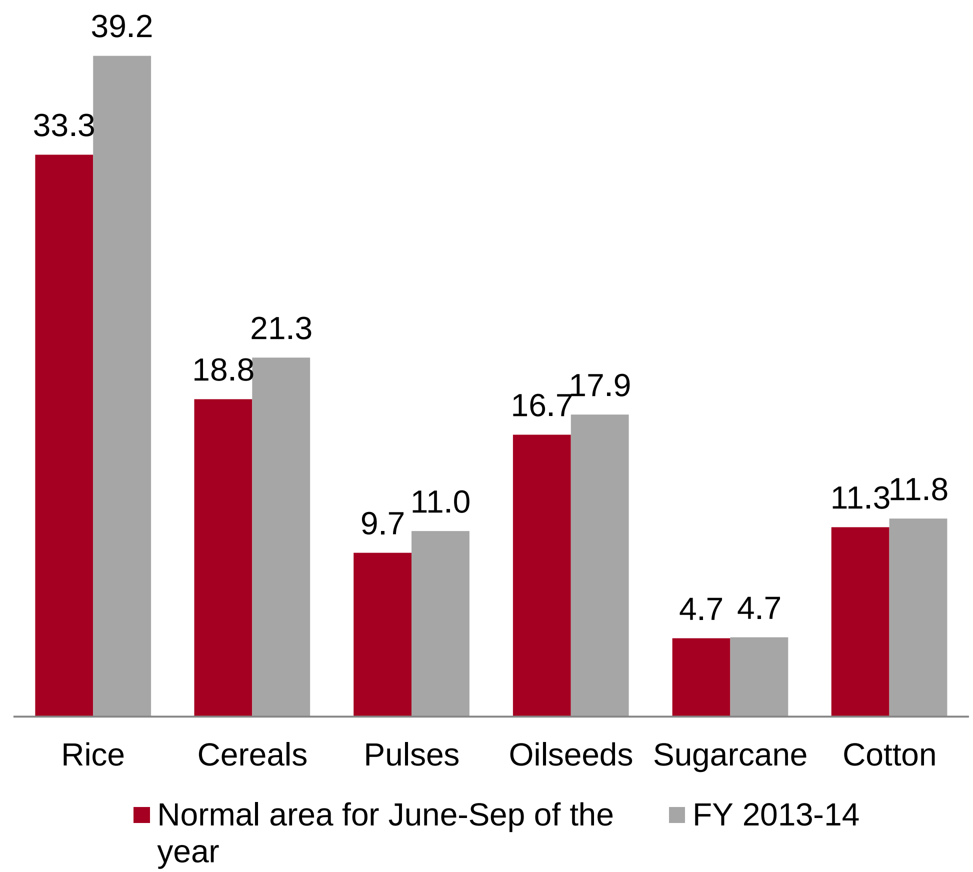
India looks forward to bumper winter crops in wake of monsoon rains

Monsoon 2013

India: Rainfall from October 1 to October 25, 2013



All India Crop Planting Progress (Mn ha of crop planted)



Source: India Meteorological Department, Avalon Consulting Research and Analysis

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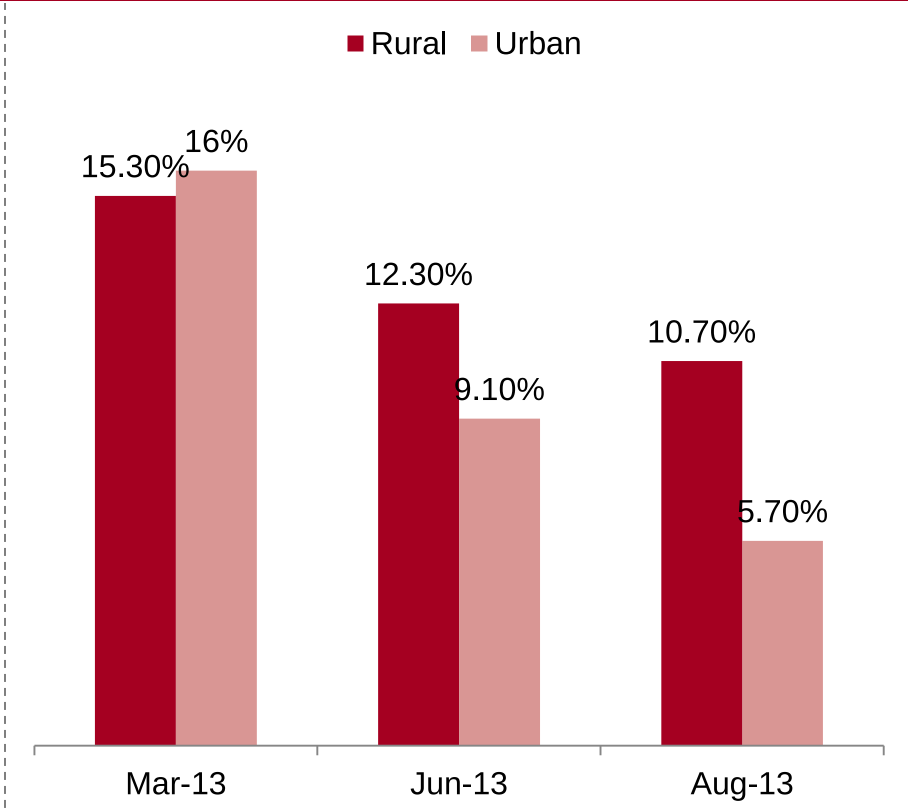
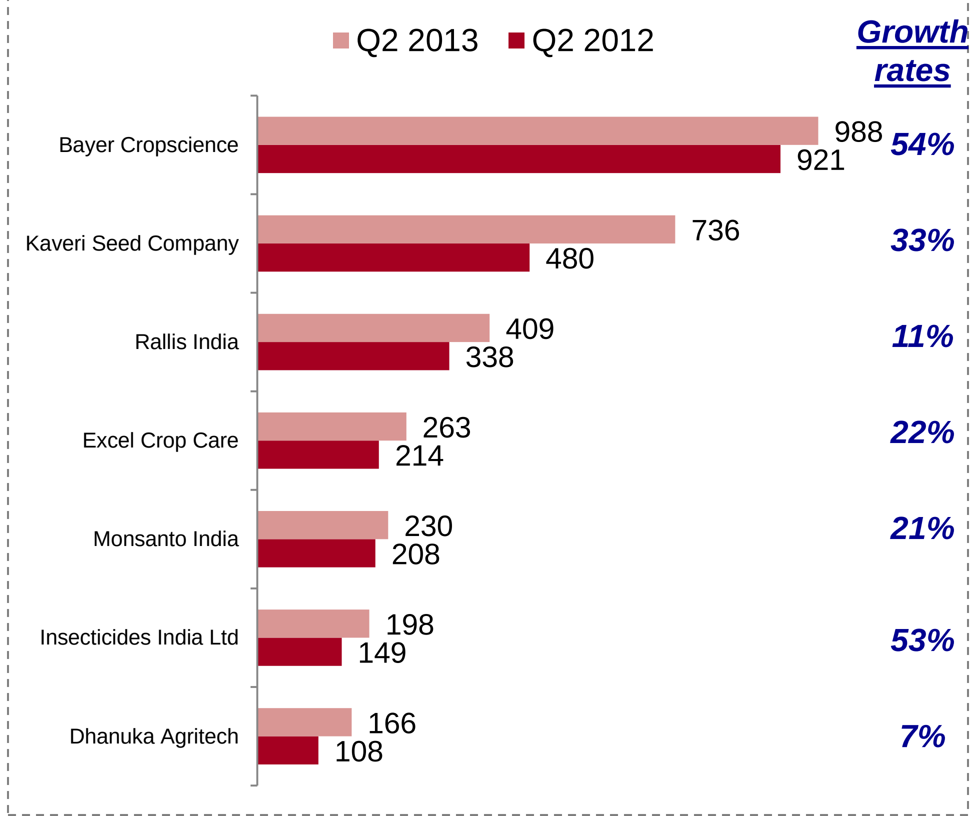
Good monsoon is expected to drive rural economic growth and benefit FMCGs, agrochemical and fertiliser companies

Sectors benefiting from good monsoon

FMCG Industry Growth Rates (2013-14)



Sales growth of select agrochemical companies (Rs cr)



Note: Growth rates are calculated over the same period in the previous year

Fertilizer production registered a growth of 5.3% in September, 2013 (YoY basis) and a cumulative growth of 2.5% during April to September, 2013-14 (YoY basis)

Source: Press reports, Avalon Consulting Research and Analysis

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Rural economy and agricultural GDP will grow faster in FY14

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Source: Avalon Consulting Research and Analysis

The Indian rupee has strengthened against the US dollar since our last review due to the delay in tapering of the Fed's stimulus programme giving us temporary respite

Recovery of the Indian Rupee

INR vs. USD (till Oct 25th 2013)

- Rupee has recovered nearly 11% since RBI introduced measures to stem the slide
- It also received help from US Fed's postponing of the tapering (liquidity infusion) program.
- The temporary shutdown in the US also raised hopes that tapering would be postponed further, giving markets a leg-up.
- Analysts believe that tapering is unlikely to start before March 2014 giving us respite at least till Q3, FY 2014
- If we have a good Q4 and our CAD is between 3.5 to 4% of GDP in FY14, hopefully the impact of this move will not as severe as we witnessed across Q1 and Q2

Source: XE.com, Press reports, Avalon Consulting Research & Analysis

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Crude oil prices fell slightly in the month of October 2013 and future outlook is weak in the short term

Movement of crude oil prices

Brent Crude Oil Spot Price (USD) over 6 months ending Oct 21, 2013

- US government shutdown has dragged down 4th Quarter growth and hence oil demand from the world's largest consumer
- During Oct 2013, crude oil price went down due to rise in U.S. fuel inventories (crude oil inventories rose by 4.1 million barrels last week to 383.9 million barrels, the highest level since June)
- Brent crude prices further weakened on hopes that renewed negotiations between Iran and western powers are likely to lead to an easing of sanctions and increase in production in Libya (by 100,000 barrels per day)

Source: Press reports, Avalon Consulting Research & Analysis

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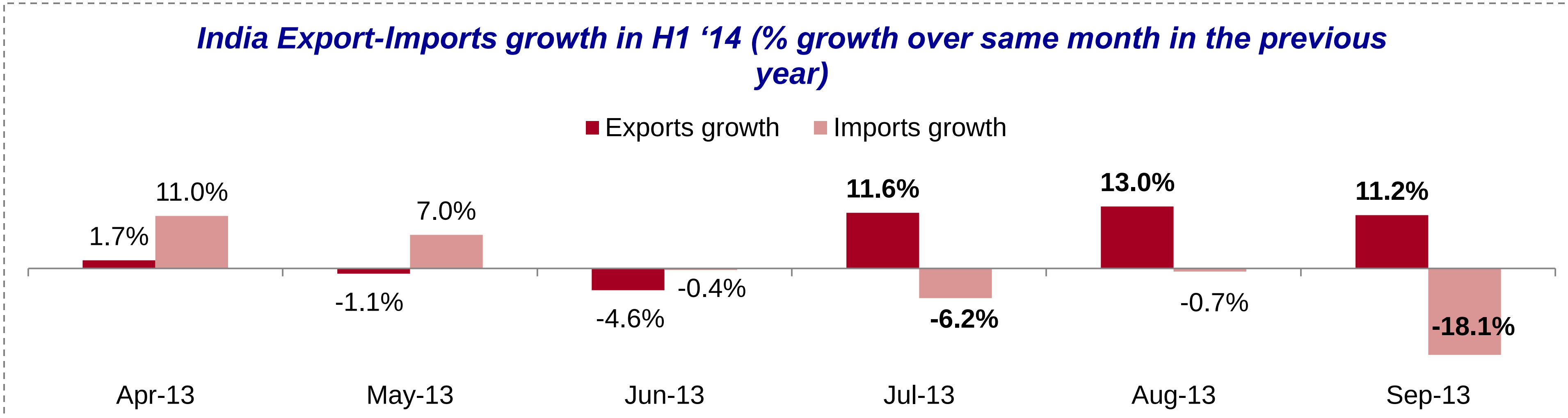
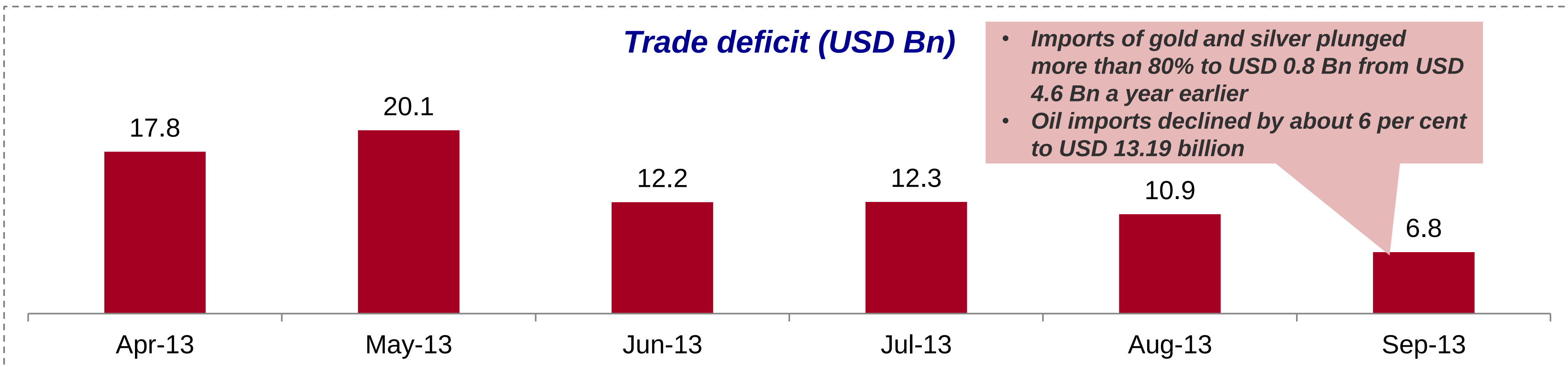
The depreciating rupee has expectedly boosted exports and measures taken to curb gold imports have paid off resulting in a significant fall in the trade deficit

India trade deficit





Source: Ministry of Commerce, Avalon Consulting Research and Analysis

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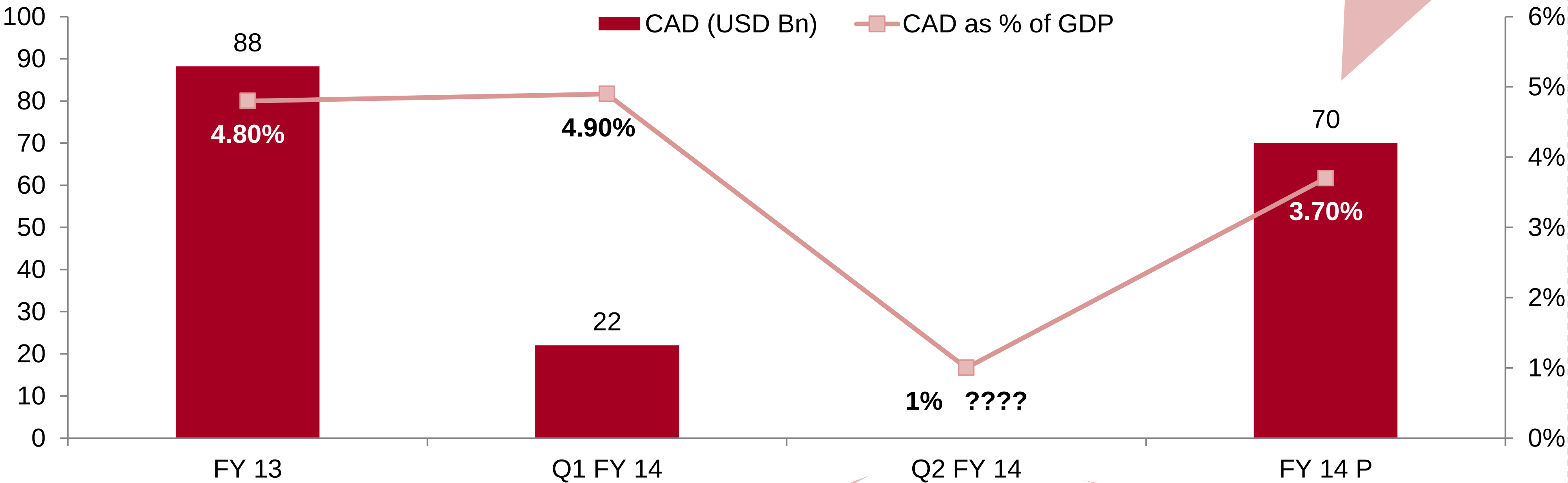
Hence, current account deficit (CAD) is expected to be contained under USD 70 Bn (3.5% to 4% of GDP) this fiscal as against USD 88 Bn (~5% of GDP) last fiscal

Improvement of the current account deficit

"There is also a possibility that India's CAD to fall below $60 billion, or 3.3% of GDP, in FY14"
- Barclays India

Current Account Deficit (CAD) 2012-14



"CAD will fall sharply in Q2 and may be around 1 per cent of GDP"
- India Ratings

"An over $20 billion reduction in merchandise trade deficit in Q2 compared to Q1 suggests significant improvement in CAD for the second quarter" **- CRISIL**

"We do believe that current account deficit (CAD) in Q2 (July-September quarter of 2013-14) may touch the positive zone" **- SBI**

Source: Press reports, Avalon Consulting Research & Analysis

However, we are unlikely to hit our fiscal deficit targets despite optimistic assurances by the FM, given the likely shortfall in the GDP growth vs. budgeted figures

India fiscal deficit

In 2012-13, absolute fiscal deficit was controlled by slashing planned expenditure

India's fiscal deficit target was set at 5.1% of GDP

Fiscal deficit reached 51.5% of the full year target in Q1

FM slashed plan spending by nearly Rs 92,000 Cr during the year

India's fiscal deficit last year was contained at 5.2% of GDP

2012 -13

This year, while the FM again plans to control absolute fiscal deficit by slashing expenditure, downward revision in GDP growth will result in a slightly higher fiscal deficit as a % of GDP

India's fiscal deficit target was set at 4.8% of GDP

Fiscal deficit for H1 is already 74.6% of the full year target

Infation is expected to be controlled at ~ 6.0% for the entire basket of goods in the economy

FM will slash plan spending and control absolute fiscal deficit (similar to FY 13)

Fiscal deficit as a % of GDP is expected to close at ~ 5% because India's GDP is expected to grow at ~ 4.5% in FY14 (as against the projected 6.3%)

2013-14

Source: Press reports, Avalon Consulting Research & Analysis

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CAD will improve and will be contained well under 4% of GDP in FY ‘14

Assumptions underpinning economic recovery

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- **Good monsoon will significantly boost the rural economy**
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- **The pace of reforms has picked up and must not slow down due to election year pressures**
- **Favourable interest rate revisions are critical for sustained recovery and policy rethink is essential on inflation**

Source: Avalon Consulting Research and Analysis

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There has been a decline in investments in fixed assets in recent years

Capital expenditure (investment in fixed assets) intentions of the companies in private and joint business sector in order to assess broadly the short-term changes in business sentiment

Year of Sanction	Capex envisaged	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	Beyond 2013-14
	(Rupees Billion)										
From previous years	699	452	170	64	12	1					
2005-06	1598	586	532	246	95	25	18				
2006-07	3418	149	1296	1094	577	157	31	20			
2007-08	2682	5	113	881	880	423	326	78	47		
2008-09	3432		1	265	1239	951	530	346	84	46	
2009-10	4436			2	437	1480	1311	770	316	77	34
2010-11	4089				3	287	1257	1161	817	469	94
2011-12	2305					57	232	926	685	301	125
2012-13	2634						1	384	970	727	549
Total		1192	2112	2552	3243	3381	3706	3685	2919	1620	802

Note: The analysis is based on envisaged cost of projects for which funds are raised from banks/FIs or through External Commercial Borrowings (ECB) or domestic equity issues
Source: RBI Bulletin dated 10 Sep 2013

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There were also mixed signals on the investment outlook for FY 2013-14 until end of Q1

Outlook on Investment for 2013-14

- ***Lead indicators have been poor for FY 2013-14***
  - The Reserve Bank of India, in its First Quarter Review of 2013-14 of Monetary Policy placed the baseline projection of real GDP growth at 5.5 per cent in 2013-14, which did not indicate much improvement in the demand conditions
  - Performance of the capital goods sector, which acts as a barometer for investment climate, has also remained poor
  - WPI inflation for 2013-14 is also expected to be range bound around 5.0 per cent and this may inhibit significant reduction in interest costs faced by the corporates.
  - According to CMIE, investment proposals to create new capacities, which declined sharply in 2012-13, have further tapered off in the first quarter of 2013-14
- However, in a CEOs' Survey conducted by the Confederation of Indian Industry (CII) amongst 75 National Council members, ***44 per cent of the respondents envisaged an increase in their domestic investment*** during the current fiscal and another ***37 per cent of the respondents did not see a decline*** in their investment level in the current year
- ***Envisaged investment by the private corporate sector in 2013-14 were expected to be lower than that in the previous year***
  - The capital expenditure already planned to be spent in 2013-14 aggregated to `1,620 billion (financed by banks/FIs: `1,388 billion, ECBs/ FCCBs: `227 billion and domestic equity issuance: `5 billion)
  - Even if companies adhere to their investment plan, to match the capex envisaged in 2012-13 (i.e., `2,919 billion), the minimum capital expenditure of around `1,299 billion needs to come from the new investment intentions by the private corporate sector in 2013-14
  - Going by the assessment (end of Q1), capital expenditure of the above order did not appear to be feasible
  - The problem was been compounded by large projects in sectors like power and telecom getting stalled over last few years

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However there are signs of an upswing in credit and investment growth in Q2 which could accelerate in the coming months

Upswing in growth

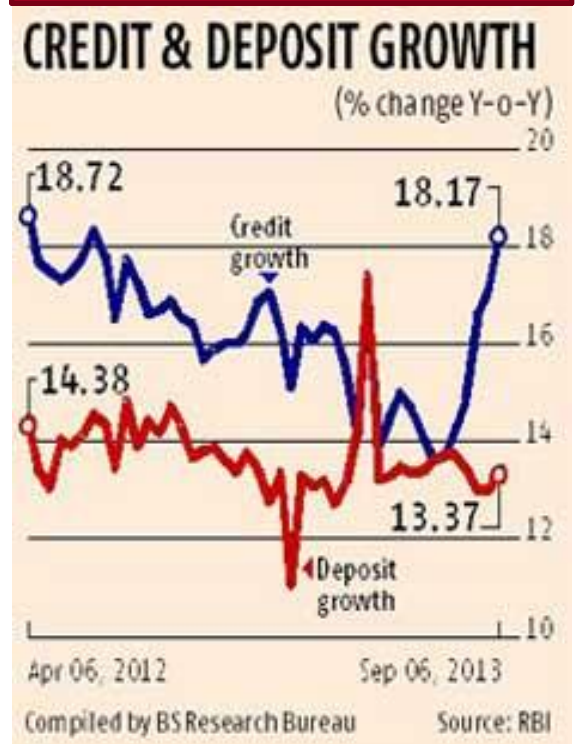
Project Clearances by CCI & increased lending for investments

- In Q2 FY 14, the Cabinet Committee on Investment (CCI) cleared 36 projects worth Rs 1.83 lakh cr across sectors such as power, roads, railways, petroleum and natural gas
- Projects that have been cleared by the CCI include Reliance Power's 4,000-MW ultra mega power project at Sasan in Madhya Pradesh, L&T's Metro Rail project, Hindalco Industries project and Essar Power's Jharkhand project
- Banks have already disbursed as much as Rs 30,000 cr for power sector projects
- With CCI clearances in place, banks would provide more funds for these newly cleared projects

Credit Growth > forecast

- The industry credit growth accelerated to 16.6% on a year-on-year basis to Rs 5,614,926 crore at the end of October 18, 2013.
- The increase was more than the Reserve Bank of India's (RBI) forecast of 15% year-on-year growth in bank advances in 2013-14

Credit Growth



Source: Press releases, Avalon Consulting Research & Analysis

Note: State Bank of India (SBI), the country's largest lender, had raised its bulk deposit rates up to 175 basis points for deposits below one-year tenure last year. The bank, however, has left lending rates untouched for now (base rate was 9.7% as of Sep 19, 2013). Most other banks have raised their lending rates.

Thus, there is early evidence of the pace of reforms and investment and credit growth accelerating in H2

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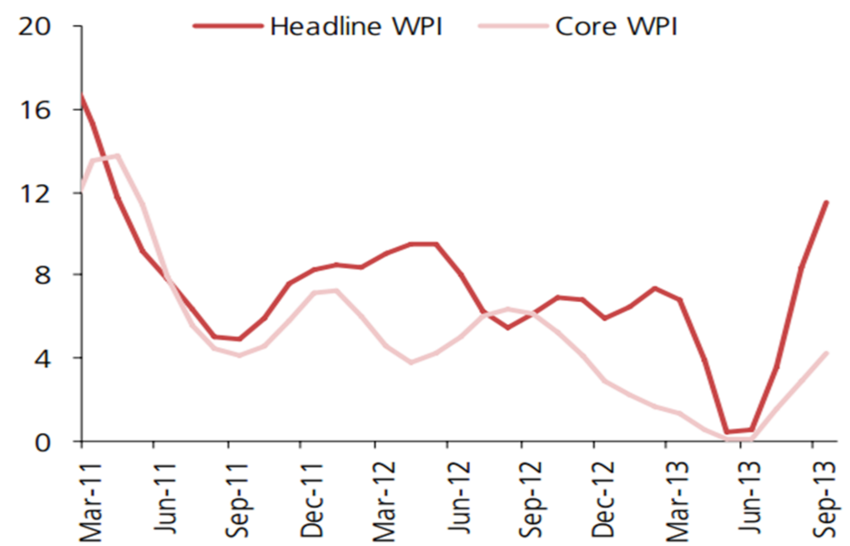
Source: Avalon Consulting Research and Analysis

Interest rates have been hiked but both RBI and Government have announced counteracting measures to boost bank liquidity & credit availability to select sectors

Inflation vs. Interest rate revisions by the RBI

India WPI Inflation (%)



Source: CEIC, Kotak Economic Research

RBI and Government Measures impacting Monetary Policy

- RBI raised short-term lending (repo) rate by 0.25% to 7.75% (to combat inflation arising out of speculation) and lowered Margin Standing Facility (MSF) rate by a similar margin to 8.75% (to improve banking sector liquidity)
- Banks (especially PSBs) which are combating capital adequacy pressures are expected to increase lending rates
- However the MSF rate cut along with recapitalization (capital infusion into PSBs in excess of the budgeted Rs 14000 cr) is expected to persuade banks to use that additional liquidity to lend to selected sectors (two-wheelers, consumer durables, etc.) to stimulate demand and drive growth; and to get banks to reduce interest rates in order to induce consumers into borrowing (especially in the “festival season” when the pressure to spend is high)

Source: Press Reports, Avalon Consulting Research and Analysis

Overall, the economy is expected to recover in H2, albeit slowly driven by farm output, exports and investment recovery

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Favourable interest rate revisions are critical for sustained recovery and policy rethink is essential on inflation X

Source: Avalon Consulting Research and Analysis

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Thus, the Indian economy is expected to grow between 4.5% to 5.0% in FY14 – this will mean a good Q4 and a sense of relief exiting FY14 and hopefully looking forward to a more robust FY15

India economic outlook

	2012-13	2013-14 (Previous forecast)	2013-14 (New forecast)
GDP Growth	***5%***	***5.7%***	***4.8%***
Agriculture Growth	1.9%	3%	3.7%
Industry Growth	1.2%	3.6%	1.3%
Services Growth	6.8%	7.1%	6.2%
Average WPI inflation	7.4%	5.3%	6%
Export Growth	-1%	4.4%	3.8%
Import Growth	0.5%	3.9%	-1.9%
CAD (% of GDP)	4.8%	4.4%	3.5%
Fiscal deficit (% of GDP)	4.9%	4.8%	5%

- ***India would recover from stress in the second half of this fiscal to return to high growth over the next two years***
- ***Economy would grow by 4.5 to 5% in the current fiscal, pinning its hopes on good farm output, improved exports and investment recovery***
- ***The recovery will enable the economy to grow 6-7% next fiscal (2014-15) and return to 8% growth in fiscal 2015-16***

Source: RBI estimates, Avalon Consulting Research and Analysis

Every one of us has to rethink our businesses and investments during this crisis

Crisis is an opportunity for those who think and act

"**You never let a serious crisis go to waste. And what I mean by that, it's an opportunity to do things you think you could not do before**"

a quote attributed to an Obama advisor Rahm Emanuel (borrowed from others including Winston Churchill who said that earlier)

How will business and investments react ?

- If the Rupee settles between 60 and 63 to the US $, making Indian manufacturing and services globally competitive?
- What will global manufacturers do when India becomes more competitive than China, Vietnam, etc.?
- What impact do you expect in your business when infrastructure, auto, steel, cement, garments & textiles, pick up?
- What if you are an exporter?
- What will you do when M&A activity steps up?
- How will you think if you are creating a new business?

Everyone has to reset his thinking about business and investments now……….

For further information:

Premchand C., Executive Director
✉ premchand.c@consultavalon.com
☎ +966 553335188
☎ +91 9841069590