ALCHEMY

PRIVATE WEALTH

Investment Matters

AUGUST 2014

BESPOKE
FINANCIAL EXPERTISE
TO MAKE THE RIGHT
MOVES, MORE OFTEN.

EQUITY OUTLOOK

The planning commission of India had published a vision document for infrastructure investment in the country in FY07 for the eleventh and twelfth five year plan ending FY12 and FY17 respectively. The commission along with the government identified projects/segments to be targeted to achieve an Infrastructure investment to GDP ratio of 9% by FY12 and further raising the same to 15% by FY17 from the levels of 5% in FY07. This meant an incremental investment required in the infrastructure space of $1 trillion over a space of 10 years. The government, early on, realized that a large part of this investment will have to be contributed by the private sector (48% share i.e. $480 bn) thereby aggressively promoting public private partnership through the BOT route. The planning commission soon released model BOT concession agreements which became the benchmark document for each of the sub segments in the infra space. In the initial few years of the government push, infrastructure investment in the country grew at a fast pace and came very close to the government targets at 8.4% of GDP by FY11 (3G spectrum sale to the telecom sector was a big contributor to this number), however the story since then has been a big disappointment – Infrastructure investment to GDP ratio has come down to 6% once again by the end of FY14.

Power sector was the largest recipient of investments by the private sector followed by Telecom and Roads. During the past 5 years, capacity additions in the power sector have moved up significantly averaging 12000-15000 MW per annum with almost 60% being contributed by the private sector. In roads, though the pace of growth has been slower, 100% of investments came from the private sector in the NHDP programme through the BOT route.

The slowdown in investments in the infra sector in the recent years, specially the power and roads segment, is something which is worrisome and needs urgent attention from the policymakers. Our analysis/interactions with various large players in both Power and Roads segments suggests that each and every player in the sector has a stressed balance sheet with no ability to add any new capacity in the power sector going ahead and has no plans to take on fresh BOT road project from the government. All of them have highlighted a number of projects in the sector which are stuck at the implementation stage due to a combination of lack of funds, fuel availability, environmental clearance delays, land acquisition issues, cost over runs, etc. which have raised question marks over the viability of the projects. These are fundamental issues affecting the infra investment in the country and would need serious and urgent measures to be taken by the government to kick start the same over the next few years.

An example can best highlight some of the issues faced by the companies in the sector - A leading private infra company set out to invest in a 3600 MW thermal power plant in phases at an investment of Rs 18000 cr with equity contribution worth Rs 6000 cr. The company achieved financial closure on the back of the government allotting a coal mine which was to be developed to supply captive coal to the power plant. Since the expected cost of coal was attractive compared to the coal supplied by Coal India, the company, based on its workings, entered into a long term contract of 20 years with few state electricity boards to supply power at sub Rs 3 per unit. Half way through the execution of the first few phases of the project, the company realised that the environment clearance for the captive coal mine was delayed and in fact the government sent a notice to the company to cancel the coal mine allocation due to delay in production from the mine which to a very large extent was related to the delay at one of the government department ie the environment ministry. To take care of the problem, the company applied with the coal ministry for tapering linkage of coal from Coal India, however Coal India prices have become a lot higher than the earlier assumed coal cost out of the captive mine. This directly affected the cost of power for the power plant and in turn the company's contract with the state electricity boards becomes no more viable and the company is likely to suffer losses due to this change.

This has also meant that the company has now cancelled the implementation of the remaining phases and is also purposefully delaying the commissioning of the project under implementation to avoid defaulting to banks who have funded the project. Such abrupt changes in rule of law has very serious negative implications on infra investment as can be seen from the example. This is only one example of why infra investment is getting negatively impacted. The solutions are also pretty clear for the govt to apply their mind on. One thing is very clear - the investment cycle continues to remain in a weak phase and is likely to take some time to pick up once again.

The new government at the centre led by Mr Narendra Modi has started on a very positive note with having a single minister in his cabinet manage the Power and Coal ministry. This move is certainly likely to lead to better and faster decision making benefiting investments in the sector. Though it is early days, the new minister has articulated the need to auction coal blocks to private companies so as to increase coal production in the country. The minister has also been in discussion mode with lenders and developers to come out with the right policy prescriptions for the sector including measures to be taken to remove hurdles/bottlenecks on projects under implementation. Separately, the new Transport Minister in charge of the Road sector has been on an aggressive drive to construct 30km per day of new roads compared to the current <10 km per day. We are quite enthused by the fact that his ministry understands that in current circumstances, BOT projects will not be successful due to weak financial position of the private sector and hence starting FY15, the ministry is once again coming out with bids for EPC projects for roads worth 3500 KM. These are welcome changes and will certainly go a long way in improving the sentiment and profitability of these sectors. The new finance minster along with the Reserve Bank of India are also contributing their bit to increase the fund availability for the infra sector by making all incremental lending to the infra sector by Banks free of CRR and SLR.

The bottomline – a good beginning is being made by the new government at the centre, one which can improve the investment scenario if carried through to its logical end. The circumstances lead us to believe that India has seen the worst in the past few years and incrementally we are likely to see gradual improvement in its growth profile.

Chandraprakash Padiyar

Portfolio Manager
Alchemy Capital Management Pvt. Ltd

DEBT OUTLOOK

Debt markets were subdued in the month of July and reacted negatively to RBI policy meeting held on 5th August 2014.

The following are the key points of the third RBI bi-monthly monetary policy statement 2014-15:

1. The key policy rate (repo rate) remains unchanged at 8%, as widely expected by the markets. The Cash Reserve Ratio (CRR) also remains unchanged at 4%.
2. Consequently the reverse repo rate remains unchanged at 7%, and the Marginal Standing Facility (MSF) rate and the Bank Rate at 9%.
3. However, the RBI has further cut the Statutory Liquidity Ratio (SLR) by 50 bps from 22.5% to 22.0% with effect from the fortnight beginning August 9, 2014. In the second bi-monthly monetary policy of June 2014, the RBI had reduced the SLR to 22.5% in anticipation of recovery in economic activity. The central bank said in this policy statement that with the Union Budget 2014-15 renewing commitment to the medium-term fiscal consolidation roadmap and budgeting 4.1% of GDP as the fiscal deficit for the year, space has opened up further for banks to expand credit to the productive sectors, as growth picks up.

The cut in SLR is not likely to have an immediate impact, as the banking system is already at around 29% SLR. Over a medium to long term, we expect SLR cut to be supportive of credit growth. The cut in the HTM limit for SLR bonds (to 24% of NDTL from 24.50%) would increase the amount of bonds that would have to be marked to market for a bank (part of available for sale – AFS- category) so there would be potential reduction in demand from banks.

The RBI also appears to be cautious on the inflation front. While the RBI has acknowledged that the recent decline in consumer price was due to both, strong base effect as well as steady deceleration in the non-food non-fuel component, the RBI feels that inflationary pressures are down but not out. The RBI is worried that there could be an upside risk to its consumer price inflation target of 8% by Jan 2015 and 6% by Jan 2016. Market participants have attributed this statement as a departure from the statement in its previous policy statement, where it had alluded to the possibility of a Repo Rate cut in case of higher-than-expected decline in retail inflation, adjusted for the base effect.

On the liquidity front, the RBI seems committed to maintain the overnight rates around the repos rate (currently at 8%). Hence tightness in liquidity if any would likely be temporary in nature. The RBI observed that liquidity conditions have remained broadly stable, barring episodic tightness on account of movements in the cash balances of the government maintained with the central bank. The central bank also added that in order to manage transient liquidity pressures associated with tax outflows and sluggish spending by the government; it injected additional liquidity through special term repos during the months of June and July.

Debt markets reacted negatively and the new 10Y government bond yield hardened to 8.59% from around 8.50% at the beginning of the day, while the old 10Y government bond yield hardened by 8 basis points to 8.81%.

DEBT OUTLOOK

We expect government bond yields to remain range-bound with an upward bias in the near-term in the absence of any positive near-term catalysts. The timing of the rate cuts would continue to be largely data dependent as the RBI has also stated that they would not hold rates longer than necessary. The shorter end of the curve is likely to remain supported as the outlook for liquidity remains comfortable. Going forward, market would keenly watch inflation trajectory and situation on the global front.

Clarification on LTCG on Mutual Fund Units transferred between 1-4-2014 and 10-7-2014:

Long-term Capital Gains on mutual funds (other than equity oriented mutual funds) are proposed to be taxed at the rate of 20%. Accordingly, option to pay tax at the rate of 10% (without indexation) would not be available in case of long-term capital gain arising from sale of such units.

However, the Finance Bill, 2014 as passed by the Lok Sabha provides that the benefit of the proviso shall continue to be available for the long-term capital assets, being units of Mutual Funds, transferred between April 1, 2014 and July 10, 2014. Thus, the assessee shall have an option to pay tax at lower of following rates if units of Mutual Funds are transferred between the said periods:

A) At 10% of capital gains as computed after reducing the cost of acquisition without indexation

B) At 20% of capital gains as computed after reducing the indexed cost of acquisition

The Finance Bill, 2014 provided that the amendments to section 112 will take effect from Financial Year 2014-15. This raised doubts among investors regarding the retrospective effect of the provision to tax the units of Mutual Funds (other than equity oriented mutual funds) redeemed during period April 1, 2014 to July 10, 2014. Thus, a proviso has been inserted for the transitional period to allow benefits of concessional tax rates during the aforesaid period.

Question remains, what to do with current FMPs which are due for maturity post 10th July 2014. We advise investors to roll over their FMP for two years to enjoy tax benefit. As Indexation benefit would be available the tax liability will be reduced to greater extent. Investors should continue focus on accrual strategies with a 2-3 year investment outlook. Those with appetite for duration and interest rate exposure should find favor with bond and gilt funds at such elevated yield levels. For investment tenure of 6-12 months, we believe equity arbitrage funds are a good avenue, given the positive sentiment in equity markets and tax benefit they enjoy.

Rupesh Nagda

Head – Investments & Products
Alchemy Capital Management Pvt. Ltd

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Edited by: Rupesh Nagda (Ph: +91-22-66171785), Sudeep Pai (Ph: +91-22-66171772)
Alchemy Capital Management Pvt. Ltd., B-4, Amerchand Mansion, 16 Madame Cama Road, Mumbai 400 001. Ph: +91-22-66171700
CIN- U67120MH1999PTC119811, Email ID: contactus@alchemycapital.com