TANTALLON CAPITAL

**April 2016**

# TANTALLON INDIA FUND

The Tantallon India Fund is a fundamental, long-biased, India-focused, total return opportunity fund, registered In the Cayman Islands and Mauritius. The Fund invests with a 3-5 year horizon, in a concentrated portfolio (25-30 unlevered positions), market cap/sector/capital structure agnostic, but with strong conviction on the structural opportunity, scalable business models, and in management's ability to execute.

Tantallon Capital Advisors, the advisory company, is a Singapore-based entity, set up in 2003, holding a Capital Markets Service License in Fund Management from the Monetary Authority of Singapore.

**Performance,** in USD

(*Inception on September 1, 2015*)

| | Tantallon India Fund | MSCI India($) | Over/Under Full Performance |
|---|---|---|---|
| April 2016: | +2.10% | +0.59% | +1.51% |
| 2016 YTD: | -5.76% | -2.37% | -3.39% |
| 2015: | +0.24% | -7.53% | +7.77% |
| 2014: | nm | +21.92% | nm |
| Inception: | -5.53% | -3.10% | -2.43% |

| | | | |
|---|---|---|---|
| Compound Returns | -8.19% | Volatility | +23.41% |
| 3 month US T-bill | +0.23% | Sharpe Ratio | -0.359 |

**The Tantallon India Fund closed up 2.1% for April, after expenses, in a month where volatile trading patterns and redemption-driven selling by 'active' foreign institutional investors remained the norm.** *The simple Math is that in the last 3 months, we have seen US$1bn in outflows from active managers invested in India (-US$408m in April) versus US$1.3bn in ETF inflows (+US$449m in April); the silver lining is that despite the ~20% uptick in gold prices, domestic investors have kept the faith, registering US$668m in inflows into domestic equity mutual funds in April.*

- ***Amidst significant global uncertainty, our conviction grid stands:*** positive Indian demographics will be a tailwind for sustained consumption; inflation and interest rates in India continue to trend lower; the government remains committed to significant new investments in mass housing, water, and urban infrastructure; and we are seeing the first signs of a revival in the cap.ex. cycle, and specifically, in light manufacturing.
- ***Our portfolio companies are set to compound earnings at a 15%+ run-rate over the next 3 years.***
- ***As the legislative calendar becomes more pro-reform focused (we see last week's passage of a new Bankruptcy Code in the Lower House as a harbinger of things to come), we expect equity multiples to be sustained*** by a buoyant investment cycle, visible earnings/cash flow growth, and structurally lower borrowing costs.

***More than half way through earnings season, we would highlight the following:***

- *Earnings are no longer being revised down.* In fact, after six quarters of negative earnings revisions, **our belief is that the market needs to start to price-in market earnings compounding at 12%+ over the next 2-3 years.**
- The **pick-up in transparent tendering and actual contract awards across a slew of urban infrastructure projects** is increasingly visible in order-books and in management's outlook commentary: railways, roads, fly-overs, metro link projects, water and sewage treatment plants, transmission and distribution, and low income mass housing.
- **Operating leverage in the commodity, infrastructure, and industrial cyclicals (autos and cement in particular) continue to surprise positively on the upside** – despite the obvious headwinds on pricing for the commodity sector in particular.
- **Over the next 3 years, rising rural incomes/consumption may well be a significant positive driver for the real economy** ***- and even more so, if the monsoons are bountiful, driving a strong recovery in agri-output, and containing food inflation*** - on the back of the government explicitly investing in rural infrastructure, (rural electrification, roads and irrigation projects), connectivity, and mass housing.
- Despite the hype and the significant capital raises (largely from Venture Funds), there is **zero visibility on a path to profitability for the e-commerce companies.**

Building on the water infrastructure theme from last month, we wanted to highlight our conviction in the cement sector, and our investments in ***Shree Cement*** and ***Orient Cement.***

**FUND DETAILS**

**The Tantallon India Fund**

**AUM USD 13,000,000**

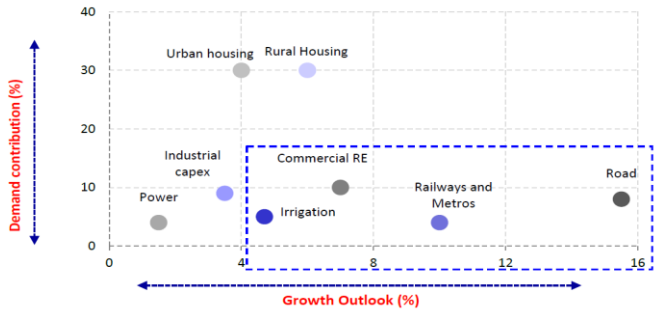
| | |
|---|---|
| **Investment Advisor:** Tantallon Capital | **Minimum Investment:** USD 5,000,000 |
| **Administrator:** Trident Trust Company (Mauritius) Ltd | **Fees:** 1.5%pa Management fees 12.5% on annual returns in excess of 7.5% USD hurdle |
| **Domicile:** Mauritius | **Dealing:** Monthly |
| **Feeder funds** US Feeder and Non-US Feeder (Cayman Islands) | **Lawyers:** Maples & Calder; Shearman & Sterling LLP; Rajah & Tann Singapore LLP |
| **Auditor:** KPMG | **Contact:** Alex Hill (alex@tantalloncapital.com) |

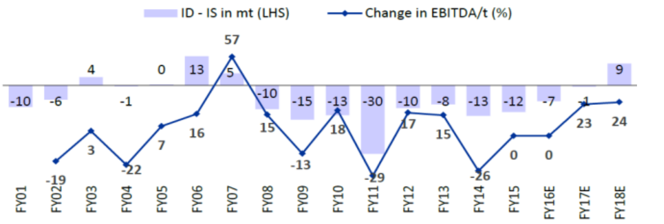
***Demand/Supply/Pricing:***

- ***Over the next 3 years, we expect cement demand to compound at 7% annually, at ~1x real GDP growth*** *(substantially below the historical peak of 1.4x real GDP growth, but a meaningful improvement over the 3% CAGR posted over the past three years, a multi-decade low, reflecting the industrial and balance sheet recession India went through),* on the back of a credible and sustained pick-up in infrastructure activity (concrete roads, rail, irrigation, the Dedicated Freight Corridor, metro projects) and mass housing projects in rural and semi-urban India,
    - What's not built into our forecasts at this point is any positive impact from (i) the proposed US$90bn+ Delhi-Mumbai Industrial Corridor (incorporating nine mega industrial zones, a high speed freight line, three ports, six airports, a six-lane intersection free expressway connecting Mumbai and Delhi, and a 4,000MW power plant); (ii) the proposed US$75bn development of the new capital city of Andhra Pradesh; and (iii) the US$30bn allocation to develop new 'smart cities.' ***As funding is tied up and these mega projects get under-way, we would not be surprised if our estimates on demand growth prove conservative.***

| YEAR | RETURNS | JAN | FEB | MAR | APR | MAY | JUN | JUL | AUG | SEP | OCT | NOV | DEC |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Inception | -5.53% | | | | | | | | | | | | |
| 2016 | -5.76% | -8.33% | -9.98% | +11.86% | +2.10% | | | | | | | | |
| 2015 | +0.24% | | | | | | | | | -0.14% | +1.36% | -2.09% | +1.14% |

- **The key for us is our view on the near-term cap.ex. cycle and incremental new capacity additions in the cement sector having peaked.** *Over the next 3-5 years, we would anticipate incremental supply compounding at no more than 4% annually* given the very real challenges in securing assured raw material supply, and the environmental clearances to set up new capacity.
- **With the Incremental (Demand – Supply) Gap turning positive for the first time in a decade, and industry utilization rates finally nudging over 80%, we anticipate the return of some pricing power to the sector.**
    - In prior cycle peaks, cement pricing improved at a 13.3% compound annual run-rate over a three year period where volumes compounded at 9% annually; **we are currently projecting a 5% compound annual recovery in pricing over the next 3 years on volumes compounding at 7% annually.**




*ID - IS: Incremental Demand - Incremental Supply*
*Source: Motilal Oswal*

**Shree Cement** has delivered the strongest and most consistent growth in capacity and profitability in the sector, for over a decade. Having doubled capacity to 25m tons over the last four years, management's goal is to raise capacity to 40m tons by March 2019 at roughly US$70/ton in incremental capex (versus the industry standard of US$120/ton) thanks to self-sufficiency in lime-stone reserves and having already secured the land needed for its expansion plans. Shree Cement remains the low cost producer in the sector (35% lower costs than the industry average) on the back of economies of scale, best in class energy efficiency, and significant savings on logisitics and transportation costs relative to the sector), allowing for sustained earnings growth and significant FCF generation.

- On the back of the new capacity additions, and stable/improving pricing, we are comfortable projecting revenues growing 50%+ over the next years.
- We remain comfortable projecting EBITDA margins at 25%+ for next 3years, with utilization rates remain in above 80% over the next 3 years.
- Given Shree's aggressive use of accelerated depreciation (with 90% of the asset being depreciated within the first four years), EBITDA and EPS growth is significantly understated. As reference, consensus expectations would suggest EPSe of ~Rs..500 in FY18e (3x higher than FY16 EPSe); our expectations are for cash earnings of close to Rs.850/share, with ROEs trending towards 24%, and ROCE trending close to 28%.

**Orient Cement** has underperformed over the last few months over market concerns on the slower-than-expected ramp-up of the new capacity that was commissioned at the end of the last calendar year, and the pricing weakness in Maharashtra, a key market, where rural demand has been negatively impacted by two consecutive years of drought, exacerbated by the delays in planned project execution given the impasse within the ruling coalition in the state.

- We are clearly optimistic on a revival in demand (on the back of affordable housing projects in Andhra Pradesh and Maharashtra, the construction of the new capital of Telengana, the Polavaram irrigation project in Andhra Pradesh, and a better monsoon season restoring rural demand). Our base case incorporates utilization rates in excess of 70% on the 8m tons of nameplate capacity, translating to a minimum 35% growth in volumes over the next 2 years.
- In addition, as industry utilization rates edge over 80%, we expect a 5%-7% increase in average price realizations over the next 18 months.
- EBITDA is currently tracking at Rs.400/ton; over the next two years, as utilization rates ramp-up, as realizations improve, and as energy cost efficiencies are realized (with new waste heat recovery program and the use of pet coke), we are comfortable projecting EBITDA closer to Rs.900/ton (versus the peak of Rs.1,200/ton), with ROEs trending back to prior peak levels of 21%, and ROCE trending to 20%.

***To conclude:***

- ***We live with significant global uncertainty; our positive stance on India continues to focus on*** Indian ***demographics and consumption***; ***lower inflation and interest rates;*** and government spending on urban and rural infrastructure, and mass-housing, kick-starting a ***new investment cycle.***
- An improving fundamental outlook underpins our conviction in our ***portfolio companies delivering on earnings compounding at a 15%+ run-rate over the next 3 years.***
- ***As the legislative calendar becomes more pro-reform focused, we expect equity multiples to be sustained*** by a buoyant investment cycle, visible earnings/cash flow growth, and structurally lower borrowing costs.

*Please do let us know if you would like a follow-up conversation, or a catch-up.*

## Portfolio Overview

| Top 5 Positions | Sectoral Break-down: | As % NAV | Sector Performance | MTD Performance |
|---|---|---|---|---|
| Bajaj Finance Ltd | Agriculture: | 3% | Agriculture: | +0.30% |
| Natco Pharma Ltd | Autos: | 8% | Autos: | -0.06% |
| Kotak Mahindra Bank Ltd | Building Materials: | 12% | Building Materials: | -0.18% |
| ZEE Entertainment Enterprise | Consumer Discretionary: | 17% | Consumer Discretionary: | +0.98% |
| Asian Paints Ltd | Financials: | 22% | Financials: | +0.47% |
| | Industrials: | 15% | Industrials: | +0.40% |
| | Infra Backbone: | 11% | Infra Backbone: | -0.87% |
| | IT Services: | 2% | IT Services: | -0.19% |
| | Logistics: | 3% | Logistics: | +0.43% |
| | Pharmaceuticals | 8% | Pharmaceuticals: | +0.82% |