TANTALLON CAPITAL

December 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
December 2016:	-2.83%	-0.25%	-2.58%
2016 YTD:	-5.79%	-2.90%	-2.90%
2015:	+0.24%	-7.53%	+7.77%
2014:	nm	+21.92%	nm
Inception:	-5.57%	-3.62%	-1.95%
Compound Returns	-4.21%	Volatility	+22.60%
3 month US T-bill	+0.497%	Sharpe Ratio	-0.208

FUND DETAILS

The Tantallon India Fund

AUM USD 16,000,000

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

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At the outset, a very Happy, Healthy, and Prosperous New Year to you and your families!

The Tantallon India Fund closed down -2.83% in December, after expenses, bringing a year that had promised much, to a very disappointing close: for the year, the Fund was down -5.79%, caught in a year-end backdraft from the Trump-rally induced rising Emerging Markets risk aversion, and the market trying to calibrate the short-term drag on domestic growth, consumption, and corporate earnings following India's demonetization program in November/December.

…and in the face of significant headline pessimism over the short-term negative impact on growth, watching our consumer facing portfolio claw back some lost ground in the first few trading days of the New Year, we are certainly reminded that the markets do keep us very humble. Onwards and Upwards!

Top-down, framing our expectations following the forced adjustments in India's cash economy post de-monetization:

- ***We expect real GDP growth for the fiscal year ended March 2017 of about 6.5% (with December probably marking the low mark), accelerating to a 7.5%-8% compound annual run-rate over the next 3-4 years*** on the back of GST implementation, a surge in fixed asset investments and in employment, and sustained consumption growth post the demonetization re-set.
- ***We do expect regulatory forbearance, and more monetary policy easing*** by the Reserve Bank, ***as well as significant non-monetary stimulus*** (we expect lower direct taxes and a significant fiscal spending package in the February 1 budget).
- *Given the flood of liquidity into the banking system, it is not surprising to see the banks cut lending rates aggressively – and quite frankly,* ***we would expect borrowing costs to continue to trend lower over the next 12-18 months supported by benign inflation data****.*
- *Earnings for the December quarter for the consumer facing companies are a wash-out* with retail and sales and property transactions having collapsed. However, recent high frequency data is already suggesting that the second derivative has turned, and that growth/demand is 'normalizing;' ***our expectations are for reasonably stable 4th quarter FY2017 earnings, heading into a much stronger FY2018.***
- Given the markets pricing-in the near-certainty of multiple Fed rate hikes over the next 12 months, suggesting a stronger US$, and collateral damage in currencies across Asia, ***our base case assumption now is for the rupee to settle around Rs.72/US$ over the next 18 months.***

On demonetization, we have honestly been surprised at the negative feedback loop that the sell-side and the media-pundits have sought to amplify over the last six weeks. In contrast, despite the obvious execution challenges, and the short-term hit to growth/earnings, having spent three of the last six weeks traveling across India, **we remain unambiguously positive on demonetization, the forced digitalization of the Indian economy, the re-set in the domestic economy, and a strengthening Indian equities narrative.**

- Demonetization will reduce the severe economic distortions within India's massive parallel economy (gold and food commodity hoarding, artificially high urban real estate prices).
- Demonetization allows for inflation/inflationary expectations, interest rates, and borrowing costs to trend lower – in part due to a lower fiscal deficit, in part, due to the forced reduction in money in circulation, and in part due to the flood of deposits into the formal banking system. (*Case in point: earlier this week, State Bank of India cut their base lending rate by 90bp!)*
- Demonetization will broaden the government's tax net, allowing for targeted tax cuts and fiscal stimulus to spur the real economy.
- Demonetization is the first step on Modi's ideological commitment to fight corruption; there will no question, be an impact on psyche,

YEAR	RETURNS	JAN	FEB	MAR	APR	MAY	JUN	JULY	AUG	SEP	OCT	NOV	DEC
Inception	-5.57%												
2016	-5.79%	-8.33%	-9.98%	+11.86%	+2.10%	+1.89%	+5.44%	+6.37%	+1.66%	-0.74%	-1.69%	-9.26%	-2.83%
2015	+0.24%									-0.14%	+1.36%	-2.09%	+1.14%

and the hitherto, brazen trading of access and patronage – and India, and all Indians, will benefit. *(Please note: we would certainly anticipate further restrictions targeting properties owned under nominee accounts, and on un-documented bullion purchases.)*

- ***Bottom-line, we expect that the markets will price the economic re-set and the earnings decline relatively efficiently:*** we expect that the focus to switch to the significant tailwinds accruing post demonetization, and that the markets will start to anticipate the re-set in the real economy, a stimulative pro-growth Budget, and the positive uplift to tax collection and to corporate earnings post GST implementation in the first half of 2017.

The key headline risks to keep an eye on: 1) the near term growth uncertainty arising from demonetization; 2) a sharp increase in crude (in particular) and other commodity prices; 3) policy uncertainty and a sharp spike in US treasury yields which are likely to contribute to further risk aversion for emerging markets assets broadly, and to volatile emerging market currencies; 4) rising trade and non-tariff barriers that would potentially be negative for Indian exporters; and 5) domestic elections in 5 states to be held over the next 8 weeks, and which are likely to be 'noisy,' and seen as a barometer of public support for Modi's reform agenda.

The stock we wanted to highlight this month is *Bharat Electronics,* *India's only pure-play, listed, defense company, focused on radar and guided-missile systems, avionics, and satellite communication and surveillance systems.* BHE is ***the*** flag-bearer of the government's 'Make-In-India initiatives,' and having substantially upgraded its manufacturing facilities, augmenting its core strengths in R&D, engineering, and systems integration, is poised to see its order book expand dramatically over the next 3-4 years.

Top-down, the thesis is fairly straight-forward: as the largest weapons and electronic systems integrator in the country, BHE is the single biggest beneficiary of the Indian government (spooked by China's territorial posturing and the aggressive ports-related investments in Pakistan and Sri Lanka to facilitate Chinese control of the shipping lanes across the Indian Ocean) looking to significantly upgrade India's own early-warning missile defense capability, naval and satellite surveillance systems, battle field management systems, tactical communication systems, and long-range surface-to-air missile capabilities. ***We expect the current order book of US$5bn to double over the next three years.***

What we are most enthused by is:

- Scaling-up of the pool of scientists and engineers – ***currently 50% of the total engineering work force of 5,000 is directly employed in R&D*** (versus 35% just 5 years ago), reflected in R&D expenses rising to 10%-12% of revenues (up from under 5%, 5 years ago).
    - *Amazingly, 85% of current revenues accrue to internally developed R&D.*
- We believe management's guidance of 10%-12% annual growth in revenues is conservative, reflecting the natural delays that go with government-to-government negotiations on defense technology transfers, and the lumpiness of new defense
    - However, as we assess a robust new defense spending pipe-line, and the prioritization of spending by the Army and the Navy on systems and surveillance/weapons integration, ***we are currently modeling BHE's order book to double, and for revenues to compound at a minimum 15% CAGR over the next three years.***
- As order book execution ramps up, and operating leverage kicks-in, ***we expect expect a minimum of 100bp improvement in operating margins to 21%, over the next three years.***
- Given the urgency on new defense contract awards, and hence, improving visibility on the top-line, and good operating leverage, we are comfortable modeling earnings compounding at close to 20% annually over the next three years.
- Given US$1bn in cash on the balance sheet, improving working capital cycle, and strong FCF generation post the capex to augment its manufacturing facilities, ***we believe that there is room for the current 30% dividend payout to be boosted.***

As we prepare for Trump's inauguration and (hopefully) some clarity on policy-direction out of the US, and as we look to re-set our expectations on geo-politics, global growth, Fed policy rates, European elections, fractious Brexit negotiations, Chinese capital flows, global terrorism, and importantly, global equity investor risk appetite, ***there is no question that extreme market volatility will likely continue to test our convictions.***

Amidst the uncertainty and the volatility, **<u>we would reiterate our conviction to deliberately increase exposure to Indian equities,</u>** *and to stay focused on the long runway ahead of us in India, at a key inflection point in the investment cycle, invested in private financials, discretionary consumption, the massive infrastructure roll-out across the country, specialty pharmaceuticals, and improving operating leverage.*

- **Valuations** have meaningfully corrected *(at 15x forward earnings, market multiples are now back to where they were in June 2013 in the midst of the taper-tantrum),* and especially with regards to the domestic fixed income alternatives *(attested to by the US$10bn of inflows into domestic equity funds in November and December);*
- **Having rigorously tested our assumptions, we are focused on the sustained growth and earnings visibility within our portfolio, with earnings compounding at a 15% CAGR;**
- A shift in funding mix to FDI (as opposed to debt and equity funding), and improving terms of trade making the case for **relative rupee stability** *in the face of higher interest rates globally and a potentially stronger US$;*
- **Structurally falling borrowing costs, will boost infrastructure spending and domestic consumption;** and
- Despite the hiccups with demonetization, Modi's government remains unwaveringly committed to a path of **intentional structural reforms and to addressing chronic corruption.**

Again, all our very Best to you for a successful 2017!

Please do let us know if you would like a follow-up conversation, or a catch-up in the New Year.

Portfolio Overview

Top 5 Positions
Natco Pharma Ltd
Kotak Mahindra Bank Ltd
HDFC Bank Ltd - ADR
Bajaj Finance Ltd
Zee Entertainment Enterprise

Sectoral Break-down:	As % NAV
Agriculture:	4%
Autos:	5%
Building Materials:	14%
Consumer Discretionary:	15%
Financials:	32%
Industrials:	11%
Infra Backbone:	4%
IT Services:	0%
Logistics:	3%
Pharmaceuticals	9%
Retail	3%

Sector Performance	MTD Performance
Agriculture:	+0.16%
Autos:	+0.07%
Building Materials:	-0.95%
Consumer Discretionary:	+0.25%
Financials:	-1.13%
Industrials:	-0.42%
Infra Backbone:	+0.17%
IT Services:	0.00%
Logistics:	-0.46%
Pharmaceuticals:	-0.51%
Retail:	-0.01%