TANTALLON CAPITAL

February 2017

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
February 2017:	+8.73%	+5.85%	+2.89%
2017 YTD:	+17.80%	+10.49%	+7.31%
2016:	-5.79%	-2.90%	-2.89%
2015:	+0.24%	-7.53%	+7.77%
Inception:	+11.24%	+6.49%	+4.75%

Compound Returns	+7.37%	Volatility	+23.07%
3 month US T-bill	+0.604%	Sharpe Ratio	0.293

FUND DETAILS

The Tantallon India Fund

AUM USD 19,000,000

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)

The Tantallon India Fund closed up +8.7% in February; the sharp rebound in stock prices reflects a measure of forced short covering, re-enforced by strong domestic equity fund inflows, *AND* a re-set on earnings expectations given how well corporate India seems to have coped with de-monetization.

As global markets wrestle with justifying reflation trades in the face of rising geo-political risks and elevated policy uncertainty globally, and the near certainty of higher interest rates and risk premiums, our simple message stays on-point: ***look for opportunities amidst market volatility to increase exposure to Indian equities;* *disciplined executive/legislative reforms and policy momentum (driving infrastructure spending, job creation, and risk capital deployment), lower domestic borrowing costs, and recovering rural demand, provide our portfolio holdings with idiosyncratic opportunities to grow markets/market share.***

- *Our strongest convictions are in the financials, industrials, healthcare, building materials, and consumer discretionary stocks.*
- *We continue to have no exposure to IT Services and telecom.*
- *We are increasingly intrigued by the 'un-loved' in the property sector, and in the IT services space.*

Brand Modi is intact; Brand Modi is now, genuinely, National. *The BJP's sweeping victory in the state elections in Uttar Pradesh, India's most populous state (accounting for 15% of the seats in Parliament), rewarded an election strategy exclusively focused on Modi's national development agenda and reform measures, cutting across the religious and caste-based voting lines that have historically characterized state elections.*

- It is now irrefutable that **de-monetization has strengthened Modi's anti-corruption and pro-reform credentials** in the most extraordinary way: ***a 'young' India is voting, aspirationally, for reform and for opportunity.***
- **The significant political capital Modi has earned should give fresh impetus to his development agenda centered on infrastructure, job creation, rural incomes, social welfare, and affordable mass housing, setting the stage for the next national Elections in 2019…**
- ***…anchoring domestic investor expectations, and encouraging continued strong flows into domestic equity funds.***

We would explicitly make the case that domestic investors are now 'setting prices', and that domestic flows will continue to be supportive of market multiples, even as earnings are poised for a strong cyclical rebound.

- *De-monetization and Modi's crusade against corruption and black money is transforming domestic investor psyche, risk appetite, and the historical penchant to 'store' wealth in physical assets, i.e., gold and property;* ***the surge in domestic financial savings augurs well, obviously, for flows into the equity markets – and that is exactly what we have seen over the last 24 months.***
  - In the last year, Indians have opened 12 million domestic equity mutual fund accounts (currently, there are about 53 million 'active' equity mutual fund accounts).
- Over the last 24 months, aggregate inflows into domestic equity mutual funds alone have been close to US$12bn *(as compared to US$3bn in foreign inflows over that same time period that have been ETF driven, and narrowly focused on the index heavy-weights).*

Having met with more than two dozen companies over the last 6 weeks, we would share the following data-points:

- With 1.1bn *(not a typo!)* UID cards in issuance, 400m of which are linked to active bank accounts, thanks to direct benefit transfers, *annual government subsidy savings of US$7bn+ is*

YEAR	RETURNS	JAN	FEB	MAR	APR	MAY	JUN	JULY	AUG	SEP	OCT	NOV	DEC
Inception	+11.24%												
2017	+17.80%	+8.34%	+8.73%										
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%

quite probable over the next two years (currently, these savings are tracking at US$2bn annually on just the food and cooking fuel subsidy), creating a platform for intentional government investments into social and industrial infrastructure.

- *GST implementation, currently scheduled for a July 1, 2017, roll-out,* will continue to accelerate the shift in favor of the organized sector – from food and groceries, to retail, to building materials, and jewelry.
- *Domestic SME activity has recovered sharply in January/February, and is expected to show robust growth from March onwards* on the back of re-stocking of inventory at the wholesale/ retail levels.
- *Commercial bank liquidity is at a 10-year high,* a precursor, generally, to strong loans growth; the significant opportunity is for banks who can retain the windfall deposits that cascaded into their accounts through de-monetization, and who are able to thoughtfully cross-sell products.
- Rising disposable incomes, and a re-set in particular, in rural and SME-linked incomes and spending patterns, will be supportive of *discretionary consumption demand, overall credit demand, and selectively, affordable/mass housing.*
- *Cement pricing has remained resilient,* despite overall demand having contracted close to 20% as a result of depressed building activity.
- *Basic necessities like detergent and soaps have largely recovered to pre-demonetization levels,* while premium segments and discretionary categories are tracking at about 90% of pre-demonetization levels.
    - *Interestingly, non-cash purchases of FMCG goods are tracking at about 50% of transactions in the southern and western parts of the country (versus an average of about 15%, pre-demonetization).*
- On real estate, *office and retail space demand has been unaffected by de-monetization; residential prices however, remain under pressure, especially in the northern and western parts of the country.*

The stock we wanted to highlight this month is *CCL Products (CCL),* the leading manufacturer of instant coffee globally, with private label customers in 60 countries, purchasing its spray-dried, freeze-dried, and liquid concentrate variants of instant coffee. CCL currently has 30,000 metric tones of capacity globally (half of which is in India). The significant opportunity in the medium term, is to develop and establish its own brand in the domestic market (which is currently a cosy duopoly shared between Nestle and Unilever).

We expect consolidated revenues to conservatively compound at close to 20% annually over the next three years.
No question, the key growth driver in the medium term, will be volume expansion with management having outlined its plans to increase global capacity by 50% over the next 3 years (+5,000 MT greenfield in India, and +10,000 MT brownfield in Vietnam).

- As utilization rates improve on the existing facilities, underpinned by strong, visible demand globally, and given the opportunity to scale-up its domestic branded sales, *we expect that volumes will continue to surprise the market on the upside, to close to 40,000 MT, for the fiscal year ended March 2019.*
- ***We expect that the upside on revenues (relative to more sedate consensus expectations of about 10% CAGR) will come from accelerating mix improvement with the commissioning of new freeze-dried capacity in mid-2018 and higher domestic branded sales.***

We expect profits to compound at a 25%+ run-rate over the next three years on the back of mix improvement and operating/scale efficiencies (thanks to the increase in demand for the higher-margin freeze-dried product, higher branded sales in the domestic market, improving utilization rates and automation).

- The market is currently projecting EBITDA margins to stabilize in a 25%-26% band. ***We expect EBITDA margins to be tracking closer to 28% by FY19e, and that the market is under-appreciative of the structural mix improvement that is under-way, and the volume/revenue/margin uplift from scale and establishing a domestic brand.***
- Management is guiding towards an effective tax rate of 23% by FY19e as utilization rates ramp-up at the Vietnam plant; we are currently modeling a flat 26% tax rate, suggesting potentially, further upside to our earnings estimates.
- Given low gearing levels (we are modeling net debt/ebitda at 0.4x by March 2019), and extremely strong free cash flow generation post capex, ***we also expect meaningful upside to the current consensus on a 20% payout ratio.***

To conclude: we remain focused on a portfolio that is clearly differentiated relative to headline benchmarks, and with clear conviction in our holdings in financials, industrials, healthcare, building materials, and consumer discretionary stocks.

- We retain confidence in **India delivering on real GDP growth compounding in excess of 7% over the next 3-5 years,** as Modi's pro-reform, pro-growth initiatives drive a strong, sustained investment cycle.
- Our conviction is underpinned by the structural uplift provided by the **channeling of wasteful government subsidies into intentional infrastructure development**, the **digitalization of the hitherto ubiquitous cash economy, India's rural recovery,** and **sustained consumption demand.**
- **We expect lower borrowing costs and sustained flows into domestic equity funds to provide strong valuation support for our portfolio companies compounding earnings at a 15%+ CAGR over the next 3 years.**

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

Portfolio Overview

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

Sectoral Break-down:	As % NAV
Agriculture:	4%
Autos:	4%
Building Materials:	13%
Consumer Discretionary:	17%
Financials:	30%
Industrials:	11%
Infra Backbone:	4%
IT Services:	0%
Logistics:	4%
Pharmaceuticals	10%
Retail	3%

Sector Performance	MTD Performance
Agriculture:	-0.01%
Autos:	+0.25%
Building Materials:	+1.20%
Consumer Discretionary:	+1.44%
Financials:	+1.20%
Industrials:	+0.85%
Infra Backbone:	+0.55%
IT Services:	0.00%
Logistics:	+1.64%
Pharmaceuticals:	+1.44%
Retail:	+0.17%