TANTALLON CAPITAL

July 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
July 2017:	+4.30%	+7.21%	-2.91%
2017 YTD:	+38.35%	+28.44%	+9.91%
2016:	-5.79%	-2.90%	-2.89%
2015:	+0.24%	-7.53%	+7.77%
Inception:	+30.65%	+23.79%	+6.86%

Compound Returns	+14.96%	Volatility	+21.52%
3 month US T-bill	+1.06%	Sharpe Ratio	0.65

FUND DETAILS

The Tantallon India Fund

AUM USD 25,000,000

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% US$ hurdle rate compounding annually
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 +4.30% in July, after expenses. Given the mini taper tantrum last month, and the seemingly never-ending flow of negative geo-political headlines (from a stalled legislative agenda in Washington and the blockade on Qatar, to increasingly strident saber rattling in Eastern Europe, over the Korean Peninsula, in the South China Sea, and on the Dolam Plateau), we have been surprised by robust fund flows into India through ETFs and global EM mandate allocations, driving the strongest monthly uptick for the year in terms of broad index performance, making light of the GST-implementation related earnings dislocations.

Perhaps the real take-away is that the markets are starting to look beyond (i) a period of prolonged US$ weakness, and (ii) conflicted Central Bank messaging on 'normalizing' monetary policy, and to (re)focus instead, on the genuinely structural opportunities set against a backdrop of inherent global growth-challenges, and relatively benign policy choices/outcomes.

<u>**Our basic framework stands: we should continue to expect bouts of market volatility; however, that intermittent volatility (as we saw last month) will provide us a window to be intentional in increasing our allocation to Indian equities.**</u> *In the build-up to the next General Elections in 2019, we retain clear conviction in Modi's pro-reform/anti-corruption/pro-growth platforms; we are particularly excited about the idiosyncratic opportunities in financial services, discretionary consumption, mass housing, the digitalization of the real economy, and infrastructure.*

The 'surprise' for the month was no question, the stunning developments in Bihar (India's 5th largest state), which saw the incumbent Chief Minister, Nitish Kumar, break ranks with the National Opposition parties, and forge a new coalition with the BJP.

- The fact that Nitish joined hands with the BJP to form the new state government in Bihar, literally, hours after announcing the split with his erstwhile partners (Congress and RJD) over (yet) another corruption probe against RJD head-honchos, Lalu and Tejashwi, puts to rest months of speculation following **Nitish's unexpected support of Modi's anti-corruption agenda, de-monetization, and the introduction of GST.**
    - ***Yes, conspiracists and cynics will have a field day; but, our view is that it is only a positive for the country to see the two most credible proponents of an efficient, corruption-free Executive, put aside their egos and personal differences, to shape and implement a strong pro-reform/anti-corruption platform.***
- The ramifications go well beyond the state of Bihar, **under-scoring the Opposition's inability to coalesce around a platform or an individual,** potentially setting the stage for another strong national mandate for Modi at the Polls in 2019.
- Importantly, Nitish's support (and the visibility it provides in terms of additional seats for the BJP in Parliament in the next General Elections), significantly **reduces the risk of Modi adopting a more populist stance in the run-up to the Polls over the next two years, or being forced to tone down his anti-corruption and reform agenda.**

Rural India remains extremely important politically (accounting for close to 70% of the population), as well to corporate profitability.

- *Rural India employs half the country's labor force, and generates close to 50% of national incomes.*
- Over the last four years, the Rural India growth engine has effectively stalled on the back of two consecutive poor monsoons, and the government's concerted efforts to eliminate wasteful subsidy programs, and to rein-in food inflation, and inflationary expectations.
    - *The slump in nominal agricultural GDP growth to a 7% CAGR over the last three years (down from close to a*

YEAR	RETURNS	JAN	FEB	MAR	APR	MAY	JUN	JULY	AUG	SEP	OCT	NOV	DEC
Inception	+30.65%												
2017	+38.35%	+8.34%	+8.73%	+6.73%	+6.54%	-1.20%	+0.23%	+4.30%					
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%

12% CAGR over the preceding three years) has translated to ***ZERO growth in rural incomes over the last three years (versus a 6% CAGR in the preceding three years), explaining the sharp pull-back in rural consumption – with a correspondingly negative impact on demand, industry utilization rates, revenues, margins, and profitability.***

In the lead-up to the next General Elections in two years, we now expect to see strong policy impetus (via counter-cyclical fiscal measures as well as good old-fashioned pump-priming) to drive sustained rural income growth, and improved standards of living – and as a result, delivering a meaningful kicker to industry utilization rates, corporate revenue growth, and profitability.

- We expect to see carefully modulated increases in the government's minimum support prices for grain and pulses – the tight-rope of course being managing inflationary expectations while ensuring remunerative pricing for India's indebted agrarian economy.
- We expect to see savings from the subsidy cut-backs over the last three years being re-cycled into the rural economy via targeted direct cash transfers to the 'bottom-of-the-pyramid' similar to the very successful replacement of the LPG subsidy program.
  - *Most importantly, we expect to see a series of reforms specifically pertinent to (1) encouraging foreign direct investments into food retailing thereby, encouraging an effective supply chain eliminating the middle-men); (2) encouraging the leasing of farm-land and the consolidation of the extremely fragmented small farm holdings to drive efficiencies and scale economies; and (3) the encouragement of mechanization, drip irrigation to, crop protection, and hybrid seeds to significantly improve yields.*

The stock we wanted to highlight this month is Heritage Foods (HTFL), a south India focused dairy company that is leveraging its relationships with organized retailers to develop a strong brand, and a pan-India distribution presence. Management's aspirations are to double their capacity and triple revenues over the next five years. Against the backdrop of urbanization, rising disposable incomes, and significantly increased awareness and demand for healthy dairy options (packed/pouched milk, yogurts, flavored/malted milk, cheese, whey), we are excited about the sustained demand opportunity, and the opportunity to systematically improve mix/margins with branding, and category extensions.

We expect revenues to conservatively compound at 12%+ annually over the next 3 years to about Rs.38bn, with the market projecting a subdued 5% CAGR in revenues. *Quite frankly, we would not be surprised to see revenues grow significantly ahead of our current estimates.*

- *80% of the overall dairy market is still controlled by the unorganized, local market participants.* In the quiet, efficient roll-out of the franchisee footprint (currently, HTFL has 1,700 franchised stores in five states, and is looking to add 100 Heritage Parlors annually), what is currently under-appreciated is HTFL's accelerating access to mom & pop convenience stores, and the reach made possible by the substantial retailing footprints being developed by Reliance Fresh and Big Bazaar.
- *Also under-appreciated is the opportunity for significant mix improvement: currently, 75%+ of current consolidated revenues is from the sale of milk.* Our expectation is that ***over the next three years, value-add, non-commoditized, higher price-point dairy products will account for close to 40% of consolidated revenues.***

We expect earnings to compound at close to 40% annually over the next three years, with consensus estimates anchored around a 20%-or-so CAGR.

- *The commitment to 100% direct sourcing from the farmers (eliminating the middle-man), intentional farmer outreach, support, and education programs, and guaranteed off-take agreements with the farmers, genuinely differentiate the business model relative to the industry peer group, allowing HTFL to maintain strict control over quality and input costs.*
- Over the next three years, despite a significant increase in advertising and brand-building (from 0.5% of sales to 1.5% of sales), given higher utilization rates, sustained mix improvement, and greater control over input costs, ***we are comfortable with our outlook on operating margins improving from 5.3% to about 8%.***

To conclude:

- ***In the lead-up to the 2019 General Elections, we should expect Modi to be decisively focused on his anti-corruption and reform programs, and to be intentionally directing fiscal stimulus and risk capital towards infrastructure development, rural reflation, industrialization, job creation, and the ongoing digitalization of the real economy.***
- GST-implantation will make for noisy earnings comparisons in the short-term, given the forced adjustments in inventory and working capital; however, ***we retain strong (well-differentiated) conviction in our concentrated holdings in financials, industrials, healthcare, building materials, and consumer discretionary stocks, and in their ability to sustainably grow markets/market share/earnings.***
- ***Strong inflows into domestic equity funds*** (anticipating a policy-driven revival in capital spending, domestic demand, and discretionary consumption) ***will remain supportive of market valuations.***

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
Bajaj Finance Ltd
Natco Pharma Ltd
HDFC Bank Ltd - ADR
Kotak Mahindra Bank Ltd
Asian Paints Ltd

Sectoral Break-down:	As % NAV
Consumer Discretionary:	17%
Consumer Staples:	6%
Energy:	3%
Financials:	29%
Health Care:	12%
Industrials:	13%
Materials:	14%
Retail:	4%
Utilities:	2%

Sector Performance	MTD Performance
Consumer Discretionary:	+0.67%
Consumer Staples:	-0.02%
Energy:	+0.04%
Financials:	+2.87%
Health Care:	+0.02%
Industrials:	-0.02%
Materials:	+0.85%
Retail:	+0.13%
Utilities:	-0.24%

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