TANTALLON CAPITAL

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
September 2018:	-12.87%	-9.07%	-3.80%
2018 YTD:	-28.14%	-10.67%	-17.47%
2017:	+59.14%	+36.84%	+22.30%
2016:	-5.79%	-2.90%	-2.89%
2015:	+0.24%	-7.53%	+7.77%
Inception:	+7.99%	+17.81%	-9.82%

Compound Returns	+2.53%	Volatility	+20.47%
3 month US T-bill	+2.19%	Sharpe Ratio	0.016

FUND DETAILS
The Tantallon India Fund

AUM USD 30,000,000

Investment Advisor: Tantallon Capital

Minimum Investment: USD 1,000,000

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:
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The Tantallon India Fund closed down -12.87% in September, after expenses.

It's been a very tough month, with India continuing to be an outlier in the context of global equities with country risk premiums spiking (CDS spreads are up to about 150bps, the rupee is down 12% y-t-d versus the US$), and intensified foreign institutional selling of equities and fixed income (amazingly, calendar year to date, net foreign portfolio outflows of US$11bn now exceed the prior 'record' outflows of US$10.2bn in 2008!).

Given continued robust growth expectations, stable inflation data, credible monetary and fiscal policies, and supportive flows into domestic equity funds (+US$14bn y-t-d), the sell-off is hard to explain – beyond pointing limply to markets, hyper-sensitive to negative news flow, extrapolating a short-term liquidity event at a large domestic infrastructure lender, into significant systemic liquidity and contagion risks.

At the risk of sounding a tad naïve, we would continue to make the case for sustained secular tailwinds underpinning the Indian growth dynamic: fiscal discipline, credible inflation-targeting monetary policy, and transparent policy-making encouraging the commitment of risk-capital to industrialization, urbanization, consolidation, financial intermediation, digitization of the real economy, enhanced agricultural productivity, and the growth in rural incomes and discretionary spending. **<u>We would urge investors to take advantage of the sell-off, and to look for opportunities to invest in Indian equities on a structural, longer-term view.</u>**

Taking a deep breath:

No question, higher energy prices have hurt. This is what we got genuinely wrong. When Trump articulated renewed sanctions on Iran earlier in the year, we did not expect that the Saudis specifically, and OPEC in general, would resist the jaw-boning, and refuse to plug the potential 'shortfall' from lower Iranian crude exports, allowing crude prices to break through US$85/barrel.

- Higher crude prices are inherently inflationary, and as a result, we have seen calibrated monetary tightening from the Reserve Bank of India over the last six months, anticipating the impact on inflation and inflationary expectations.
    - *Significantly, in the most recent policy meeting last week, the RBI opted for a 'pause,' suggesting a relatively benign outlook following two rounds of pre-emptive rate increases earlier in the year.*
- Higher crude prices have also created a significant drag on the trade and the current account deficit (currently tracking at about 2.5% of GDP, largely explaining the sell-off in the rupee), and incrementally, on the fiscal deficit (with the government cutting excise duties on transportation fuels to buffer the impact of higher energy prices).

In perfect hindsight, we should have been prepared to absorb the significant cost of hedging the rupee earlier in the year; it would have protected capital.

The default at IL&FS, India's largest whole-sale funded infrastructure lender, is NOT symptomatic of the broad banking sector, or of latent system stress, or of an imminent liquidity/credit crisis.

- The surprise default of IL&FS commercial paper borrowings reflects very poorly on the external credit rating agencies who were blind-sided (again!), and on management's indiscipline in the deliberate asset-liability mismatch they ran.

YEAR	RETURNS	JAN	FEB	MAR	APR	MAY	JUN	JULY	AUG	SEP	OCT	NOV	DEC
Inception	+7.99%												
2018	-28.14%	-1.87%	-7.58%	-1.07%	+3.20%	-4.66%	-5.58%	+1.29%	-2.30%	-12.87%			
2017	+59.14%	+8.34%	+8.73%	+6.73%	+6.54%	-1.20%	+0.23%	+4.30%	-1.47%	-0.69%	+5.64%	+6.79%	+4.21%
2016	-5.79%	-8.33%	-9.98%	+11.86%	+2.10%	+1.89%	+5.44%	+6.40%	+1.66%	-0.74%	-1.69%	-9.26%	-2.83%
2015	+0.24%									-0.14%	+1.36%	-2.09%	+1.14%

- However, having spent significant time analyzing both the reported financials at IL&FS, and the price-action in various domestic fixed instruments of varying tenors, in the immediate aftermath of the default, what seems clear is that the financial 'shock' and contagion risk was contained by the RBI and the Finance Minister reacting decisively, replacing the management and the Board at IL&FS, recapitalizing the entity with lines from the State Bank of India and Life Corporation of India, and injecting significant liquidity into the system through open market operations.

The important take-away for us is that the markets, while nervous, are liquid, and open for business. Credit costs have gone up; however, despite all the hand-wringing by the talking heads, this is not, by any stretch, a 'Lehman moment.' <u>The panic selling in both fixed income and equity markets reflects fragile investor sentiment, rather than deteriorating fundamentals.</u>

India's domestic economy (tracking at 8%+ GDP growth), and earnings profile is structurally accelerating relative to the rest of the world.

- Our interaction with managements on the ground, and in particular, in the supply chains and distribution channels, would suggest that corporate confidence is at a multi-year high, and that with utilization rates inexorably rising, revenue growth and profitability is mean-reverting from several years of below-trend growth.

India's corporate profit share in GDP is at an all-time low, and our sense is that we are on the cusp of a meaningful recovery to the upside on earnings and cash flows.

The stock we wanted to highlight this month is ***Bajaj Finance,*** India's largest consumer finance company with a very well funded, well-diversified, loan book, and a significant opportunity to continue to grow market share in the consumer durables space at the expense of weaker competitors. Having tracked management and the stock for years, what really stands out for us is management's ability to balance growth and profitability, preemptively raising growth capital, aggressively investing in technology to improve credit underwriting standards, and to realize cost efficiencies, and to leverage brand/scale/outreach and structurally lower funding costs to systematically build national market share.

Over the next three years, we expect Bajaj Finance's well-funded capital base, product suite, and the focus on cross-selling to deliver on assets growth compounding at 20%+ annually (versus consensus looking for sub-15% growth).

- Having raised adequate growth capital last year, and with a Tier 1 ratio of 19%, Bajaj Finance is adequately capitalized, a significant advantage in an environment where liquidity has tightened, and the banks and the bond markets have become lot more cautious in funding competing consumer loan portfolios.
- Over the last 3 years, Bajaj Finance's point of sales have quintupled, and the branch network has increased seven fold, with a specific focus on growing the rural network.
- Having launched 8 new products over the last two years, there is a significant opportunity to leverage technology, to data-mine their existing customer base in order to cross-sell on rural and agricultural financing, inventory and vendor financing, SME financing, auto loans, credit cards, and mortgages.

We expect Bajaj Finance to deliver on a 3.5% ROA, and a 25%+ ROE over the next three years (versus the market looking at the stock through a 20% +/- ROE filter).

- The ability to 'price-for-risk' in a less competitive environment, a well-diversified funding base (debentures: 43%; banks: 31%; short-term commercial paper: 5%), and an explicit focus on managing the asset-liability mis-match conservatively, will see Bajaj Finance deliver on stable/improving yields over the next three years.
- Scale and the significant upfront investments in technology will see the cost-to-income ratio improve by 100bp+ annually over the next three years to about 36%.
- Deliberate credit discipline has translated to gross non-performing loans tracking under 1.6%, with coverage ratios in excess of 80%; we expect credit costs to continue to remain modest as management's conservative credit scoring standards deliver on profitable growth.

To conclude, acknowledging the reality of short-term tension points *(Fed tightening, crude prices, a depreciating rupee, tightening domestic liquidity, trade conflicts and custom union negotiations, China jitters, and the inevitable uncertainty in the build-up to the General Elections),* **we are encouraged by the continued strength in the high frequency data, domestic investor flows continuing to back-stop valuations, and importantly, our expectations of continued strength in corporate earnings and cash flows.**

We would urge investors to look to structurally increase their allocation to Indian equities.

- **India's domestic economy is structurally accelerating relative to the rest of the world.**
- *Corporate confidence in India is at a multi-year high* given the growth-supportive policy imperative, industry utilization rates trending off decade lows, and revenue growth and profitability inflecting decisively to the upside. **We have strong conviction on our portfolio holdings delivering on earnings and cash flows compounding at 15%+ annually over the next three years.**
- **Valuations are compelling** given our benign outlook on Indian inflation/interest rates, and the long runway opportunities in industrialization, urbanization, consolidation, financial intermediation, digitization of the real economy, enhanced agricultural productivity, and growth in rural incomes and discretionary spending.

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	Sectoral Break-down:	As % NAV	Sector Performance	MTD Performance
Bajaj Finance Ltd	Financials:	36%	Financials:	-5.63%
HDFC Bank Ltd ADR	Consumer Discretionary:	16%	Consumer Discretionary:	-1.72%
Kotak Mahindra Bank Ltd	Consumer Staples:	11%	Consumer Staples:	-1.22%
Titan Co Ltd	Materials:	10%	Materials:	-0.93%
Shree Cement Ltd	Health Care:	8%	Health Care:	-0.58%
	Technology:	7%	Technology:	-0.93%
	Industrials:	5%	Industrials:	-0.49%
	Real Estate:	4%	Real Estate:	-0.94%
	Energy:	3%	Energy:	-0.28%
	Utilities:	0%	Utilities:	-0.10%
	Retail:	0%	Retail:	-0.05%

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