Grant Thornton

India Watch

Issue 14 October 2011

In association with London Stock Exchange

Welcome to the Autumn edition of Grant Thornton's India Watch, in association with the London Stock Exchange.

In this issue we highlight how the India Watch Index has out outperformed all major London indices in the third quarter of 2011; winners among Indian companies listed in London are commercial real estate and oil and gas companies.

Our research on cross border M&A shows that, in line with market conditions, M&A activity slowed in the third quarter. However, the market still presents opportunities in specific sectors including energy and tourism. Private Equity activity also slowed although the total deal activity for the first nine months of the year surpassed the total for 2010.

An overview of the Indian economy this quarter shows how a toxic combination of high inflation, currency devaluation and faltering economic growth is creating pressure for the Indian government to do more to tackle the economic situation. Nonetheless, our guest contributor, Nick Paulson-Ellis, India Country Head of Espirito Santo Investment Bank, outlines that India right now looks like an increasingly attractive investment option when comparing its economy to those of developed countries.

Lastly, we discuss how changes to the financial reporting landscape, including IFRS convergance, will impact Indian businesses.

If you would like to discuss any of the matters arising in this issue or how Grant Thornton's South Asia group can help you, please contact me.

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Grant Thornton India Watch Index outperforms all major London indices in the third quarter

The India Watch small-cap index* outperformed all major London indices in the third quarter of 2011, falling by only 8.12% compared to the FTSE 100 (-13.74%) and FTSE AIM 100 (-20.6%).

Even as investors bailed out of some of the largest Indian shares – the full India Watch Index plunged, losing 32.27% of its 1 July value, nearly triple the loss of the FTSE 100 (-13.74) – the India Watch small-cap index remained relatively unbroken, a reflection of either greater ownership by investors knowledgeable about the companies or the degree to which large caps are now globally correlated.

The Indian small-cap performance was exceptional because although the current financial crisis might have been made in Europe, it is emerging companies in India and the other emerging markets that have suffered most from the ‘flight to quality’ – or rather, a flight to the familiar, given that the fundamentals of most Indian companies remain strong and the Indian economy itself is still expected to grow by more than 7% this year.

Although losers outnumbered winners by more than two to one in the full India Watch Index, the quarter did have a few bright spots. Despite the macro-worries that dented leveraged companies and commodities companies everywhere, certain commercial real estate and oil and gas companies led India Watch winners.

Top performer in Q3 was Hardy Oil & Gas, an oil and gas production company focused on India, which gained 21.19%, perhaps boosted by the news that it had discovered three new gas reserves.

Hardy was followed close behind by Hirco, a £56.30 million real estate investment company that gained 19.85% in the third quarter. The Isle of Man company focuses on the development of large-scale, mixed-use communities in India, sometimes co-located in special economic zones. Hirco currently has 66.4 million square feet in development in its Hiranandani Palace Gardens projects in Chennai and Panvel, outside Mumbai.

Next best was also a real estate company, Unitech Corporate Parks, an office park owner and developer that gained 13.64% for the quarter. Unitech was followed by Jubilant Energy, another oil and gas exploration company, which brought home 13.48%.

Among the losers, worst suffering was India Capital Growth. The closed-end fund dropped -50% in the third quarter, and is now down -82% for the year. An August note by fund adviser David Cornell blamed market volatility brought on by the July 50 basis point interest rate hike by the Reserve Bank of India and Standard & Poor’s downgrade of the United States’ AAA rating.

Other names were caught in the global avalanche of falling mineral prices. Despite revenue that rose 44% in FY2011 and $2.42 billion in free cash flow, Vedanta Resources dropped 47.42% in Q3, including 13% on a single day, 24 September, trapped in a global sell-off along with many other mining companies.

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* The India Watch Index consists of 31 Indian companies listed on AIM or the Main Market (excluding GDRs). We only consider companies to be Indian if they are domiciled in India and/or foreign companies holding Indian assets or Investment companies with Indian promoters. The index has been created via Datastream, a Thomson Reuters product and is weighted by Market Value. To avoid distortion of index trends, the two largest market cap entities, Essar Energy and Vedanta Resource, are excluded.
** Data sourced from Thomson Reuters.

India Inc treads cautiously, M&A activity slows down

Merger and acquisition (M&A) deal activity in the first nine months of 2011 totaled US$ 32.6 billion from 465 deals compared to US$ 42.4 billion from 511 deals during the corresponding period in 2010. While the first half of 2011 kept pace with the corresponding period of 2010 in terms of deal value, the M&A space witnessed a marginal setback in the third quarter of 2011 owing to European debt woes, S&P's downgrade of US sovereign debt, rickety markets and tightening monetary policy in India.

Q3 Deal Summary	Volume		Value (US$b)	
Year	2010	2011	2010	2011
Inbound	19	34	1.19	1.19
Outbound	39	29	0.63	3.69
Cross Border	58	63	1.82	4.88
Domestic	68	86	11.69	1.03
M&A	126	149	13.51	5.91
PE	58	94	1.71	1.91
QIP	16	3	2.18	0.27
Grand Total	200	246	17.40	8.10

In Q3'11, India witnessed 149 M&A transactions compared to 126 in the corresponding quarter of 2010. However, M&A transaction values in Q3'11 were estimated at US$5.91billion, compared to US$13.51billion during Q3'10. Q3'11 witnessed only one transaction greater than a billion US dollars and this accounted for 21% of the total M&A transactions in the quarter. H1'11 saw five billion dollar deals, which accounted for over 63% of total deal values. Q3'10 witnessed two billion dollar deals and these accounted for 89% of the total M&A deal value. The trend clearly indicates drying up of large deals in the quarter.

Domestic deal activity in Q3'11 saw a sharp decline as compared to Q3'10 mainly due to focus on internal group restructuring activities and limited focus on inorganic growth - a continuation of the trend seen in H1'11. While inbound deal values tripled in H1'11 (US$17.4 billion) as against H1'10 (US$5.4 billion), Q3'11 witnessed relatively muted inbound activity, with values remaining at the Q3'10 levels of US$1.19 billion.

The slowdown in inbound activity could be attributed to apprehension among foreign companies to commit capital to buy assets in India. The surge in outbound activity in Q3'11 has been driven by GVK Power & Infrastructure's stake acquisition in the Alpha Coal mine and Alpha West Coal projects of Hancock Group for US$1.26 billion, which is the fifth largest M&A deal in 2011. Another outbound deal in the mining sector was seen in this quarter between GMR Energy and PT

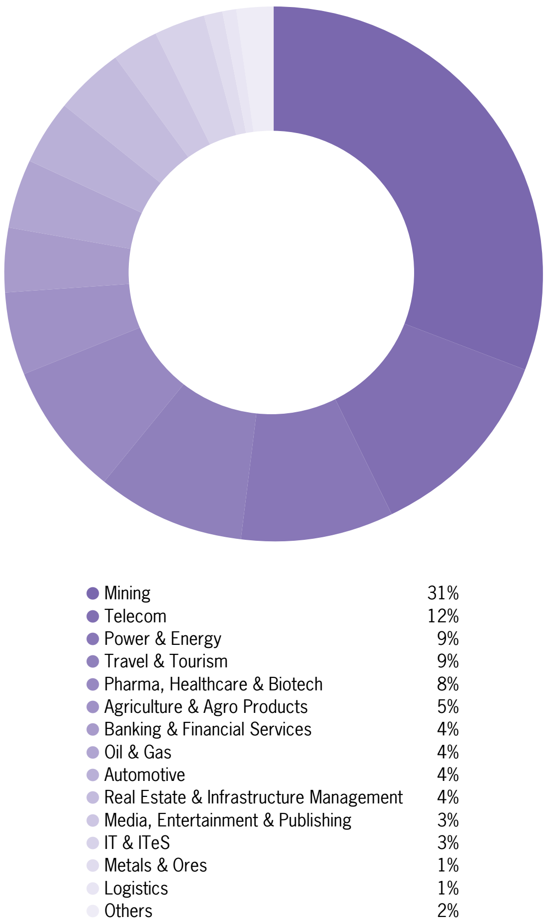
Golden Energy Mines for US$550 million. The last few years have seen Indian energy companies scouting the world for reasonably priced coal assets to feed several ongoing and planned power projects in the country. The ‘coal rush’ as it is being called, is a result of India’s rising appetite for energy, coupled with production shortfalls on account of environmental hurdles etc and is expected to result in continued deal activity in the quarters to come.

The quarter witnessed a noteworthy deal involving stake acquisition by Piramal Healthcare in Vodafone Essar. Though the minority stake in Vodafone India did not mark an entry into the telecom sector, nor did it indicate an exit from the pharmaceutical business it did highlight a possible short to medium term strategy for companies with significant cash reserves.

The acquisition of Holidaybreak Plc by Cox and Kings for over US$500 million has brought the Indian travel and tourism sector back into the spotlight. The sector had seen subdued activity in the past owing to the 2009 downturn. However, the travel and tourism sector has made a comeback of sorts in the face of increased government spending; the launch of universal crowd-pullers such as Formula 1 in India and rising disposable incomes in the country. As a result the sector is expected to present an attractive avenue for investment, and possible subsequent consolidation.

The capital intensive telecom infrastructure business is expected to face a challenge in raising capital from both volatile equity markets and the increasingly expensive debt market. We therefore expect consolidation in the near future as companies find it difficult to compete with larger players with the existing scale of operations.

Top Sectors M&A: Q3’11 sector break-up by value



In terms of volume, the most active sector was information technology (IT) and information technology enabled services (ITeS) which saw 29 transactions, followed by the Pharmaceutical and Media and Entertainment sectors, witnessing 17 and 14 transactions respectively in Q3 2011.

Top 10 M&A Deals: Q3'11

Acquirer	Target	US$m	%
GVK Power & Infrastructure	Hancock Group – coal mines and a port and rail project	1,260	79
Piramal Healthcare Ltd	Vodafone Essar	640	5.5
GMR Energy	PT Golden Energy Mines	550	30
Adani Power Ltd	Growmore Trade and Investment	531	N.A.
Cox & Kings Ltd	Holidaybreak Plc	510	100
Group Danone	Wockhardt Group Nutrition Business	355	100
Sanlam	Shriram Capital	266	26
Softbank Corp	InMobi	200	N.A.
Motherson Sumi Systems	Peguform Group	193	80
United Phosphorus	DVA Agro Do Brazil	150	51
Ram Kaashyap Investment	Gemmia Worldwide S.A.	150	100

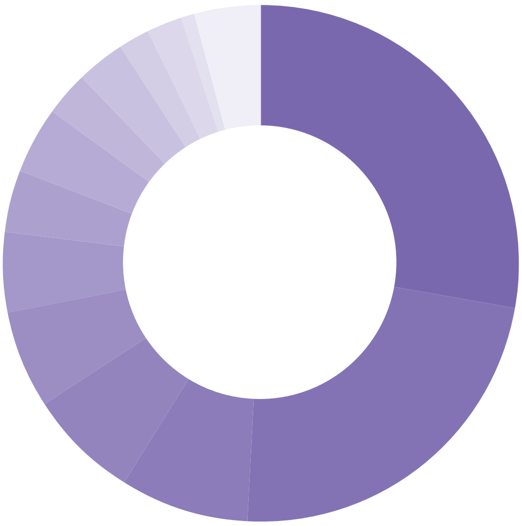
Private Equity (PE) activity in Q3'11 saw a significant surge in terms of deal volumes and a moderate increase in terms of deal value as opposed to Q3'10. The first nine months in 2011 saw private equity deals surpassing the total deal quantum during the year 2010. While the initial half of the year observed brusque deal activity worth over US$5 billion from c. 200 transactions, the relatively sluggish beginning of second half of the year reflects the current market mood for steady and vigilant moves rather than the aggressive ones witnessed in the first half of the year. PE funds generally invest in unlisted companies with the hope of generating returns by exiting through IPOs. Volatility in Indian markets during the quarter and a passive IPO market could possibly have been reasons for cautious and subdued PE investments in the quarter. Moreover, valuation increases in sectors such as e-commerce pose a challenge to investors, with too much money chasing too few opportunities forcing deals to hit a roadblock. On the exit front, PE investors no longer continue to leverage on IPO as the sole value unlocking mechanism as exits in the year-to-date have largely been a combination of strategic and secondary sales.

The quarter also witnessed diminishing share prices of listed companies adversely affecting the portfolios of large private equity players. Despite volatility in markets, existing listed companies will find it more attractive to raise private equity funds than going for rights issues or external borrowing, as PE investors may tend to value a company on its fundamentals rather than on the basis of short-term price movements. Thus, even during unfavourable market conditions, experts believe transactions in the listed space are likely to go up as the typical fund raising sources dry up. However, deals may take longer to close, given the prevailing market conditions and the resultant iterative negotiation process.

Top 10 PE Deals: Q3'11

Investor	Investee	%	US$m
Blackstone Group	Embassy property Developments	37	200
Goldman Sachs	ReNew Wind Power	N.A.	200
Standard Chartered Private Equity, JMF, JMF Trustee Co, JMF Products & Build India Capital Advisor	GMR Airports Holding Ltd	N.A.	131
Blackstone Group	Visa Power Ltd	N.A.	111
JP Morgan Asset Management	Soma Group	N.A.	110
Capital International	L&T Finance Holdings	N.A.	74
Standard Chartered Private Equity	Varun Beverages	5	56
Xander Group	HCC Infrastructure	15	52.17
Blackstone Group	Jagran Media Network Investment	N.A.	50
Blackstone Group	Monnet Ispat & Energy	7	50
NEA, Omani industrial group & GTI	Nova Medical	N.A.	50

Top Sectors PE: Q3'11 sector break-up by value



Real Estate & Infrastructure Management	28%
Power & Energy	23%
IT & ITeS	8%
Banking & Financial Services	7%
Pharma, Healthcare & Biotech	6%
Media, Entertainment & Publishing	5%
Engineering	4%
Manufacturing	4%
Hospitality	3%
Steel	3%
Shipping & Ports	2%
Education	2%
Retail	1%
Others	4%

Real estate and infrastructure continues to be the top scoring sector aggregating investments over US$500 million during the quarter, followed by power and energy with deals worth over US$400 million.

We expect the last quarter of the year to have both sunny and not-so-sunny sides, keeping in line with the global scenario. On the gloomier side, economic uncertainty, rising interest rates, and adverse currency movements are expected to make investors cautious and M&A financing difficult to come by. On the sunnier side, certain sectors with potential for expansion such as energy and resources, present ideal avenues for investment. Certain 'wild cards' in the mix also include revised takeover norms stipulated by SEBI on increasing the threshold for triggering an open offer, and the current economic situation in Europe. While the former could lead to larger transactions going forward, the latter could imply attractive European targets. Whatever the outcome of the interaction of these myriad factors, the last quarter is likely to play a key role in defining the overall sentiment of the year.

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An overview of the Indian Economy

As we enter the final quarter of 2011, the world's economies remain on a knife edge. Economic concerns coming out of the US and the eurozone continue to cause uncertainty across global markets.

These effects can be clearly seen across the world's market indices. For example, in the year to date, the Dow Jones has seen a fall of nearly 6%, the FTSE 100 a 12% fall and India's Sensex Index is down a remarkable 23% (with the last quarter seeing the worst fall for almost 3 years). In February of this year, India's Government assumed economic growth of nearly 9% in this fiscal year. Even without the benefit of hindsight this was a highly ambitious target. However, since then, inflation has continued to spiral out of control and the budget deficit remains extraordinarily high. Furthermore, legacy issues such as slow infrastructure development and investment continue to bite at the country's heals; with poor infrastructure now thought to add roughly 2 percentage points to inflation.

India's economy grew by 8.5% in the last fiscal year but slowed to 7.8% and 7.7% in the quarters ending March and June, respectively. Some economists are predicting that India's growth rate is set to slow further due to the impact of 12 interest rate increases in 18 months, continued inflationary worries and the effect of diminishing export levels to the world's major economies, many of which are facing years of economic stagnation. Furthermore, The International Monetary Fund recently cut its India growth forecast to 7.8% in 2011 and 7.5% in 2012, from 8.2% and 7.8% in June, respectively.

As mentioned above, inflation levels continue, as ever, to be at the forefront of India's economic issues. Persistent inflation levels, which are clearly far in excess of targets, have forced the Reserve Bank of India to raise interest rates again, even as growth levels around the world slowdown. If the Indian Government can't correct the nation's inflation rate soon they risk prolonging the depth and duration of this downturn significantly.

To make matters worse, at a time when significant investment is needed across the country, investors continue to reduce their exposure to emerging markets. The effect of this on the Indian Rupee has been to weaken it by around 9.5% against the dollar so far this year - the biggest drop out of the 10 Asian currencies excluding Japan's yen, according to Bloomberg data.

The Reserve Bank of India highlighted the Rupee's fall in its policy review last month. This issue was made all the more significant following its intervention to help try and stabilise the price two days earlier. Unfortunately, however, the Rupee is tightly correlated to the Sensex, which in turn, is largely driven by foreign investment flows and, according to macroeconomist Renu Kohli, $1.8 billion was withdrawn from India's markets in August due to the current risk aversion of global investors. On this basis, should economic worries persist, the Reserve Bank of India might find themselves having to take substantially more action to remedy the situation.

As highlighted above, there are a number of external factors affecting India's economy, but the Indian Government should now be doing its utmost to minimise these effects. We should not forget that in relative terms the Indian economy is growing unlike most other economies of the world which are in stagnation and turmoil. If the Indian Government is able to move past its much publicised corruption issues and get a firm grip on the current economic stagnation and the lack of direction, it might be able to bring India back from the path which it is currently on.

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India – A port in a global storm?

Indian markets have had a challenging 2011, first on domestic issues, and more recently on ‘global cues’. But how much will global events hurt Indian GDP and corporates? Not as much as expected.

Overall Indian corporates are predominantly exposed to the domestic economy. Looking at the largest 100 listed Indian companies, global revenue exposure is only 24% on average, and that exposure is very sector specific, mainly in IT services, healthcare and materials. Whilst rising rates have taken their toll on pockets of credit related spending, overall domestic demand remains strong, driven by robust services growth, rising incomes, fiscal support for the rural economy and higher middle class aspirations. Although India’s GDP growth is slowing in response to rate hikes, downgrades to GDP forecasts are c.10% to c.7.5% growth v 30-100% downgrades seen in developed economies to borderline recession territory.

Given the extent of current global uncertainties, we suspect India’s domestic exposure will come back into focus for global investors. In the last downturn its domestic exposure meant India’s earnings outperformed significantly.

Right now the rest of the world makes India look increasingly good.

The list of problems India faces is by no means trivial - with the global crisis added to a domestic list of inflation, rates, slowing growth, earnings downgrades and corruption. This has resulted in bearishness about Indian equities. Yet were becoming cautiously optimistic. This is not to trivialise the issues as they won't disappear overnight, but India has already been through a lot of pain.

There are now far more compelling opportunities to invest in the Indian market, given a 20% fall and earnings multiples more than one standard deviation below the long-term average.

At the broad level it is not all gloom and doom: the global slowdown should help reduce commodity prices, in turn easing corporate margin pressure; we believe interest rates have now peaked, and inflation should start falling in January; India's GDP growth is slowing, but its differential v the rest of the world is rising; corporate balance sheets are in good shape; and the pace of reform may slowly be picking up.

So how should investors play India's domestic story? The obvious sector, FMCG, is alas, too obvious, and the combination of domestic focus and defensiveness means it is expensive. We see three compelling themes with powerful structural drivers:

1) domestic consumption, through consumer durables, autos and auto components

2) rural India, especially through agri related firms, and for the brave

3) play the reform agenda through infrastructure, capital goods and renewables.

What about the prospects of Indian firms seeking a London listing?

In the very short term listing conditions are difficult everywhere in the world. But the theme of investors in London listed companies seeking growing exposure to emerging markets generally, and India specifically, is only going to get stronger. The FTSE 350 has seen significant growth in its exposure to emerging markets, by our estimates rising from 14% revenues in 2005 to c. 20% of total sales in 2010. The UK is the least domestically exposed stock market in the world, with only 27% of sales coming from within its own shores. There are now two Indian companies in the FTSE 100. One point that is often missed is that the index of Indian companies listed in London has significantly outperformed both the wider FTSE indices, as well as the Indian local indices. That performance has persisted for three years now. India has its fair share of short-term challenges, but India is all about time horizons – extend your time horizon and you reduce risk and enhance returns. India will grow at 8-9% GDP growth for a generation. The drivers of that growth remain strong, and the investment opportunities for long-term investors remain compelling.

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Financial reporting requirements are changing in India – how significant are these changes?

The year 2011-12 was meant to be a turning point in India's financial reporting and regulatory landscape. Lawmakers and standard setters in India had committed to update the old and somewhat archaic requirements to converge with International Financial Reporting Standards (IFRS), and to introduce new corporate and tax regulations by 2011. In 2008, the European Commission recognised that these changes were underway, and provided transitional relief for Indian companies reporting within the EU to use Indian GAAP financial statements on a temporary basis until 31 December 2011.

However, none of these changes have yet materialised and the new standards and regulations are now expected to be rolled out over the next one to two years. In the midst of all these deferments, earlier this year, the Ministry of Corporate Affairs (MCA) in India introduced a couple of new requirements that will change the manner in which companies compile, present and file financial information. This will include amendments to the prescribed format of balance sheet and profit and loss accounts as well as introducing eXtensible Business Reporting Language (XBRL) for annual corporate filings; both of these are steps in the right direction for the bigger change that is expected to follow.

Format of balance sheet and profit and loss accounts

Indian companies have been required to use the format of financial statements prescribed in Schedule VI to the Indian Companies Act, 1956, and since the format has largely remained unchanged for several decades, the financial statements of Indian companies have grown increasingly out of sync with companies in other parts of the world.

The MCA has finally introduced the revised Schedule VI (New Schedule), which prescribes a format closer to the current international practice and which is largely consistent with IFRS. In the meantime, the MCA has developed another variant of the New Schedule, which would be made applicable once the IFRS convergent standards are introduced in India.

The New Schedule became applicable from 1 April 2011 and also requires the comparative information to be recast as per this format in the year of transition. Further, this requirement to recast comparative periods would also apply to companies accessing the capital markets for an issue of equity shares from 1 April 2012.

The New Schedule brings about the following significant changes:

- balance sheet structure as per vertical form and profit and loss accounts to be prepared using nature of expense method
- current and non-current classification of assets and liabilities on the balance sheet
- additional disclosure requirements on share capital, including names of shareholders with over 5% shareholding
- additional disclosures on long-term borrowings
- disclosures on overdue sundry debtors
- removal of certain outdated disclosure requirements relating to quantitative information on inventory, licensed and installed capacity, etc.

The New Schedule will require a focused effort from companies to ensure smooth implementation. Apart from training personnel involved in the financial reporting process, companies would also be required to make changes to IT and other reporting systems to capture the required information at source. Further, companies would also need to monitor the impact of these new requirements on their contractual arrangements, such as loan covenants, etc, as the key financial ratios are likely to be impacted by these changes.

The bigger challenge for India, however, is to keep this New Schedule dynamic and changing in response to changing global trends.

XBRL for annual corporate filings

The MCA has mandated that certain companies in India file their annual financial information with the MCA for the year ended 31 March 2011 using XBRL. The use of XBRL to convert financial information into machine readable data is already being used in other major economies of the world such as the USA and the UK.

Its introduction in India is expected to reduce the challenges faced by the MCA in compiling and maintaining a registry of financial information of over 850,000 companies in India. The XBRL data collected would significantly enhance the MCA's capabilities in policy formulation and regulatory functions.

MCA has developed the Indian GAAP taxonomy based on current Indian GAAP including the Old Schedule VI format. Listed companies and their Indian subsidiaries as well as other unlisted companies with a turnover in excess of INR 1 billion or share capital in excess of INR 50 million are required to use it. Banks, insurance companies, non-banking finance companies (NBFCs) and companies in the power sector are exempt from this requirement, as taxonomies for such sectors are under development. The current mandate prescribes companies to file both their separate and consolidated financial information using XBRL apart from the Directors Report and Auditors Report.

Considering that these requirements have been introduced towards the end of the year, the MCA has extended the timelines for companies to file their annual returns for this year. However, despite the extended timelines, the readiness of all stakeholders including the companies, appears far from satisfactory. Most large companies will face the challenge of transitioning from the taxonomy used in the current year to a revised taxonomy under the New Schedule the next year and another version to meet IFRS convergent standards the year after.

Despite all these hiccups, companies have welcomed the move hoping it will ultimately lead to a more efficient regulatory compliance framework providing reliable and accurate information to investors and other users of financial information.

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About us

Grant Thornton UK LLP established a dedicated South Asia Group in 1991 to serve Asian owned businesses in the UK as well as those investing into and from the Indian subcontinent. We are proud to be one of the first UK accountancy firms to focus on this region.

We are widely recognised as one of the leading international firms advising on India-related matters and have been in involved in every IPO involving an Indian company on AIM, with the exception of the real estate sector.

For those clients requiring advice in both the UK and India we offer a seamless service building on the already strong and close relationship between Grant Thornton UK LLP and Grant Thornton India.

International and emerging markets blog

As part of our commitment to remaining at the forefront of changes and developments in regards to UK-India relationship we will be using this space to post original thought leadership and research relevant to the industry. The idea is to encourage discussion around these issues and to open up new areas and debate.

To participate:
www.grant-thornton.co.uk/thinking/emergingmarkets

More information about our South Asia Group can be found at:
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