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INTRODUCTION

The Martin Currie Asia Pacific Fund and Martin Currie GF – Asia Pacific Fund have been increasing their exposure to India during 2009 and, since April, both funds have been overweight to the country. The weakness in exports since the beginning of the global financial crisis is renewing the emphasis on domestic demand in the Asian growth model. While India has not been immune from the global downturn, strong domestic consumption underpins its economy – exports as a proportion of GDP account for around only 20% compared to 40% for the rest of the region. The funds' overweight allocation to India reflects their focus on strong companies with visible demand for their products, which, in this environment, leads to an emphasis on domestic demand.

THE PURPOSE OF MY TRIP

I recently spent a week in India meeting companies. I wanted to understand how well the domestic consumer was doing. The rural market is particularly important to the economy and here, demand has been significant. So I also wanted to establish whether this is sustainable. Like many countries, India has put in place a stimulus package and a looser monetary policy in response to the global economic slowdown, and it is important to understand how effective these measures have been. I also used the trip to visit the management of companies we currently hold in the funds.

The key areas I explored and questions I wanted to answer during my visit are captured in this note. I have included charts where I think they help demonstrate my findings. The major themes from my trip are:

- Indian companies are bullish about the rural economy, which is supported by a range of government-led incentives. The spending power of rural consumers, which number around 825 million, is set to increase significantly.
- While the urban consumer has not been immune from the global financial slowdown, many industries remain resilient and the property market is now beginning to see transaction volumes start to recover.
- The political environment is positive. Supportive policies will benefit sectors such as infrastructure and financial services.
- India's structural growth story is compelling. With its huge domestic economy, it is in a stronger position than most in the Asia Pacific region. Along with China, it is one of the fastest growing economies globally and its long-term investment potential is considerable.
- The trip reaffirmed my conviction in the funds' current holdings.

Companies are bullish about the rural economy

Companies are bullish about the rural economy. In India, rural households account for 71% of the population, equivalent to some 825 million potential consumers. The purchasing power of rural India is considerable and set to grow:

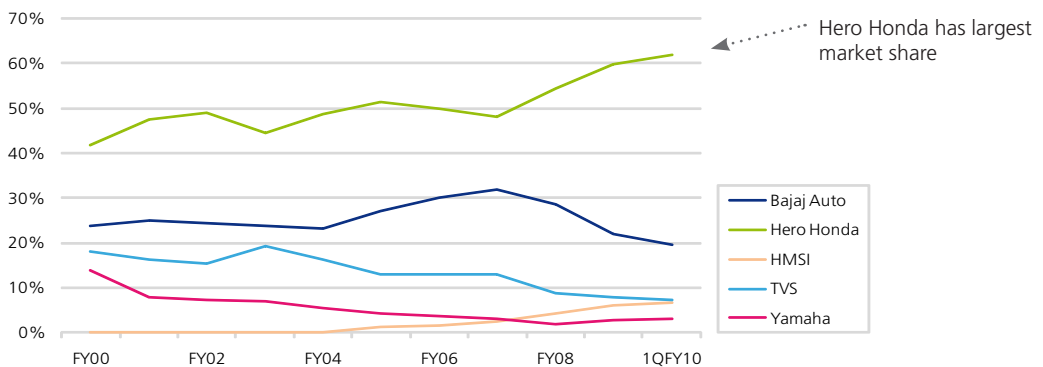
- Total income in rural India (about 43% of total national income) is expected to increase from around US\$220 billion in 2004-2005 to US\$425 billion by 2010-2011. Importantly, there is no tax on farm income.
- Rural employment and income levels have been boosted by a series of good harvests, and government schemes such as the National Rural Employment Guarantee Scheme, which guarantees 100 days of employment to one member of every rural household, effectively place a floor on demand. However, it is worth noting that this year's monsoons have been weaker than average. This may harm the summer crops and could have negative implications for rural consumption.
- Farmers have benefited from loan waivers, and there have been excise duty cuts on automobiles and cement.

Small farmers are enjoying a one-time loan write-off worth around US\$14 billion, and larger farmers have had 25% of the value of their loans written off.

Hero Honda, is an example of a company benefiting from its exposure to domestic consumption. The company is India's largest manufacturer of two-wheelers. Ample liquidity and the fiscal stimulus package has ensured exceptionally strong sales growth (+23% year on year), while falling raw-material prices and an improving product mix have led to increasing margins. My visit reinforced my expectation that these positive operating trends will continue, prompting further earnings upgrades for this market leader.

Hero Honda increasing its market share

Market share of Indian domestic motorcycle manufacturers

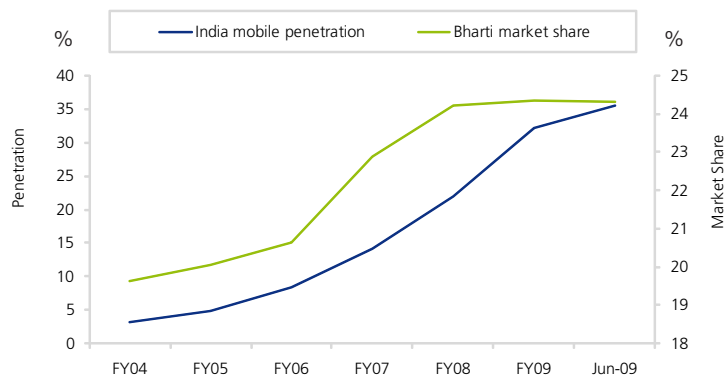


Source: CLSA, Company accounts

Areas such as Indian mobile telephony are also key beneficiaries of the strong secular industry growth driven by low penetration rates and rising disposable incomes. The fund owns Bharti Airtel which has combined its dominant scale with aggressive cost control to deliver the highest profitability in the industry. The launch of 3G services later this year will help to spark a further round of earnings growth for Bharti as it will provide an additional driver of subscriber growth while also decreasing elements of competitive threat. The high level of capital expenditure involved in obtaining 3G licenses will prohibit the more aggressive smaller players from entering this space.

Bharti has 24% market share of Indian mobile phone market

Indian mobile penetration and Bharti Airtel's market share



Source: CLSA, Company accounts

But companies mixed towards urban consumer

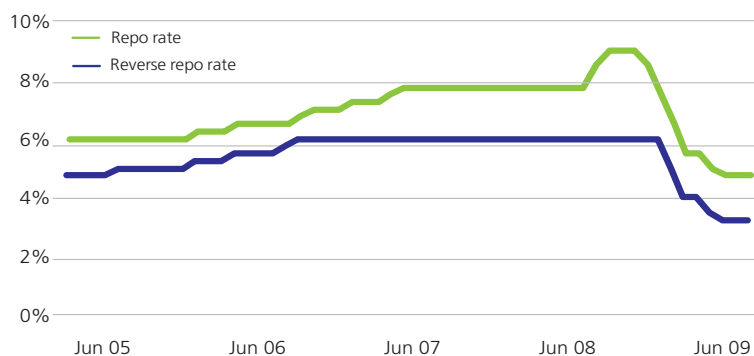
While rural India has been insulated from the global downturn, urban India has felt some effects. The slowdown has affected sectors that are driven by global macro trends such as IT services and financial services, as well as areas like textiles and real estate.

But there is evidence that property transactions have started to pick up. In India, the government has started to implement staggered interest rate subsidies on mortgages below certain values, helping to drive transaction levels up to around 60% of peak run rates.

The funds have recently invested in the Indian property market for the first time through Unitech, a real estate developer. Because of its low-cost land bank, the company has decided to shift its focus to the high-growth affordable housing sector for new projects. The environment of easy liquidity means that interest rates are now at a level where mortgages have become a mass-market product, sparking huge demand for this type of housing. Sales volumes are currently running ahead of analysts' expectations, and this should cause further earnings upgrades. Additionally, the company has been going through an aggressive de-gearing of its balance sheet and looks good value at a 20% discount to NAV.

Aggressive monetary easing has fueled resurgence in property market activity

Policy rates (repo and reverse repo rate)



Source: CLSA, Bank of India

Election has been supportive

The May general election saw the incumbent UPA government returned to power with a large majority. This is a positive outcome for the Indian equity market – the market rose 17% on the day of the results. The UPA's new majority is most certainly a 'game changer', as this is the first time since the early 1990s that a government will be able to proceed with economic, social and political reform with minimal impediments from the opposition.

After the election we added Infrastructure Development Finance Company to the funds. IDFC is one of India's leading infrastructure-financing companies and should benefit from a strong pipeline of infrastructure projects over the medium to long term. This should cause earnings upgrades, as analysts' expectations for loan growth now appear too low. IDFC's strong balance sheet means that this non-bank financial company will have no problems in sourcing liquidity to fund this growth, whilst they should also be able to increase leverage in order to enhance their return on equity.

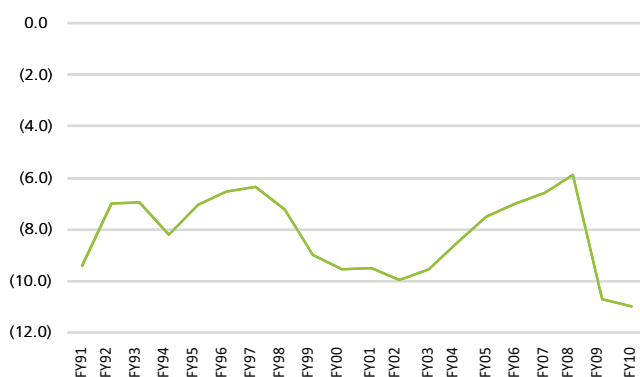
First budget focused on social security expenditure

Shortly after I returned from India, the new government delivered its first budget. Ahead of the budget there were overly ambitious expectations that this would address a range of issues including economic reform and clarification of how the rising fiscal deficit will be tackled. The new government is forecasting a 6.8% fiscal deficit for FY10 (up 0.8% YoY), which rises to 12% including off balance sheet items such as state level deficits and oil subsidies. This is unsustainable on a medium term view, and provides a key concern over the economic outlook. Public debt requirements may crowd out private sector investment, constraining GDP growth unless we see foreign capital inflows resume. I'm watching medium and long-term government bond yields as a gauge of how easily the government is able to finance this debt.

The budget primarily addressed spending on social security. Here, expenditure is expected to rise by 13% YoY in 2010. This included a meaningful increase in spending on agriculture, education, health and rural development.

Indian fiscal deficit forecast to rise

Indian government consolidated fiscal deficit as a % of GDP



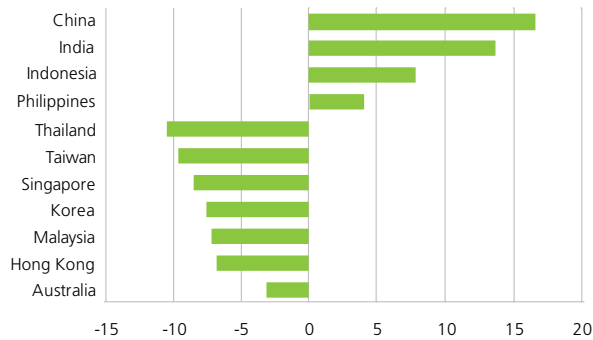
Source: CLSA, Bank of India

Economy: reasons to be cautious but positive overall

India's economy is in a stronger position than most in the Asia Pacific region and, arguably, globally. I am bullish on the outlook for corporate earnings, as consensus expectations for flat growth year on year looks too conservative. Strong loan growth of around 20% over the year, and significant interest rate cuts since the Autumn will help to support domestic demand, whilst the May election has provided additional fiscal support across various industries. The government's targeted 5-7% real GDP growth is beginning to look very achievable, and the chart over the page illustrates the relative strength of the Indian economy versus the rest of the region.

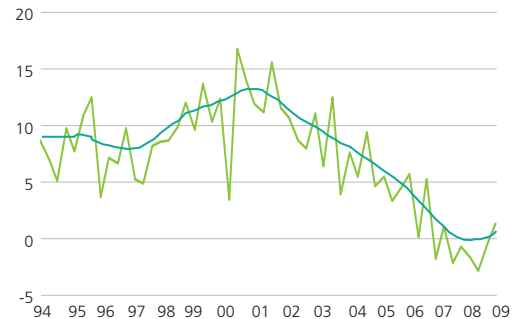
The last few months have seen a significant improvement in macroeconomic indicators. As the second chart below shows, industrial production turned positive again in April (+1.4% YoY) after contracting the first quarter – and first quarter GDP was +5.8% YoY. But there are some challenges. Valuations have run up since March lows, with the market now trading on 3.4 times price/book and 18 times earnings. Furthermore, the rally in equity markets has led to an ever-growing pipeline of equity issuance, and this removal of liquidity from the market may be a short term overhang. In this environment stock selection is of paramount importance.

China and India to lead economic growth into 2010
Projected GDP growth 2009 to 2010 (%)



Source: CLSA, Asia-Pacific markets

Industrial production has turned positive
Index of industrial production (%YoY)



Source: CLSA

New ideas generated by the trip

I think the educational sector is very interesting. There is a massive supply/demand mismatch and many teachers are poorly trained. The scope for an increase in spending here is huge and I am looking at companies that would be beneficiaries of this.

India's secular growth outlook and new government provide an interesting opportunity in the financial services sector. There are a number of smaller private banks, such as Axis Bank, that have been building up an excellent liability franchise, attracting low cost deposits from customers that are currently using government owned banks. This trend will persist into the medium term as the private players continue to offer superior service levels, a wider product range and an increased branch network. This, alongside their strong balance sheets, provides them with ample opportunity to grow their loan books aggressively at high margins. The longevity of these trends may well surprise the market.

Martin Currie Asia Pacific and Martin Currie GF - Asia Pacific funds: strategy

In the current environment, our investment strategy aims to combine the most attractive plays on growth in domestic demand with a highly selective approach to long-term winners in the export space. We feel very strongly that these areas represent the most compelling investment opportunities for the next few years, and that they satisfy all the elements of our investment process: quality, value, growth and positive change. The export crisis is renewing the emphasis on domestic demand in the Asian growth model and this bodes well for the performance of the best domestic consumption franchises over the longer term. Secondly, manufacturers that are able to navigate this period successfully by continuing to invest in new products and maintaining margins by flexing their cost base while weaker competitors shrink or go out of business, will benefit significantly when the market recovers. These 'strong survivors' offer phenomenal long-term potential and we are invested in a select group of global export leaders.

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