Fund Insights

L&T Mutual Fund

September 2015

L&T Infrastructure Fund

Positioned to benefit from capex revival

Since the presentation of budget for 2015-16, there have been increased efforts to revive the investment climate in the country and government has been focused on accelerating clearances of stalled projects. While the corporate capex is yet to see meaningful pick-up, the government's increased spending in the current fiscal compared to the previous fiscal and frontloading of its plan expenditure is expected to aid the revival of the economy. The government's spending has been focused on roads, railways, defence and agriculture and this is likely to provide strong boost to the performance of businesses in infrastructure related sectors. However, given the delay in economic revival and some changes made in budgetary allocations like increased states share in central taxes and higher focus on SPV mode of financing, on-the ground project activity is has been slow to pick-up. As a result, stocks of many of these businesses have seen reasonable correction over the past few months, thus making them fairly attractive for investors with medium to long term investment horizon. In this edition of Fund Insights we assess some of the factors that are likely to positively influence the prospects of the companies in the infrastructure sector and discuss how L&T Infrastructure Fund with its focus on this theme could help in gaining from this investment opportunity.

INFRASTRUCTURE SECTOR'S LONG-TERM POTENTIAL

The development of infrastructure is one of the most crucial factors for the growth of an economy and India's existing infrastructure facilities are grossly inadequate for achieving sustained long-term economic growth. Acknowledging the need for improvement in infrastructure, the government has been focusing on infrastructure development. Given India's strong long-term growth potential and poor infrastructure facilities, the focus on this sector is likely to continue for the next several years. Some of the recent steps taken by the government to provide boost to the sector include:

- Overall investment in infrastructure sectors is proposed to increase by Rs. 700 billion in FY16 (BE) over FY15 (RE) – capital outlays for roads and railways have been increased by Rs. 140.3 billion and Rs. 100.5 billion respectively
- Rebalancing of risks in PPP projects with government taking up major risks
- Setting up of 5 ultra mega power projects totaling 20 GW in the plug-and-play mode wherein all clearances and linkages will be obtained before awarding the project
- Undertake large infrastructure projects such as building of 100 smart cities
- Faster execution of dedicated freight corridor for railways
- Easing funding for infrastructure sector through key policy measures such as easing of FDI norms for construction, railways and defence, liberalization of ECB policy and promoting REITs and InvITs.

HOWEVER, GIVEN THE CHALLENGES THAT EXIST, THE RECOVERY IN THE SECTOR IS LIKELY TO BE GRADUAL

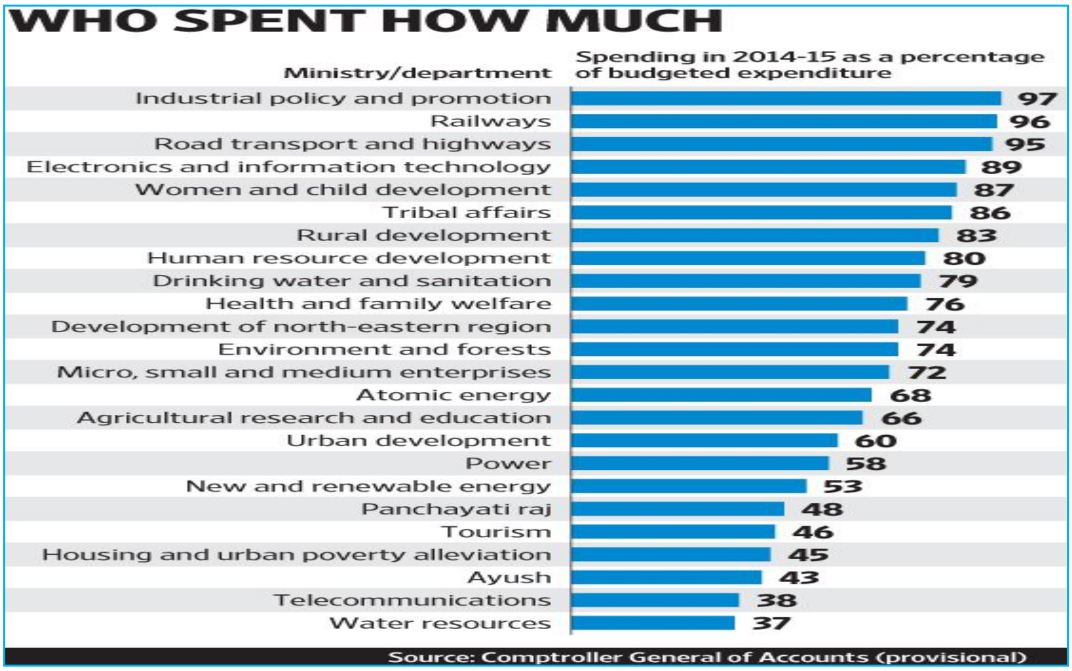
The government has been taking steps to revive the investment in infrastructure sector but the revival is likely to be more gradual in nature given some of the challenges including:

- Highly leveraged balance sheets and stalled or slow moving projects for large number of players in the sector
- Both FY15 and FY16 budgets (post BJP regime) have been fiscal prudence oriented with the country rating downgrade fears in mind. Multilateral loans were repaid as against expected incremental borrowing. In addition, states share of central taxes was increased thus leaving less in the hands of

central government. While this move is towards making states more responsible, it has caused delays in new project awards.

- Focus is laid on the SPV mode of financing infrastructure projects, whereby entities like Coal India and State governments are expected to invest equity in SPVs which independently borrow loans from markets to reduce dependence of central funding. This also has caused delays, albeit temporary.
- Uncertainty around policy reforms such as land acquisition bill
- Weak growth environment leading to reduced level of risk appetite of developers towards new projects
- Challenges in addressing long term funding needs of the sector despite several reforms by the government

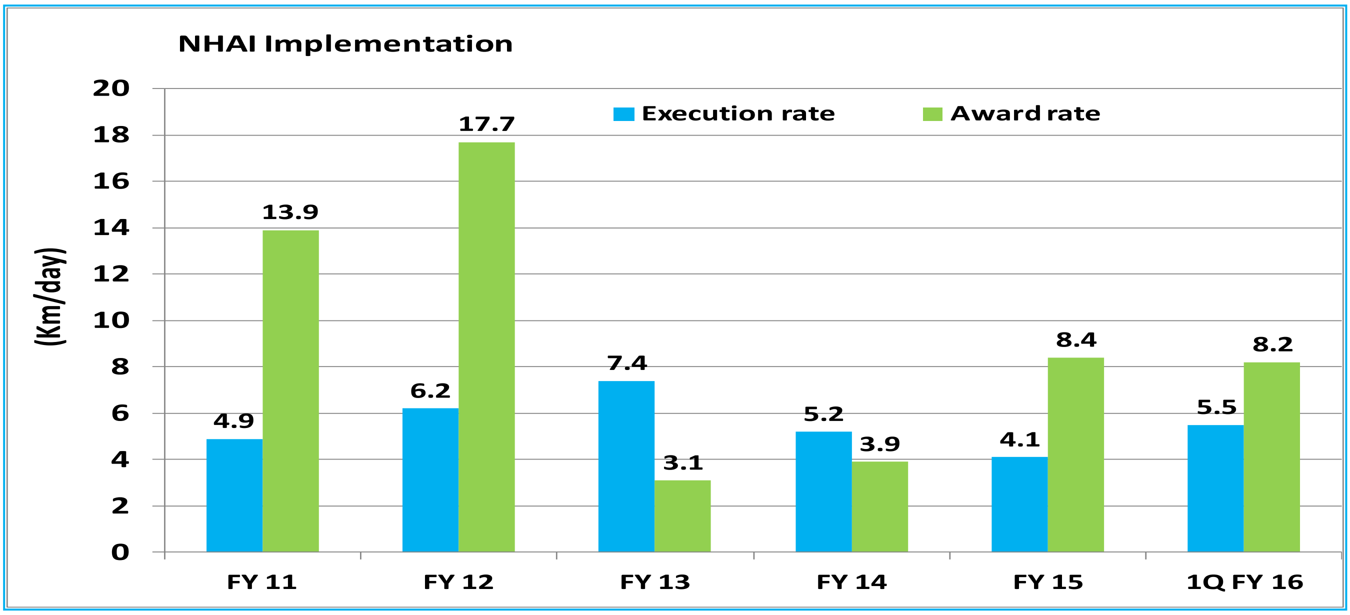
While these are very real challenges, the government is committed to reviving the infrastructure sector which is already reflecting in the government's recent capex expenditure. In fact in the first quarter of FY 2016, the government has spent 38% of its plan capex for the full year. Even in FY 2015, road transport and highways and railways were the two of the three ministries which spent more than 95% of the budgeted expenditure for 2014-15 which clearly demonstrates the infrastructure focus of the government. Increased public spending, creation of new infrastructure funds and laying out the foundations for a stronger, more transparent PPP process are some of the other initiatives which also shows the government's commitment in improving the prospects of the infrastructure sector.



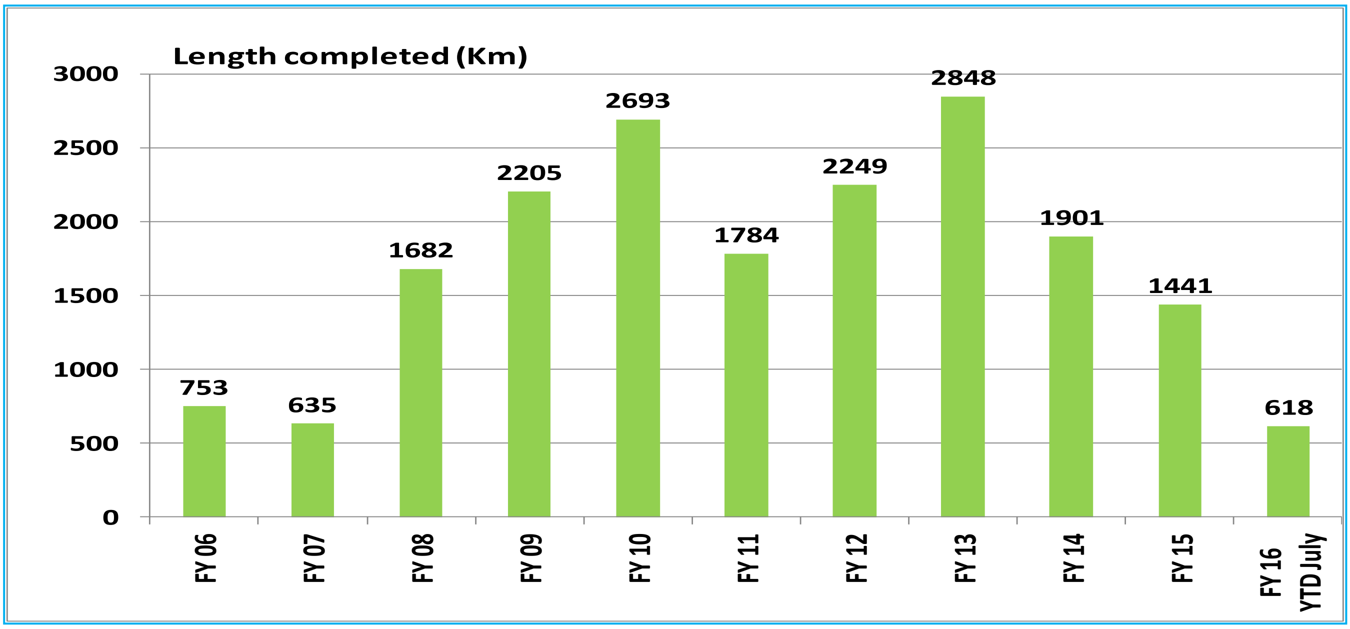
Source: www.livemint.com

Roads and Highways

The budgetary thrust on the sector coupled with the policy push is likely to revive the prospects of the sector over the next few years. The first chart below on NHAI implementation point towards significant increase in number of orders awarded and executed in Q1 FY 2016 after a downward spiral in FY 13 / FY 14 and some improvement in FY 15.



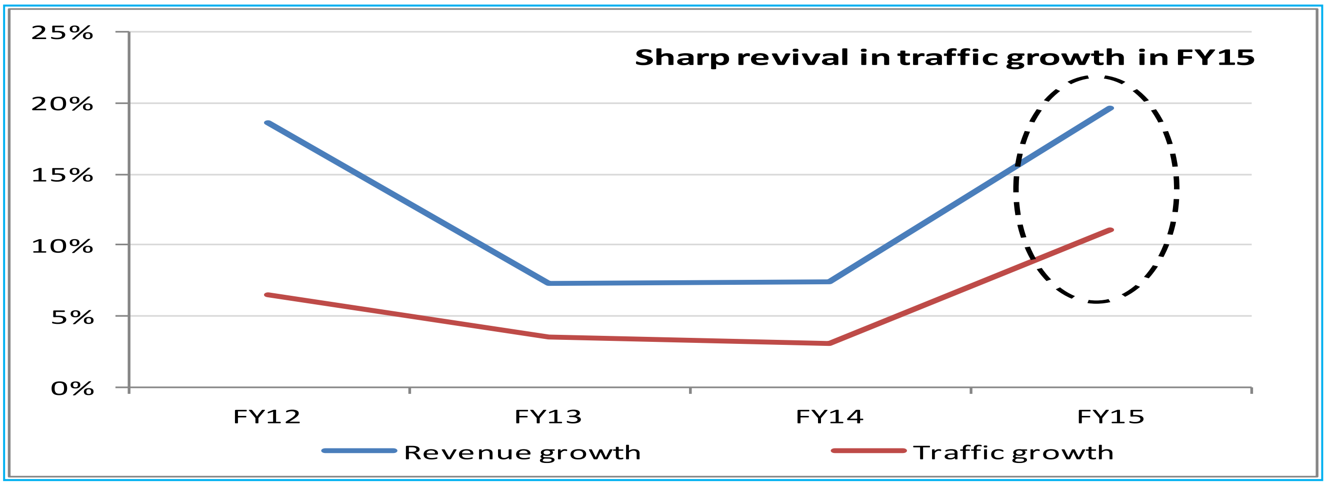
Source: MoRTH, NHAI



Source: NHAI

The overall target for FY 16 is to bid out projects of 9000 km (5000 km from NHAI and 4000 km from MoRTH). Over the next 4 years, NHDP would need Rs. 3500 billion in construction which translates to Rs. 875 billion per year. In addition, state highways, border roads and Sagar-Mala would constitute projects of about 7000 km. The second chart above shows NHAI's completion record on annual basis. As seen, NHAI has in the past 10 years completed c.18000km (c.1800km per year) whereas the plan now is to complete c35,000km in 4 years, which is a sizeable opportunity for EPC contractors.

Roads also offer an opportunity for BOT asset owners as part of this opportunity will be through BOT awards. BOT is traffic and interest cost sensitive business. As seen in chart below, traffic has seen a sharp uptick in FY15 with the rebound in the economy, after remaining below expectation in the FY12-FY14 period. Implication is that if GDP growth remains strong, so will traffic, thus aiding companies in the BOT space.



Source: Spark capital

Railways

The railway capex has remained poor over the past 7-8 years leading to under-investment across route length, wagons, locomotives and electrification of railways. Such under-investment has resulted in significant decline in the share of railways in freight transport. However, with the change in government at the center, the sector has been one of the focus areas for the government. Increasing scope of PPP beyond providing maintenance and other supporting roles, allowing 100% FDI in the sector, introduction of innovative technological solutions and focus on improving passenger amenities are some of the government initiatives that are likely to boost the prospects of the sector. The government has proposed plan outlay of Rs 1,00,011 crore for FY 2015-16, a 53% increase from 2014-15 budget estimates and the proposed investment over the next 5 years is Rs. 8.5 lakh crore which is an increase of 275% over the previous 5 years. Increasing industrial activity on account of economic revival, urbanization and rising incomes are some of the factors that are likely to drive the demand for the railways. More importantly in today's context, the financing of this capex in also largely finalized. The key sources of finance to be Central budget, LIC loans, Mutli-lateral agency loans, PPP model in certain opportunities and likely monetization of IRCTC.

	Rsbn	US$bn
Network Decongestion (Incl. DFC)	1,993	32.4
Network expansion (including electrification)	1,930	31.4
National Projects (North Eastern & J&K connectivity)	390	6.3
Safety (Track renewal, Signaling, Telecom)	1,270	20.7
IT and Research	50	0.8
Rolling stock	1,020	16.6
Passenger amenities	125	2.0
High speed rail and elevated corridor	650	10.6
Station redevelopment and logistics parks	1,000	16.3
Others	132	2.10
Total	**8,560**	**139**

Source: Highlights of Railway Budget Speech, Citi Research

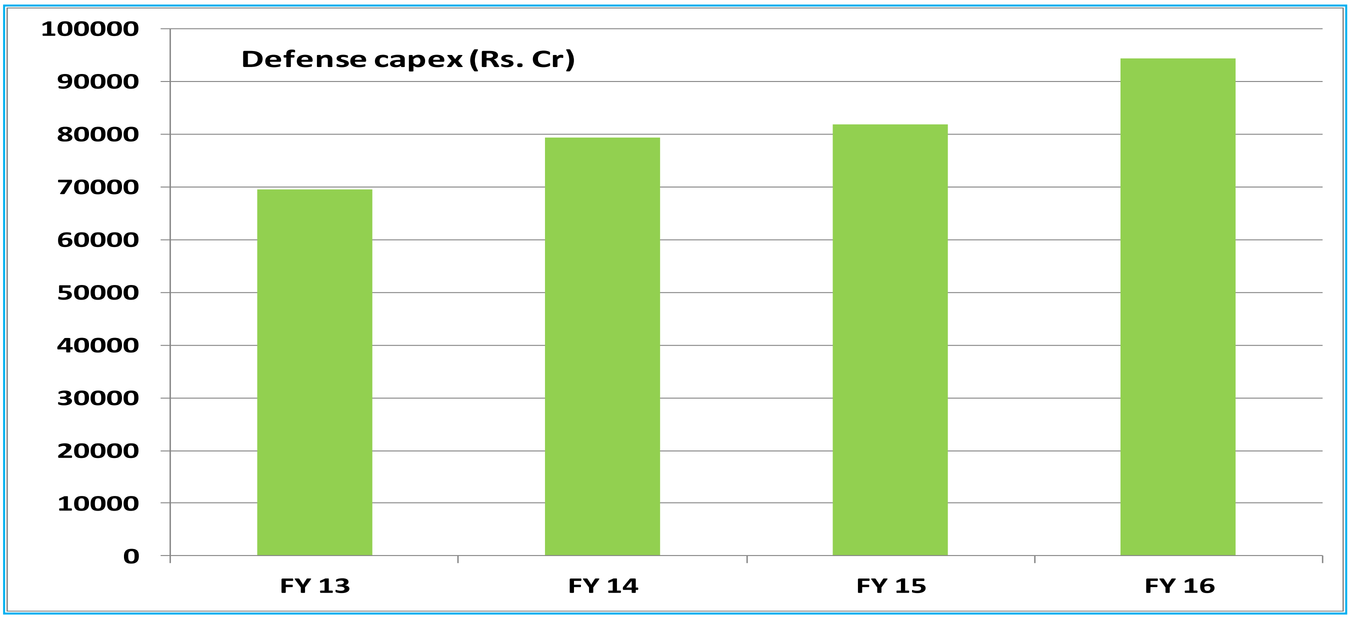
Power

According to government sources, the Indian power sector has an investment potential of Rs 15 trillion (US$ 237 billion) over the next 4–5 years, thereby providing immense opportunities in power generation, distribution, transmission, and equipment. The government's immediate goal is to generate two trillion units (kilowatt hours) of

energy by 2019 which means doubling the current production capacity.
The government had revised the National Solar Mission with the electricity production target of 100,000 MW by 2022. The government has also sought to restart the stalled hydro power projects and increase the wind energy production target to 60 GW by 2022 from the current 20 GW.
The potential demand for power in the country, large capacity additions and increased availability of fuel resources at reduced prices are some of the key factors that are likely to drive the growth of the power sector over the next few years.
The key reform has also been seen in the related sectors viz. State DISCOM loans restructuring for banks and coal mining. There is a new restructuring plan in the works for working capital loans of State DISCOMs, which can potentially reduce stress on the banking sector. Coal mining volume targets are massively increased to 1.5bnT in the next 5-7 years from c.550mT currently. All the possible issues with mine allocations to private sector have been addressed.

Defense

Defense is a key area requiring 18-20% of non-plan spend by the central government. Defense spend has increased consistently over the past 6 years. The NDA government has focused more on defense spend whereby FY16 budgeted spend is likely to be higher. Capital expenditure in defense is what is more relevant for the infrastructure and industrial sector companies. As seen below, capital expenditure has grown at 11% CAGR over the past four years, but the FY16 budgeted spend in higher than FY15 by 15%. More importantly, a large portion of the budgeted defense capex is spent in commitments which are for equipment purchased in the past. It is expected that as the committed capex portion reduces, there will be much more space for new project awards. Various projects announced by the defense ministry likely to come up for awards in the next few years are to the tune of Rs 1.9 trillion. More importantly, with initiatives like Make-in-India and offset clauses in place, the share of Indian corporate in the defense capex is likely to rise.



Source: Budget documents

L&T INFRASTRUCTURE FUND – POSITIONED TO BENEFIT FROM CAPEX REVIVAL

L&T Infrastructure Fund is a theme based fund which predominantly invests in stocks and sectors that are likely to benefit from country's infrastructure growth. The fund is agnostic to style and market capitalization and typically holds a diversified portfolio spread across various sectors within the infrastructure space. It provides long-term investors an opportunity to benefit from India's structural infrastructure growth. Given the potential that the India's infrastructure sector offers and the government's increased focus on providing necessary stimulus to the sector, we believe this fund has a potential to deliver significant alpha over the next few years, albeit at a relatively higher risk. We believe this fund could easily complement the core fund holdings in investor's portfolio and has strong potential to provide boost to investor's overall portfolio returns.

Current portfolio positioning

The fund's portfolio is positioned to benefit from the recovery which in the initial stage is likely to be driven by government spending. The Fund is significantly overweight on sectors such as construction Project, industrial capital goods, transportation and cement. The overriding principle is to invest in businesses with strong balance sheets and execution capabilities, which are in a position to capitalize on the opportunities that likely to come about over the next few years.

Sector	Stocks owned	Rationale
Construction projects (21.62%)	L&T, Techno Electric Engineering Company Ltd, Ashoka Buildcon, Sadbhav Engineering, Indian Hume Pipe Company Ltd, Voltas Ltd, KEC International	As a result of government spending across roads, railways, ports, power / renewable energy, agriculture, etc, construction activity to gain momentum over the next few calendar quarters. We own businesses with strong order book and execution capabilities. Focus on businesses with strong growth potential available at reasonable valuations.
Industrial capital goods (18.40%)	Centum Electronics, Honda Siel Power Products, Siemens, Titagarh Wagons, Alstom India, ABB India, Triveni Turbine, BEML, Thermax, TD Power Systems	Government spending in railways, smart cities, renewable energy, etc likely to aid business growth. Stocks of some of these businesses have seen significant correction in the recent past.
Transportation (12.89%)	VRL Logistics, Gateway Distriparks, Snowman Logistics, Container Corporation of India, Blue Dart Express	Expected to benefit from broader economic recovery. Portfolio exposure in high quality businesses across road logistics, container logistics and temperature controlled integrated logistics
Cement (9.72%)	Grasim, The Ramco Cements, ACC, Shree Cement, Birla Corporation	Increased spending on road infrastructure, economic recovery likely to drive capacity utilization levels higher thereby aiding profitability. Realization levels also likely to improve with increase in capacity utilization.

Source: Internal

Portfolio data as on 31.08.2015

IN CONCLUSION

The immense growth potential of the infrastructure sector coupled with government's focus on reforms is expected to provide enormous investment opportunities for long-term investors. We believe L&T Infrastructure Fund with its focus on investing in companies that are likely to benefit from country's infrastructure growth could be an attractive investment option for long-term investors looking for investing in a fund with high alpha potential.

*The Fund Manager for L&T Infrastructure Fund is **Mr. Soumendra Nath Lahiri.***

He is the Chief Investment Officer at L&T Investment Management. Mr. Lahiri has over 23 years of experience, of which 19 years is in equity markets in India. Prior to joining L&T Investment Management, he was Head of Equities at Canara Robeco Mutual Fund. He has also worked with Fortuna Capital and DSP Black Rock in his previous assignments. Mr. Lahiri holds a B.E. degree in Mechanical Engineering and an MBA from Indian Institute of Management, Bangalore.

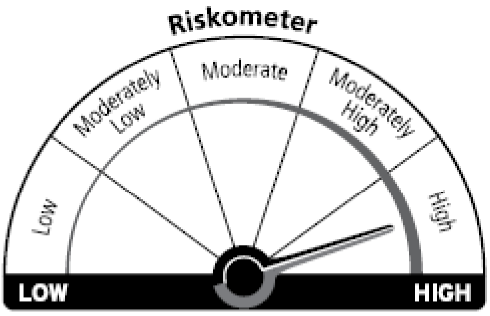
Product Labeling

An open-ended equity scheme

This product is suitable for investors who are seeking*

- Long term capital appreciation
- Investment predominantly in equity and equity-related instruments of companies in the infrastructure sector

*Investors should consult their financial advisers if in doubt about whether the product is suitable for them.



Investors understand that their principal will be at high risk

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Mutual funds investments are subject to market risks, read all scheme related documents carefully.

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