QUARTERLY OUTLOOK

JULY 2017

EQUITY

FIXED INCOME

REAL ESTATE

IIFL INVESTMENT MANAGERS
ASSET MANAGEMENT

DAWN OF A NEW ERA!

India ushered in yet another path-breaking reform as the Goods and Services Tax came into effect recently. The transformed environment has the potential to significantly improve the revenue growth for the government as a large part of the unorganized economy shifts to the organized sector. In the real estate segment too, the GST launch and Real Estate Regulation and Development Act (RERA) implementation seem to be the prevailing themes during the quarter.

The government, which completed three years in power under the able leadership of Prime Minister Narendra Modi, has achieved many milestones including macro-economic stability not seen in decades.

The Indian equity market's performance was the second best after China in the last three years and during the last quarter, India was the best performing market globally. Yet, one would think that the equity markets have been throwing caution to the winds for a while now. Liquidity continues to be a major driver and for our industry, it is heartening to see mutual funds' average assets under management skyrocket to close to Rs.20 trillion in the April-June quarter. Equity mutual funds added 1 million investor accounts in June itself, taking the total number of folios to an all-time high of 57.82 million. Net inflow into equity funds was at an impressive Rs. 28,332 crore.

While record highs by benchmark indices may paint a rosy picture about the market, the fact remains that there is a huge mismatch between actual performance and euphoric expectations. Our quest continues for sectors and companies where earnings pick-up signs are visible. We are progressively reducing risks from our portfolio by shifting to stocks where earnings risk and valuation risks are not high. We are actively scouting for domestic stories where the markets haven't yet priced in an aggressive recovery. Of course we pay special attention to valuation comfort too. Our bias would be towards the large caps rather than mid-caps where valuations are often frothy.

The underlying market sentiment for debt remains positive as an interest rate cut from the Reserve Bank of India is anticipated in the coming months. Normal monsoon and falling inflation could trigger this move. The primary market continues to see quality paper with a deluge of Initial Public Offerings (IPO). Our innovative offering - the IIFL Special Opportunities Fund - offers individual investors a unique opportunity to participate primarily in IPOs and pre-IPOs on similar lines as institutional investors. When Fairfax Financial Holdings Ltd sold its stake in general insurance ICICI Lombard General Insurance Co Ltd, we joined a clutch of marquee names in picking up stake through IIFL Special Opportunities Fund.

I am happy to share that the IIFL Special Opportunities Fund and its next 2 series received an overwhelming response as we garnered a record ₹ 4000 crore prompting us to launch additional series of the same offering.

Our funds will continue to scout for unique opportunities in pre-IPO and listed space.

AMIT SHAH

EQUITY

PRASHASTA SETH

UNIQUELY INDIAN
UNDENIABLY GLOBAL

We began the financial year 2017-2018 with many hopes and beliefs and continue to work hard towards achieving outperformance over benchmarks and peers. In our previous communication, we had mentioned how our earlier strategy of being overweight on companies, which were available at cheap valuations and also were not cyclical in nature (Pharma and Technology companies), had hurt the returns of our funds and we would be taking corrective measures for the same. During the last quarter, we have significantly increased our exposure to consumer-oriented financials, where we continue to see strong earnings growth and also have stability in the business environment. Having said that, we continue to search for sectors and companies where pickup signs in earnings are visible, because in majority of the companies on D-street today, there is a huge mismatch between actuals and expectations.

On one hand, growth slowdown intensified in 4QFY17 as real Gross Domestic Product (GDP) growth fell to 6.1% in 4QFY17 from 7.0% in 3QFY17. Although real GDP growth fell in the second and third quarters by 0.4% and 0.5% points respectively, the magnitude of fall following demonetization was far sharper leading to a reduction of 0.9% points in 4QFY17. GDP growth during FY17 was largely consumption-driven, with private consumption adding 4.8% points and government consumption adding 2.0% points to growth. Contributions to growth from net exports showed improvement, marginally increasing to 0.4% points in FY17 from 0.2% points in FY16.

On the other hand, government capex has seen some major improvement. We have always argued that government capex will drive private capex. Though private capex is still dismal but for the month of April, total government expenditure rose 49% yoy. Both, revenue and capital (largely incurred on infrastructure and asset creation) expenditures have increased a significant 51% and 38% yoy respectively. While the government has been attempting to reduce the seasonality in government expenditure, we attribute the sharp rise in expenditure in April to the advancement and passage of Union Budget by one month. The central government's capital expenditure has accelerated over the last few years and we expect this trend to continue. Compared to an average annual growth of 6% over FY11-15, the central government's capital expenditure growth rate is expected to average 17% per annum over FY16-18, at current year's budgeted growth estimate. Our analysis of government expenditure trends indicates that government expenditure tends to accelerate sharply in the final two years of every political administration.

Earnings delivery over the last three years have been tepid. Nifty's earnings performance has been flat, with Earnings Per Share (EPS) fluctuating at around INR400 over FY14-17. Between FY14 and FY17, earnings were impacted by several factors – lack of private capex revival, asset quality review of banks, deflation in commodity prices, two consecutive years of drought, and demonetization. Though Nifty earnings have remained flat over the last three years, the earnings composition has changed drastically. Cement, Media, Oil & Gas, and Consumer sectors have grown the fastest; Metals and PSU Banks have been the key laggards. The share of Public Sector Undertaking (PSU) Banks in Nifty Profit After Tax (PAT) has declined from 7.6% to 2.9% over FY14-17 owing to Asset Quality Review (AQR), which resulted in sharp jump in provisions. The contribution of Oil & Gas and Metals has also fallen. Metals were impacted by correction in commodity prices in FY15 and FY16. The shares of Technology, Private Sector Banks and Healthcare have increased.

There are some worrying signs in the economy which the market wants to discount as of now, but we think these are critical and investors should keep them in mind. The recent trend of farm loan waivers is not a healthy credit sign for the economy. These loan waivers apply only to loans by banks, which in due course will get compensated by the respective state governments. However, the concern is the risk of 'moral hazard' – i.e., willful defaults by borrowers. In our view, the impact is likely to be greater for banks with large unsecured farm loans and less for secured loans or Joint Liability Group lending. PSU banks would be the most impacted in our view.

One of the other worrying signs we see is the drastic reduction in employment generation by the IT sector in India, which has traditionally been one of the main recruiters and job creators in India and the reason for the increased consumer spending over the last two decades. Private sector wage bill has also slowed down drastically in the last couple of quarters and is now at historic lows of mere 7%. If this trend continues, it could hurt urban consumption. However, it's too premature to factor in any impact on economic growth from these concerns.

Given significant uncertainty over growth, we believe stocks with rich valuation multiples are vulnerable from both, earnings and valuation perspectives. Thus, we prefer stocks and sectors with low earnings and valuation risks. Indian valuations are at +2SD (Standard Deviation) from the mean and are indicating caution. We have been looking to progressively reduce risks from our portfolio and invest into stocks where earnings and valuation risks aren't high. We are looking for domestic stories where the markets aren't pricing in an aggressive recovery and where there is a valuation comfort. Though as a whole, we think domestic-focused stocks are extremely overpriced, we do see some individually reasonably-priced stocks in sectors like power and roads where we have strong visibility on growth going forward. We are looking to selectively increase our exposure there.

FIXED INCOME

RITESH JAIN

UNAFRAID TO BE UNCONVENTIONAL

On the domestic front, we started FY17-18 on a soft note as bond yields fell during the quarter, as the Monetary Policy Committee (MPC) kept rates on hold, and lowered the inflation projections simultaneously. The Consumer Price Index (CPI) based inflation or retail inflation slowing down for the second consecutive month in May and continuing to remain at its lowest level in five years helped sentiment. The CPI and Wholesale Price Index (WPI) converged at a low of 2.2% in May on the back of disinflation in vegetables and pulses. This reinforced expectations among market participants that MPC might consider lowering interest rates in the near term. However, whether such low readings of inflation would sustain going forward, will be determined by three crucial factors - primarily the distribution of rainfall, impact of rise in minimum support prices on the sowing pattern of crops, and the extent to which prices get revised amid transition to GST. The positive base effect for food inflation is expected to continue till Jul 2017 and according to Reserve Bank of India (RBI), inflation may move up in the second half of FY18.

The underlying market sentiment for debt remains positive, as market players anticipate an interest rate cut from the RBI in coming months, given the decline in domestic inflation. The RBI sounded incrementally dovish about future inflation projections while maintaining that persistence in this softening inflation reading would have to be monitored closely. The rise in global commodity prices and concerns over a weak monsoon were cited as one of the reasons for maintaining a cautious outlook. Both concerns have now been tempered. Global commodity prices are in a declining trend with a benign outlook. Monsoon is also expected to be normal. Therefore, if inflation undershoots their expectations significantly, falling below 3.5% and in a sustainable band of 2.5-3.5%, the RBI may consider going down the path of rate cuts again. Until then, the RBI would continue with its neutral stance.

On the macro side, the government achieved its fiscal deficit target of 3.5% of GDP in FY17. Data from RBI showed that India's Current Account Deficit (CAD) narrowed to US$3.4 billion (bn) (0.6% of GDP) in Q4 of FY17 from US$8.0 bn (1.4% of GDP) in the preceding quarter. However, it widened from US$0.3 bn (0.1% of GDP) in the same quarter of the previous fiscal. CAD widened on yoy basis due to higher trade deficit driven by a larger increase in merchandise imports relative to exports.

Globally, US Federal Open Market Committee (FOMC) increased the Fed Funds rate 25bps to 1-1.25%, as expected. It termed the risks to economic outlook as roughly balanced but acknowledged it was monitoring the inflation situation closely, given recent declines. It introduced balance sheet unwind into the equation, laying out a roll-off plan, starting at US$10 bn a month (US$6 bn of treasuries and US$4 bn of mortgage-backed securities). The amount will increase at US$10 bn every quarter till it reaches US$50bn a month and will continue at that pace thereafter. The date of the roll-off plan wasn't announced but it could start in Q4 this year.

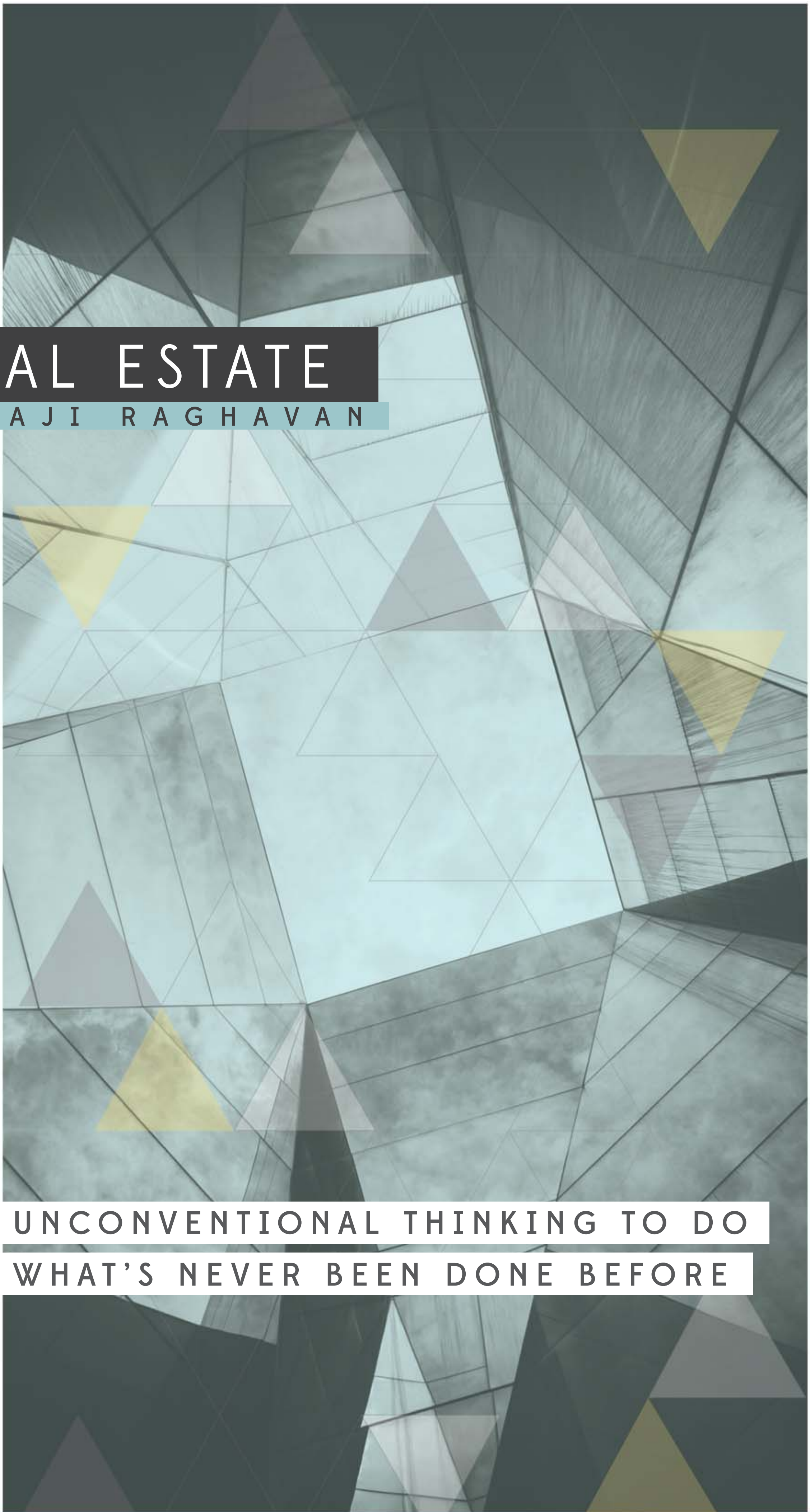
The real action, however, was in what the central banks like US Fed, European Central Bank (ECB), Bank of England (BoE) and Bank of Canada communicated about the future path of monetary policy, indicating a gradual end to extraordinary loose policy. Incoming data will become even more important in coming months as the Fed prepares to navigate through unchartered waters of simultaneous rate hikes and balance sheet reduction. Investors will look forward for guidance from Fed's monetary policy and ECB's monetary policy review in July. During the quarter, the ECB kept rates and Quantitative Easing (QE) targets unchanged but altered its forward guidance in acknowledging dissipated deflationary tail risks due to steady economic expansion and strong employment growth. BoE kept rates unchanged in a close vote as 3 out of 8 members pressed for a hike, as inflation has been above their policy goal of 2% since Feb 17. It is likely to stay above 2% as effects of a weaker Great Britain Pound (GBP) flow through.

We believe that monetary accommodation from prominent central banks will be gradually reduced. The US Fed could hike rates once more this year and gave strong indications about its intention to start the QE unwind process. Benign inflation and decent growth support the case for a gradual withdrawal of accommodation globally. While we think that the risk-on environment can continue for some more time, key risks that we are consciously watching out for include -

- Policy-related disappointments from Donald Trump (tax cuts or fiscal spending plans).
- The possibility of trade disruptions and trade wars if US imposes stiff tariffs on imports, as we get to the end of the 100-day evaluation period agreed between US and China.
- Geopolitical issues relating to North Korea and Asia.
- Any development which could turn the low volatility environment around, given that risk-premia have been suppressed by low volatility across key asset classes.

REAL ESTATE

BALAJI RAGHAVAN



UNCONVENTIONAL THINKING TO DO WHAT'S NEVER BEEN DONE BEFORE

The government has embarked upon a path of regulatory reforms. Not surprisingly, GST launch and Real Estate Regulation and Development Act (RERA) implementation seem to be the prevailing themes in the real estate sector this quarter.

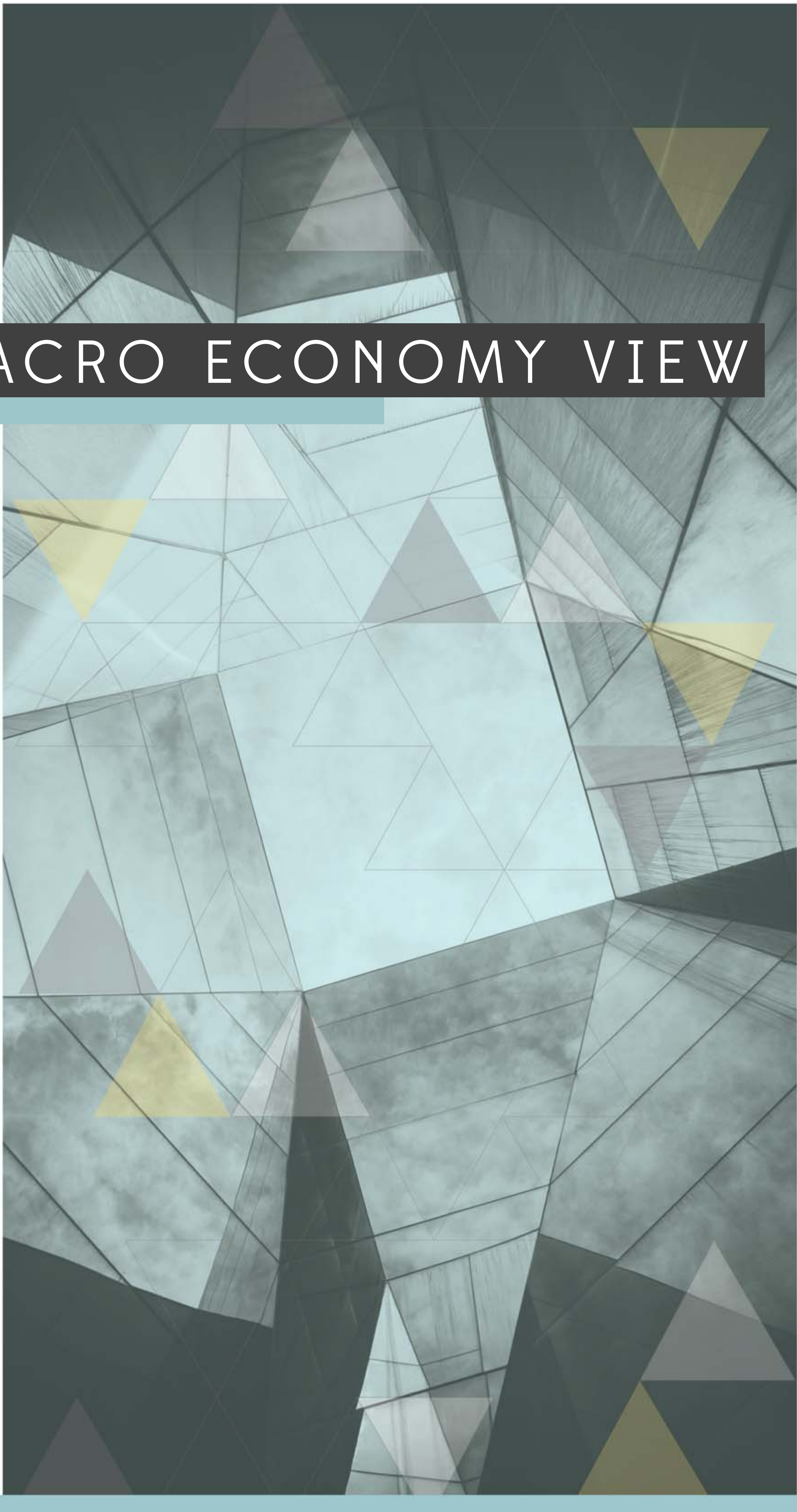
The VAT and Service Tax incidence for under construction projects varied from 4.5-6.5% across states. This has now been replaced by an effective rate of 12% GST (18% with a 1/3rd offset for land component across projects). State-specific registration and stamp duties remain. Most input materials like tiles, granite, etc. have been placed under a higher tax bracket of 28%, marginally increasing the cost of production. Most purchasing in the sector till date has been from the unorganised sector. As a result, availability, computation and subsequent passing on of input credits to consumers might be a little way off. With cost expected to rise, many developers across the country reported a spike in collections and registrations before the July 1, 2017 deadline, but now expect the market to be flatter.

It may be noted that sale of constructed property, renting of residential housing and construction of affordable housing under the Pradhan Mantri Awas Yojana (PMAY) have been left out of the GST ambit. On the other hand, lease of commercial, retail and warehousing properties will attract a higher rate of 18% instead of 15%, increasing the cost for users. The warehousing industry is expected to witness long term rationalisation and growth. Under the 'One Market' scenario, logistics players are now expected to base investments on efficiency, rather than tax considerations.

The larger regulatory change is the RERA implementation. The Act is expected to boost consumer confidence significantly, giving them well established rights and regulating what developers can sell. The Act regulates the use of money collected from buyers, improving project delivery timelines. All plans, agreements, marketing materials have to be uploaded online, enhancing transparency and consumer confidence. But challenges remain. Most states have not notified their regulation, or are under process of setting up the regulatory commission. Others are struggling with setting up websites or implementing the basic registration processes. But rules notified vary significantly from state to state. Developers are simply not sure what the new rules are, or how to abide by them. Lenders, an important aspect of the industry, seem to have been left out and clarity on their rights is yet to come. As the industry struggles to ensure compliance, project launches are getting delayed.

In a falling interest rate scenario and the huge impetus on affordable housing, the end buyers may finally be able to realise their dream of buying a home. RERA will also ensure that they will get a fair deal. Input tax credits through GST and tax waivers for affordable housing may ultimately put the dream home within their reach. But for now, things are work-in-progress and difficult. Thus tangible benefits to the consumer will take time to materialise.

MACRO ECONOMY VIEW



"The stock market is a discounter of all known information" ***– Kenneth Fisher***

The above quote aptly summarises the current mood of euphoria in the markets wherein all news, good or bad gets discounted. India has been the best performing equity market in CY2017 so far and it seems there is no sign of India giving up this poll position any time soon. Some might call it liquidity-driven, while others attribute this outperformance to fundamental changes on the ground. We believe it's a mix of both and this outperformance is here to stay though valuations may not be the cheapest among the peers.

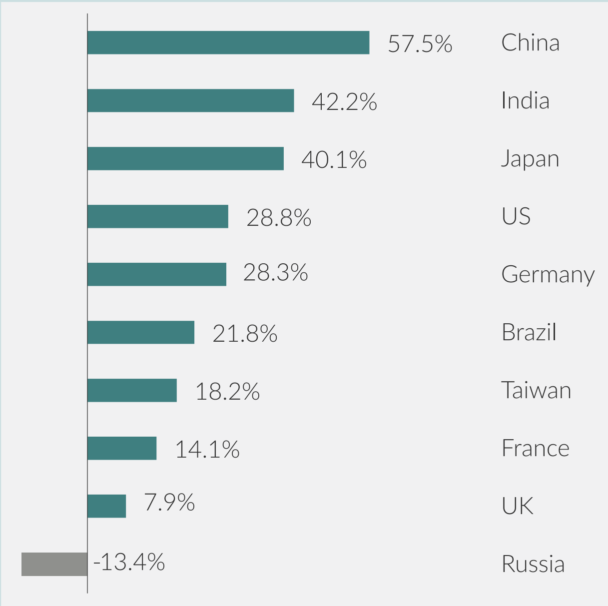
Coincidentally, Prime Minister Narendra Modi's government completed three years in office in May 2017. A lot has happened during this period. The defining feature of the Indian economy over May 2014 - May 2017 has been the achievement of macroeconomic stability. Taming of inflation (supported by benign crude oil prices) coupled with controlled twin deficits – both fiscal as well as current account deficits – and stable currency are the key achievements of the past three years, in our view. This has provided a resilient backdrop for foreign capital inflows to the Indian economy (reflected in the highest-ever FDI inflows). The stable macroeconomic backdrop augurs well from the "growth-inflation" perspective.

The same has been reflected in the market's performance, wherein India was the second best performing market after China in the last three years (May 01, 2014 – June 30, 2017). During the most recent quarter, as India geared up for its landmark taxation change towards GST, the equity markets gave a thumbs up by being the best performing market globally.

However, the Nifty is currently trading at 19x forward earnings, which is close to 2SD above its long term average. In fact, over the last five years, the markets have never traded at these valuations for a sustained period of time and this naturally gives rise to an important question – will the re-rating endure?

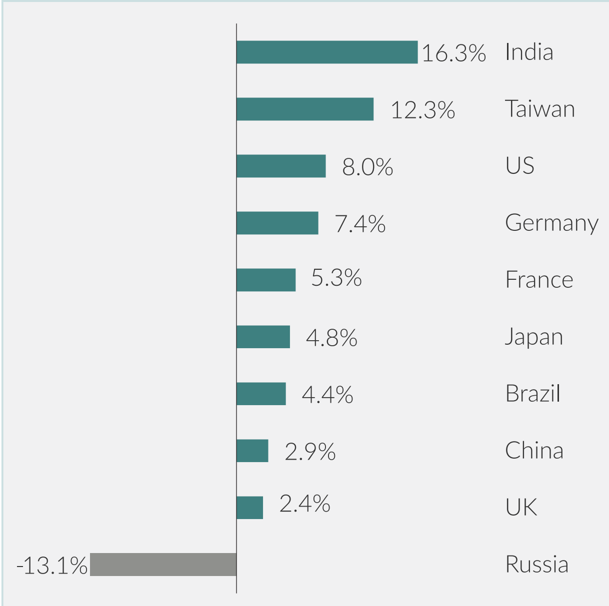
The market rally has been devoid of any consistent earnings growth/ Return On Equity (RoE) expansion, resulting in a re-rating of Price Earnings (P/E) multiples based on liquidity flows. Benign interest rates along with liquidity have been a catalyst for the underlying P/E expansion. However, we see limited room for further P/E expansion. The current period is characterized by rising pace of disruptions in various parts of the economy – be it owing to government actions like demonetization

GLOBAL INDICES PERFORMANCE LAST 3 YRS



Source: Bloomberg, IIFL Research; data as on 30th June, 2017

GLOBAL INDICES PERFORMANCE IN CY17



Source: Bloomberg, IIFL Research; data as on 30th June, 2017

and GST or those pertaining to developments in the technology arena. Specifically, the ascendance of technology in the Banking, Financial Services and Insurance (BFSI) sector has caused significant upheavals. This has relevance from the perspective of job creation in the sector. While the Public Sector Undertaking (PSU) banking space is going through a tumultuous phase of Non-Performing Assets (NPA) recognition and resolution, the private banking space is undergoing disruption owing to technology changes (with digitization of services becoming a cornerstone of many strategic initiatives undertaken).

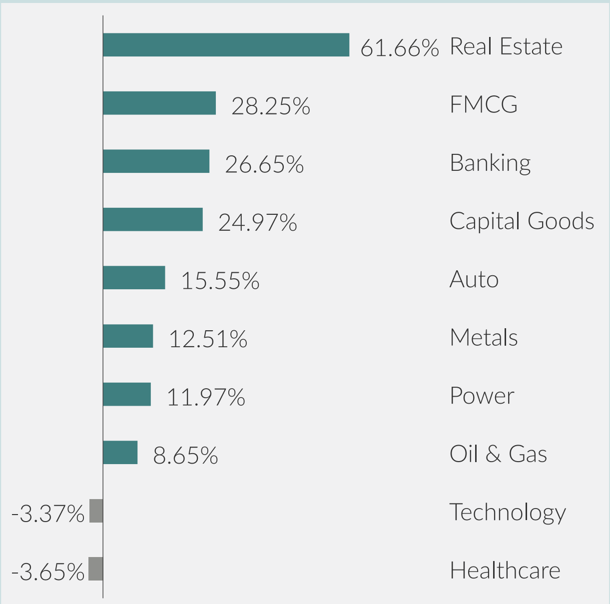
Secondly, the bedrock of Indian earnings for a decade (FY05-15), Information Technology and Pharma are witnessing structural changes in their respective business models. These changes are a result of both regulatory headwinds as well as change in the way business is being done. Consequently, earnings growth in these two important sectors has decelerated sharply in the last two years (FY15-17).

The same is reflected in the performance of the companies in these sectors. Technology and Healthcare were the worst performing sectors over the past six months. At the same time, domestic focused sectors like FMCG, Banking, Auto and Capital Goods outperformed the broader market. Real Estate, as a sector which had seen major sell off in Nov-Dec'16 post the demonetization announcement, saw major pickup as the valuations became attractive and fears of a complete rout in the sector was overdone.

Nevertheless, liquidity both from domestic and Foreign Institutional Investors (FII) continues to be a major driver for the markets. It is, however, comforting to know, that the flow of money is to a large extent from domestic funds, which are considered much more stable than FII money. This is adding stability to the markets.

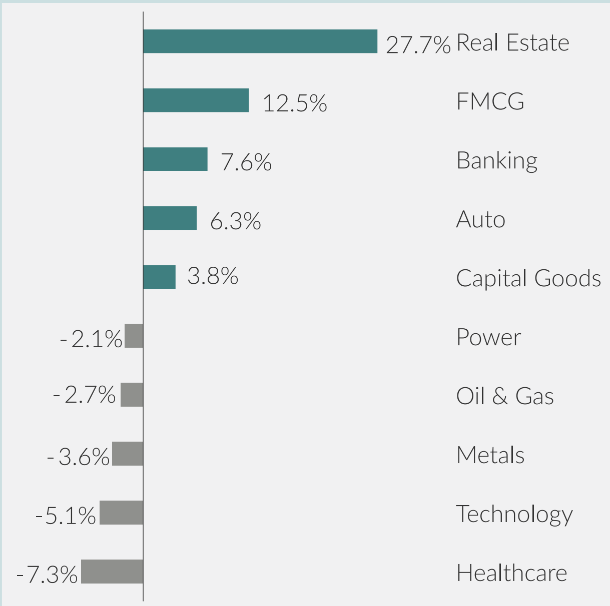
In the last three years, the government has implemented / initiated several important reforms. **GST, easing of Foreign Direct Investment (FDI) limits in various sectors, Direct Benefit Transfer (subsidy reforms), Financial Inclusion and Digitization, Make in India, Ujjwala Yojana, and Ujwal Discom Assurance Yojana (UDAY) Scheme for Power sector** are some of its signature initiatives, in our view. The common thread running across reforms like GST and demonetization, seems to be a thrust towards formalization of the economy and enhancement of tax base.

SECTORAL PERFORMANCE IN CY17

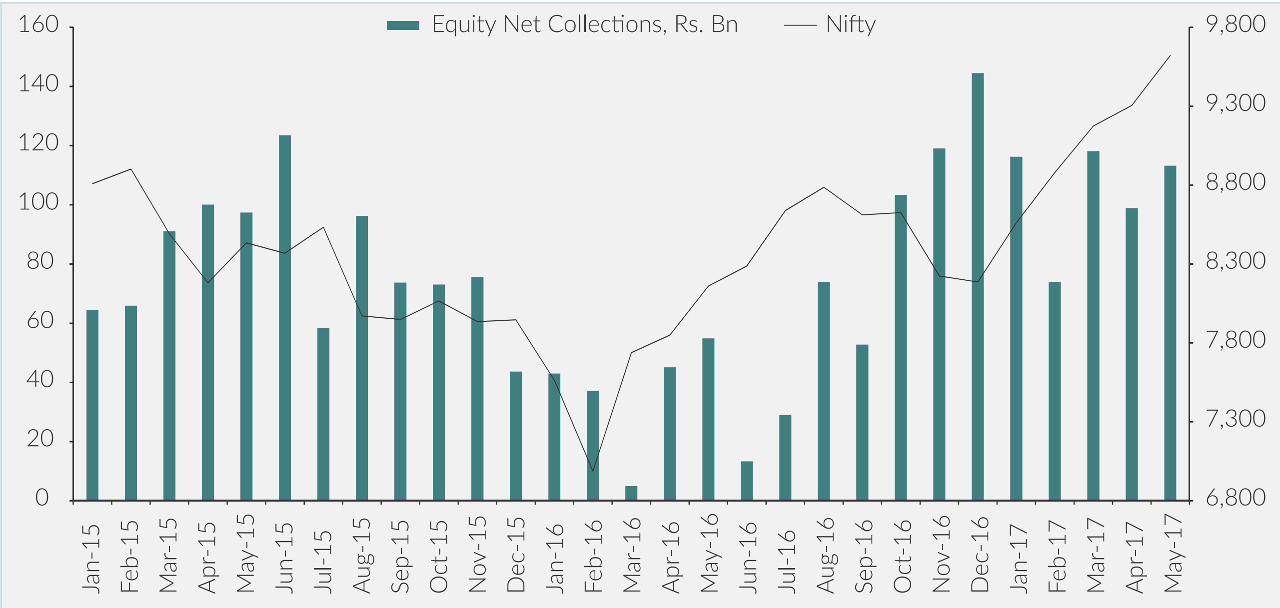


Source: Bloomberg, IIFL Research; data as on 30th June, 2017

SECTORAL PERFORMANCE IN Q1FY18



Source: Bloomberg, IIFL Research; data as on 30th June, 2017



Source: Bloomberg, IIFL Research; data as on 30th June, 2017

Demonetization has also resulted in a deluge of liquidity in the system, driving interest rates lower. A considerable change has been seen in the fortunes of a few important sectors like Oil & Gas and Power.

GST AND BEYOND FOR INDIAN ECONOMY

Among the policy enactments, GST is likely to have the biggest and deepest impact in the Indian economy for decades. GST is expected to drive large scale benefits for the government, corporates as well as customers. While the government will gain from higher tax collections, corporates will gain from complete tax set-offs along the chain, while being able to streamline their logistics costs. Customers will ultimately gain from lower prices, as the benefits to the system are passed on. We believe that GST is a powerful reform, which will reaffirm the market's faith in the reforms process initiated by the government.

The main benefits to economy from GST are highlighted below:

1. **Complete tax set-offs to lower cost:** India's tax structure was compartmentalized leading to loss of input tax credits and inefficiencies in the supply chain [Value Added Tax (VAT) on Central Value Added Tax (CENVAT), Central Sales Tax (CST)]. GST integrates the country under a single taxation regime and the unique Integrated GST (IGST) system will facilitate inter-state trade.

2. **Plugging tax leakages:** We believe that the tax leakage at the semi-organised level was a bigger problem than the shift from unorganized to organized sector. In this regard, the robust filing system through Goods and Service Tax Network (GSTN) will plug the leakages while the 'reverse charge mechanism' will incentivise compliance.

3. **Rationalization of supply chain:** With tax-related inefficiencies out of the way, businesses can realign their supply chain and warehousing to meet the requirements of end consumers in a better manner. Further, the elimination of state check posts will be a transformation for the logistics industry.

The key winners are likely to be:

- **State finances:** Indian states had gained revenue efficiency by introducing Value Added Tax (VAT), and now after GST, the impact will be much more profound. Along with the assurance of compensation from the Centre, the states will now have a share of tax revenues from services. Services has been the fastest growing segment across all the states and tax/

Gross Domestic Product (GDP) can rise by 100bps over the next two years.

- **Consumption:** This includes the entire segment of stocks in buckets like paints, apparel, building materials and consumer electricals. The main benefit is likely to accrue with the shift from the unorganized to the organized sector, as plugging tax leakages creates a level playing field for all, while savings in supply chain will be an added advantage. We estimate that the organized sector in each of these segments will grow at a much faster pace than the industry averages post GST.
- **Transportation:** The most apparent beneficiary is the express logistics space due to the shift from unorganized to organized, but multifarious themes emerge on various dynamics including increased usage of 3PL, deployment of large format warehousing/consolidation centers and long distance multi-modal transport.

Why we see a market re-rating possibility from GST?

India is a country of high leverage traditionally, and given the inefficiencies at various levels, a small reform can trigger a big wave of growth and re-rating. We have seen that in 1999, 2003, 2011 (on the reverse) and in 2014. When such events happened, the market multiples also shifted. GST is one such reform and there are multiple benefits for all participants in the value chain apart from opening up a virtuous cycle of higher tax compliance and growth. This is not a perfect GST, but in context of India's strong federal polity, this is a pragmatic GST and the powerful GSTN or the backbone Information Technology (IT) structure, the entire supply chain will be now completely mapped without the hindrance of a state boundary.

BUT EARNINGS CONTINUE TO PLAY HIDE AND SEEK WITH STREET

Earnings growth over the last three years has been lackluster, with flattish Nifty Earnings Per Share (EPS) over FY14-17. Earnings growth was hamstrung by the absence of revival in private investment cycle, two consecutive droughts (impacted consumption spending), asset quality stress at PSU banks and corporate private sector banks, deceleration in credit growth, deflation in commodity prices in FY16 and the demonetization exercise. While we are disappointed by the lack of earnings growth, we believe the underlying change in the economy has erased the problems of the past and created a foundation for future growth. We believe an earnings up-cycle is ahead and this would be critical for further market returns. However, we expect earnings to revive over FY17-19 and see earnings CAGR of ~15% for the Nifty.

We believe broader market valuations have limited re-rating triggers in the near term, unless accompanied by earnings recovery. Going forward, broad-based earnings recovery would be a function of revival of private capex cycle as well as resolution of stressed assets at PSU banks. Re-capitalization of PSU Banks would also be keenly awaited, we believe.

GLOBAL GROWTH PROJECTED TO RECOVER IN 2017 SUPPORTED BY A PICK-UP IN MANUFACTURING AND TRADE

The World Bank (Global Economic Prospects, June 2017) has projected global growth to increase from a post-crisis low of 2.4% in 2016 to 2.7% in 2017 and 2.9% in 2018 because of a recovery in manufacturing and trade. Growth in advanced economies is projected at 1.9% in 2017 due to a pick-up in the growth prospects of the US, Japan and the Euro area. In the US, following a slowdown in 2016 due to weak investment and exports, GDP growth is projected to recover to 2.1% in 2017 and 2.2% in 2018. The unemployment rate has steadily fallen and inflation expectations have increased from 2016. In view of this improvement, the US Fed, in its June 2017 monetary policy review, raised the target range for the federal funds rate to 1-1.25%.

In China, GDP expanded by 6.7% in 2016. Infrastructure spending by state-owned companies partially offset the sharp slowdown in private investment. Growth is projected at 6.5% in 2017, indicating strengthening trade, with a moderate recovery in imports and a gradual acceleration of exports. However, financial sector vulnerabilities and protectionist policies in advanced economies pose a challenge to China's growth outlook. Both Brazil and Russia are expected to emerge from recession in 2017, helped by recovering commodity prices. Global trade growth is expected to increase from 2.5% in 2016 to 4% in 2017, supported by stronger import demand from major advanced economies, increased trade flows to and from China and recovering import demand from commodity exporting Emerging Markets (EMs).

SECTOR OUTLOOK AND MARKET VALUATIONS

The market is poised at such levels that there is little room for any negative surprise. As has been said above, earnings support is required for market valuations to start looking cheap again. With regard to sectors, we are bullish on Financials and especially well-managed Private Banks and NBFCs. We are bullish on the housing finance space which we believe will be the biggest beneficiary of the government's low cost housing focus. We believe that private sector banks are better placed to leverage the next round of growth in India, as their balance sheets are better placed and they also have the systems in place to play the growth. We are underweight on cyclicals and sectors where earnings visibility is still not clear.

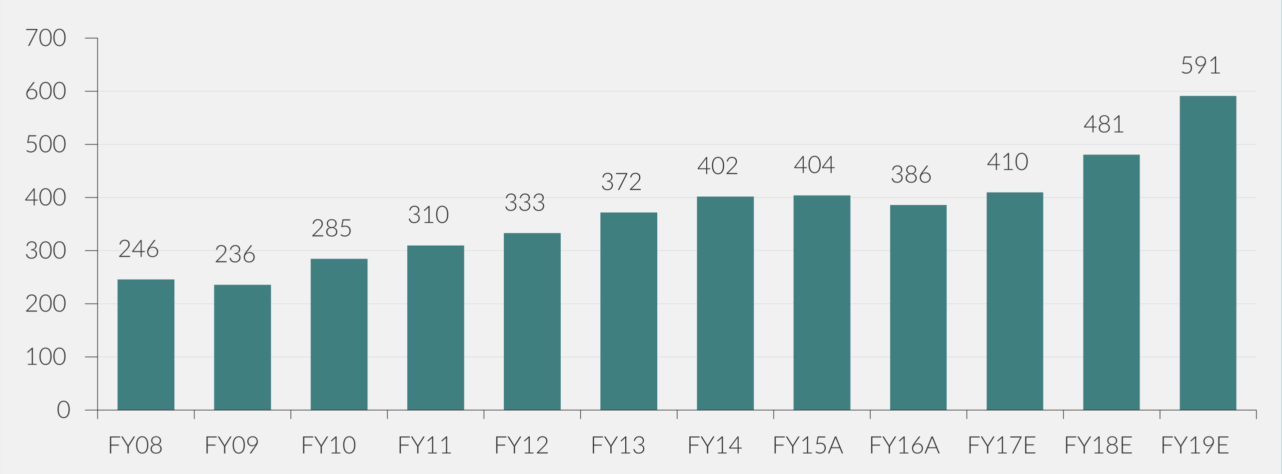
In the near term, risks to earnings could stem from the implementation of GST and strengthening of the Rupee. De-stocking in trade supply chain and implementation-related initial hurdles could pose a threat to earnings for B2C sectors in 1HFY18. That said, we believe GST will

NIFTY P/E CHART

Source: Bloomberg, IIFL Research; data as on 30th June, 2017

drive formalization of the economy while enhancing the tax base in the longer term. Going forward, we believe broad-based earnings recovery will be a function of revival of private capex cycle as well as resolution of stressed assets at PSU Banks. Re-capitalization of PSU Banks will also be keenly awaited, in our view. In this backdrop, we prefer large caps over midcaps. We prefer to stay with names having earnings visibility, reasonable valuations, and stock-specific triggers.

NIFTY EPS



Source: Bloomberg, IIFL Research; data as on 30th June, 2017

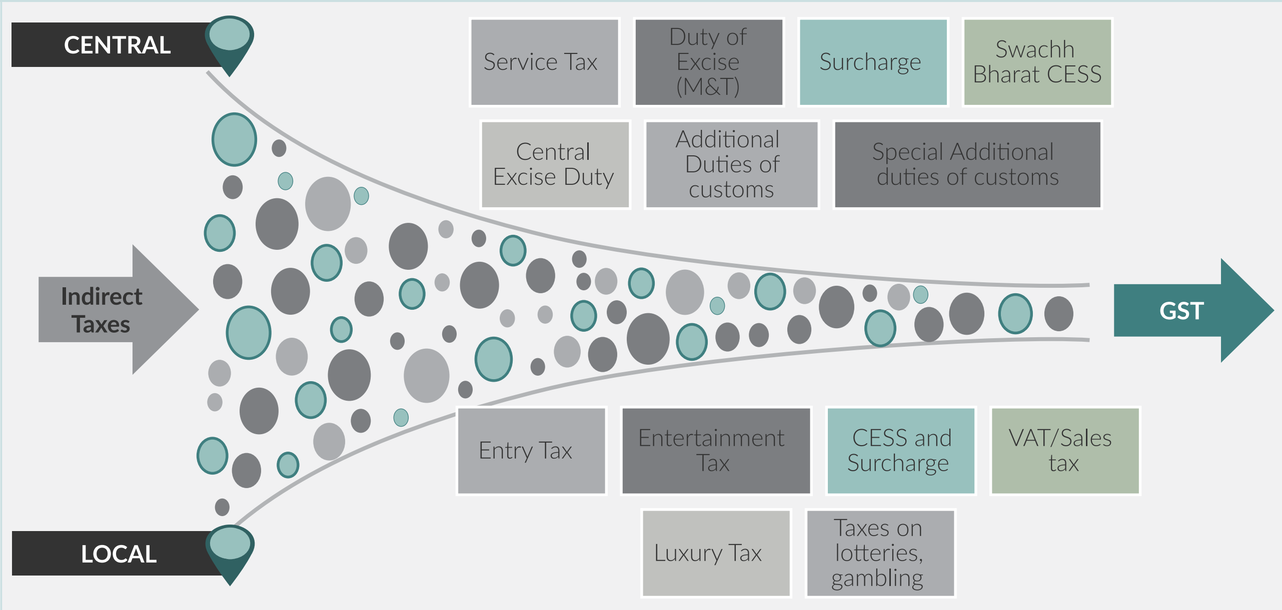
GST RECKONER

GOODS & SERVICES TAX (GST) RECKONER

WHAT IS GOODS & SERVICES TAX?

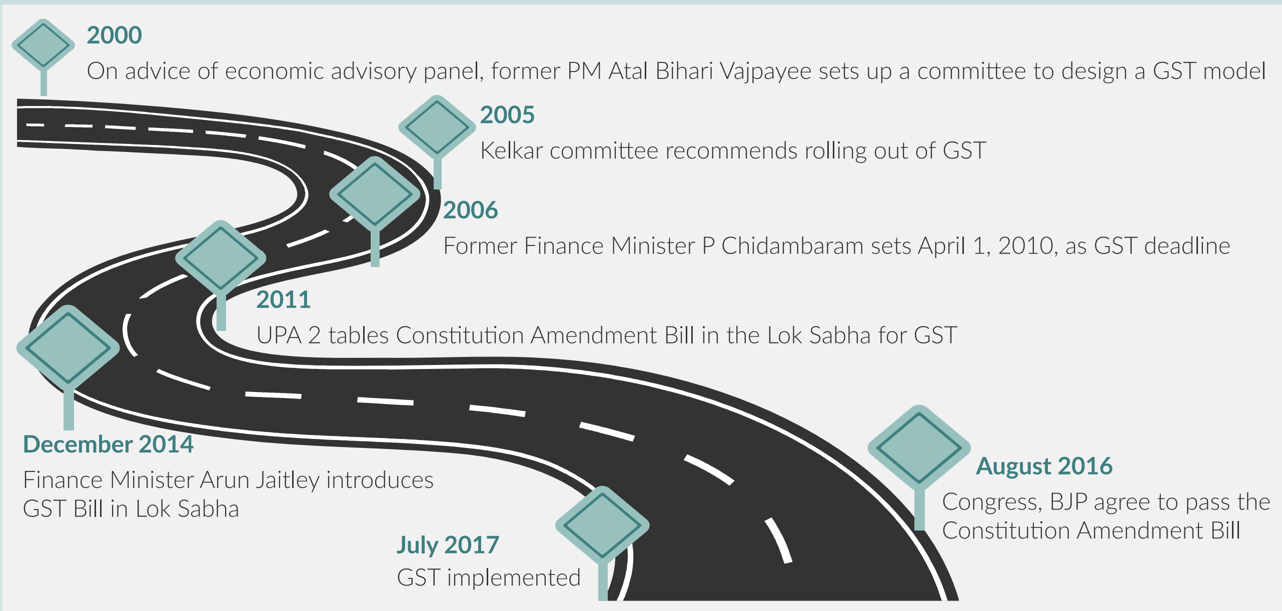
- GST means a comprehensive tax on supply of Goods or Services or both
- It will be applicable on transaction value and combines other indirect taxes
- It is a consumption-based tax; tax will be payable in the state in which goods and services are finally consumed

WHAT ALL TAXES GST SUBSUMES?



Source: Ministry of Finance

GST TIMELINE



Source: Ministry of Finance

UNDERSTANDING COMPONENTS OF GST

- **Central Goods and Services Tax (CGST):** Paid on all transactions collected by the Center
- **State Goods and Services Tax (SGST):** Paid on all transactions within a State, collected by the States
- **Integrated Goods and Services Tax (IGST):** Paid on all inter-state transactions, or import of goods, collected by the Center

WHY GST?

- The old indirect tax system had cascading impacts with multiple taxes at the state and central levels
- Complex valuation of taxes; multiple acts governing them; and hence reduced ease of business
- In the indirect tax regime, India used to operate like a fragmented market
- The old indirect tax system worked like an entry barrier for manufacturers and service providers

WHAT ARE THE ADVANTAGES GST IS EXPECTED TO BRING?

ONE NATION ONE TAX

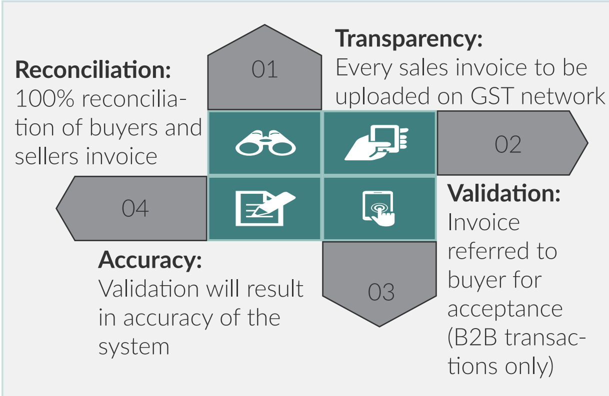
- India will now work as a uniform market
- The structure has been non-transparent till now; central levies are not eligible with state set-off
- Classification disputes between services and goods

The new regime under GST will change the way business is done; one single tax increases ease of doing business

BUOYANCY IN TAX COLLECTION

The tax reform is expected to increase net tax collection; system has inbuilt incentives to report and comply in the form of input tax credits; systematic reporting under GST regime will also pave way for plugging direct tax leakages.

GST system resides on four main pillars as shown below

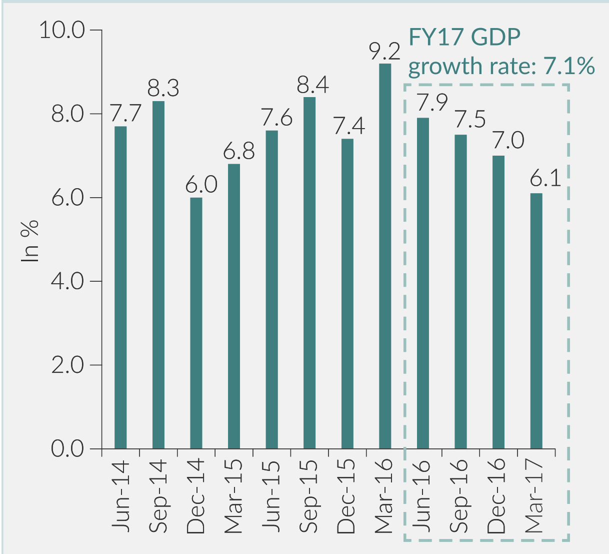


SEAMLESS FLOW OF GOODS; LOWER DISTRIBUTION COST

- Seamless market across states and Union territories
- As per reports, the current logistics cost is around 13% of GDP in India compared to 8% in case of western countries; this is expected to reduce as inter-state operability eases
- Emergence of new and more effective supply chain models

The lowering of logistics cost will directly impact all sectors; new supply chain models are expected to emerge

GDP GROWTH RATE (%)



Source: RBI

BOOST TO MACROECONOMIC FRAMEWORK

- The steady uptick in GDP growth that was seen from FY14 to FY16 was interrupted in FY17
- India's gross domestic product (GDP) at constant (2011-12) prices grew 6.1% in the March quarter of 2017, slower than provisional 7.0% rise in the previous quarter
- It is expected that better tax to GDP ratios will take economy to the next level; IMF estimates that GST could help India cross 8% GDP growth rate

The increase in tax collection will help in reducing fiscal deficit; improve government financials and provide country the necessary boost as India is highly dependent on public spending.

NECESSARY FILLIP TO MANUFACTURING SECTOR

- Increase in ease of doing business is expected to provide boost to manufacturing
- Input tax credit can make manufacturing more viable in some products

Earlier, companies had to evaluate where they should open a manufacturing unit; however, under the new tax regime, the consideration is now reduced and will help manufacturing segment.

BOOST TO CONSUMPTION

- It is expected that in medium to long-term, GST will reduce inflation as gains at input credit level will be passed on to consumers
- GST council has incorporated "anti-profiteering" provision to ensure reduction of tax is passed to consumers

In the near term, GST is expected to increase inflation to some extent as consumption of services will become expensive due to higher GST rate; however, in medium to long term, inflation could come down as gains under GST will be passed on to consumers.

IMPACT AS PER SIZE OF BUSINESS

- With additional investment in IT infrastructure, large companies should be easily able to handle the GST rollout
- Large businesses will have to sort out the inventory classification issues in the old and new regime
- It is expected that it would take months to sort out such cases
- For larger firms, challenge is making a provision for training requirements and dealing with supply chain management
- **SMEs** will be impacted with higher compliance costs; infrastructure setup costs
- GST intends to bring **unorganised sector** under the tax net; these kind of sectors will have lot of challenges shifting to a new regime
- The biggest challenge of the small businesses are high costs of migration and lack of awareness

CONSUMER PRICE INFLATION COMPONENTS

	Weight in CPI Index	YoY Inflation (June-2017)
Food and beverages	45.86%	-1.17%
Pan, tobacco and intoxicants	2.38%	5.62%
Clothing and footwear	6.53%	4.17%
Housing	10.07%	4.70%
Fuel and light	6.84%	4.54%
Miscellaneous	28.32%	3.29%

Source: MOSPI

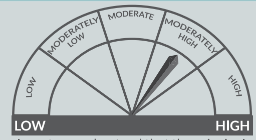
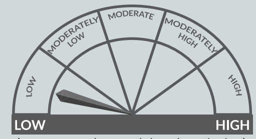
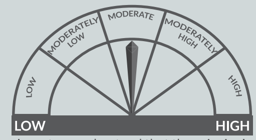
SECTORAL IMPACT		
Sector/Industry	**Impact**	**Comments**
Cement & Building materials		Overall tax in cement sector may decline; possible reduction in logistics cost and availability of input tax credit will also help the sector
Capital Goods		Fall in rates from 25% to 18% is positive for the sector
Automobiles & Auto Ancillaries		• Passenger vehicle segment will see reduction in overall taxation • Hybrid vehicles are set to become expensive with an additional CESS of 15% • Two-wheelers will be marginally impacted with GST rate in range of 28%-31% from current tax rate of 30.2% • GST rate for commercial vehicles will be marginally lower at 28% compared to 30.2% in current system
Healthcare/Pharma		Taxation rate doesn't change much; however, input tax credit will lead to disruption in the supply chain model
IT Services		Under GST, both the IT service providers and their clients will be eligible to claim full credit of GST
Financial Services		Higher taxes compared to the old regime will make transactions costly
Consumer Discretionary		White good products like televisions, air conditioners, refrigerators and washing machines are set to be expensive as old tax was in range of 23-28%, however, in places where additional octroi of 5% was charged, there will be a marginal reduction in price
Consumer Staples		Lower taxes compared to old regime, except in few cases, may lead to increase in demand

MARKET IMPACT		
Index	**Post-GST (till Jul 12, 2017)**	**Pre-GST (FYTD till Jun 30, 2017)**
S&P BSE Sensex	2.86%	4.39%
S&P BSE AUTO	3.47%	6.34%
S&P BSE Bankex	1.99%	7.60%
S&P BSE CONSUMER DURABLES	-0.07%	4.95%
S&P BSE CAPITAL GOODS	2.79%	3.83%
S&P BSE FMCG	2.24%	12.49%
S&P BSE HEALTHCARE	2.29%	-7.33%
S&P BSE IT	2.96%	-5.13%
S&P BSE METAL	4.73%	-3.65%
S&P BSE Oil & Gas	4.95%	-2.66%
S&P BSE POWER	1.98%	-2.15%
S&P BSE Realty	4.99%	27.70%
S&P BSE Teck	3.34%	-4.29%

Source: BSE

- With reduction in CPI and headline inflation, the base case scenario for rate cut is now set; however RBI might wait to see the impact of GST
- GST has been one of the biggest tax reforms and it is expected that successful implementation of the same to be a game-changer for the economy in the long run
- Higher tax collection is also expected to improve the macroeconomic framework

PRODUCT LABELLING DISCLOSURES

Name of the scheme	This product is suitable for investors who are seeking	Riskometer
IIFL INDIA GROWTH FUND **(An Open Ended Equity Scheme)**	**This product is suitable for investors who are seeking*** • Capital appreciation over long term; • Investment predominantly in equity and equity related instruments. ** Investors should consult their financial advisers if in doubt about whether the product is suitable for them.*	 Investors understand that the principal will be at moderately high risk
IIFL LIQUID FUND **(An Open Ended Liquid Scheme)**	**This product is suitable for investors who are seeking*** • Income over short term horizon • Investments in money market and short term debt instruments, with maturity not exceeding 91 days ** Investors should consult their financial advisers if in doubt about whether the product is suitable for them.*	 Investors understand that the principal will be at low risk
IIFL DYNAMIC BOND FUND **(An Open Ended Income Scheme)**	**This product is suitable for investors who are seeking*** • Income and long term gains • Investment in a range of debt and money market instruments of various maturities ** Investors should consult their financial advisers if in doubt about whether the product is suitable for them.*	 Investors understand that the principal will be at moderate risk

Different plans shall have a different expense structure.

MUTUAL FUNDS

IIFL India Growth Fund - EQUITY	30-June-16 to 30-June-17	PTP (₹)	Since Inception	PTP (₹)
IIFL India Growth Fund - Regular Plan (G)	21.94%	12,194	12.42%	13,667
IIFL India Growth Fund - Direct Plan (G)	23.02%	12,302	13.59%	14,050
Benchmark*	14.88%	11,488	5.91%	11,656
Additional Benchmark**	14.53%	11,453	4.71%	11,307

*As on June 30, 2017 Point to Point (PTP) returns in ₹ is based on standard investment of ₹ 10,000. Since Inception date is 30-Oct-2014. *Nifty 50; ** S&P BSE Sensex. Managed by the fund manager since November 03, 2016. Scheme has been in existence for more than 1 year but less than 3 years. Effective November 03, 2016, Mr. Prashasta Seth has been appointed as Fund Manager of the scheme. Different plans shall have a different expense structure.*

IIFL Liquid Fund- FIXED INCOME	30-June-14 to 30-June-17	PTP (₹)	30-June-16 to 30-June 17	PTP (₹)	Since Inception	PTP (₹)
IIFL Liquid Fund-Regular Plan (G)	7.43%	12,401	6.42%	10,642	7.59%	13,042
IIFL Liquid Fund-Direct Plan (G)	7.48%	12,148	6.47%	10,647	7.65%	13,068
Benchmark*	7.83%	12,540	6.86%	10,686	8.13%	13,281
Additional Benchmark**	7.55%	12,266	6.45%	10,654	7.86%	12,852

*As on June 30, 2017 * Crisil Liquid Fund Index,** Crisil 91 Day T-Bill Index. Point to Point (PTP) returns in ₹ is based on standard investment of ₹ 10,000 made on the $ Inception date 13-Nov-2013. Scheme has been in existence for more than 3 years but less than 5 years. Effective March 08 2017, Mr. Ankur Parekh has been appointed as Fund Manager of the scheme. Different plans shall have a different expense structure.*

IIFL Dynamic Bond Fund - FIXED INCOME	30-June-14 to 30-June-17	PTP (₹)	30-June-16 to 30-June 17	PTP (₹)	Since Inception	PTP (₹)
IIFL Dynamic Bond Fund - Regular Plan (G)	9.30%	13,061	8.37%	10,837	7.53%	13,388
IIFL Dynamic Bond Fund - Direct Plan (G)	9.85%	13,259	8.91%	10,891	8.07%	13,661
Benchmark*	10.91%	13,647	11.47%	11,147	9.31%	14,301
Additional Benchmark**	11.15%	13,736	11.69%	11,169	7.72%	13,484

*As on June 30, 2017 * Crisil Composite Bond Fund Index,** Crisil 10yr Gilt Index. Point to Point (PTP) returns in ₹ is based on standard investment of ₹ 10,000 made on the inception date. $ Inception date 24-June-2013. Scheme has been in existence for more than 3 years but less than 5 years. Effective March 08 2017, Mr. Ankur Parekh has been appointed as Fund Manager of the scheme. Different plans shall have a different expense structure.*

Past performance may or may not be sustained in future.

MUTUAL FUND INVESTMENTS ARE SUBJECT TO MARKET RISKS, READ ALL SCHEME RELATED DOCUMENTS CAREFULLY

IIFL FUNDS PERFORMANCE

(as on June 30, 2017)

AIF FUNDS

EQUITY FUND	Region	AUM (in USD mn)	Returns (in %) 3 Months	YTD	3 years
IIFL NDA Fund	DOMESTIC	76.22	3.00	24.30	NA
IIFL Asset Revival Fund 2	DOMESTIC	76.92	0.70	19.20	NA
Nifty Index			4.18	22.35	5.14

ALTERNATE	Region	AUM (in USD mn)	Returns (in %) 3 Months	1 Year	3 years
IIFL Seed Ventures Fund (31st May'17)	DOMESTIC	67.70^	-1.44%	21.19	NA

^ *Total Committed capital*

FIXED INCOME	Region	AUM (in USD mn)	Returns (in %) 3 Months	YTD	3 years
IIFL Cash Opportunities Fund	DOMESTIC	147.07	1.99	8.60	NA

REAL ESTATE	Region	AUM (in USD mn)	Returns (in %) 3 Months	YTD	1 year
IIFL RE Fund Domestic Series 4	DOMESTIC	29.24	18.45	29.47	16.81
IIFL RE Fund Domestic Series 3 Class B	DOMESTIC	59.15	19.8	32.97	16.29
IIFL RE Fund Domestic Series 2	DOMESTIC	161.75	11.67	27.39	15.81

AIF Schemes - Past performance may or may not be sustained in future. Returns greater than 1 year period are compounded annualized and less than 1 year period are on absolute basis. Distributions, if any are assumed to be reinvested.

AIF Schemes are governed by SEBI (Alternative Investment Funds) Regulations and can strictly solicit funds only through Private Placement. The performance of the Schemes stated herein is for information purpose only and should not be construed as an offer or solicitation to buy any Scheme(s).

PMS

IIFL Multi Cap Portfolio- EQUITY	Region	AUM (in USD mn)	Returns (in %) 3 Months	1 Year	3 years
IIFL Multi Cap Portfolio- EQUITY	DOMESTIC	73.78	2.30	30.20	NA

Returns below 1 year is absolute & above 1 year is CAGR

FEEDER FUNDS

ALTERNATE	Region	AUM (in USD mn)	Returns (in %) 3 Months	1 Year	3 years
IPEplus Fund	OFFSHORE	44.98	0.44	2.92	5.79
IIFL Global Bond Fund 2	OFFSHORE	23.60	2.31	4.15	NA

Returns below 1 year is absolute & above 1 year is CAGR

All returns are in USD

USDINR as on 30th June - 64.5813

I I F L   A S S E T   M A N A G E M E N T

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TERMS & CONDITIONS WITH RESPECT TO THIS REPORT

WE'RE IN THE BUSINESS OF
UNDERSTANDING BUSINESSES.

IIFL
INVESTMENT MANAGERS
ASSET MANAGEMENT