
To Our Shareholders:

Fairfax India had very good results in 2016, its second full year of operations.

	2016	2015
	<i>(\$ million, except per share amounts)⁽¹⁾</i>	
Income	128.6	65.3
Net earnings	107.8	40.9
Total assets	1,303.5	1,025.5
Investments	1,095.6	978.6
Common shareholders' equity	1,075.4	1,013.3
Book value per share	\$ 10.25	\$ 9.50

Fairfax India's increase in common shareholders' equity in 2016 was \$62.1 million, which raised book value per share, our key performance measure, by 7.9%, from \$9.50 to \$10.25. During the same period the USD BSE 30 Index was relatively flat.

Fairfax India had excellent growth in net earnings in 2016, largely the result of net unrealized gains on investments of \$105 million versus \$14 million in 2015, partially offset by lower interest income of \$21 million versus \$45 million in 2015 (when a larger portion of its funds were in high yielding Indian bonds, awaiting deployment into Indian investments) and a \$7 million loss due to foreign exchange versus a \$7 million foreign exchange gain in 2015.

Fairfax India has also made very good progress on investments in 2016. After completing two investments in 2015, it announced its third investment in February 2016. With these three investments it had deployed about \$370 million of its investable funds. By the middle of 2016, Fairfax India made two more investment commitments and had essentially fully committed the entire \$1 billion that it had raised. Since it was continuing to see excellent new investment opportunities, in September 2016 Fairfax India obtained a \$225 million two-year secured term loan from a syndicate of Canadian banks. By year end it made two more investments and committed to a third one. In two years Fairfax India deployed or had commitments for its entire \$1.2 billion of investable funds. Given these circumstances, on January 13, 2017 Fairfax India issued 42.6 million shares at \$11.75 per share in a public offering and a private placement to OMERS and Fairfax Financial, raising gross proceeds of \$500 million. When the term loan is repaid, Fairfax India will be left with about \$230 million for new investments, and ongoing expenses.

In all, Fairfax India has now completed or committed to investments in eight companies, working through Fairbridge, its sub-advisor in India (wholly-owned by Fairfax Financial), and through its portfolio advisor Hamblin Watsa in Toronto. Fairbridge operates under the strong leadership of CEO Harsha Raghavan and the excellent work of Vice Presidents Sumit Maheshwari and Sarvjit Bedi. Fairfax India's Mauritius subsidiary, FIH Mauritius Investments, and its CEO Amy Tan are also an integral part of the investment process.

All of Fairfax India's investments are in outstanding companies with a history of strong financial performance, led by founders and management who are not only excellent but also adhere to the highest ethical standards. The details of its investments are as follows:

	Date of Investment	Ownership %	Amount Invested (\$ million)
National Collateral Management Services Limited	Aug. 2015	88%	\$ 149
IIFL Holdings Limited	Dec. 2015 and Feb. 2017	27%	277
Adi Finechem Limited (renamed Fairchem Speciality Limited)	Feb. 2016	45%	19
Sanmar Chemicals Group	Apr. 2016 and Sep. 2016	Debentures and 30%	300
National Stock Exchange of India Limited	Jul. 2016	1%	27
Privi Organics Limited	Aug. 2016	51%	55
Saurashtra Freight Private Limited	Feb. 2017	51%	30
Bangalore International Airport Limited	Committed	38%	379
Total			<u>\$ 1,236</u>

(1) All dollar amounts in this letter are in U.S. dollars.

While the valuations of the private companies that Fairfax India has invested in remained relatively close to the prices paid for them, the two listed companies in the portfolio, Fairchem and IIFL, have posted strong mark-to-market gains. From the purchase price upon acquisition until the end of 2016, Fairchem's share price appreciated 135% from 212 rupees to 498 rupees, and IIFL's share price appreciated 35% from 195 rupees to 262 rupees, resulting in mark-to-market gains of approximately \$26 million and \$64 million respectively.

While the book value per share of Fairfax India was \$10.25 per share, we believe that the underlying intrinsic value is much higher. For example, in spite of an average 15.4% return on equity and a 26% annual growth in book value per share over the past ten years, IIFL, even at its current stock prices of around 364 rupees per share, is selling at a price/earnings ratio of only 14.0 times expected earnings. And the founder, Nirmal Jain is an outstanding entrepreneur. All of the companies listed above have similar characteristics. The potential for all of them is very significant.

Now we are pleased to report to you on the investments Fairfax India has made.

National Collateral Management Services Limited (NCML)

You will recall that NCML was Fairfax India's very first investment, completed in August 2015. NCML has operated for over 12 years and is now preparing to expand to take advantage of the significant market potential in India's under-developed agricultural storage industry. NCML operates in the agriculture value chain by offering end-to-end solutions in grain procurement, testing, storage and collateral management. As a result of fiscal and non-fiscal changes in agriculture and food policy, private companies like NCML are enhancing their range of services provided to Indian farmers, traders, food processors, banks, the government and other businesses connected to the agriculture supply chain. This is expected to significantly improve efficiencies to help India achieve its stated national objective of greater food security.

NCML has more than 1.5 million metric tons (MT) of storage capacity across 952 warehouses in 18 states. It has a network of 6 regional offices, more than 176 touch points at agricultural produce markets and thousands of farmers and traders to facilitate procurement of commodities. With assets under management at an all-time high of \$2.5 billion, NCML commands over a 45% share of the collateral management business in India, offering custodial services to 74 banks and financial institutions for the management of collateralized commodities based on which they advance post-harvest loans to farmers or dealers owning commodities.

Fairfax India invested a total of \$149 million to acquire an 88% interest in NCML: \$31 million was a capital infusion into NCML to fund growth plans, while the remaining \$118 million was used to buy out existing shareholders. Based on discounted cash flow valuation techniques, we now value NCML at 9,948.8 million rupees, or \$147 million, reflecting a depreciation of the rupee from the time the transaction was completed. Based on Indian GAAP for the twelve months ended December 31, 2016 NCML's revenue grew by 109% to \$118 million and shareholders' equity grew by 4% to \$76 million but net earnings fell by 21% to \$4 million. The increase in revenue was driven largely by a new government procurement contract in the supply chain business. The reduction in net earnings was as a result of a temporary higher tax expense and a small loss in the supply chain business caused by start up and higher interest costs related to the above mentioned initiative. While the price to book value of 2.2 times and price/earnings ratio of 45 times seem high, we believe that the strong growth rate of NCML more than justifies the valuation.

Under the continued able leadership of its CEO Sanjay Kaul, now assisted by executive director Unupom Kausik, NCML has made significant progress in 2016, achieving growth momentum across each of its business segments with a focus on expanding and diversifying its client base.

NCML undertook four notable business initiatives during 2016. The first was the successful launch of **NCML Finance Pvt. Ltd.** (NFin) as a Reserve Bank of India (RBI)-regulated non-banking finance company (NBFC). NFin received good response from borrowers across the country and a large number of loans were approved for borrowers serving the entire value chain. NFin obtained a credit rating of A+ in its first year of operation.

The second was the launch of a modern warehousing **silos vertical** by successfully bidding for 11 large concession contracts from the Food Corporation of India (FCI). This represents an aggregate capacity of 550,000 MT at an estimated total project cost of about \$100 million. This will principally be financed by internal cash flow. The third initiative was the unique and the first of its kind online bulk procurement, trading and sale portal – **MktYard.com** – as an independent company. The fourth was the significant expansion of their **Supply Chain** segment both in terms of revenue and number of clients. Seven very large clients who are market leaders in the agri industry were added and the segment doubled its operations over the previous year with a wider range of

commodities and geographical coverage. The division launched structured trade facilities at port locations to participate in international trade opportunities.

The warehousing business enhanced capacity by the addition of 100,000 MT during the year and work on its single largest silo facility of 38,000 MT, for maize is nearing completion. In all, this was an excellent year for NCML.

IIFL Holdings Limited (IIFL)

In December 2015 Fairfax India successfully completed an open offer for IIFL and purchased 21.9% of its shares outstanding at 195 rupees (\$2.93) per share for a total consideration of \$202 million. At 195 rupees per share, we bought our position at a trailing price/earnings ratio of 12.9 times, price to book value of 2.0 times and dividend yield of 1.5%.

At year end 2016 IIFL shares closed at a price of 262 rupees per share resulting in an unrealized gain of 35% in rupee terms. It is trading at around 364 rupees per share and in spite of a 15.4% return on equity and a 26% annual growth in book value per share over the past 10 years, IIFL is selling at a price/earnings ratio of 14.0 times expected earnings.

Fairfax Financial has known IIFL for over a decade and been a shareholder of IIFL since 2010, owning a direct interest of 8.9% and an indirect interest through P Notes of 5.2%. One of us (Chandran) has been on the Board of IIFL since 2012.

In February 2017 Fairfax India purchased 15,853,000 shares of IIFL while at the same time Fairfax Financial divested its economic interest in an equivalent number of shares that it held as P Notes. This was done for several reasons:

- Over time Fairfax Financial would prefer to have all of its Indian investments (as far as possible) in Fairfax India with the exception of Thomas Cook and its subsidiaries, Quantum Advisors and ICICI Lombard General Insurance Company Limited.
- Even at 319 rupees per share, the price/earnings ratio is 12.3 times expected earnings and represents excellent long term value for Fairfax India.

As a result, Fairfax India now owns 26.7% of IIFL.

Based on Indian GAAP, for the 12 months ended December 31, 2016, IIFL revenues grew 15% to \$688 million, net earnings after minority interest grew 26% to \$95 million, and shareholders' equity grew 47.6% to \$650 million, generating an ROE of 14.6%.

IIFL is a well-established national financial services company serving over 3.5 million customers from 2,250 service locations and over 1,000 branches across India. It has an international presence with offices in New York, London, Geneva, Singapore, Hong Kong, Dubai and Mauritius. In addition to the founding team, IIFL now has a highly qualified and experienced management team driven by pride and reward of ownership. Again in 2016 under the exceptional leadership of Nirmal Jain and R. Venkataraman, IIFL achieved outstanding results in each of its three following major business divisions.

NBFC: This division successfully diversified its lending by adding a retail-focused loan portfolio. Loan assets under management grew 15% over the previous year to approximately \$3 billion. The portfolio continued to move towards a superior loan mix by reducing its share of relatively higher risk loans to capital markets and construction finance and increasing its share of lower risk retail mortgage loans. Retail mortgages now constitute 52% of the portfolio at \$1.6 billion. Asset quality was maintained with net nonperforming assets at 0.65%.

This division acquired management and control of Samasta Microfinance Limited, a Bangalore based NBFC, a micro finance institution registered with the RBI. This acquisition is consistent with IIFL's strategy of focusing on small ticket retail credit to under-served geographies and segments.

IIFL has made very significant progress on its objective of achieving end-to-end digital interface with the increasing adoption of mobile and tablet technology. All loan products are now live with tablet-based sourcing modules. IIFL is the first mover to offer eSign facilities to customers for end-to-end paperless transactions in all their gold loan branches.

In September 2016 CDC, the UK government-sponsored private equity fund, invested \$150 million for approximately a 15% stake in the NBFC, valuing just this division at about \$1 billion while the entire company was trading in the public markets at a valuation of \$1.3 billion.

Wealth Management: IIFL Wealth has emerged as one of the leading wealth managers in India with assets under management, advice and distribution of about \$16 billion, having grown 22% this year. It offers advisory services, wealth structuring solutions, asset management and distribution services to high net worth families. IIFL Wealth NBFC, which commenced operations in February 2016, mostly offers loans against securities to a high net-worth clientele and has a loan book of about \$430 million.

Capital markets and other activities: This is a collection of several businesses, including retail and institutional stock broking, financial products distribution, mutual fund management and investment banking. The broking business is a leader in its field and provides broking and advisory services to retail and institutional clients. It is well known for its high quality and innovative research and it covers over 500 Indian companies.

The highlight for the year in this division was the landmark performance of the investment banking division that for the 9 months ended December 31, 2016 completed 16 investment banking transactions including 5 IPOs. IIFL is among the top 5 investment banks in the country in terms of the number of equity IPOs completed.

The IIFL Markets App is highly rated and the most downloaded with over 800,000 downloads on Google Play Store. The app is accessed by retail investors across 1,500 locations in India. With the growth of mobile networks in remote locations, do it yourself (DIY) mobile trading forms over 30% of clients and has reduced the information asymmetry of financial markets in Tier 2 locations in India.

Despite this stellar performance, the folks at IIFL are not resting on their laurels. They have formidable objectives:

- To double IIFL's consolidated revenues by fiscal year 2020 and, driven by margin improvement and scale benefits, to grow net profit after minority interests by 2.5 times. They hope to reduce IIFL's current borrowing costs as a result of improving credit ratings.
- To reduce cyclicity and volatility in IIFL's earnings. IIFL has a healthy mix of steady businesses, namely consumer finance and wealth, overlaid with fee income from the relatively volatile capital markets. On consumer finance, the focus is to serve retail customers digitally as far as possible.
- To de-risk the business model through multiple revenue streams from various businesses catering to various sub-segments of customers. To achieve this, IIFL has diversified its loan book in terms of products and geography, helping to provide insulation against concentration risk. IIFL will continue to work on improving its best in class risk management framework and analytics to monitor risk.

The key challenges faced by IIFL in 2016 were:

- Demonetization announced by the Government in November has affected revenues in the short term. Due to its continued focus on and investments in digitization, IIFL was able to mitigate the impact of demonetization because it had a ready platform to conveniently accept cashless payments from customers, the ability to make collections through tablets and a self-help portal for quick query resolution.
- IIFL faced increased competition, particularly in the housing finance sector which is witnessing the entry of a large number of new entrants, most of them backed by private equity. This might lead to irrational pricing in the short term. Given IIFL's distribution reach and capital adequacy, it believes it can withstand such short term pricing pressures. In any case, IIFL will not take undue risks to increase short term market share.

Overall, 2016 was an outstanding year for IIFL.

Fairchem Speciality Limited (formerly Adi Finechem Limited) (Fairchem)

On February 8, 2016 Fairfax India purchased 45% of Fairchem for 212 rupees (\$3.13) per share for a total consideration of \$19 million. The price of 212 rupees per share represented a price/earnings ratio of 12.7 times forward earnings for a company with a 20% annual growth in earnings per share over the last 10 years.

At the end of 2016 Fairchem shares closed at a price of 498 rupees per share, an increase of 135%. It is likely that the share price increase is primarily the result of the pending merger between Fairchem and Privi Organics Limited, a company in which Fairfax India invested, in August 2016, \$55 million for a 51% interest. We describe the Privi acquisition later in this letter.

Based on Indian GAAP, for the 12 months ended December 31, 2016, Fairchem revenues grew 17% to \$26 million, net earnings were flat at \$2 million, and shareholders' equity grew 11% to \$10 million, generating an ROE of 18.2%.

Fairchem made significant plant upgrades and modifications in 2016 as described below, and is now entering a phase where we expect very significant growth in revenue and profits.

Fairchem is an oleochemicals company. Oleochemicals are, broadly, chemicals that are derived from plant or animal fat, which can be used for making both edible products and non-edible products. In recent years the production of oleochemicals has been moving from the U.S. and Europe to Asian countries because of the local availability of key raw materials.

Fairchem occupies a unique niche in this large global playing field. It has developed an in-house technology that uses machinery manufactured by leading European companies to convert waste generated during the production of soy, sunflower, corn and cotton oils into valuable chemicals. These chemicals include acids that go into non-edible products like soaps, detergents, personal care products, paints, and other products that are used in the manufacture of health foods and vitamin E. The company's customers include major multinational companies including BASF, Archer Daniels Midland, Cargill, Advanced Organic Materials, IFFCO Chemicals and Asian Paints. Fairchem operates out of a single plant in Ahmedabad, the largest city in Gujarat, the home state of Prime Minister Modi. It has one of the largest processing capacities for natural soft oil-based fatty acids in India. Over the last ten years, Fairchem's sales have grown at 23% per year to \$26 million, and net earnings have grown at 24% per year to \$2 million with a return on equity over 20%.

In 2016, Fairchem developed a strong business relationship with a new U.S. based customer as the customer was emerging as a dominant player in the natural tocopherols, natural vitamin E and sterols markets. To avoid any product rejection, a joint detailed process and equipment audit was completed, which resulted in plant upgrades and modifications. Fairchem successfully started supplying to the U.S. based customer in October 2016, but the plant upgrades and modifications resulted in production losses and increased capital expenditures that negatively impacted Fairchem's net earnings during 2016.

The Indian vegetable oil market is growing at more than 10% per annum, resulting in increased availability of the raw materials required for Fairchem. At the same time, the paints and printing ink industry is also expected to grow at more than 10% per year, enabling it to absorb a higher volume of Fairchem's products. In order to capitalize on this opportunity and to improve plant efficiency and capacity utilization, Fairchem has embarked on a capital expenditure (Capex) project that will achieve energy savings and full capacity utilization by March 2017. The Capex project will also debottleneck the manufacturing facility and achieve a 33% increase in production within two years. The Capex project should help improve both top and bottom lines.

Privi Organics Limited (Privi)

Founded in 1992 by two life-long friends, Mahesh Babani and D.B. Rao, Privi is one of India's leading manufacturers of aroma chemicals such as Amber Fleur, Dihydromyrcenol (citrus character) and Sandal Touch. Privi started manufacturing aroma chemicals with only two products, which it gradually expanded to a range of over 50 products today, with a capacity of over 22,000 tonnes per annum. Its products are used as fragrance additives in perfumes, soaps, shampoos and packaged food. Privi enjoys a dominant position and economies of scale in its product categories. Privi also develops and produces custom-made aroma chemicals to specific requirements of its customers. Privi sources most of its raw materials, gum turpentine oil (GTO) and crude sulfate turpentine (CST) from pulp and paper companies globally and competes primarily with pure play and niche suppliers such as IFF, DRT and Renessenz.

One of Privi's significant strengths is its established research and development (R&D) capabilities in aroma chemicals, with a staff of 60 people, comprised of PhDs in chemistry, chemical engineers and instrumentation engineers. The research specialists continuously strive to develop new products and processes. Importantly, one of the R&D labs is completely focused on developing, through biotechnology, green products and green technologies in technical collaboration with the University Institute of Chemical Technology, Mumbai.

Privi enjoys many advantages in its business:

- It has a formidable presence in the aroma chemicals industry and is one of the leading producers of aroma chemicals in the world, with a sizable global market share in most of the products it manufactures. It is on track to be among the top 10 global players in aroma chemicals by 2018.

- Both Mahesh Babani and D.B. Rao have over two decades of hands-on experience, deep business relationships and a strong vision for the business. They are supported by a talented and professional management team with rich industry experience.
- Privi achieved revenue and net profit CAGR of 18% and 12% respectively over the last 10 years and a return on equity of 9% and expects to double its revenue by 2018 generating 16% EBITDA margins.
- By being based in India, Privi has inherent cost advantages both in terms of cheaper manpower for manufacturing and access to quality R&D talent at competitive costs.
- Privi is less susceptible to competition because it is backward integrated for key raw materials, giving it an edge on product pricing and the ability to enter into long term contracts. Process know-how, developed in-house and continuously refined through R&D initiatives over the years, and cost-efficient manufacturing create a strong competitive advantage over other international or domestic players.

Privi is a trusted supplier to all of the top 10 fragrance companies, which control about 80% of the global fragrance market. Privi enjoys long term relationships with these fragrance companies with increasing customer engagement over the years. Their major customers are Givaudan, Firmenich, Symrise, P&G, Henkel, Aromor, Lluch, SH Kelkar, Ashapura and Drom. In order to strengthen its business model and to drive growth, Privi also has direct relationships with global consumer goods giants that are the end-users of its products.

Privi operates out of two state-of-the-art manufacturing plants located at Mahad (about 175 km south of Mumbai). Both the plants have dedicated facilities enabling continuous processing for all the key products, which ultimately results in cost efficiency for the entire production system. Both the plants also enjoy significant cost and logistics advantages because of consistent and on-time deliveries to customers, resulting from the plants' proximity to the Mumbai port (JNPT). One of the plants also enjoys certain tax benefits because of its 'Export Oriented Unit' status.

Privi overcame some significant issues in 2016 and stands poised for a bright future. Low crude oil prices and a slowdown in China resulted in pricing pressures for the worldwide chemicals industry. Despite this, Privi was able to maintain the previous year's revenue with a nominal increase in EBITDA and net earnings. The abnormal delay in receiving permissions from the environment ministry restricted current year growth as the permission was received after the yearly contracts for some customers for certain products were closed, but with better control of current assets, particularly inventories, net operating cash flow has improved.

In August 2016 Fairfax India purchased 51% of Privi for \$55 million. This was comprised of a 30% secondary stake purchase from selling shareholders for \$33 million and a capital injection of \$22 million into Privi for a 21% stake. Based on 2017 projections, we value Privi as follows: price/earnings ratio of 21.9 times and price to book value of 1.9 times. At the end of 2016, Fairfax India's investment in Privi was valued at cost, since there were no changes to Privi's business and capital structure from the time of the transaction.

Additionally, the Boards of Directors of Fairchem and Privi approved a merger of the two companies to build an Indian specialty chemicals enterprise, with both companies converting renewable waste feed-stocks into value-added specialty chemicals. The merger will bring significant diversification and synergies to both partners, with Fairchem gaining access to high quality R&D facilities, and Privi benefiting from Fairchem's focus on cost optimization and capital efficiency. Fairfax India had acquired a 45% equity ownership in Fairchem in the first quarter of 2016. Under the terms of the merger, the Privi shareholders will receive 27 common equity shares and 27 compulsorily convertible preference shares of the merged entity for every 40 Privi shares exchanged (swap ratio of 1.35:1). The swap ratio was as recommended in a valuation report issued by M/s. Walker Chandiok & Co. LLP, independent chartered accountants (a member firm of Grant Thornton in India). ICICI Securities Limited issued a fairness opinion on the swap ratio. After the merger, Fairfax India will own approximately 49% in the merged business. The merger has been approved by shareholders of Fairchem and Privi and the Mumbai High Court and will be effective by March 31, 2017. After the merger, Fairchem and Privi will continue to operate as distinct and independent business units, run by Nahoosh Jariwala and Mahesh Babani respectively.

We prepared a valuation for Privi based on the year-end closing price of Fairchem and the swap ratio. This indicated that Privi's value would be \$94 million, resulting in an unrealized gain of \$40 million or 73%. However, since the merger was still pending at the end of 2016, the unrealized gain was not recognized in our financial statements. Starting in the first quarter of 2017, our investment in the merged entity Fairchem (Fairchem and Privi) will be valued based on the quarter end closing price of the public company, Fairchem.

Sanmar Chemicals Group (Sanmar)

Fifty years ago, when we arrived in Madras (now Chennai) to start our college education at IIT Madras, cricket, while popular, was not the lucrative business it is today. Players were not paid to play and had to depend on the benevolence of business houses and government companies for their livelihood. Sanmar and its owners were big supporters of the sport and the players fifty years ago even as they are today. They are a highly ethical and exemplary corporate citizen today as they were then.

In August 2015 when we met N. Sankar, the chairman, and his son Vijay, the deputy chairman, Sanmar had grown into a large private conglomerate with sales of around \$1 billion and an asset base of around \$1.5 billion. Founded in the early sixties, its business interests spanned chemicals, engineering technology and shipping, with operations in India, the Middle East and the Americas. Fairfax India's investment is in the chemicals business, which constitutes more than 80% of the group's operations and is housed within three operating companies, two in India, Chemplast Sanmar (Chemplast) and Sanmar Specialty Chemicals (SSCL), and one in Egypt, TCI Sanmar (TCI).

Chemplast is Sanmar's flagship Indian company and has been in the chemicals business for 40 years. N. Sankar is considered a pioneer in the poly vinyl chloride (PVC) industry in India. With his visionary leadership, in 2009 Chemplast commissioned one of the largest greenfield PVC projects in India with an annual capacity of 200 thousand tons per annum (ktpa) which has been enhanced to 300 ktpa, mainly through process improvements and minor debottlenecking, with an additional investment of only around \$1 million. The aggregate PVC capacity of Chemplast is 360 ktpa, making it the second largest PVC player in India. Chemplast is also the only specialty PVC company in India.

Sanmar acquired TCI in 2007, with the intention of setting up a large greenfield PVC plant in Egypt to cater to the high growth markets of North Africa, the Middle East and parts of Europe. TCI currently operates a 200 ktpa plant but only produces about 130 ktpa. TCI plans to undertake a \$200 million expansion as follows:

- Phase 1 (\$20 million): Debottlenecking of the existing PVC plant by replacing the PVC dryer which will increase production from 130 ktpa to 200 ktpa. Replacement of the dryer has been completed and the capacity is being ramped up gradually.
- Phase 2 (\$180 million): Addition of a new 200 ktpa PVC plant and a 130 ktpa calcium chloride plant. In addition, a 75 ktpa caustic soda by-product line will also be commissioned. This is expected to be completed in 2018 and the ramp-up to full production is expected to take two years thereafter. Thus, full capacity is expected to be attained by 2020. This will take advantage of Sanmar's significant investment and infrastructure in Egypt.

Our analysis of the PVC industry going back about 25 years indicates that:

1. PVC sales are highly correlated with GDP growth. The auto, housing and construction sectors (key products: pipes and windows) are key drivers of this demand. TCI Sanmar's key market areas of India, Egypt and Turkey are expected to see strong GDP growth and Sanmar has significant cost advantages supplying these countries.
2. PVC margins are not correlated to the price of crude oil or most other commodities.

In 2016 Fairfax India agreed to lend to Sanmar the rupee equivalent of \$300 million by way of non-convertible-debentures (NCDs) for a period of 7 years. The NCDs pay a 3% payment-in-kind (PIK) interest and pay a redemption premium such that the yield of the NCD is 13%. In addition, for \$1 million Fairfax India received a 30% equity interest in Sanmar's chemicals business. Fairfax India funded the initial tranche of \$250 million in April 2016 and the second tranche of \$50 million in September 2016.

From the proceeds of the NCDs, Sanmar plans to utilize \$80 million for capital expenditures at Chemplast (India), \$111 million to repay a loan from private equity firm, KKR and \$109 million to repay other Indian bank loans. At the same time, TCI is entering into an agreement with these Indian banks for a term loan for \$280 million to fund its expansion.

Based on conservative discounted cash flow and option pricing model valuation techniques, we believe that the value of our loan to Sanmar is now \$299 million and the value of our 30% equity in Sanmar's chemical business is \$0.4 million. Based on Indian GAAP for the twelve months ended March 31, 2016 Sanmar's revenues grew by 1% to \$545 million. Until Sanmar completes its capital projects in Egypt and sales ramp up to full capacity, it will lose money. Net loss in 2016 was \$90 million, the same as in 2015. However, earnings before income tax, depreciation and amortization (EBITDA) for 2016 increased 98% to \$65 million. We expect over time to make a compound annual return on this investment in excess of 20%.

There have been some significant developments for Sanmar since our investment. For the first time in a decade, optimism returned to the global PVC industry. This was due to reduced levels of production in China and Europe necessitated by the closure of sub-optimally sized and environmentally unfriendly PVC plants. Limited capacity addition and growing demand led by markets like India and Egypt resulted in very good prospects for the global PVC industry.

Chemplast, driven by strong demand, had very good financial performance in 2016. Margins were very strong, resulting in high cash generation. Chemplast is in the process of setting up a joint venture to manufacture chlorinated PVC (CPVC). CPVC is a fast growing commodity and the joint venture will be only the second domestic producer addressing a big opportunity in India. Chemplast is also in the process of acquiring a hydrogen peroxide plant that gives them the ability to manufacture a value added product that utilizes hydrogen produced by Chemplast, and provides entry into the market for a new valuable and allied product.

TCI has successfully restructured its balance sheet with a capital injection of \$207 million from the parent with a further injection of \$78 million to come in March 2017. Further, as noted above, it has obtained a \$280 million project financing loan from a consortium of Indian banks for its expansion. The key activity for TCI in the next two years will be implementation of the important Phase 2 project described above, on time and on budget. The project implementation activity is on track, orders for long lead time items have been placed and all technology tie-ups are in place.

National Stock Exchange of India Limited (NSE)

Founded in 1992, NSE is the largest stock exchange in India with a market share of over 86% in cash equity trading and 99% in derivatives equity trading. With over 200,000 terminals in over 2,000 centres, NSE provides trading facilities with national reach. The exchange uses the latest communications technology for automated screen-based trading.

Fairfax India decided to invest in NSE for the following reasons:

- It is the leading stock exchange in a fast-growing market.
- Exchange volumes are strongly linked to economic activity and growth.
- NSE has a long track record of developing innovative products and strong risk management protocols.
- At a price/earnings ratio of 14.5 times forward earnings and price to book ratio of 2.6 times, valuations were attractive for a near-monopoly business. Over the last 10 years they generated a return on equity of 19% and grew book value per share annually by 21%.

Since Indian regulations mandated that no single shareholder (other than the two founding shareholders who each own about 10%) could own more than 5%, Fairfax India decided to buy a 5% position in NSE. The position had to be accumulated from several institutional shareholders who were interested in selling. After accumulating about 1% by July 2016 and while in the process of negotiating the purchase of another 3% block, strong rumours broke again that the much-anticipated public listing of NSE was about to be announced. As a result of the rumours, the potential sellers walked away. Fairfax India therefore decided to suspend its efforts to purchase the remainder of the 5% position.

The rumours in fact turned out to be true and NSE has begun the process of launching its initial public offering. Listing is expected to be completed by September 2017.

This was indeed a case of one that got away! However, Fairfax India does have a 1% position bought for \$27 million, and we expect it to make excellent returns on that small investment.

Saurashtra Freight Private Limited (Saurashtra)

Raghav Agarwalla's is a wonderful story! He has transformed a struggling business into a real powerhouse since he took over management eight years ago when he was barely 21. Upon his return from the University of Southern California (USC) in Los Angeles he went straight to live in a dusty little port town called Mundra. You really need to see Mundra town to understand its contrast from Los Angeles!

Saurashtra is part of the privately-held Saurashtra group of companies, which has been in operation for over 30 years and was jointly founded by Surendra Kumar Sinha and Raghav's father, Dipak Agarwalla. The group comprises four companies – Saurashtra Infra and Power (which runs Saurashtra), Saurashtra Fuels, Saurashtra Ferrous and Magnum Shipping Services. All group companies are held equally by the Agarwalla and Sinha families.

Since 2008, Saurashtra has been managed by newly minted USC graduate Raghav Agarwalla. The family asked him to build the nascent container freight service (CFS) business which was struggling since nobody within the family was paying attention to it. Raghav has done a great job in growing the business to its current level.

CFSs are an important link between transport operators and shipping lines and effectively work as an extension of a port. It is in the port's best interest to focus on maximizing container traffic and not get bogged down handling containers that are waiting to be dispatched. Also, ports lack adequate storage facilities to hold containers for extended periods of time. CFSs provide a facility outside of congested ports for temporary storage of goods pending customs clearance and further distribution. Activities like stuffing and destuffing of containers, which might otherwise have to be done in the port, are done at the CFS.

Launched in 2005, Saurashtra is located 5 km from Mundra port. With 24/7 operations, Saurashtra has the capacity to handle 180,000 TEUs (twenty-foot equivalent units) per annum and handled about 88,000 TEUs in 2016, implying capacity utilization of about 50%. It has a market share of about 20% at Mundra port, the highest among all CFSs there. Saurashtra derives volume and revenue from both import and export of containers. While the ideal mix between the two for maximum efficiency is 50:50, the mix is adjusted each year in order to maximize profitability. On exports Saurashtra has relationships with more than 100 customs house agents (CHAs), who select the CFS to use. CHAs, a very fragmented industry, act on behalf of importers and exporters and are licensed by the Indian customs department to perform services related to documentation, packaging, insurance and customs clearance. On imports Saurashtra has relationships with 48 of the approximately 60 shipping lines that call at Mundra port. CHAs and importers utilizing any of the 48 shipping lines are obliged to use and pay for the services of CFSs. In return for directing import traffic to it, Saurashtra pays the shipping line a commission. Shipping lines can have agreements with multiple CFSs, but tend to use 4 to 5 at a port and normally split the cargo evenly among them.

We decided to invest in Saurashtra because:

- We admired Raghav Agarwalla's impressive leadership and track record.
- The growth in the CFS and Inland Container Depots (ICD) industry is correlated to container traffic growth, which during the last 15 years has grown at a rate of 1.3-1.4 times GDP growth, aided by increasing containerization of cargo.
- The CFS industry is highly fragmented: there are 15 in Mundra port and 34 in Mumbai port (JNPT). Since many of these are inefficient and operating below capacity, Saurashtra could serve as a platform for consolidation.
- Saurashtra is located in Mundra port, the second largest and fastest growing container port in India. Also Mundra port is modern and efficient and is in the process of expanding from 3.2 to 6.6 million TEUs.
- Raghav has assembled a management team of experienced professionals, several of whom have come from other large CFSs and shipping lines. Key senior executives have been in their roles for a minimum of four years.
- Saurashtra has a paved container yard, which reduces damage to containers and large warehousing space, and is investing in cold storage, a first for CFSs at Mundra.

- Saurashtra has leased a 30-acre container yard for storing empty containers for shipping lines and has the largest inventory of empty containers which serve as a magnet for export business as empty containers are available on demand.
- Saurashtra plans to increase its geographical footprint by acquiring an existing CFS at JNPT, followed in due course by the acquisition of an ICD in the national capital region.

On February 14, 2017 Fairfax India invested \$30 million to acquire a 51% interest in Saurashtra. \$18 million of the \$30 million will be used to purchase the founder's stake: \$10 million of this will be infused back in to Saurashtra by the founders and used to unwind all previous transactions with Saurashtra group companies. The remaining \$12 million will be invested directly into Saurashtra. Based on projected Indian GAAP financials ending March 31, 2017, this implies a price/earnings ratio of 13.9 times, price/free cash flow ratio of 8.3 times and price to book value of 3.6 times for a business that has over the past eight years grown revenue and EBITDA at 30% and 41% per annum respectively and generated a 20% average return on equity. After the completion of the transaction, Saurashtra will be left with about \$22 million of cash, which it plans to use to pursue its acquisition plans. The Agarwalla and Sinha families own equally the remaining 49% of Saurashtra. It is our pleasure to welcome the Agarwalla and Sinha families to the Fairfax India family.

Bangalore International Airport Limited (BIAL)

In 1991, a panel formed by the national airports authority of India (NAAI) selected the site for a new airport. It was Devanahalli, a village about 40 km north of Bangalore. The impetus for the decision was that the existing airport located 10 km from the city centre, was unable to cope with its fast growing air passenger traffic as Bangalore was beginning to turn into the Silicon Valley of India. There was no room for expansion and the apron could only park six aircraft! It then took another ten years of planning and delays until BIAL was formed as a public-private partnership, with the central and state governments owning 26% and the rest owned by Unique Zürich Airport, Siemens Project Ventures and Larsen & Toubro, a large Indian conglomerate. The agreement between the state government, the central government and BIAL, which was signed in July 2004, awarded a 30-year (extendable by another 30 years at BIAL's option) concession agreement to build a new large and modern airport in Devanahalli, the site that was originally chosen. Under the concession agreement, for 25 years no other airport will be allowed to be built or operate within a radius of 150 km of BIAL. After a 32-month construction period, the airport was inaugurated on May 23, 2008.

The airport is located on 4,000 acres of land and the concession agreement provides for development of 1,000 acres of this land for commercial purposes such as hotels, retail establishments, offices and industrial or entertainment parks. This will permit BIAL to monetize approximately 460 acres after providing land to build roads, utilities, landscaping and other services. This is very valuable real estate because Bangalore, given its congestion, is expanding fast in the direction of the new airport.

From a sleepy and relatively small town in the sixties, Bangalore has truly flourished to become a vibrant and growing metropolis that is now India's third largest and fastest growing city with a population of approximately 12 million. Not only is it considered the Silicon Valley of India, but virtually every major international technology company, social media company, software and software services company, investment bank, consulting company and accounting firm has a major presence in the city. It is estimated that half of the Fortune 500 companies have significant back office operations in Bangalore.

BIAL has tremendous growth potential. While its current capacity is about 20 million passengers per annum, it handled over 22 million passengers in 2016! Plans are already in place to gradually expand the capacity of the airport to 60 million passengers by 2030. This will include building a second runway, an additional terminal building and related infrastructure. Land preparation for the second runway is already underway and about half completed.

Fairfax India's team has done a great deal of work in evaluating the investment potential of all of the four private airports in India (Mumbai, Delhi, Hyderabad and Bangalore). Having considered all of the variables, including the concession agreement, revenue sharing formula with the government and the method for calculating the 16% regulated return, it was Fairfax India's firm conclusion that BIAL was the most profitable and offered the best investment opportunity.

BIAL has three potential sources of revenues:

- **Aero revenue:** Aero revenue, which has grown at 25% per year over the last 8 years, is the revenue earned from airlines for providing services such as navigation, landing, take-off, parking, ground handling and ground safety. Rates for these individual services are fixed in a manner to get the airport operator a fixed 16% per annum regulated return on invested equity. Under the hybrid till approach, applicable to BIAL, 40% of non-aero revenue is considered as a part of aero revenue to compute the regulated return.
- **Non-aero revenue:** All the revenue sources other than from aero revenue are accounted for as non-aero revenue. This includes income from activities such as cargo handling, fuel sales, food and beverage sales and duty free shops. BIAL takes an interest free deposit from all the concessionaires and earns annual revenue on a minimum guarantee, revenue share or fixed rental basis. Non-aero revenue has grown at a CAGR of 16% from 2009 to 2016 and is expected to grow substantially due to an increase in passenger growth rates, the availability of additional space and the increasing propensity of passengers to spend money.
- **Real estate monetization:** BIAL also comes with 460 acres of excess land that can be monetized by the operator. So far, aside from building a hotel next to the airport and leasing it to the Taj Hotels Resorts and Palaces on a management contract, all other land is undeveloped. Bangalore's historical population areas are getting congested, hence, the city is expanding in BIAL's direction. There will be significant upside, over time, from monetization of this real estate, a view strongly validated by Ashwin Ramesh, Fairfax's real estate expert in India.

Prior to Fairfax India's anticipated investment, the ownership of BIAL was:

	% Ownership
GVK Group	43%
Siemens Germany	26%
Zurich Airports	5%
Airports Authorities of India	13%
Government of Karnataka	13%
Total	<u>100%</u>

The GVK Group (GVK) is an Indian conglomerate with interests in energy, resources, airports, transportation, hospitality and life sciences. As part of an effort to reduce its debt, GVK offered to sell a 33% interest in BIAL.

Fairfax India agreed to purchase 33% of BIAL from GVK for \$330 million, implying an equity value for 100% of approximately \$1 billion for the whole company. Concurrently, Fairfax India will also purchase Zurich Airports' 5% interest in BIAL for \$49 million. Based on Indian GAAP 2017 projections, the purchase price values BIAL at a price/earnings ratio of 14.4 times and price to book value of 3.5 times and price/free cash flow ratio of 9.8 times. The value of the real estate that can be monetized is not included in these projections.

We are very excited about this investment.

Financial Position

Fairfax India came into being on January 30, 2015, when it issued 106.7 million shares raising gross proceeds of \$1.1 billion by completing a public offering, a placement to cornerstone investors and an issue to Fairfax Financial. In September 2016 it completed a \$225 million 2-year secured term loan from a syndicate of Canadian banks, led by Scotiabank.

At December 2016, the financial position of Fairfax India was as follows:

	<i>\$ million</i>
Undeployed cash and investments	430.7
Term loan	223.8
Common shareholders' equity	1,075.4
Total debt to equity	20.8%

On January 13, 2017 Fairfax India issued 42.6 million shares at \$11.75 per share in a public offering and a private placement to OMERS and Fairfax Financial, raising gross proceeds of \$500 million. When the announced investments are completed and the term loan is repaid, Fairfax India will be left with about \$230 million for new investments, and ongoing expenses.

Developments in India

On November 8, 2016, Prime Minister Modi stunned India and the rest of the world by announcing his most radical frontal assault on corruption and the scourge of the undeclared and hence non-tax paying “black” economy of the country, which by some accounts represents about half of India’s economic activity. He announced the historic decision to immediately withdraw all of the high denomination currency notes in circulation, the 500 and 1,000 rupee notes (worth about \$7.50 and \$15), and replace them with new 500 and 2,000 rupee notes. Remarkably, the plan was kept secret except to a handful of his closest confidantes even though the printing of the replacement notes had been well underway. People that had the withdrawn notes had until the end of the year to deposit them into banks, but they could immediately withdraw, in new notes, only a fraction of what was deposited. The objectives of what now has been universally referred to as “demonetization” was to tackle the menace of counterfeit currency, terror financing, illicit political funding, bribery, tax avoidance and the black market where cash serves as the medium for undisclosed transactions. This, coupled with the many measures taken to encourage use of electronic payments should over time result in more formalization of the economy, increased tax collections and a reduced hoarding of illicit cash.

In order to understand the gravity and boldness of this decision, you need to understand that it is reliably estimated that about 80% of all transactions in India, both legitimate and black are conducted in cash and that the withdrawn notes represented 85% in value of all currency in circulation.

The reaction was immediate and severe:

- The people attempted to use loop holes to legitimize their undeclared cash. The government moved fast to block the loop holes, resulting in confusion for those just trying to comply with the new regime.
- There were huge line-ups at banks and ATMs as the supply of usable new cash ran low and many ATMs became non-operational.
- People used to doing legitimate business in cash were severely constrained.

The expressed reactions to the move were highly partisan. Those in opposition and generally predisposed to oppose the Prime Minister characterized the move as one of the dumbest of all time, while Mr. Modi’s supporters cheered and said they would take the short term hardships as long as the move helped take away the fruits of illegal activity and bribery from the powerful and rich and resulted, in the future, in more transparent transactions within the official framework.

While the controversy rages on, we believe that Mr. Modi’s motive was focused on reducing corruption, terrorist financing, counterfeiting and tax avoidance that is endemic in India. We believe that there are more actions like this to come!

Based on the latest economic numbers, it appears as though the negative impact of demonetization on the economy was not as severe as those predicted by the nay-sayers. Also, results from some state and municipal elections indicate that the majority of the electorate, despite some hardships, is firmly behind Mr. Modi’s demonetization decision.

Prime Minister Modi continues to aggressively pursue the implementation of all the reform measures that we wrote about in last year’s letter. Many of these reforms required legislative changes. The government successfully passed the following bills by building a consensus:

- The constitutional amendment bill to enable the introduction of a single goods and services tax in place of the current myriad number of indirect taxes.
- The Aadhaar (targeted delivery of financial and other subsidies, benefits and services) act to enable targeted delivery of government subsidies and services using the biometric Aadhaar identity.
- An insolvency and bankruptcy code to help resolve business stress in a timely manner so that the value of underlying assets can be maximized. This is important given the backdrop of large non-performing assets in the banking system.

- The real estate regulation and development act to establish a real estate regulator in every state so that the interests of consumers, and in some cases developers too, can be protected. Bargaining power in the sector which hitherto was overwhelmingly in the hands of the developer should now be more balanced.
- An amendment of the RBI act, introducing a new monetary policy framework. Monetary policy setting has now been entrusted to an independent monetary policy committee (MPC) which has an explicit inflation targeting mandate. The RBI will have a majority on the MPC, ensuring its independence.

India continued to build on the macro-economic stability achieved over the last couple of years with the fiscal deficit, inflation and the current account deficit all projected to fall in fiscal 2017 (FY17).

- The government continued on its path to fiscal consolidation by committing to reduce the fiscal deficit to 3.5% of GDP in FY17. Data for the first 9 months of the financial year suggests the government is on track to achieve this.
- Inflation continued to moderate and in FY17 should average less than 5% for the second consecutive year. While this is partly due to the fall in global commodity prices, the government should be given credit for continuing its tight fiscal policy and allowing only modest increases in support prices for farm products.
- India's current account deficit has continued its declining trend with the deficit likely to fall below 1% in FY17, the lowest in over a decade. Further, the RBI successfully managed the redemption of high cost foreign currency deposits raised from non-resident Indians during the 'taper-tantrum' of late 2013 without creating any volatility in either the currency market or money market.
- As a consequence of continued macro stability, the Indian rupee, compared to other emerging market currencies, remained relatively stable through the course of 2016 despite bouts of global volatility after the Brexit vote and the U.S. elections. In the last three years, the Indian rupee has outperformed a basket of emerging market currencies by a wide margin.
- Continued moderation in inflation, which is now well within the target band of 2-6%, allowed the RBI/MPC to cut interest rates by 50 basis points in 2016. Consequently, interest rates across the spectrum fell. The yield on the benchmark 10-year government security fell by 125 basis points through the year while those on the benchmark 3-month treasury bill fell by about 100 basis points.

The government continues to focus on increasing the enrolment in Aadhaar and using it for efficient targeting of government subsidies and programs. As of January 2017, over 1.1 billion people had been issued the biometric Aadhaar identification number, covering over 90% of the adult population. The government's effort to open bank accounts for those under served by the formal financial system has also continued to yield good results. By the end of January 2017, a total of 270 million bank accounts had been opened. Of these, more than half are linked to the unique Aadhaar number and are thus ready for direct transfer of government subsidies. The government has already shifted the cooking gas subsidy to direct benefit transfer (DBT), whereby the subsidy is directly credited to the intended recipient's bank account. The government is currently doing a pilot study to shift other subsidies such as those for kerosene, food grains and fertilizers to the DBT mechanism. Aggregate subsidies have already fallen due to the decline in oil prices and deregulation of petrol and diesel prices. After the shift to DBT, subsidies are likely to fall further.

India continued to be the fastest growing large economy in the world. GDP growth improved by 40 bps to 7.3% during the first three quarters of 2016, largely due to improvement in agriculture growth to 2.4% from 0.7% last year. Both industry and services growth was broadly stable at 6.4% and 9.1% respectively. Given the normal monsoon rainfall after two consecutive droughts and salary revisions for government employees, consumption demand showed signs of revival in the second half of the year.

On the not so positive side of the ledger, the government has projected GDP growth of 7.1% for FY17, which is lower than the growth of 7.5% in FY16. Further, this estimate may not have fully accounted for the impact of demonetization, so growth could slip below 7%.

Capex activity continues to remain weak due to low capacity utilization levels in many sectors. On the one hand, new capex project announcements grew about 17% in 2016 to \$120 billion, and execution also picked up sharply. On the other hand, stalled projects continue to rise, now totaling about \$180 billion of projects that are stalled due to policy or commercial reasons.

Indian equity markets were relatively flat for a second consecutive year in 2016 as the benchmark rupee Sensex index rose by just about 2%. While total initial public offerings more than doubled in value terms to about \$4 billion, equity capital raised declined 40% to \$10 billion. Inflow from foreign portfolio investors (FPI) was one of the lowest in recent years, with net inflow of \$2.9 billion in equities and net outflow of \$6.5 billion from debt markets. However, domestic flows held up well as domestic equity mutual funds collected more than \$10 billion in net inflows.

Despite these minor negatives, you can see that the government is focused on economic development and inclusive growth. In this environment, the companies that Fairfax India has invested in continue to make significant progress.

Fairfax India has now completed over two years of operations. We would like to acknowledge the leadership provided by John Varnell, who took on the role of founding CFO and shepherded the company through its formation. John has now handed over CFO duties to Jennifer Allen, who has done an outstanding job during the transition and is now fully in charge. We also welcome Keir Hunt, who has taken over as General Counsel and has performed admirably in this role. John will continue as Vice President of Corporate Affairs.

We would like to thank our independent director, Dr. Punita Kumar-Sinha, who has decided not to stand for re-election, for her excellent contribution and wish her well in her future endeavours. We also thank our independent directors, Deepak Parekh, Tony Griffiths, Chris Hodgson and Alan Horn for their wise advice, support and encouragement.

So Fairfax India has ended a very exciting and productive year. We are looking forward to seeing you at the annual meeting to be held on April 20, 2017 at 2:00 p.m., Toronto time at Roy Thomson Hall, 60 Simcoe Street, Toronto, Canada, where you will have the opportunity to meet with Sanjay Kaul, Nirmal Jain, Nahoosh Jariwala, Vijay Sankar, Mahesh Babani and Raghav Agarwalla, the excellent leaders of NCML, IIFL, Fairchem, Sanmar, Privi and Saurashtra. Again, we are truly appreciative of your support as shareholders, and we hope to see you on April 20.

March 10, 2017



Chandran Ratnaswami
Chief Executive Officer



V. Prem Watsa
Chairman