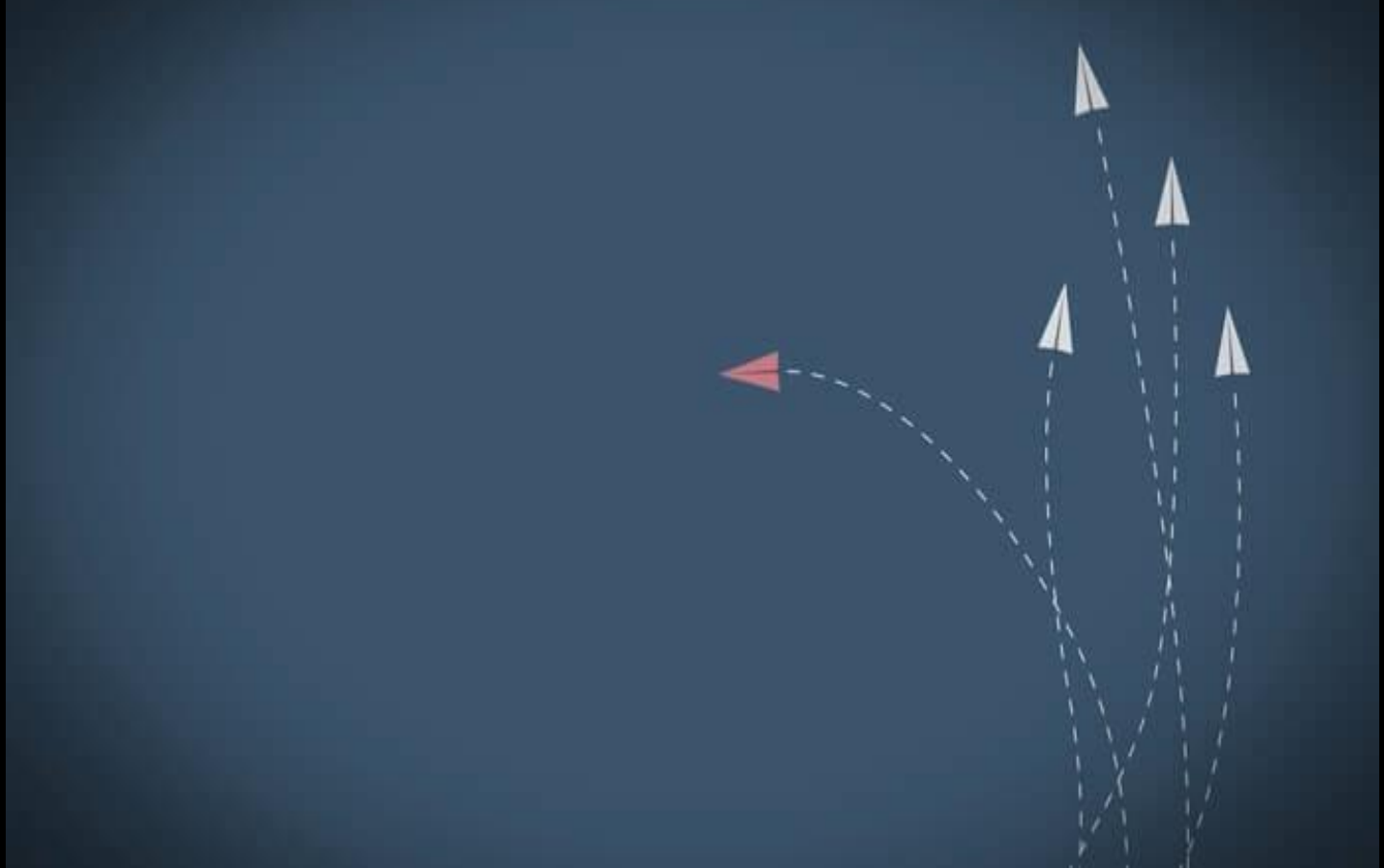


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AMBIT ASSET MANAGEMENT

GOOD & CLEAN
by Ambit

Good & Clean Portfolio



Coffee Can Portfolio



**Emerging Giants:
G&C Small Cap**

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READ ALL SCHEME RELATED DOCUMENTS CAREFULLY BEFORE INVESTING**

Disruption is inevitable: We are prepared

We at Ambit are constantly trying to stay ahead of the curve by drowning out the noise and looking ahead. In keeping with our long term investment thesis we like to stay adept with not just the present impediments faced by your portfolio companies but also long term disruptions which can hit these companies. Hence we will regularly come out with our thoughts on disruptions in our portfolio companies/ sectors and for the first write ups of this series we have chosen the paints sector and Asian paints.

A disruptive technology/ innovation is one that helps create a new market and value network, and eventually goes on to disrupt an existing market and value network (over a few years or decades), displacing conventional wisdom or technology.

Delving right in we realize disruptions can be dime a dozen but we take a closer look at some notable disruptions companies have faced (and brought about) and how responding to this disruption was invaluable. It is not only important to learn from disruption but also to stay ahead by being prepared for it as best possible.

1. BSE: Disrupted by NSE it had to change its archaic ways

- You may remember that not too long ago shares were traded physically. In those times the Bombay stock exchange had the last word on anything to do with stocks. However in 1992 along came the NSE and launched the electronic exchange system which revolutionized the business forever.
- After some years of neglect, finally in 1995 the stock market behemoth BSE was forced to embrace change (launched BOLT system) or face becoming irrelevant. This story had a happy ending for both BSE and NSE, but all may not be as lucky.

2. Micromax: First the disruptor later the disrupted!

- In 2014 Indian budget smartphone maker Micromax ousted Samsung in India as the leading brand in all types of mobile phones. An incredible feat the company did by focusing on prevalent problems customers faced and creating process/ecosystem allowing it to address just that.
- Low cost phones was a key focus in price sensitive India so Micromax championed this cause: It outsourced products from China doing away with manufacturing, used cheaper chips from Media Tek and provided feature heavy phones at low prices. The company took extra care to meet user requirements launching high battery life phones, dual Sim phones and innovative designs with a focus on rural India.
- However once the company's success became well known the jig was up. The company had no sustainable moat and by 2016 it was marginalized at its own game taken to task by Chinese smart phone companies like Xiaomi, Vivo, Oppo.

3. Indigo: Low cost not low quality disrupting the full service carriers

- Against all odds Indigo created a low cost carrier in India and today has a ~50% passenger market share. The company set up shop in a loss making industry amongst heavily competing full service carriers and transformed it by focusing on what mattered.
- Indigo achieved this by focusing on: low cost not low quality, hassle free service and on time performance. A rare and potent combination at the time.
- A smart single fleet strategy, unprecedentedly large airline orders, and superior on time performance made this start up India's first choice for air travel vs established rivals like Kingfisher and Jet Airways. All this while maintaining one of the lowest cost per ASK's (ex-fuel) in the world.

4. Amazon cloud business: a technology company not an e-commerce giant

- While many of us know Amazon as the e-commerce giant some of us know that it makes money not only from retail but also digital advertising and cloud services.
- Constant efforts to self-disrupt and innovate with a *passion for invention* have helped it stay adept to the latest trends. Its hugely successful cloud business is one such example generating ~\$7.3bn in operating income (CY18) –now contributing more than half of the company's operating income and controlling a third of the cloud market while competing with heavyweights like Microsoft's Azure, and Alphabet Inc.'s Google Cloud.
- This is a company that keeps innovating/disrupting and its enormous revenue and market reach have given it unique power to invest heavily in new products and markets.

The company and its strategic planning are guided by four principles: (1) customer obsession rather than competitor focus (2) passion for invention (3) commitment to operational excellence (4) long-term thinking

-Amazon CY18 Annual Report

5. Identity failure at Kodak: A company that thought it was in the film business

- At its peak, Kodak captured 90% of the US film market and was one of the world's most valuable brands. Contrary to popular belief Kodak was not behind in digital capability rather it actually invented the first digital camera in 1975.
- The problem lied in how the company thought of itself. The company had the nearsighted view that it was in the film business and it believed that it could protect its massive share of market with its marketing.
- In the end this blind faith in its marketing ability to overcome the threat of new technology proved fatal. Kodak failed to adapt to a new marketplace and new consumer attitudes.

Focus Piece: Disruption in Paints

Disruption in paints led by Asian Paints

Historically the paints industry has been no stranger to disruption. In India Asian paints has been a pioneer in this effort, always leading the way be it by focusing on the under developed decorative paints segment (when Industrial paints was the norm) or investing in super computers to do advanced data analytics when not many had even seen a computer. These mega disruptions however have been limited given the nature of the underlying industry which served two primary purposes: to protect the underlying surface and to decorate.

The last few years has seen a more gradual disruption and innovation (progression) taking place. Some of these initial efforts are once again evidenced by efforts of market leader Asian paints. Three major areas of focus for progression in FY19 have been:

1. Technology/Innovation paints: FY2018-19 witnessed the launch of 23 new products in the architectural paints segment and 15 in the Industrial paints segment. Notable FY19 launches included:

- Paints with 15 years of waterproofing warranty damp proof range of paints with 10 year waterproofing warranty
- Anti-graffiti self-cleaning paints and anti-dust paints for the fan industry
- Anti-rust enamel paints with 2 year warranty for rust protection were also launched

2. Diversification into Home improvement business:

- Investments in Sleek modular kitchens and Ess Ess bath fittings (chrome plated fittings). Both these businesses did exceptionally well in FY19 while growing at >20%.

3. Environmental sensitivity and Innovations:

- Paints To address safety and health issues conforming to Anti-asthma requirements of American Asthma foundation
- The Company has been taking all possible measures to reduce Volatile Organic Compounds (VOC) levels in paints. Additionally restriction of lead in paints has been a focus area even before it was mandated by the Ministry of Environment Forest and Climate Change in 2016.
- The company launched a new product Nilaya Natural. The product is designed as per Ecocert standard for natural Origin paints and Coatings and more than 97% of its ingredients are either natural or natural origin.

“We continue to be inspired in expanding our wallpaper range, wall stencils, wood finishes, adhesives, and waterproofing solutions, primarily according to the changing consumer preferences.”

- Asian paints AR19

“We are now confident that they (kitchen and bathware) would be growth drivers of the future.”

- KBS Anand, MD & CEO Asian Paints

Paints Industry: From progressions to disruptions

1. Regulations can be a major disruptive force

- Take for instance the US coatings and paints industry in the 1970's was essentially marketing a technology described as low solids, solvent borne paint or coating to most of the end-users in North America. In December, 1970 the EPA (regulator) demanded a monumental changes in solvent emissions causing the industry to change the way they did business.
- In India regulations have protected incumbent thus far and stringent norms have created barriers to entry for the organised paints segment in the country while environmental requirements have been behind some developed economies. A deregulation of these norms can lead to removal of the barriers to entry and make competition more prevalent in paints. On the other hand an increase in focus on emissions and environment can require a change in the way the business is done (product/distribution/labour).

“Our long-term ambition is further evidenced in the way we are embracing open innovation. New ways of doing things often require new ways of thinking”

- Thierry Vanlancker, CEO and Chairman, Akzo Noble

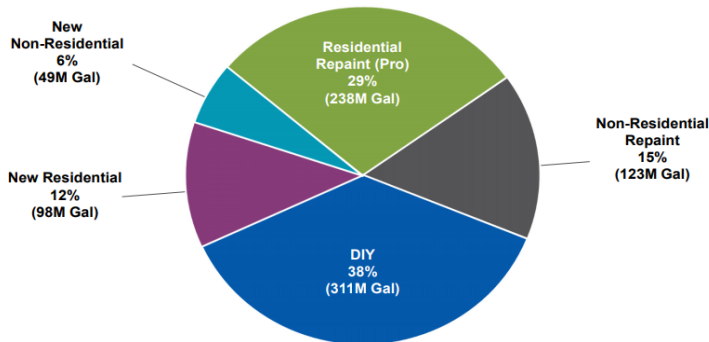
2. Change in preferences

Particulars	Overview
Paint substitutes/ tiles/wall papers	<ul style="list-style-type: none"> Reduce painting time and increase convenience
Repaint demand frequency reduced by better quality	<ul style="list-style-type: none"> Repaint demand is strong/ frequent in India but advanced weather resistant products may drastically reduce demand
Do it yourself (DIY)	<ul style="list-style-type: none"> Still a wave that has not touched India so far due to availability of cheap labor. As labor costs for painting become larger portion of the expense, from the perspective of the application process, do-it-yourself painting can prove disruptive in India. In time if this picks up and it can significantly change the way business is done right from distribution, purchase, price and product mix.
Do it for me	<ul style="list-style-type: none"> While parts of the world go through a DIY wave some developed markets are going through a "Do it for me wave" whereby they are willing to pay for a professional to come and do the painting on their behalf. The thinking is my time is more important and <u>I don't mind paying</u> someone to do it for me.

Source: Ambit Asset Management

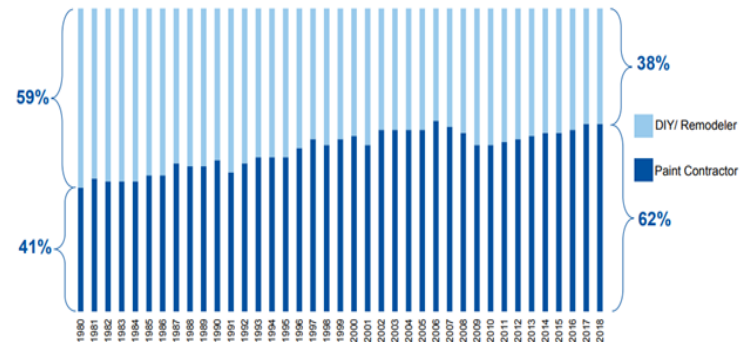
Sherwin Williams is a US based company which much like its US/European peers has a high share of DIY customers (38%). The company recognized this large DIY segment, over the years steadily building increased capability in its painting accessories and equipment segment to hugely benefit. Companies need to constantly adapt and change. The trends in western countries have shown a decline in DIY for a preference for Do it for me painting, no doubt great companies will constantly adapt to the "new normal"

Exhibit 6: While DIY can gain momentum in India, US/Europe manufacturers have large DIY customer base (Pictured below Sherwin Williams US customer mix)



Source: Ambit Asset Management

Exhibit 7: DIY is however fading in these markets and Do it for me is gaining momentum (Pictured below Sherwin Williams US customer mix)



Source: Ambit Asset Management

3. Aggregator based model: It's the era of aggregators. Taking a leaf from the models of players like Uber, Urban Clap and the like Berger paints has tried an aggregator model of its own by creating huge inventory of painting contractors. If a homeowner contacts the company they will arrange a painter from the vicinity.

4. Removal of inhibitors in the processes: Berger for instance had launched an Express Painting (XP) initiative few years ago based on customer insights. "Most people put off repainting off their homes troubled by the thought of dust flying when the manual sandpapering is done prior to painting," Sandpapering done by machine can reduce time taken by upto 40% and also employs an inbuilt vacuum which does away with the 'dust problem' .As these technologies and services become more affordable it will lead to huge disruption with maximum benefit going to first to enter and scale.

5. The Buying process gets significantly altered

Particulars	Overview
Organised retail formats	<ul style="list-style-type: none"> Can be a major disruption in the way that retailers and fabricators purchase products in home building, India has not been so much of a DIY market so far but this can be a major disruption in years to come that would lead to need for change in distribution model. (E.g. <i>Shankara Building Products</i>)
E-commerce	<ul style="list-style-type: none"> Demand pick up for Building material/Paint products) through consumer facing platforms (e.g. <i>Pepperfry</i>, <i>Urban Ladder</i>) OR <u>More radical</u> forms of addressing paint requirements head on through modern platforms launched in the west such as <i>Clare.com</i> which might lead to change in paint demand including preference to purchase goods based on convenience, price and customer support/colour consultancy.
Live space/Godrej Interio	<ul style="list-style-type: none"> In the near future we can see a more prominent role played by companies such as <i>Livespace</i> in end to end home interiors or companies like Godrej Interio which are involved in home and workspace solutions. As prominence of such companies increases it will have a higher influence on the end purchase decision vs the brand itself just like Jabong would have over purchase of fashion products today. Exclusion from these platforms, tie up with new and existing competition or direct sale by these platforms from their own brands can cause disruption to the status quo. We feel paint will play a big role in transforming home/work spaces going ahead and that's what these companies are looking to do.

Source: Ambit Asset Management

6. Change the way we build things:

- 3D printing: Manufacturing of buildings on a larger scale (starting with smaller structures) might change the way we build things (process, product, appearance and consumption). e.g. might require 3D printer friendly raw materials, paints, colours which eliminate the need for factory production or traditional painting
- Smart connected home: Homes of the future could make use of digital surfaces or LED surfaces which might not need painting.
- Preference for non-painted/rustic looks: As is prevalent and also cost effective a lot of commercial spaces (especially restaurants) have begun to use architecture that requires minimal paint and maintenance. Use of green designs and glass based natural lighting structures to conserve electricity and reduce cost can also lead to lower demand in paint in new structures over generations to come.

“Enriching life by transforming home and work spaces.”

-Godrej Interio Mission statement

Besides thinking about the immediate next steps for your portfolio we at Ambit are constantly trying to stay ahead of the curve and in keeping with our long term investment thesis like to stay adept with long term disruptions your companies can face in the future. This note takes a closer look at the disruptions and innovations at Asian Paints today (and historically) with the (1) Technology/Innovations in paints, (2) Diversification into Home improvement business (Ess ess and Sleek) and (3) Analytics, Environmental sensitivity and related innovations. It also seeks to identify progressions and disruptions we can foresee for tomorrow for the paint Industry on the whole and consequently your portfolio.

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