Acumen at work

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AMBIT
ASSET MANAGEMENT

Coffee Can Portfolio

Not a Doomsday yet

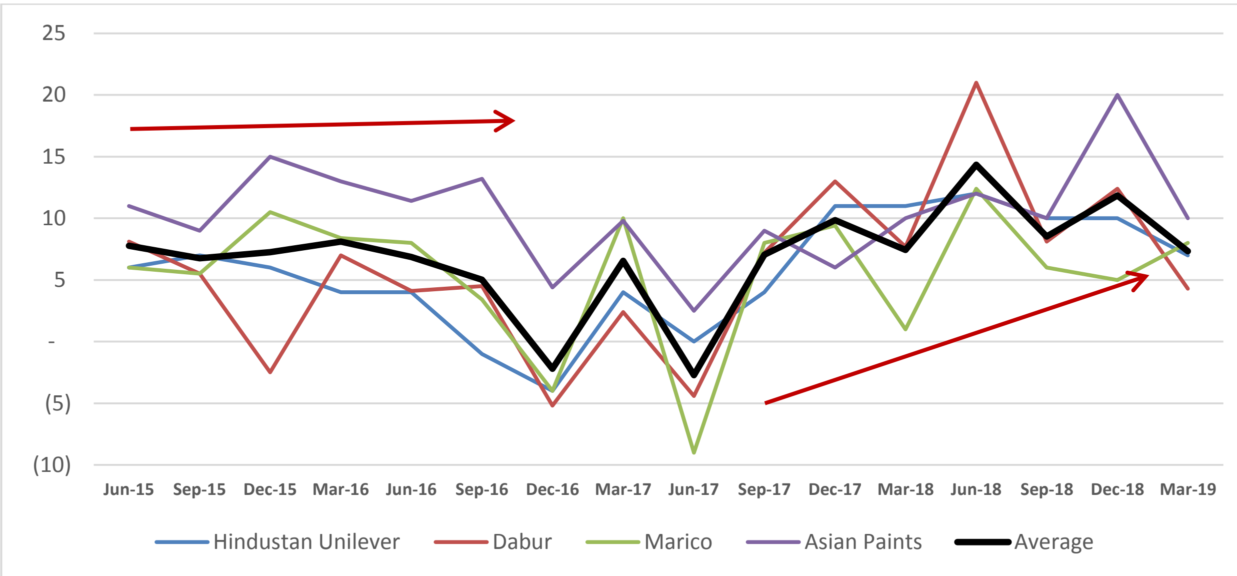
Dear Investor,

Post the union budget for 2019-20, Indian equity markets have witnessed a broad based selling with all major indices yielding negative return in July '19. We do believe that FII selling, the first instance this calendar year, has been a significant contributor to the same. The negative sentiment has been further compounded by a dismal Q4FY19 earning. Given the weak macroeconomic conditions, expectations from Q1FY20F too remain muted. The current prevalent, risk off sentiment is also fueled by trust deficit in the financial market and the liquidity conundrum.

As mentioned earlier, getting into the quarter, earnings expectations have been moderate largely due to weak demand condition and lack of channel financing. We had witnessed some early evidence of the same, in growth trajectory slowdown happening in Q4FY19 to conclude that the trend was likely to accelerate further in Q1FY20F.

However, contrary to consensus belief, results in Q1FY20 so far have been fairly encouraging and quite surprisingly resilient. Enough companies have reported results to come to an early conclusion on consumption trend. Consumer sector is an ideal indicator of economy health. While there has been some incremental slowdown in rural growth and some climb down in trajectory of volume growth, but by and large they have been better than what most believed initially.

On a two year quarterly average basis (average of Q1 last year and Q1 this year) HUL's volume growth stood at ~9% and if you leave out Q3FY19 (11%), and then this is the best volume growth registered since March '12. Similarly, Dabur reported 9.6% volume growth on a fairly higher base of 21% YoY. So, have Colgate (4% volume growth), Asian Paints (high double digit growth), and United Spirits (8% volume growth). All of these number were much higher than street estimates, and indicate that things are not that worse as envisaged (refer chart below).



Banking & Financial services sector, have so far reported better than expected numbers. However, with the tight liquidity scenario in the wholesale lending and some early concerns emerging on quality of retail loan book, banks expects that there could be slight deterioration in assets quality for ensuing quarters. This we believe is the key reason for the market to retain its cautious stance on frontier banking and NBFC names.

Auto sector, after a good run up from 2016 to 2018, saw signs of slowdown by mid of 2018. The situation got worse with the onset of liquidity crisis. Auto sector growth is primarily dependent on financing and with the liquidity crisis we have witnessed double digit volume decline in monthly numbers. What has further dampened the growth environment is the increased cost of ownership related to insurance, BS-VI. The recent hike in registration cost is the death nail in coffin.

We are of the view that while there has been incremental slowdown in economy which is visible on the ground, it has been more aggravated by the liquidity crisis and trust deficit which has engulfed the financial market. The lack of trust in financial system is probably stopping Indian economy from being in decent growth zone as people have reduced transacting fearing the worst. In the current environment, banks are cautious, NBFCs are unable to lend, and wholesalers are not able to rotate capital, which is reflecting in weak sales and thus economy tightening. One unique conclusion which came out post our interaction with many companies over the last 6 months, is that trade partners are finding it very difficult to rotate capital and sales are getting impacted adversely, especially in Auto and consumer durables.

However, looking at this quarter earnings of consumer staples, it is so far showing that inherent demand is more than what was envisaged, and it is only a matter of time till we see things turning for good. So is the case for other sector like cement, Infra, private banks, and home building where things reported are better than expected.

Another noticeable thing in the last one month has been the stark movement in the G-Sec yield, which has slid to 6.5% from 6.8%. The interest environment is expected to remain conducive given low inflation expectations for ensuing quarters. However, the transmission of rates has not picked up. We are of the view that transmission of interest rate cuts and rebuilding of trust in financial lending, will be the key to see growth coming back to the economy. Once the trust comes back in the system, economy should improve, as formalization and increased compliance (due to effective implementation of E-way bill & GST) is happening for sure.

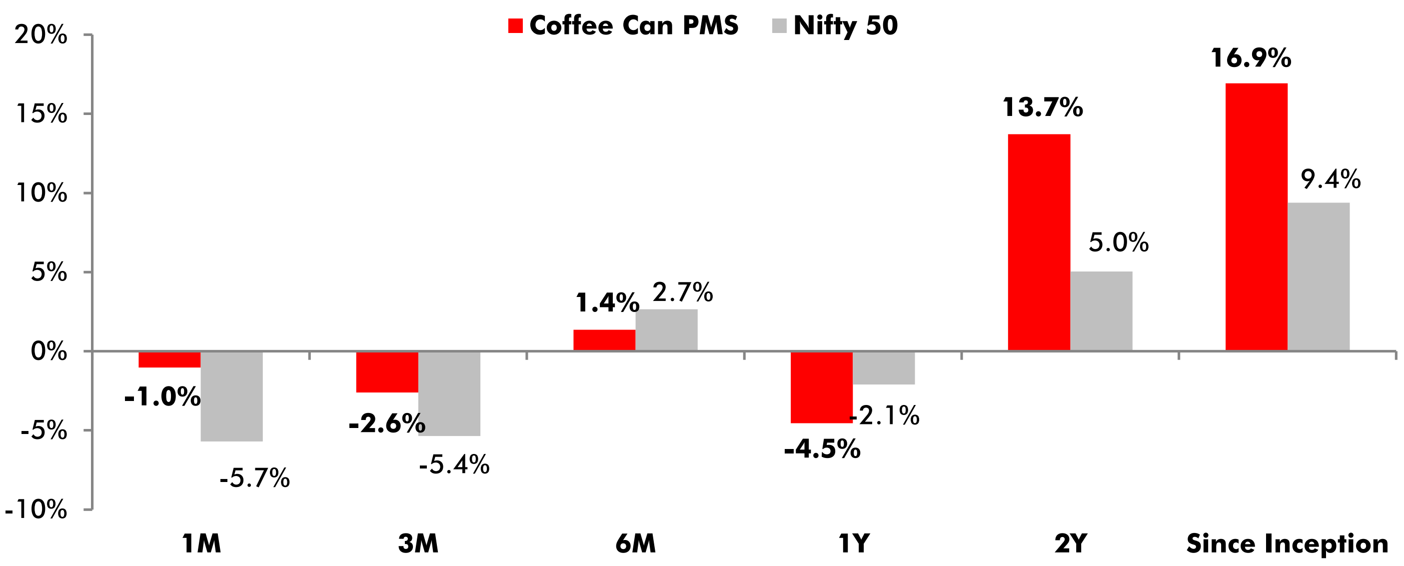
With more increased compliance and paucity of capital, many unorganized players in different pockets are shutting shop, eventually shifting volumes to organized players. Formalization should materially benefit our portfolio companies, given the shift from unorganized to organized theme gaining pace.

Last but not the least, if we compare the ten year G-Sec yield and Nifty 50/ and Nifty midcap 100 earning yields, the difference has narrowed to one of lowest in the last ten years, which indicates the market is in oversold zone (especially the broader market) due to adverse negative sentiment. Added to that, multiples of good companies have come down and offer great investment opportunities. We believe this is the correct time to build a portfolio for the long term.

Ambit Coffee Can Portfolio

At Coffee Can Portfolio, we do not attempt to time commodity/investment cycles or political outcomes and prefer resilient franchises in the retail & consumption oriented sectors. The Coffee Can philosophy has unwavering commitment to companies that have consistently sustained their competitive advantages in core businesses despite being faced by disruptions at regular intervals. As the industry evolves or is faced by disruptions, these competitive advantages enable such companies to grow their market shares and deliver long-term earnings growth.

Exhibit 1: Ambit's Coffee Can Portfolio performance update



Source: Ambit; Portfolio inception date is March 6, 2017; Returns as of July 31, 2019; All returns (except Since inception) are absolute returns net of fees & expenses; **Note:** *Returns prior to Apr'19 are returns of all the Pool accounts excluding non-aligned portfolio, and returns post Apr'19 is based on TWRR returns of all the pool accounts.*

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