MONTHLY NEWSLETTER

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AMBIT
ASSET MANAGEMENT

Emerging Giants:
G&C Small Cap

After deteriorating macros through the early part of last year, the December quarter saw a favorable macro backdrop. INR appreciated by 4% to $69.5 after reaching all-time low at $74.5 in early October & Brent crude recovered from over $80/bbl to $53/bbl. 10Y bond yields also rallied 60Bps to 7.4% as the RBI undertook several measures to stabilize liquidity post the tightening of financial conditions from IL&FS default.

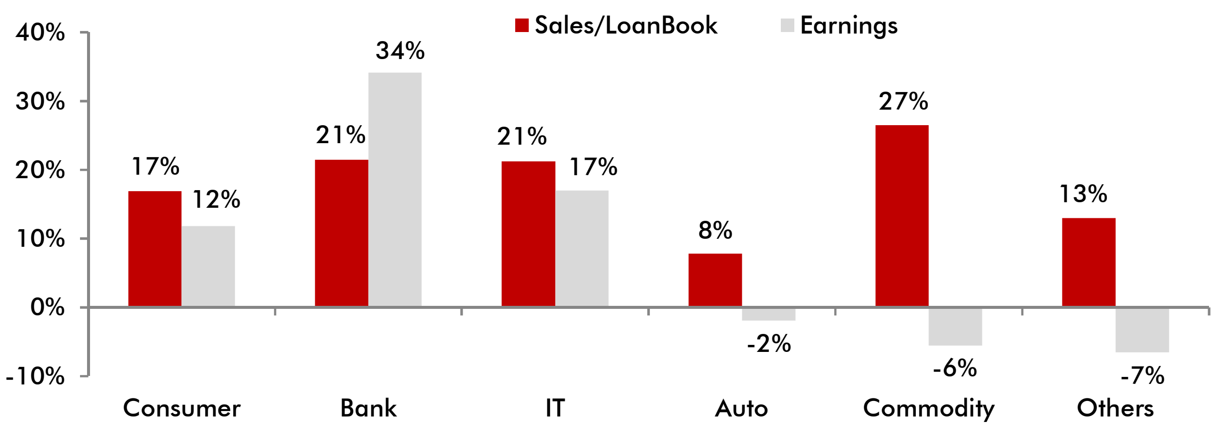
Against the macro backdrop, overall, the quarterly earnings for the BSE Sensex displayed strength led by **corporate lending banks**. In first signs of revival of investment cycle, corporate lenders showed high loan disbursements and the sector signaled the end of NPA cycle. While on the other hand despite lower G-Sec yields, the spreads for **NBFC**'s increased. NBFC earnings were severely impacted by liquidity tightness in wholesale debt markets and the sector showed signs of stress with rising borrowing cost, declining interest margins & declining loan disbursements.

Given that a significant part of **passenger vehicle** is financed by loans from NBFC's, it seems clear that the rise in cost of funding for NBFC's is affecting demand. Volume growth was negative & high promotion expense combined with input cost pressures dented margins for the leading car manufacturer. Even in **2-wheeler space**, rising insurance premiums & fuel costs dented consumer sentiment and the resulting discounts by manufacturers negatively impacted margins.

The resilience of **consumer/FMCG** sector continued. With near normal monsoon, stabilization post demonetization/GST and state intervention to boost farm incomes – consumer companies displayed double digit revenue growth. Further, the cooling off of commodity prices provided strong support for margins expansion.

IT companies continued to deliver strong revenue growth & margin expansion led by strong demand from the US economy & currency tailwinds. Among the other sectors, **Telecom** remained impacted by high competition intensity, discounted pricing & high leverage.

Exhibit 1: BSE 30 Sensex Sales & Earnings growth (Q3-2019 vs. Q3-2018):



Source: Ambit Research; Note: Does not include 6 companies (2 Auto, 3 commodity & 1 other) whose Q3 results have not yet been announced

Interim Budget: The key announcement from the vote on account interim budget was the Rs.6000 handout to small farmers and proposed income tax exemption for up to Rs.5lakh total income. With increased government spending in run up to elections, G-Sec yields are not likely to drop despite the expected RBI rate cuts. All of this will eventually bring more money in the hands of the consumer and signal a huge positive for consumption sector. NBFC sector and consumption growth fuelled by borrowing is likely to continue witnessing a slowdown. Given the deep inter-linkages between NBFC's & real estate, we foresee stress in the NBFC sector to creep into real estate sector as well.

Emerging Giants: G&C Small Cap

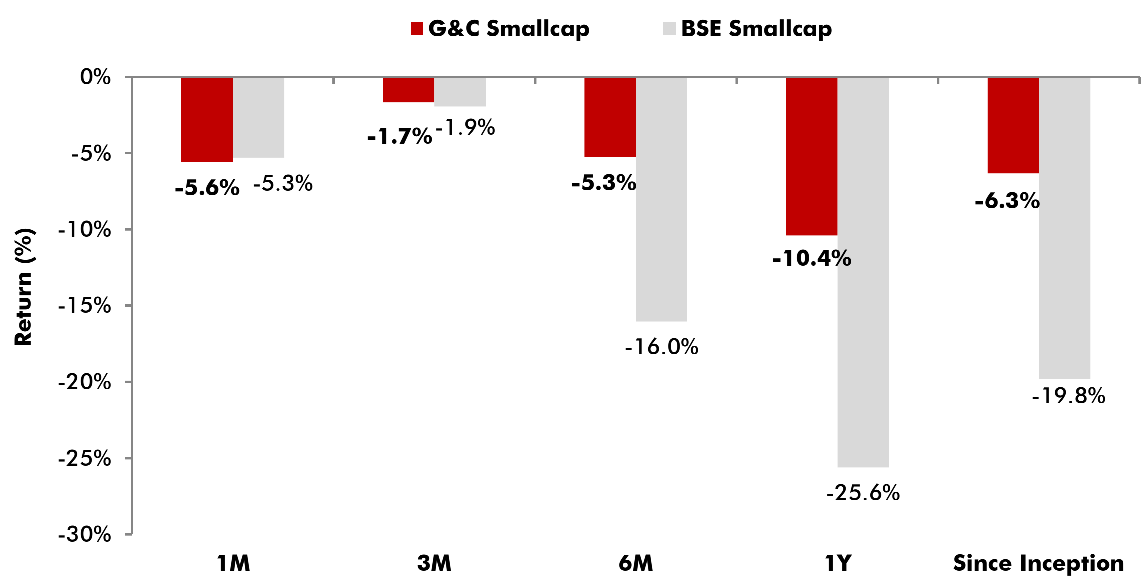
Smallcaps with secular growth, superior return ratios and no leverage

Ambit's Emerging Giants portfolio aims to invest in small-cap companies with market-dominating franchises and a track record of clean accounting, governance and capital allocation. The fund typically invests in companies with market caps less than Rs4,000cr. These companies have excellent financial track record, superior underlying fundamentals (high RoCE, low debt) and ability to deliver healthy earnings growth over long periods of time. However, given their smaller sizes these companies are not well discovered, owing to lower institutional holdings and lower analyst coverage. Rigorous framework-based screening coupled with extensive bottom-up due diligence lead us to a concentrated portfolio of 15-16 emerging giants.

- **Rigorous stock selection process:** Starting at a large investible universe of about 1,300 smallcaps, Ambit's proprietary frameworks along with extensive bottom-up research helps create a concentrated portfolio of 15-16 companies at any time. The process focuses on identifying companies which in addition to being clean on governance and accounting, have business models that are profitable, scalable, sustainable and self-funding for their growth requirements.
- **Long-term horizon/low churn:** Our holding horizons for investee companies are 3-5 years and even longer with annual churn not exceeding 20-25% in a year. The long-term orientation essentially means investing in companies that have the potential to sustainably compound earnings, with the compounding earnings acting as the primary driver of investment returns over long periods.

As laid out in the recent months' newsletters, liquidity environment is getting tighter and thereby increasing volatility in equity markets. Hence investors should be wary of investing in companies/sectors with dubious accounting practices, high leverage and capital miss-allocation. In general, as cost of capital rises and money becomes dearer, investors should become more cognizant of quality. This in turn should hold the Good & Clean portfolio in good stead.

Exhibit 2: Ambit' Emerging Giants: G&C Small Cap performance update



Source: Ambit; Portfolio inception date is December 1, 2017; Returns as of January 31, 2019; Since inception returns are annualized. ***Returns are net of all fees and expenses***

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