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AMBIT
ASSET MANAGEMENT

Emerging Giants:
G&C Small Cap

Value trap in the Indian Markets

India has proved to be a graveyard for traditional value investing strategies. Almost always, companies with Low PE trade at those values deservedly so due to 1) Poor Accounting quality 2) Fraudulent Management and 3) Inefficient Capital Allocation. As shown in exhibit below earnings of value stocks (as measured by lowest PE ratio or the 4th quartile) remain the weakest over the long term.

Exhibit 1: Earnings of value stocks are weakest in the long term

Quartiles based on starting P/E multiple	Subsequent Median earnings growth (%)		
	3Y	5Y	10Y
Q1 (high P/E)	16%	9%	14%
Q2	11%	8%	10%
Q3	5%	6%	7%
Q4 (low P/E)	**-16%**	**-5%**	**7%**

Source: Ace Equity, Ambit Research; Note: Universe represents all the listed companies whose data are available for subsequent periods; Stocks with negative P/E and P/E above 200 are excluded; 10Y represents PAT cagr from FY08 to FY18; 5Y represents PAT cagr during FY13-FY18; 3Y represent PAT cagr during FY15-FY18;

Firstly, accounting is as much an art as it is a science. Creative means are used by companies' management to show the best possible reflection of financial performance to maximize earnings, the stock price and ultimately their own stakes through ownership/stock options. Generally accepted accounting principles or GAAP are nothing more than what it is called i.e. "generally accepted" and provide enough maneuverability to the management to distort the reality.

Secondly, companies with shady managements & promoters go a step further and commit blatant fraud rather than just window-dress books of accounts. Siphoning off precious funds from public companies by fraudulent promoters is all too common.

Finally, very few companies maintain focus on their core business and aim to build and grow sustainable competitive advantages. Rather, as soon as a company grows in size, hubris sets in and the company looks at high growth opportunities entering into new business lines and expensive acquisitions. Very few managements and companies look at relative value addition (returns over cost of capital) for capital allocation decisions.

How do we at Ambit overcome these challenges?

While quantitative filters are a good starting point to stock picking, many a times, numbers are not as they seem. A further deep-dive into the business model, growth prospects, governance & management provides a complete picture and is required to build a high quality & high return generating stock portfolio, especially in the Indian context.

Forensic Accounting framework: Our robust accounting framework penalizes companies that conduct accounting jugglery to show a distorted picture different from the true economic reality. We extensively screen and avoid companies that have aggressive revenue recognition policies, aggressive provision practices, questionable related party transactions and poor quality of auditors. Our valuation models further focus on actual cash flows earned rather than accounting earnings which are calculated on accrual basis.

Focus on highest quality corporate governance: We only focus on companies with a truly independent board, empowered management & strong corporate governance. We stay away from questionable companies & management and undertake several checks to ascertain quality of management and corporate governance.

Companies with undeterred focus on core business: We like companies that have unwavering focus on core competencies and laser-like focus on core business. This enables them to build structural competitive advantages, grow their competitive moats and gain market share from other players who lack the same amount of dedication & focus.

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.

EG portfolio companies continue to deliver healthy earnings growth

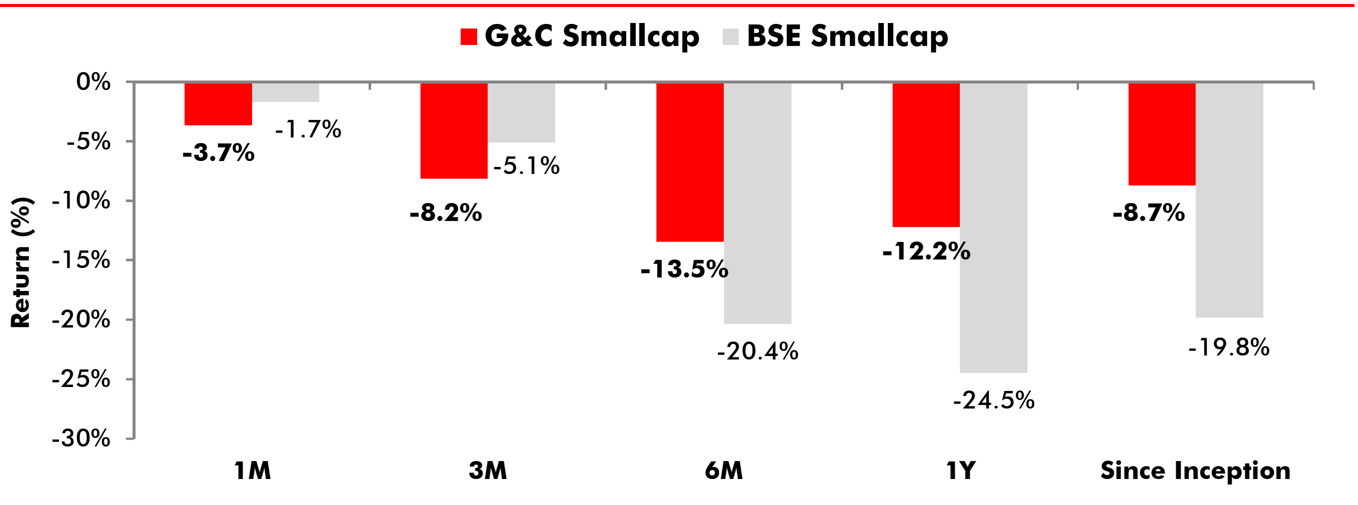
In FY19Q3, Emerging Giants portfolio companies delivered healthy revenue growth and strong earnings. As shown in the exhibit below, the portfolio companies showed an average Revenue/EBITDA growth of 25%/20%. On a stock specific level, EBITDA margin of few companies were under pressure due to higher input costs, which we believe will be passed on with a lag. But on a portfolio level, the results have panned out well, which is on the back of 22%/21% growth witnessed in the 2QFY19 quarter. We therefore don't believe that anything has fundamentally changed for our portfolio stocks.

Exhibit 2: G&C Portfolio Companies Q3-19 Performance

Growth	Average		Median	
	YoY	QoQ	YoY	QoQ
Revenue	25%	9%	16%	6%
EBITDA	20%	8%	6%	4%
PAT	24%	71%	14%	-4%

Source: Ambit Capital Research

Exhibit 3: Ambit' Emerging Giants: G&C Small Cap performance update



Source: Ambit; Portfolio inception date is December 1, 2017; Returns as of February 28, 2019; Since inception returns are annualized. ***Returns are net of all fees and expenses***

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