MONTHLY NEWSLETTER

AMBIT
Acumen at work

June 2018

AMBIT

ASSET MANAGEMENT

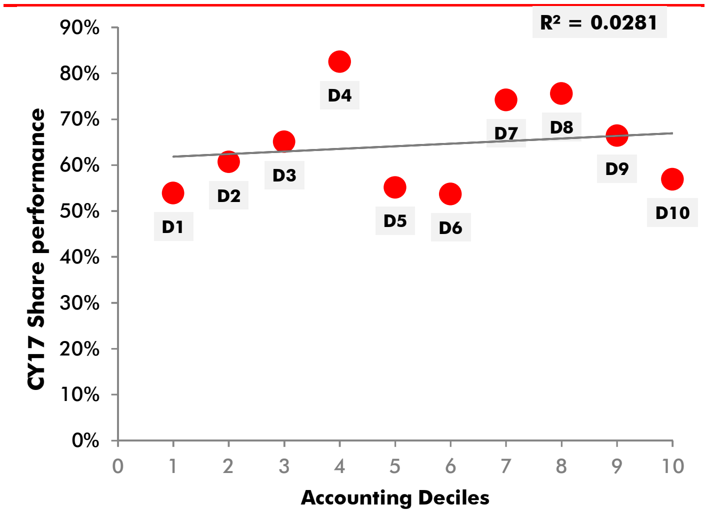
Emerging Giants (Good & Clean small cap)

Focus back on accounting quality

In the long run, good accounting quality and efficient capital allocation (in some ways reflected in higher ROCEs) define investment success. A look at longer-term stock returns suggests a direct relationship between better accounting quality and superior stock performance. Similarly, over the long run, there is a strong link between ROCEs and share price performance. Yet in the shorter run, markets do have a tendency to test patience even with most time-tested and rational investment methods. For instance, the bull market of CY17 saw speculative excesses being created in lower quality stocks. In CY 2017, the worst 20% stocks on accounting quality outperformed the Sensex by nearly 35% points.

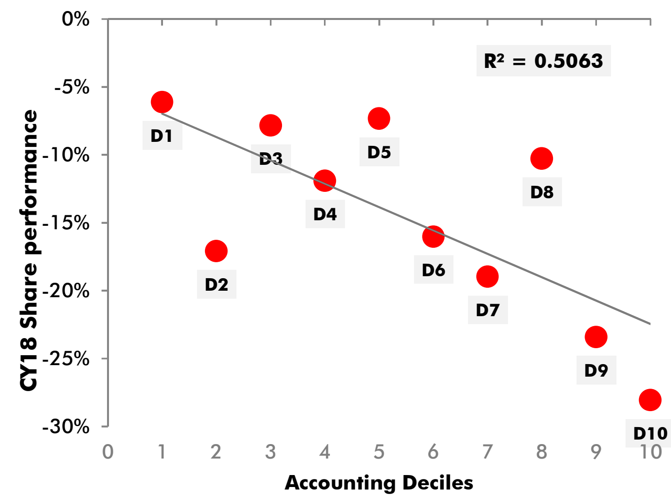
However, things have changed with the onset of CY18. As the cost of capital rose (reflected in the rising bond yields), liquidity started drying up and equity markets turned volatile. This, in turn, has made investors more selective. Recurring news flow on auditor resignations has further spooked investors of late. All of this, in turn, has brought the focus back on accounting quality. This has resulted in good quality companies outperforming their poor quality counterparts by a considerable margin in CY18 so far – clearly, a departure from the trend witnessed in the bull market of CY17. The exhibits below clearly bring out the above divergence.

Exhibit 1: Accounting quality took a back seat in CY17...



Source: Ambit, Ace Equity, Bloomberg

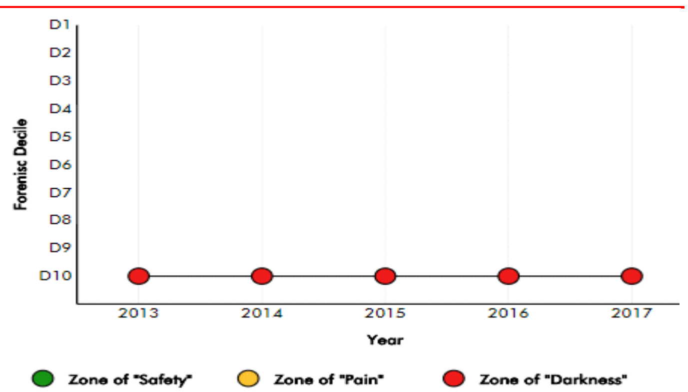
Exhibit 2: ...but back in the reckoning in CY18



Source: Ambit, Ace Equity, Bloomberg

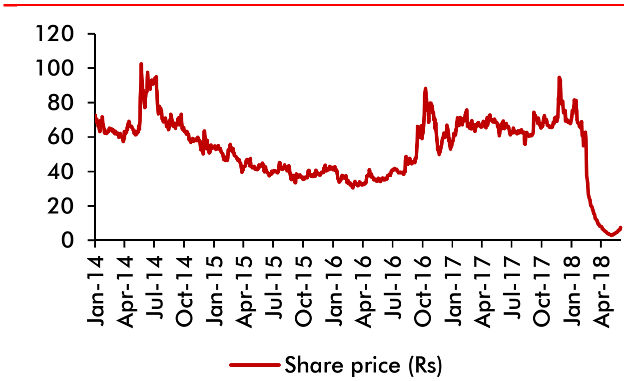
The important take away for investors therefore is that there are prolonged periods when markets deviate from rationality. Sticking to a sensible process in such periods is imperative rather than being bogged down by near-term share price performance. Because when things do revert back to rationality eventually, it is likely to happen at a pace rapid enough to catch everyone unaware. Consider for example the case of a jewellery company that was in the limelight recently for all the wrong reasons. The stock had always been an inferior performer on our accounting frameworks. Yet the stock price more than tripled between 2016 and 2017, before eventually losing 90% within just four months.

Exhibit 3: The Jewellery Company consistently featured in lowest accounting decile in Ambit's accounting framework...



Source: Ambit, Ace Equity, Bloomberg

Exhibit 4: ...with its stock price eventually catching up with its poor accounting score

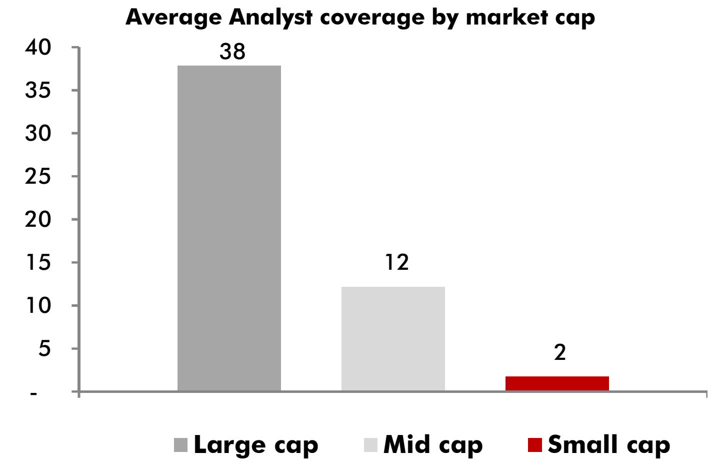


Source: Bloomberg

Small cap investing is rewarding

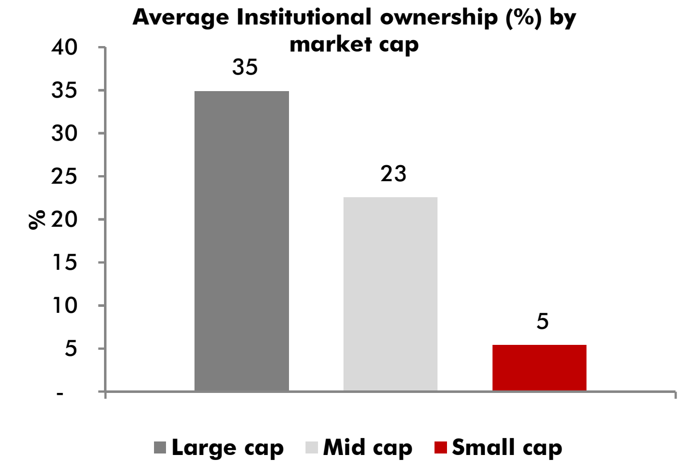
Due to the small market capitalisation and low liquidity, most of the small caps don't fall within the consideration set of large institutional investors as well as sell-side analysts' research coverage. On the other hand, owing to their smaller size, non-linearity in earnings growth can be significantly higher than large caps for scalable business. These opportunities but low information availability creates mispricing opportunities in the small cap space.

Exhibit 5: Low analyst coverage for small caps



Source: Bloomberg, Ambit Note: Large cap above represented by largest 50 listed companies, Mid –cap from 51st to 500th largest listed companies and Small cap by 501st to 1,500th largest listed companies

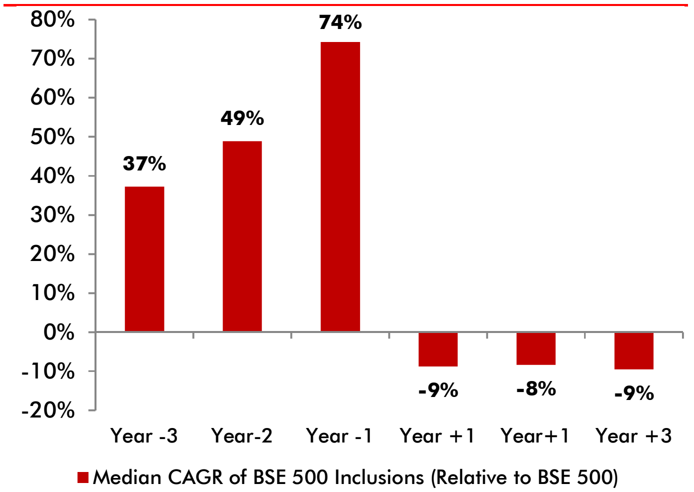
Exhibit 6: Low institutional ownership in small caps



Source: Bloomberg, Ambit Note: Source: Bloomberg, Ambit Note: Large cap above represented by largest 50 listed companies, Mid –cap from 51st to 500th largest listed companies and Small cap by 501st to 1,500th largest listed companies. Data as of July 31st, 2017

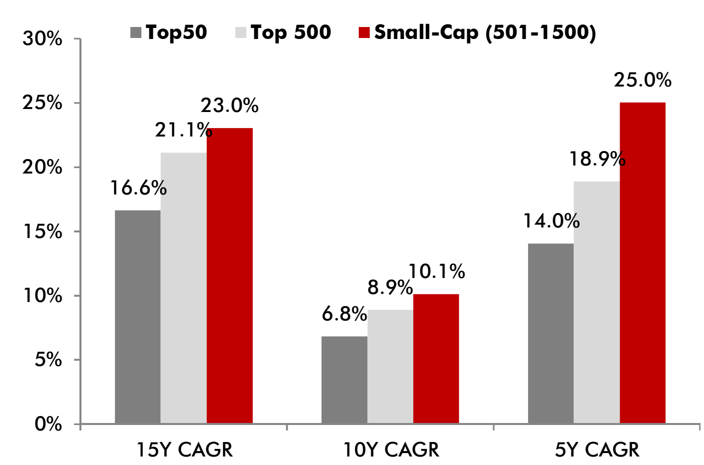
The widely tracked universe of larger companies such as the BSE500 itself churns at 30% over a 5 year period. That is, 150 new entrants replace existing companies every 5 years. Interestingly, before their entry into the index, the entrants have already outperformed by over 35% per annum. Hence, identifying these winners early on (in their small cap avatar) can be quite enriching for investors.

Exhibit 7: Relative performance of BSE500 inclusions pre and post inclusion



Source: Bloomberg, Ace Equity Note: Data as of July 31, 2017

Exhibit 8: Small caps have outperformed their larger peers historically in India



Source: Source: Bloomberg, Ace Equity Note: Data as of July 31, 2017

Emerging Giants – Small caps with secular growth, superior return ratios and no leverage

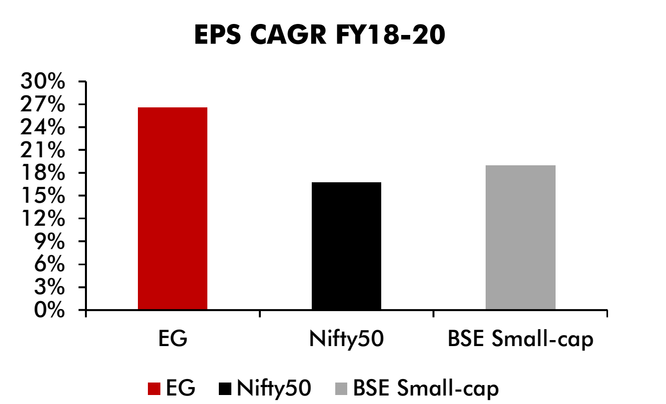
Ambit's Emerging Giants portfolio aims to invest in small-cap companies with market dominating franchises and a track record of clean accounting, governance and capital allocation. The fund typically invests in companies with market caps less than Rs2,500cr. These companies have excellent financial track 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 relative large investible universe of about 1,300 small caps, 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 this earnings compounding acting as the primary driver of investment returns over long periods.

As highlighted earlier, small caps investing can be rewarding. However, at the same time, low research coverage and in some cases, relative young history of operating performance implies a higher degree of diligence required before investing. In this context of opportunities but at the same time perils of investing in small cap space, we believe our Emerging Giants portfolio is relatively well positioned due to the following reasons:

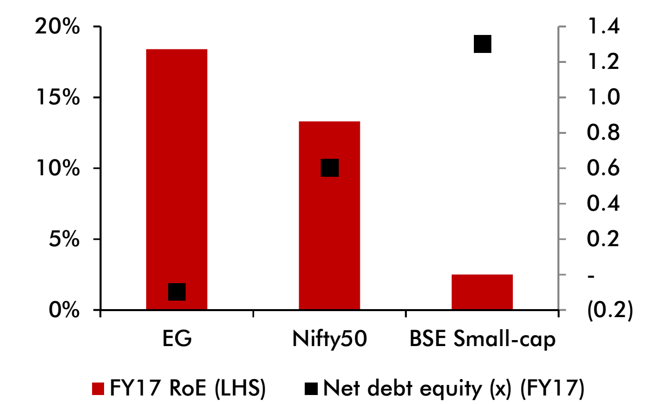
- EG portfolio is a good mix of consumer discretionary, light industrials (including exporters), media, specialty chemicals and good quality lenders, all of which should benefit in our view in light of a global and local economic growth revival. We expect EG portfolio to deliver close to 25% net earnings CAGR over FY18-20, much higher than the Nifty or the BSE small-cap.
- The average net-debt equity ratio (March 2017-end data) for the EG portfolio is almost NIL, again significantly lower than Nifty's 0.6x and BSE Small-cap's 1.3x.
- EG portfolio enjoys significantly better return ratios than Nifty and BSE Small-cap. While the weighted average FY17 RoE for EG portfolio stood at 18%, that for Nifty and BSE Small-cap stood at a much lower 13% and 3% respectively.

Exhibit 9: EG portfolio expected to deliver much higher earnings growth than benchmark indices…



Source: Ambit, Bloomberg

Exhibit 10: …combined with much better RoEs and significantly lower leverage



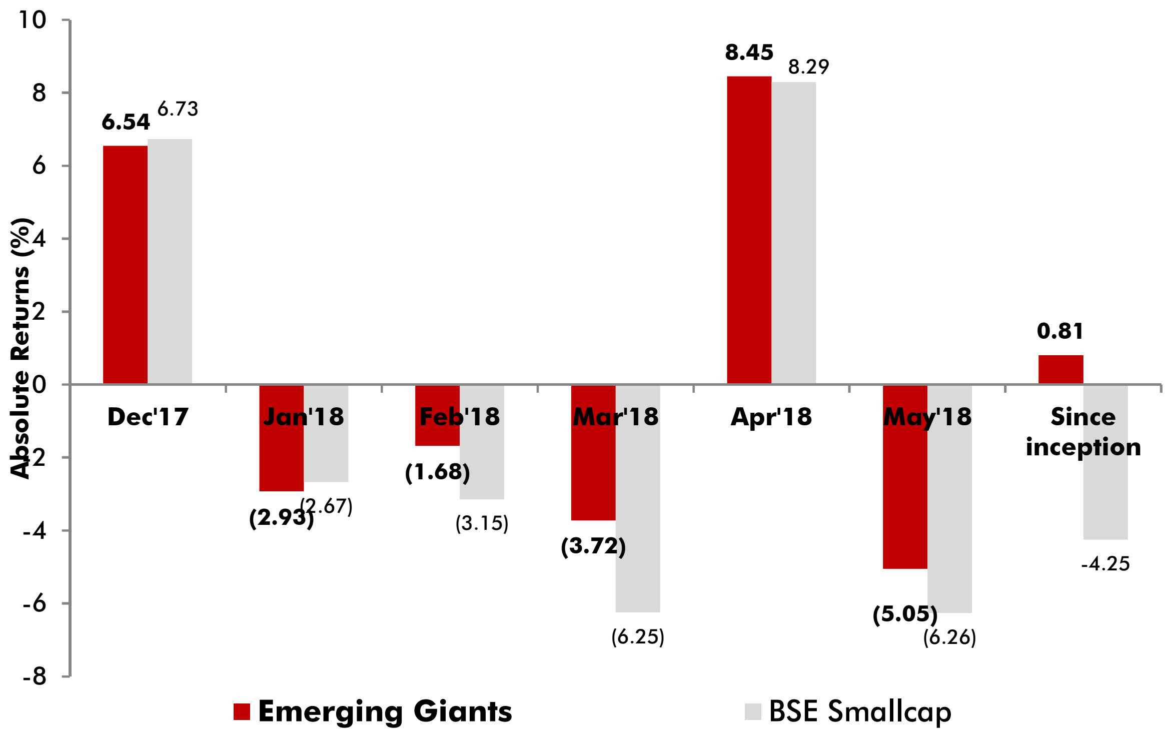
Source: Ambit, Bloomberg

Investing in winners of today and tomorrow – timing is futile

To give a flavour of the kind of stocks we have invested in Emerging Giants portfolio, we highlight below a company from the portfolio. Essentially for well-run market leading franchises, timing the entry is futile.

- **A leading process equipment manufacturer:** The Company is the market leader in the critical process equipment used in the Pharma/Chemical industry, products that require significant engineering expertise. The company has deep competitive moats given the critical nature of their products, the technological expertise it possesses and a strong relationship with its parent (global leader). The company is focussing on new product development leveraging its pedigree and reputation for reliability along with longstanding relationships with Pharma and Chemical majors. At the same time, a change in ownership at the global parent has triggered cost rationalisation measures opening the door for the company for exports to the global parent. On the back of product diversification and rising exports, company registered a healthy 15% growth in revenues in FY18 but more importantly EBITDA margin expansion of nearly 180bps (resulting in EBITDA growing 31% YoY). The share price is up 54% in the last one year (vs BSE Small-cap's 13%) and up 11% since small cap index peak on January 15, 2018 (BSE small-cap index down 14% since then). The stock trades at 23x FY19 net earnings which in the context of 25% RoE (FY18) and earnings growth outlook (>20% over FY18-20), looks attractive.

Exhibit 11: Ambit's Emerging Giants update



*Source: Ambit, Bloomberg *Date of inception=1st December 2017. Returns as of May 31, 2018*

Disclaimer

Ambit Capital Private Limited ("Ambit") is a registered Portfolio Manager with Securities and Exchange Board of India vide registration .number INP000002221.

This *presentation / newsletter / report* is strictly for information and illustrative purposes only and should not be considered to be an offer, or solicitation of an offer, to buy or sell any securities or to enter into any Portfolio Management agreements. This *presentation / newsletter / report* is prepared by Ambit strictly for the specified audience and is not intended for distribution to public and is not to be disseminated or circulated to any other party outside of the intended purpose. This *presentation / newsletter / report* may contain confidential or proprietary information and no part of this *presentation / newsletter / report* may be reproduced in any form without its prior written consent to Ambit. If you receive a copy of this *presentation / newsletter / report* and you are not the intended recipient, you should destroy this immediately. Any dissemination, copying or circulation of this communication in any form is strictly prohibited.

Neither Ambit nor any of their respective affiliates or representatives make any express or implied representation or warranty as to the adequacy or accuracy of the statistical data or factual statement concerning India or its economy or make any representation as to the accuracy, completeness, reasonableness or sufficiency of any of the information contained in the *presentation / newsletter / report* herein, or in the case of projections, as to their attainability or the accuracy or completeness of the assumptions from which they are derived, and it is expected each prospective investor will pursue its own independent due diligence. In preparing this *presentation / newsletter / report*, Ambit has relied upon and assumed, without independent verification, the accuracy and completeness of information available from public sources. Accordingly, neither Ambit nor any of its affiliates, shareholders, directors, employees, agents or advisors shall be liable for any loss or damage (direct or indirect) suffered as a result of reliance upon any statements contained in, or any omission from this *presentation / newsletter / report* and any such liability is expressly disclaimed.

You are expected to take into consideration all the risk factors including financial conditions, Risk-Return profile, tax consequences, etc. You understand that the past performance or name of the portfolio or any similar product do not in any manner indicate surety of performance of such product or portfolio. You further understand that all such products are subject to various Market Risks, Settlement Risks, Economical Risks, Political Risks, Business Risks, and Financial Risks etc. You are expected to thoroughly go through the terms of the arrangements / agreements and understand in detail the Risk-Return profile of any security or product of Ambit or any other service provider before making any investment. You should also take professional / legal /tax advice before making any decision of investing or disinvesting. Ambit or Ambit associates may have financial or other business interests that may adversely affect the objectivity of the views contained in this *presentation / newsletter / report*.

Ambit does not guarantee the future performance or any level of performance relating to any products of Ambit or any other third party service provider. Investment in any product including mutual fund or in the product of third party service provider does not provide any assurance or guarantee that the objectives of the product are specifically achieved. Ambit shall not be liable to client for any losses that you may suffer on account of any investment or disinvestment decision based on the communication or information or recommendation received from Ambit on any product. Further Ambit shall not be liable for any loss which may have arisen by wrong or misleading instructions given by you whether orally or in writing.