MONTHLY NEWSLETTER

AMBIT
Acumen at work

July 2018

AMBIT

ASSET MANAGEMENT

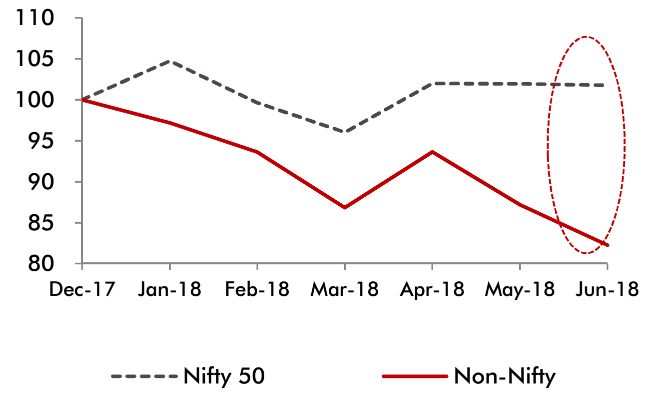
Ambit Emerging Giants (Good & Clean small cap)

A tale of two markets

The big disconnect- Nifty and the broader markets

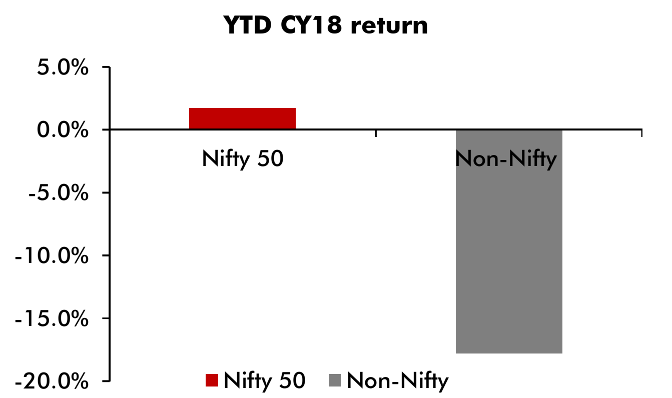
The equity market performance in June 2018 continued to reflect the recent months' trends: headline indices (Nifty/Sensex) showing much greater resilience compared to the broader market. In the calendar year 2018 so far, Nifty has risen by 1.7% as compared to non-Nifty stocks' (above 1000cr market cap) fall of nearly 18% - a divergence of close to 20% points! This therefore has been an extremely challenging phase for investors to say the least. The big question of course is that what is the way forward and what should investors do now?

Exhibit 1: The disconnect between headline indices (Nifty) and broader markets continued to widen in June ...



Source: Bloomberg Note: Non-Nifty stocks above include companies with market cap of >Rs10bn

Exhibit 2: ...with significant divergence in cumulative returns for YTD CY18



Source: Bloomberg, Note: Non-Nifty stocks above include companies with market cap of >Rs10bn

What's driving this divergence?

In our view, the following factors have contributed to the above disconnect

- **The deteriorating macro** characterized by rising commodity inflation and increasing interest rates has brought about concerns on corporate earnings which anyways have been elusive so far. Hence, the incremental inflows are being directed into a relative smaller sub-set of stocks, viewed as relative defensive bets – for instance, TCS, HDFC Bank and HUL which delivered returns of 37%, 13% and 12% respectively for YTD CY18. This handful of stocks in turn is acting to keep the Nifty optically elevated even as the broader markets have been suffering.
- Technical factors such as **SEBI's reclassification** of mutual fund schemes may have led to selling in mid-small stocks.
- Thirdly and perhaps most importantly, the stock market frenzy of CY17 had created **speculative excesses** in certain low quality mid and small caps. The ongoing correction in many such names has been disproportionate- in fact 30% of all stocks (above 1000cr mcap) have lost 30% or more in CY18 so far. Recurring news flow on governance issues such as auditor resignations and the consequent collapse in stock prices suggests that the euphoria of CY17 has now given way to despondency and pessimism.

The way forward

Clearly rising rates and commodity inflation are genuine worries. However, the important thing to note is that the economy is recovering as well. In fact, any economic recovery is bound to be accompanied with rising inflation and rising interest rates.

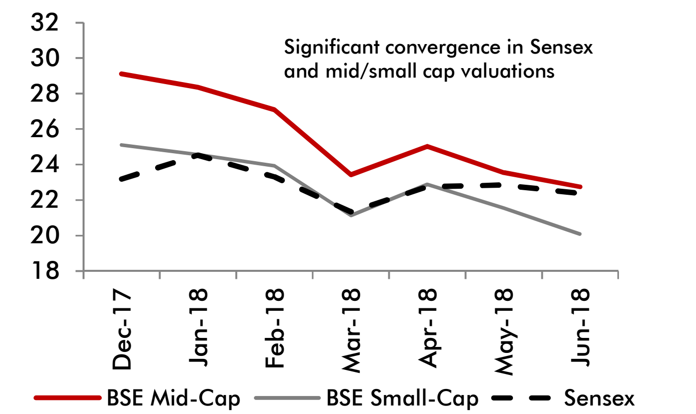
A host of micro variables are pointing to an economic revival- bank credit growth has picked up to highest levels since July 2014 (https://goo.gl/kTgzTu) auto sales, more prominently commercial vehicle sales, are robust (https://goo.gl/dXktSS), air passenger traffic growth, SME credit growth and urban consumption have been recovering strongly. Most importantly, the Index of Industrial Production (IIP) continues to trend up. Along with the pick-up in the real economy, the other positive development for listed companies is that increased GST compliance should lead to market share gains for the organized sector versus the thus-far non-compliant unorganized sector. This is corroborated by the fact that GST collection numbers have been on the rise ever since e-way implementation on April 1st

(https://goo.gl/vmTsKs). A combination of rising economy on one hand and market share gains on the other should bring about the much awaited revival in corporate earnings soon.
To add to this, the valuations for mid and small caps are looking interesting again thanks to the correction of the past six months suggesting that most of the froth is out (see exhibit 3). The combination of improving earnings outlook and saner valuations augur well for broader markets in our view.

What won't change?

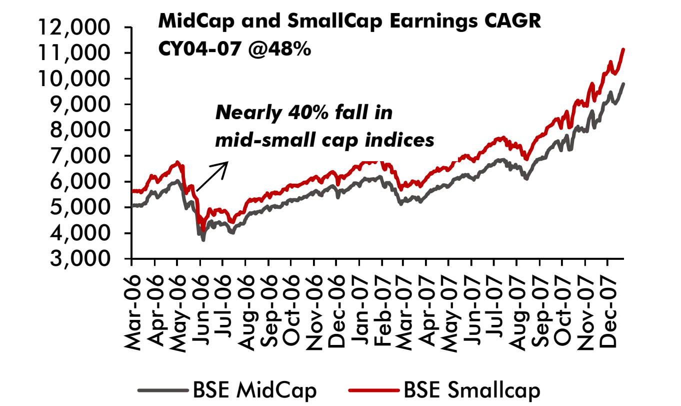
The one thing that investors however will have to be mindful of is that rising rates (which is a natural outcome of an improving economy) are here to stay. And as cost of money stays elevated so should volatility. However, rising volatility doesn't necessarily imply end of uptrend. In the FY02-FY07 period, which was arguably the best period for corporate earnings in India, interest rates and commodity prices were rising all throughout. While it did mean that volatility stayed high, it didn't deter the stock market uptrend. In fact mid and small-caps which typically show greater sensitivity to earnings revival, even withstood episodes of 30-40% stock price corrections (akin to one we are seeing today), only to exhibit even stronger rebounds subsequently (see exhibit 4).

Exhibit 3: The recent correction has made mid-small cap's valuation much more reasonable now…



Source: Bloomberg Note: Trailing twelve months earnings (only for positive earnings companies) considered above

Exhibit 4: Despite intermittent volatilities, Mid/small caps have delivered high returns during earnings recovery



Source: Bloomberg, Ambit; Note: For Earnings mentioned above, Mid-cap defined as stocks with 101-250th rank on market capitalisation and Small-cap as stocks with 251st-500th rank on market capitalisation.

Bottomline

We believe that earnings should inflect soon and therefore broader markets should start performing sooner rather than later. The ongoing correction therefore appears to be a corrective phase in an uptrend. However as markets move from being liquidity driven to earnings driven it's important to stick to Good & Clean as companies with stretched balance sheets and dodgy governance should have no case in a tightening liquidity environment.

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.

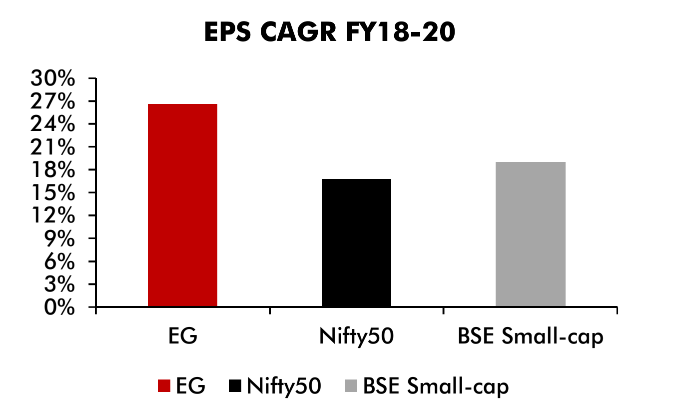
- **Rigorous stock selection process:** Starting at a relative large investible universe of about 1,300 small caps, Ambit's proprietary frameworks along with extensive bottom-up research helps create a concentrated portfolio of 15-16 companies at any time. The process focuses on identifying companies 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:

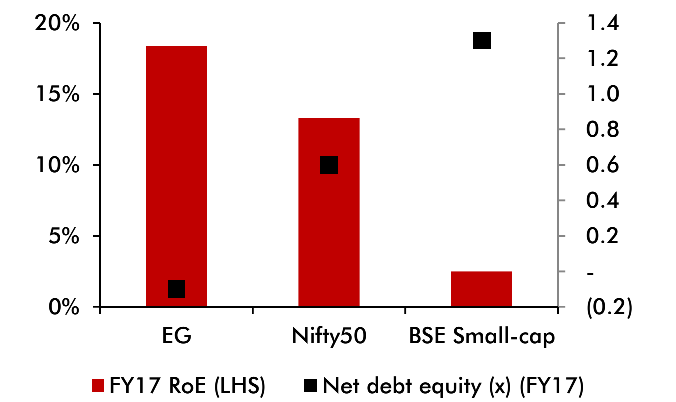
- EG portfolio is a good mix of consumer discretionary, light industrials (including exporters), media, specialty chemicals and good quality lenders, all of which should benefit in our view in light of a global and local economic growth revival. We expect EG portfolio to deliver close to 25% net earnings 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 5: EG portfolio expected to deliver much higher earnings growth than benchmark indices…



Source: Ambit, Bloomberg

Exhibit 6: …combined with much better RoEs and significantly lower leverage



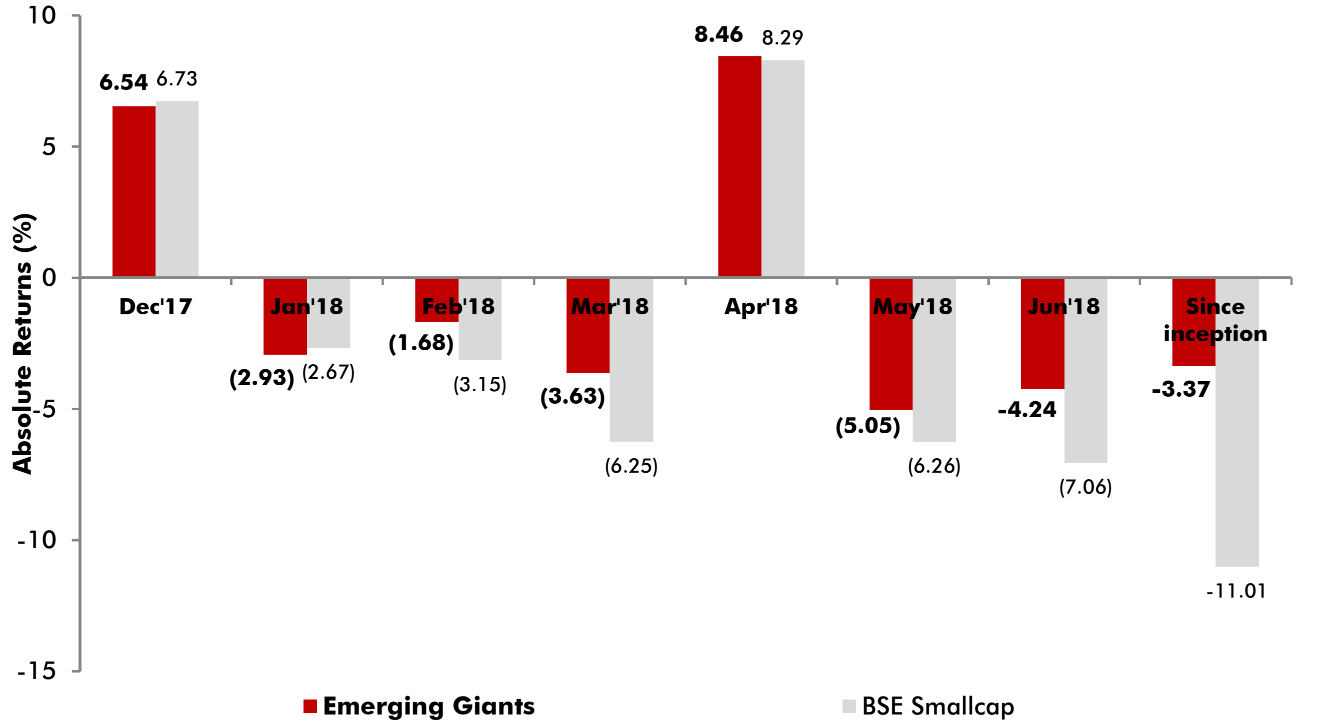
Source: Ambit, Bloomberg

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 specialty chemical manufacturer:** The Company is the second largest organised aliphatic amines manufacturer (application in agrochemicals and pharma) with about 40% market share. The market is duopoly given high fixed costs/capex intensity, hazardous nature of the product and closely guarded technology. It is in the midst of a large expansion of its capacities, with the goal of scaling up the value chain. Today, ~55-60% of revenues are basic amines. With the company's long awaited capacity addition (~2x; constraints held back recent sales growth), the share of more value added/higher realization products could rise to ~60% long term (from 40-45%) boosting realizations and margins. We expect the company to continue evolving into a high value chemicals supplier over the long term. Despite a weak macro environment, the company reported top-line and net earnings growth of 23% and 28% respectively in FY18 with a healthy RoE of 23%. The healthy financial performance is also reflected in stock returns with share price up 70% in the last one year (vs BSE Small-cap's 5%) and up down only 5% since small cap index peak on January 15, 2018 (BSE small-cap index is down nearly 20% since then). Despite this outperformance, the company trades at a relatively inexpensive 18x FY19 net earnings, more or less in line with the Nifty's and BSE Small-Cap's multiples.

Exhibit 7: Ambit's Emerging Giants update



*Source: Ambit, Bloomberg *Date of inception=1st December 2017. Returns as of June 30, 2018*

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