MONTHLY NEWSLETTER

AMBIT
Acumen at work

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ASSET MANAGEMENT

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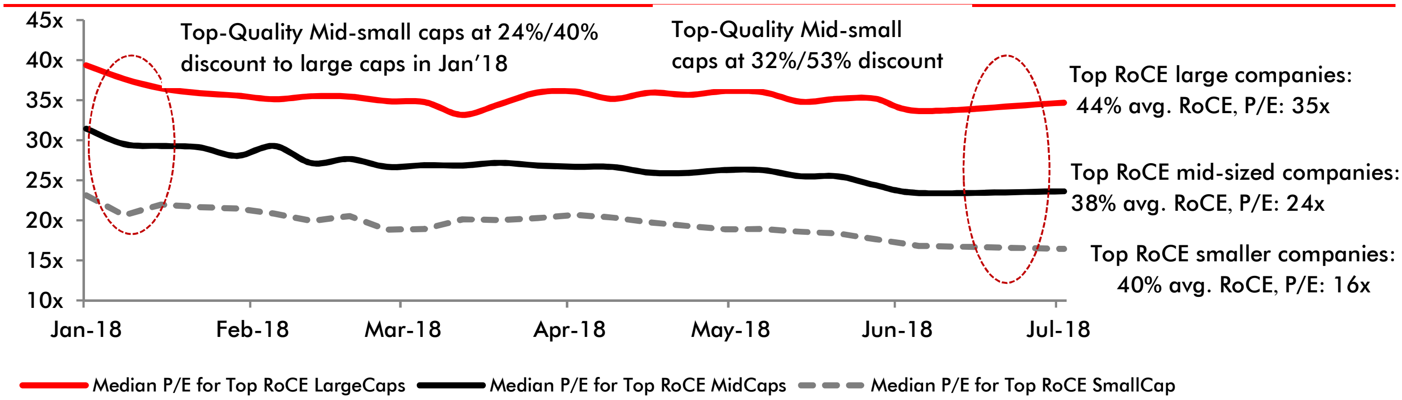
Emerging Giants (Good & Clean small cap)

Disconnect between the performance of headline indices (Nifty/Sensex) and the broader markets continued in July 2018. Equity inflows continued to chase a smaller sub-set of stocks viewed as relative defensive bets. Hence benchmark indices like Nifty remained optically elevated even as the broader markets languished. This disconnect has not been restricted to just poor quality companies but even good quality mid and small cap stocks have been witnessing a widening of valuation discount versus their larger cap counterparts. For instance, the top 20% RoCE stocks (averaging close to 40% RoCE) in the BSE large cap space now trade at average P/E (trailing twelve months) of 35x which is substantially higher than 24x average for the mid-caps and 16x for the small caps despite similar return rations and earnings growth.

Exhibit 1: Rising valuation gap in 'good quality' stocks in large cap vs mid/small cap names



Source: Bloomberg Note: Large caps defined as top 250 on market cap (within BSE 500), Mid- caps as next 250 (within BSE 500) and Small-caps are sub BSE 500 in the above chart

As discussed in our July 2018 newsletter, the above divergence may have emanated from macro concerns surrounding rising commodity inflation and interest rates, technical impact of SEBI reclassification of mutual fund schemes (leading to sell off in mid-small cap stocks) and dissipation of euphoria surrounding mid-small stocks. Unfortunately, the investor pessimism has even extended to good quality mid-small cap names (as discussed above) even though they continue to deliver a healthy fundamental performance.

A host of micro variables (bank credit growth, air passenger traffic growth, auto sales and index of industrial production or IIP) are pointing to an economic revival. 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 2, 2018. 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. On the flip side, any economic recovery is bound to be accompanied with rising inflation and rising interest rates which the investors should be wary of.

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.

The combination of improving earnings outlook and saner valuations augur well for broader markets and more **particularly for the good quality mid and small cap names.**

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

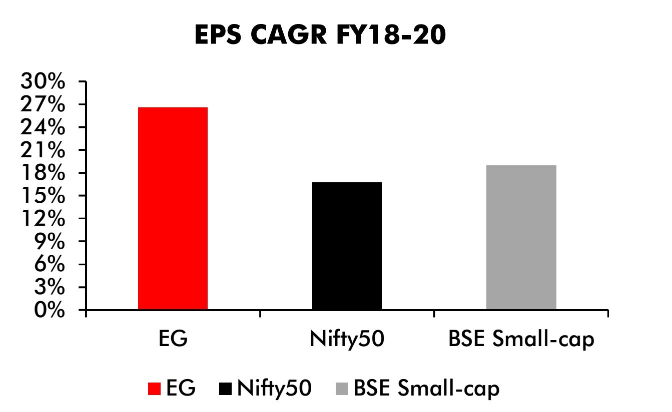
Ambit's Emerging Giants portfolio aims to invest in small-cap companies with market dominating franchises and a track record of clean accounting, governance and capital allocation. The fund typically invests in companies with market caps less than Rs2,500cr. These companies have excellent financial track 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:

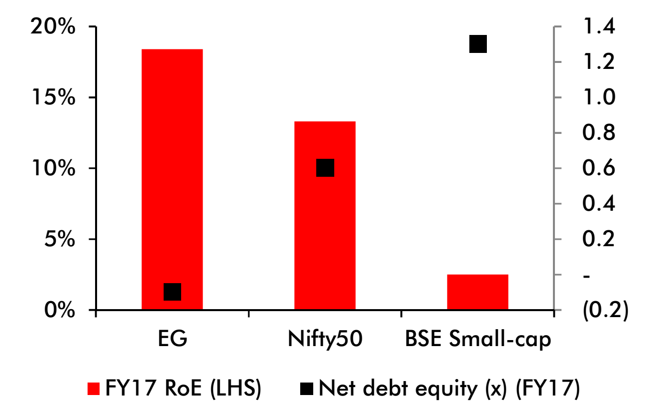
- EG portfolio is a good mix of consumer discretionary, light industrials (including exporters), media, specialty chemicals and good quality lenders, all of which should benefit in our view in light of a global and local economic growth revival. We expect EG portfolio to deliver close to 25% net earnings 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 2: EG portfolio expected to deliver much higher earnings growth than benchmark indices…



Source: Ambit, Bloomberg

Exhibit 3: …combined with much better RoEs and significantly lower leverage



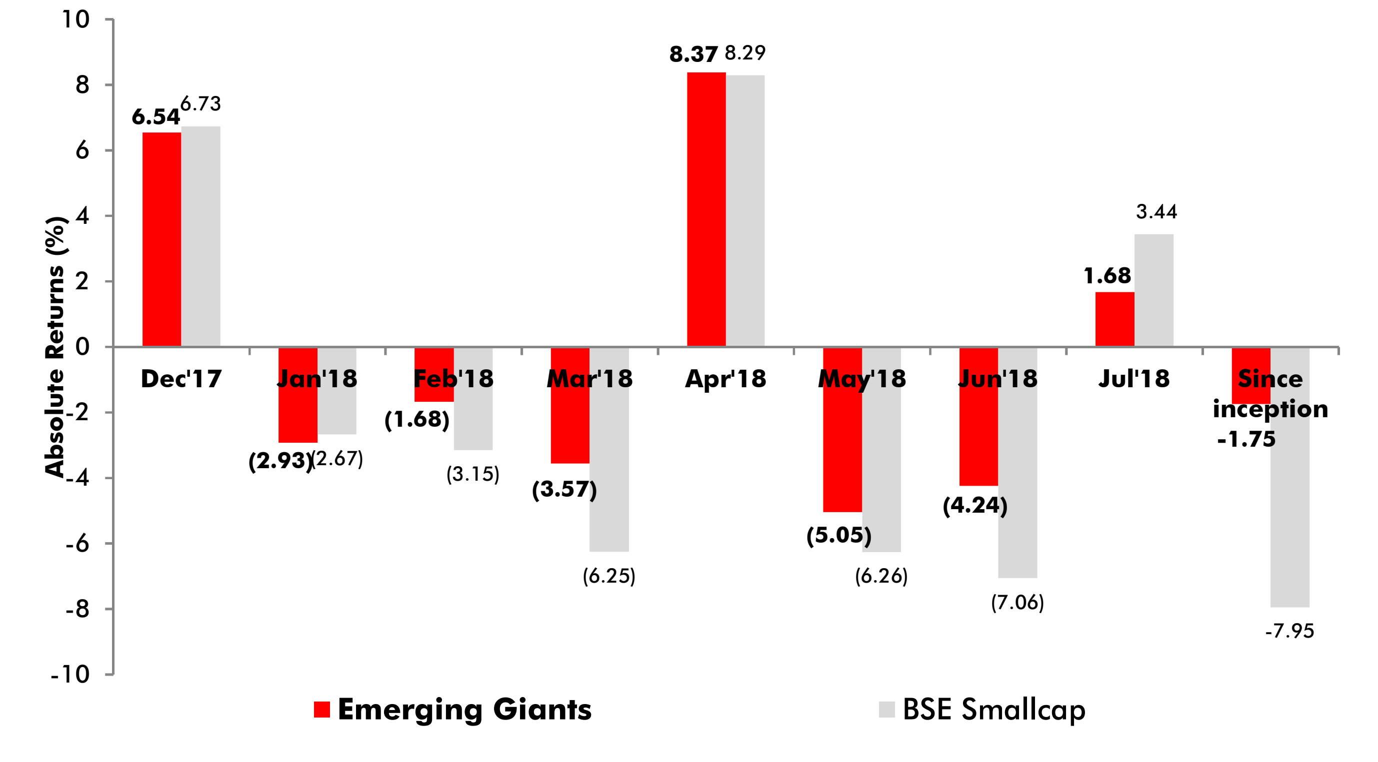
Source: Ambit, Bloomberg

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 technical textiles player in India:** It has a well-diversified portfolio across fishing, shipping, infrastructure, aquaculture and sports. The company's focus on product innovation, strong understanding of the fibre technology & polymer processing has enabled it to build leadership in domestic fishing nets (65% market share) as well a strong exports franchise (46% of revenue). We see strong growth opportunity in domestic (rising penetration of technical textiles in agri, infra, defence) and export markets (such as aquaculture). Focus on premiumisation and improving product mix should also lead to much stronger profit growth. We expect company to witness 20% net earnings CAGR over FY18-22. In the context of this earnings growth and return ratios (~20% RoE), the current valuation of 18x FY20 net earnings appears attractive.

Exhibit 4: Ambit's Emerging Giants update



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

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