MONTHLY NEWSLETTER

AMBIT
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ASSET MANAGEMENT

EQUITY INVESTMENTS & PMS ARE SUBJECT TO MARKET RISKS,
READ ALL SCHEME RELATED DOCUMENTS CAREFULLY BEFORE INVESTING

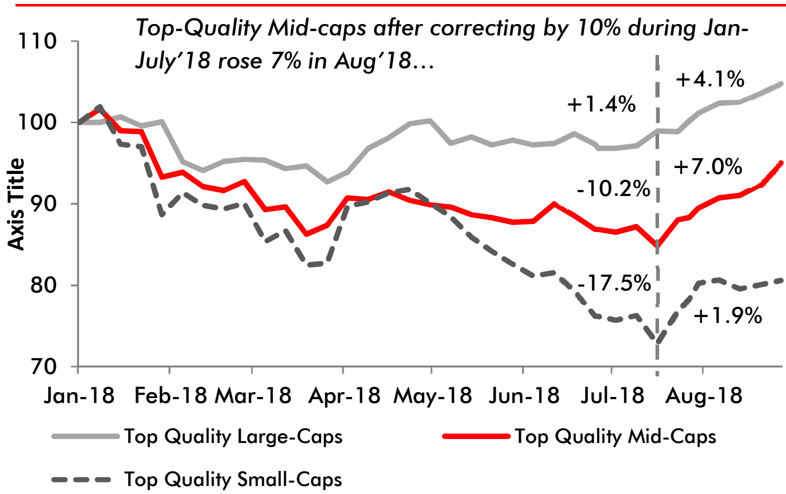
Ambit Good & Clean Smallcap Fund (Emerging Giants)

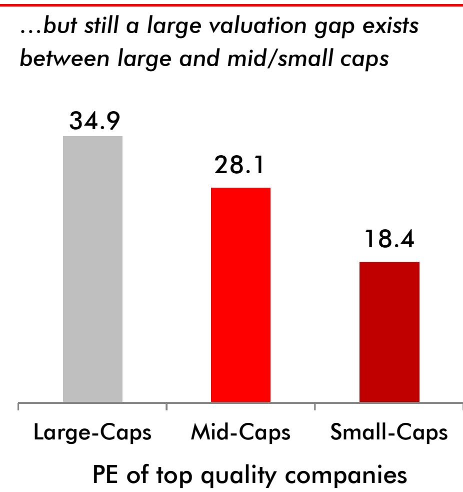
"The big money is not in the buying and the selling… but in the waiting" - *Charlie Munger*

Mid-small caps finally return to life...

In our August 2018 newsletter, we had highlighted that the valuation gap between good quality mid-small cap and large cap stocks had reached extreme and in our view unsustainable levels. At July 2018-end, the top 20% RoCE stocks in the large cap space traded at trailing 12-months P/E of 34x compared to 25x for the top RoCE mid-caps and 18x for the best RoCE small caps. This substantial gap was despite similar return ratios and earnings growth. The month of August 2018 saw a reversal in this trend to some extent with mid cap stocks clearly outperforming their larger cap peers.

Exhibit 1: Despite mid-cap outperformance in August, significant valuation gap still exists between large and mid-caps





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; Top quality stocks signifies companies within top 20% in terms of RoCE and top 50% in our forensic framework. Share price performance indexed to 100 (Jan-18 = 100)

...driven by a long awaited corporate earnings recovery in 1QFY19

Over the past few months, while a host of micro-variables (bank credit growth, air passenger traffic growth, auto sales and index of industrial production or IIP) had been pointing to an economic revival, corporate earnings growth had continued to be elusive. However, the recently concluded earnings season saw corporate India deliver strong earnings performance (G&C portfolio companies delivered a blended revenue growth of 16% YoY and core operating profit (EBITDA) growth of 22% in 1QFY18). This earnings revival brought back a revival in investor interest in good quality mid and small caps, in our view.

Earnings momentum to continue but stick to Good & Clean stocks

A combination of improving economy on one hand and market share gains for the organised sector (as better GST compliance kicks in post e-way implementation) should keep corporate earnings strong over the next few years in our view. On the flip side, any economic recovery is bound to be accompanied with rising inflation and rising interest rates. Therefore it is important to stick to Good & Clean as companies with stretched balance sheets and dodgy governance should have no case in a tightening liquidity environment.

Further, despite the outperformance in August 2018, good quality mid and small cap names still trade at a significant 26% and 50% discount to their larger cap counterparts (higher than 24% and 40% respectively at January 2018-end) as shown in the exhibit above.

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

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

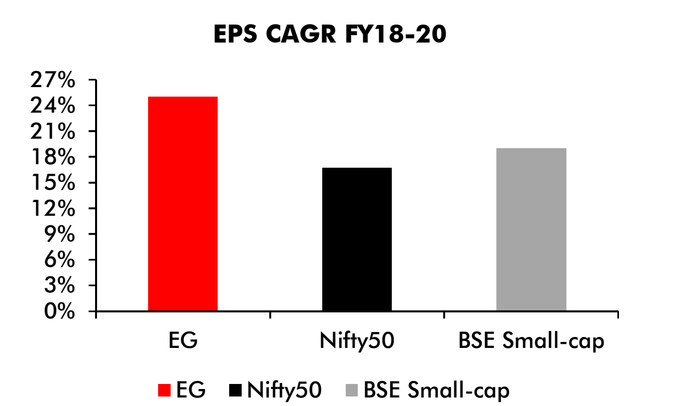
Ambit's Good & Clean Smallcap Fund (Emerging Giants) portfolio aims to invest in small-cap companies with market dominating franchises and a track record of clean accounting, governance and capital allocation. The fund typically invests in companies with market caps less than Rs2,500cr. These companies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

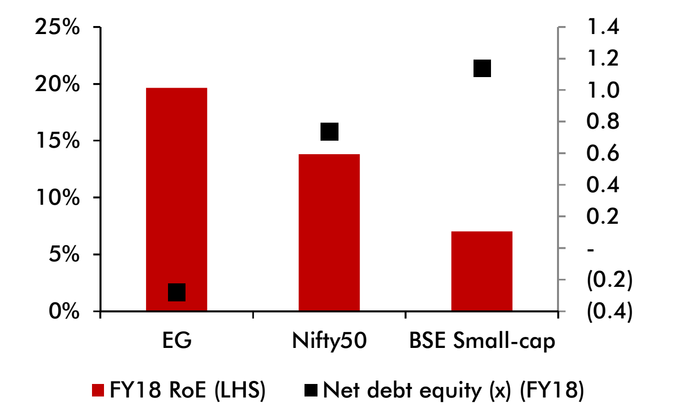
- EG portfolio is a good mix of consumer discretionary, light industrials (including exporters), media, specialty chemicals and good quality lenders, all of which should benefit in our view in light of a global and local economic growth revival. We expect EG portfolio to deliver close to 25% net earnings CAGR over FY18-20, much higher than the Nifty or the BSE small-cap.
- The average net-debt equity ratio (March 2018-end data) for the EG portfolio is almost NIL (infact net cash), again significantly lower than Nifty's 0.7x and BSE Small-cap's 1.1x.
- EG portfolio enjoys significantly better return ratios than Nifty and BSE Small-cap. While the weighted average FY18 RoE for EG portfolio stood at 20%, that for Nifty and BSE Small-cap stood at a much lower 14% and 7% 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

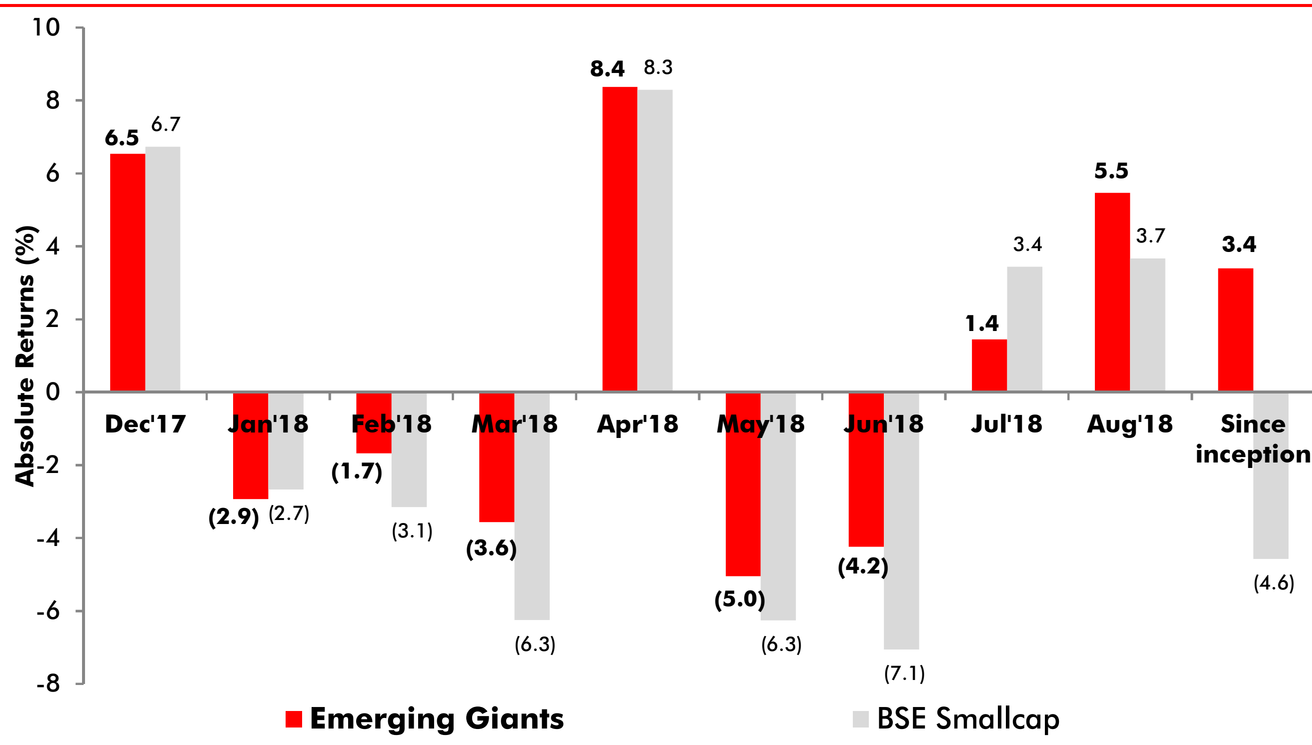
Investing in winners of today and tomorrow – timing is futile

1QFY19 results season panned out well for the Emerging Giants portfolio with portfolio companies delivering a blended YoY revenue growth of 23% and much higher 41% and 60% growth in EBITDA and net earnings respectively. The earnings growth was broad-based across the portfolio with more than 60% of the portfolio companies reporting 25% or more YoY growth in operating profit (EBITDA).

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 Gujarat based NBFC:** focused on Microfinance (~65% of book), 2Wheeler (27%) and MSME (8%). Gujarat accounts for ~50% of the AUM of ~Rs4bn, while Madhya Pradesh, Uttar Pradesh and Maharashtra account for 30%/10%/10% respectively. The company's approach to responsible growth/capital allocation is a rare trait in the industry – some instances – (i) it exited segments where it felt the competitive edge is weakening or if the sector is likely to face headwinds, such as consumer loans in FY07 and 3-Wheeler loans in FY13/14; (ii) During demonetisation, it held off on disbursements for 2 months until mid Feb'17, resulting in decline in AUM but this strategy is now allowing company to expand when peers are pulling back after getting impacted by demonetisation. The company's loan book has doubled over the past two years to ~Rs4bn. The company is now targeting a loan book of Rs10bn by FY20, primarily on the back of expansion into new states, the growth of the MSME book and increasing market share in the MFI segment. With a long term track record of superior risk management, the potential to grow its loan book north of 30% over the medium term and a management with the right approach to capital allocation, we believe valuations of ~1.9x FY20 B/V are attractive.

Exhibit 4: Ambit Good & Clean Smallcap Fund (Emerging Giants) performance update



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

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