MONTHLY NEWSLETTER

October 2018

AMBIT

ASSET MANAGEMENT

Markets- Volatility creates opportunity

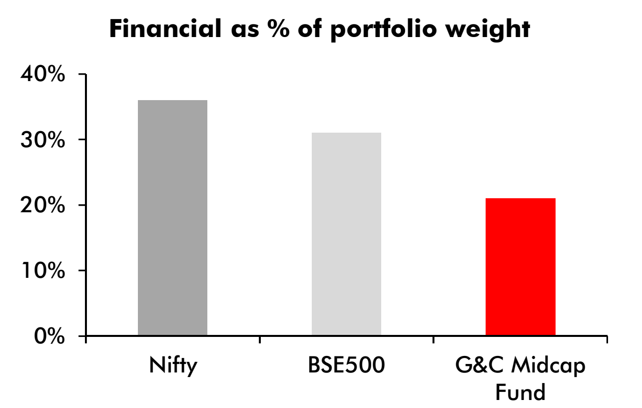
Fears of liquidity freeze cause sharp equity market correction in September 2018

The benchmark index Nifty declined by 6.43% in September 2018. However, pain in broader markets was significantly more pronounced with the BSE MidCap Index and the BSE SmallCap Index declining by 14% and 16% respectively. While liquidity had been tightening for the past several months, specific issues starting with the ILFS default and rating downgrade exacerbated the liquidity crunch in September leading to widespread panic in financial markets. From a stock market point of view, while the decline started with NBFCs, it soon spread to most other pockets. There have been developments over the past week or so aimed at stabilizing the liquidity situation and bringing normalcy to financial markets (some of these being the RBI's recent notification on Liquidity Coverage Ratio which should release liquidity to the tune of Rs 2-Rs2.5 trillion, the government's positive borrowing surprise which implies lower 2HFY19 borrowings of around Rs 200bn, OMO purchases of over 360 bn over the course of October, etc.). Equity markets however don't seem to be stabilizing as yet.

Our portfolios have limited Financials and NBFC exposure

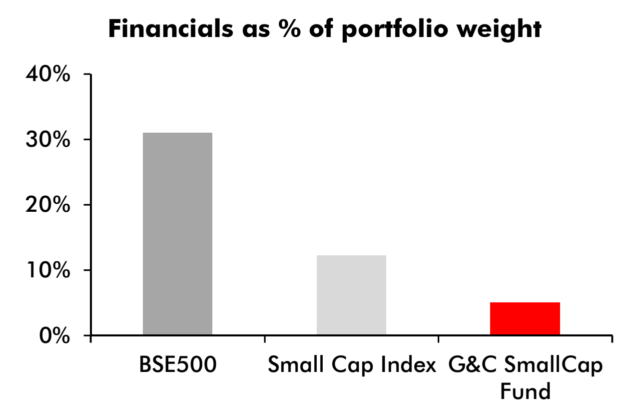
Both the midcap and smallcap portfolios have significantly lower exposure to Banks and Financial Services stocks versus benchmarks (21% and 5% respectively for midcap and smallcap portfolios versus 36% for the Nifty, 31% for BSE500 and 12% for the BSE Smallcap index). Moreover, both portfolios have one NBFC each (at around 5% weight) with strong underwriting track record and pretty well balanced asset liability profiles.

Exhibit 1: G&C Midcap portfolio is significantly underweight Financials …



Source: Ambit, Bloomberg

Exhibit 2: … as is also the case with G&C Smallcap



Source: Ambit, Bloomberg

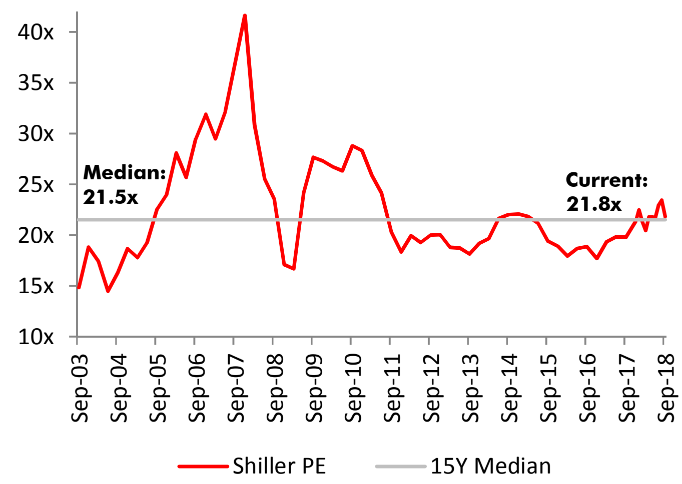
Valuations saner now- back at long term averages on CAPE

As we had highlighted in our earlier months' newsletters, steep yield curve historically has been followed by economic expansion and earnings recovery (with the 2004-2007 periods being a prominent case in point). We discussed how equity markets are now moving away from being liquidity supported (as in the recent years) towards being earnings driven. 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 (Nifty revenue growth of 18% YoY and core operating profit (EBITDA) growth of 27% in 1QFY19).

In the context of normalizing earnings growth, the recent correction has brought valuations to saner levels. The cyclically-adjusted price-earnings (CAPE) ratio is now trading close to the long term historical median.

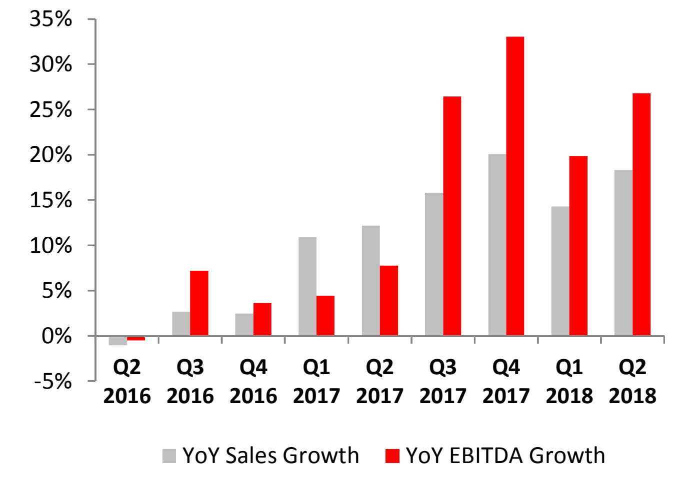
This combination of earnings recovery and better valuations should provide good entry points for long term investors on the other side of this volatility in our view, and more particularly for good quality mid and smallcap names.

Exhibit 3: Cyclically adjusted P/E now trading close to the long term average…



Source: Ambit, Bloomberg

Exhibit 4: …while corporate earnings growth has seen a pick-up recently



Source: Ambit, Bloomberg

…but remain wary of investing in companies/sectors exposed to rising interest rates and inflation

Even as the economy as well as the markets should trend up, in an environment besieged by rising interest rates, inflation and tighter money supply, investors should be wary of investing in certain companies and sectors which would be adversely impacted in our view such as:

- **Avoid suspect governance companies as also leveraged plays:** As interest rates rise and as cost of money becomes dearer, investors will become more conscious of the quality of stocks they buy. Poor accounting and governance firms should continue to be hurt in a tight liquidity scenario. Similarly leveraged plays should continue to be hurt as also weaker companies that do not have market leadership to pass on rising raw material costs to consumers.
- **Stay selective in Financials- continue avoiding HFCs:** The extent of the impact on individual NBFCs would depend on factors like liability mix and Asset-Liability (ALM) mismatch. Within NBFC, housing finance companies and wholesale lenders would stand to lose (>50% wholesale borrowings in their liability mix which is prone to volatility and quick re-pricing, and average ALM mismatch of about 2 years). On the other hand, auto financiers and consumer lenders are better placed in a rising rate environment due to lower reliance on wholesale borrowings and almost perfectly matched ALM.

Ambit Good & Clean Smallcap Fund (Emerging Giants)

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

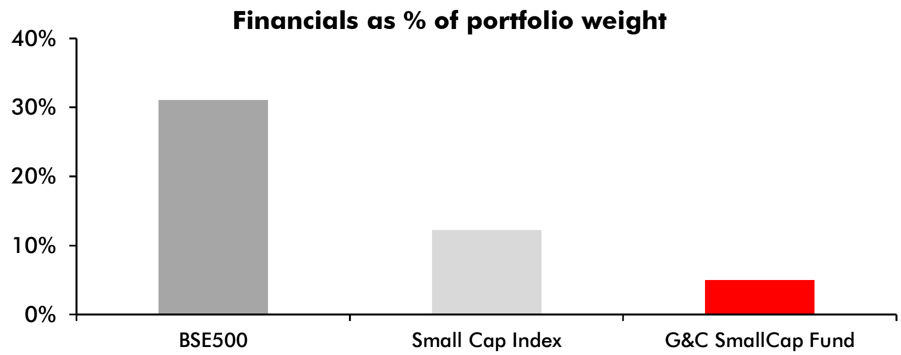
Ambit's Good & Clean Smallcap Fund (Emerging Giants) portfolio aims to invest in small-cap companies with market dominating franchises and a track record of clean accounting, governance and capital allocation. The fund typically invests in companies with market caps less than Rs2,500cr. These companies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

Our portfolios have limited Financials and NBFC exposure

Exhibit 5: G&C Smallcap Fund has much lower exposure to the Financials



Source: Ambit, Bloomberg

Within financials, G&C Smallcap Fund has exposure to just one Gujarat based Microfinance company. The company has a decently balanced asset liability profile with average loan maturity of less than twelve months.

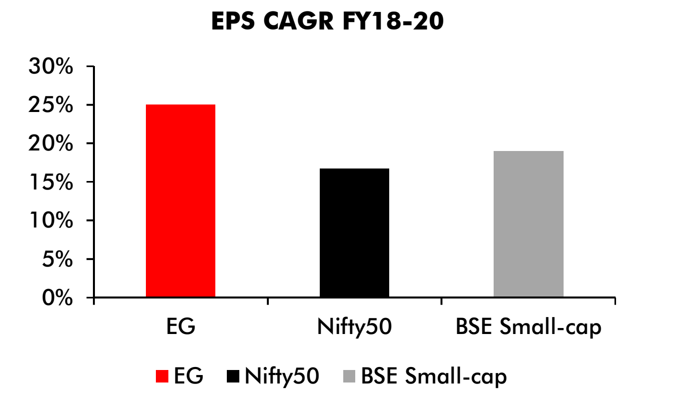
The company follows a conservative approach of lending with high credit appraisal quality & lower NPAs through cycles historically. Further, thanks to equity capital infusion from a large private equity player recently, the capital position is very comfortable with equity to loans at around 25%.

Good & Clean smallcaps- well positioned in the market turmoil

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:

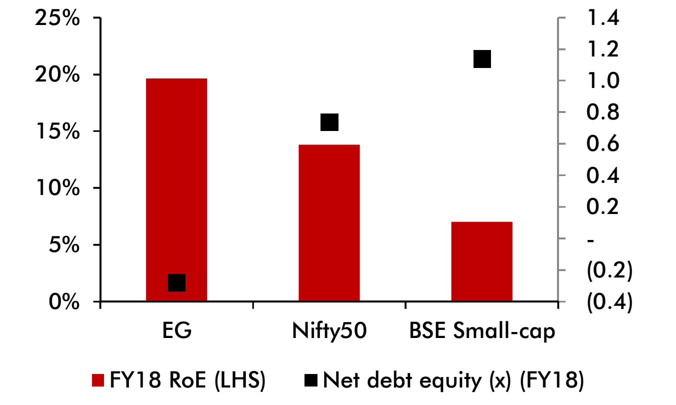
- EG portfolio is a good mix of consumer discretionary, light industrials (including exporters), media, specialty chemicals and good quality lenders, all of which should benefit in our view in light of a global and local economic growth revival. We expect EG portfolio to deliver close to 25% net earnings 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 6: EG portfolio expected to deliver much higher earnings growth than benchmark indices…



Source: Ambit, Bloomberg

Exhibit 7: …combined with much better RoEs and significantly lower leverage



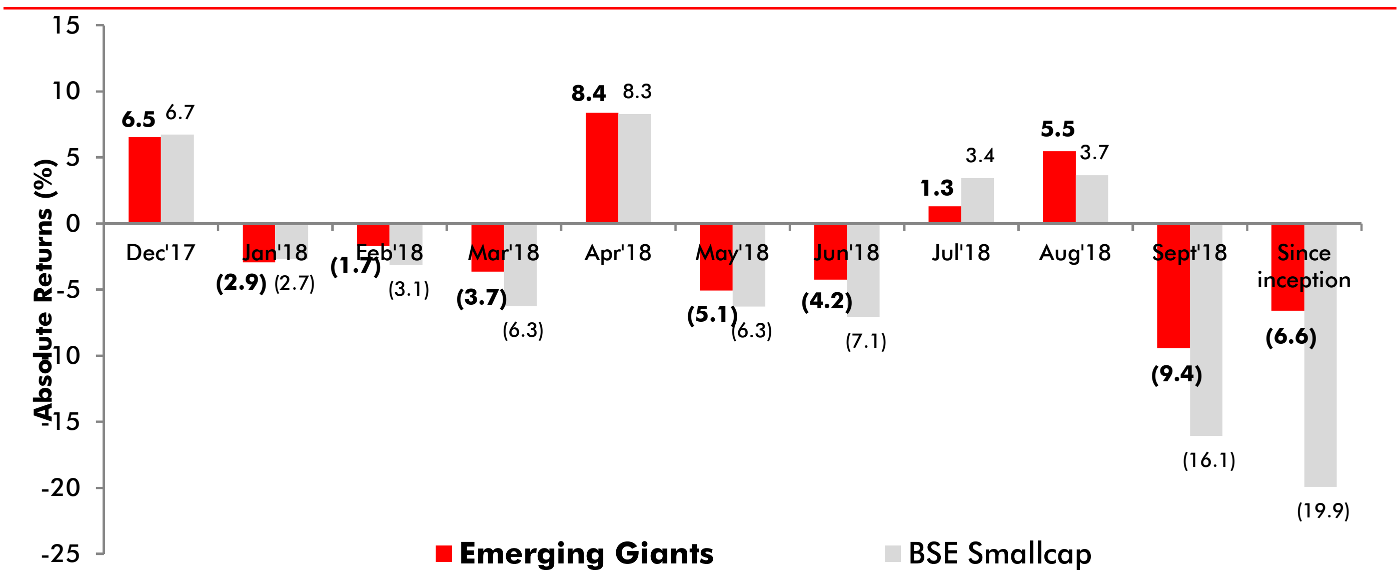
Source: Ambit, Bloomberg

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 Indian and global laminates player:** The Company is the largest domestic laminates player with about 20% organised market share. Besides, the company is the largest Indian exporter of laminates (exports contribute ~35% of revenue). It has also recently diversified into engineered wood floors/doors (the first Indian player to enter these segments). The Company's competitive advantages in the domestic market is underpinned by its strong product portfolio (>2,500 SKUs) and distribution network (>12k touch points in India). With GST rate of 18%, we expect significant reduction in the pricing gap with unorganised players (account for ~40% of the Indian laminates market). This should drive market share gains for organised players. Furthermore, significant ramp up in engineered wood flooring/doors also likely to aid top-line as well as profitability in the next 1-2 years. Innovation in laminates design (basic and bold textures), types (HD gloss, VRB, reflection, anti-finger printing) and bespoke regional distribution strategies present opportunity to evolve into a leader in the export markets (already 3rd largest globally but 1/6th the size of the largest player).

Exhibit 8: Ambit Good & Clean Smallcap Fund (Emerging Giants) performance update



*Source: Ambit, Bloomberg *Date of inception=1st December 2017. Returns as of September 30, 2018. Performance is post all fees and charges.*

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