MONTHLY NEWSLETTER

AMBIT
Acumen at work

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AMBIT

ASSET MANAGEMENT

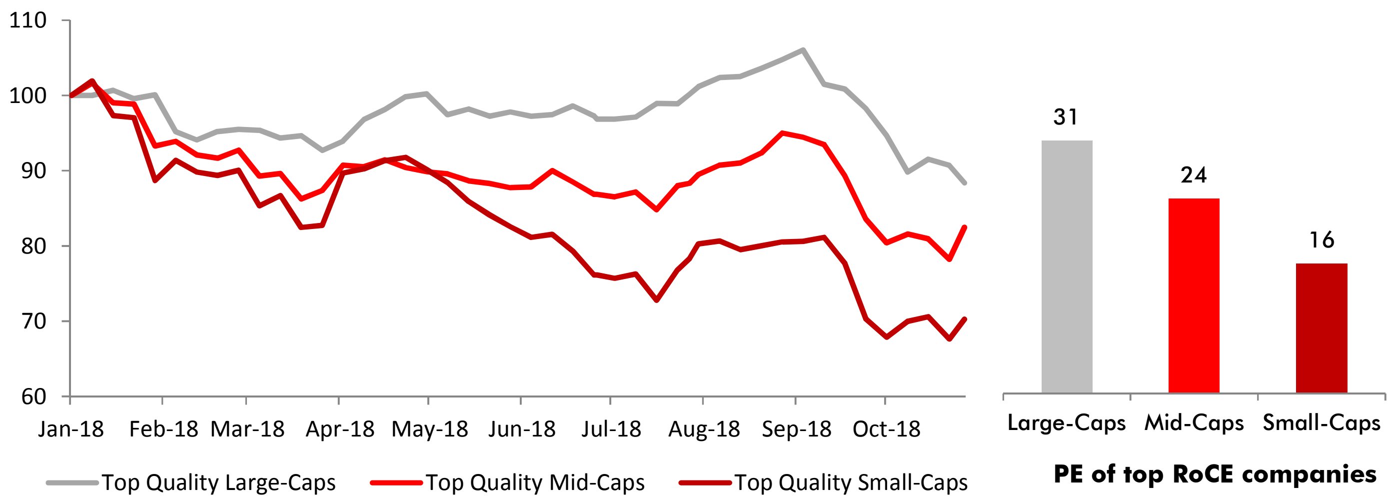
Ambit Good & Clean Smallcap Fund (Emerging Giants)

After the big sell-off of September, October was another weak month for Indian equity markets. While the Nifty continued trending lower through the month, midcaps and smallcaps outperformed their larger cap peers. Overall, post the correction of the last several months, good quality mid and small caps are looking attractive on valuations now.

Good quality small and mid-caps trade at attractive valuations

At October 2018-end, the top 20% RoCE stocks in the large cap space (defined here as largest 250 stocks on market cap) traded at trailing 12-months P/E of 31x compared to 24x for the top RoCE mid-caps (mcap 251 to 500) and 16x for the best RoCE small caps (mcap below top 500). This substantial gap was despite similar return ratios and earnings growth. This gap is reflective of the trend witnessed since January 2018 with broader markets correcting much more sharply than large caps. 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.

Exhibit 1: High quality Mid-small caps trade at significant discounts compared to their large cap counterparts

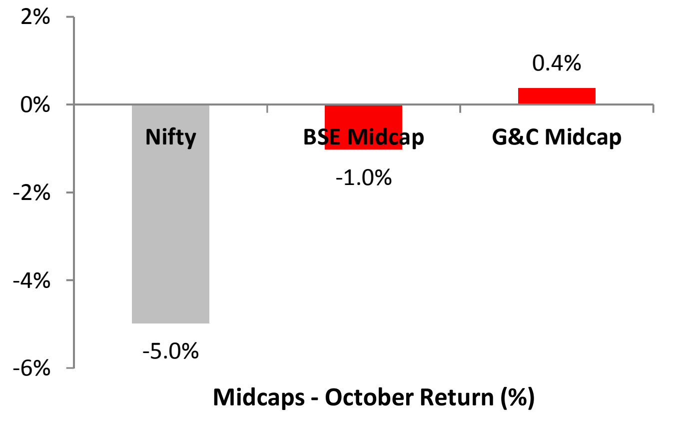


Source: Bloomberg Note: Large caps defined as top 250 on market cap (within BSE 500), Mid- caps as next 250 (within BSE 500) and Small-caps are sub BSE 500 in the above chart; Top quality stocks signifies companies within top 20% in terms of RoCE and top 50% in our forensic framework. Share price performance indexed to 100 (Jan-18 = 100)

Broader markets now outperforming the Nifty!

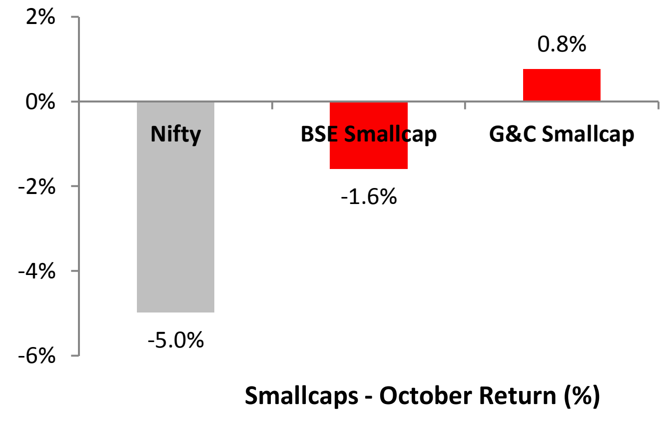
Encouragingly, over the past 30 days, we have seen a reversal of the above trend (investor preference for large over mid/small cap stock) with mid and small caps now outperforming the Nifty. In our view, this is partly driven by attractive valuations for mid and small caps (as highlighted above) and partly by broad basing of corporate earnings. For instance, our G&C mid-cap portfolio witnessed revenue/EBITDA growth of 16/22% YoY in 1QFY19 followed by 22%/23% YoY growth so far in 2QFY19 results season (based on the 12 portfolio companies that reported till 31 Oct 2018). We therefore expect this trend to continue and expect strong outperformance for good quality mid and small cap names over their larger cap counterparts.

Exhibit 2: Trend reversal is seen in broader market which has outperformed Nifty this month



Source: Ambit, Bloomberg

Exhibit 3: .....Similar trend is seen in small caps stocks



Source: Ambit, Bloomberg

A combination of improving earnings outlook and attractive valuations augurs well for broader markets in general 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.

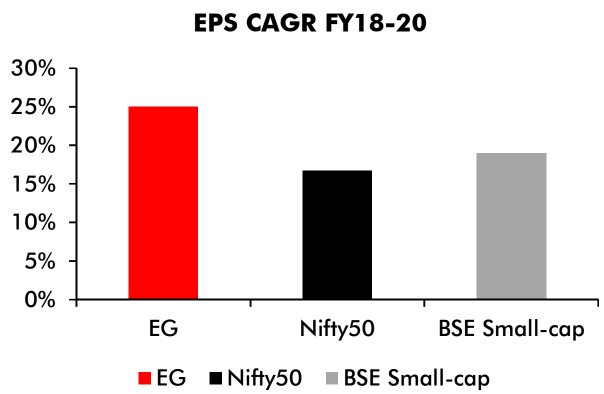
Good & Clean smallcaps- particularly well positioned in the current market environment

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:

A potent combination of healthy earnings growth with high returns/low leverage

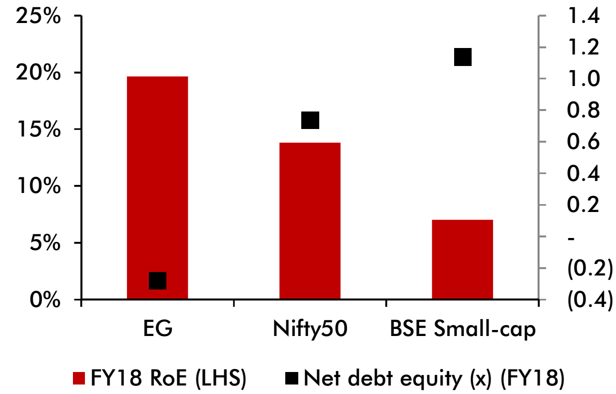
- EG portfolio is a good mix of consumer discretionary, light industrials (including exporters), media, specialty chemicals and good quality lenders, all of which should benefit in our view in light of a global and local economic growth revival. We expect EG portfolio to deliver close to 25% net earnings 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 4: EG portfolio expected to deliver much higher earnings growth than benchmark indices…



Source: Ambit, Bloomberg

Exhibit 5: …combined with much better RoEs and significantly lower leverage



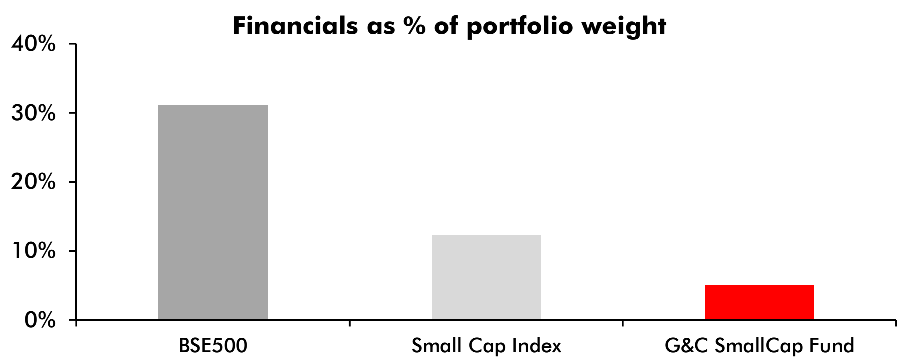
Source: Ambit, Bloomberg

Limited exposure to financials and NBFC

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%.

Exhibit 6: G&C Smallcap Fund has much lower exposure to the Financials



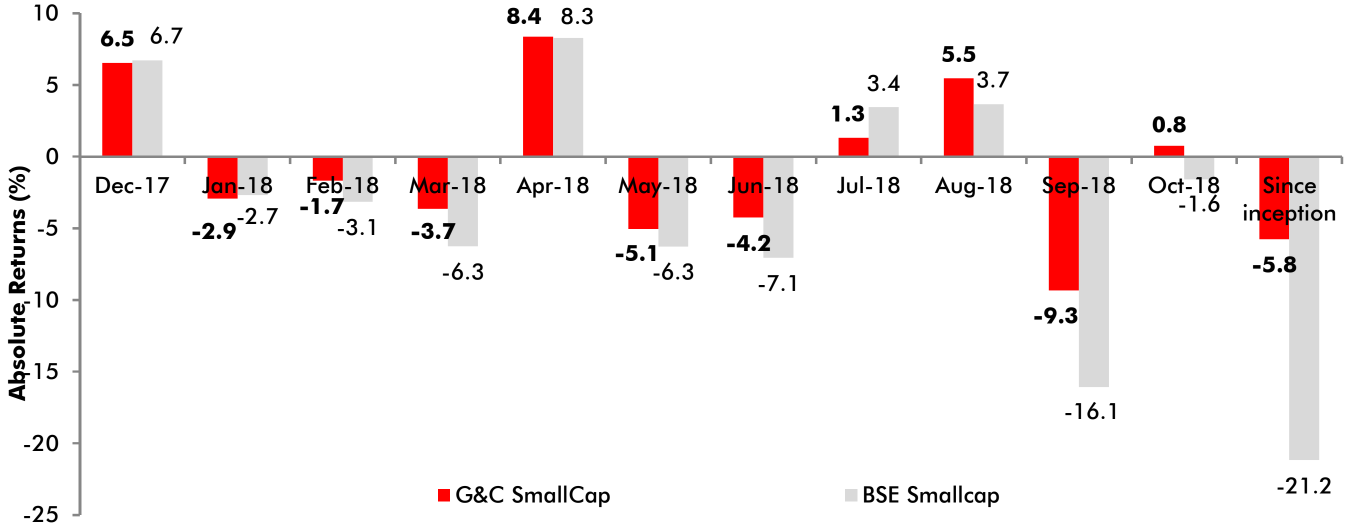
Source: Ambit, Bloomberg

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 automotive forgings supplier based in south India:** The company manufactures forged products like gears, connecting rods, flanges and spindles. India, Europe and North America account for around 1/3rd of revenue each. Vehicle-wise, commercial vehicle accounts for nearly 60%, passenger vehicles around 25% and balance being off-highway, oil & gas etc. In the domestic market, company enjoys locational advantage (South India based plants) which has helped it gain high share of business with players like Ashok Leyland and Hyundai India. In the export markets, the company enjoys strong cost advantage vs regional European and North American players. The company is witnessing a benign demand environment currently with strong cyclical recovery in the Indian and North American commercial vehicle markets. Besides the near term cyclical growth, the company is now foraying into higher value addition products (crankshafts, front axle beams) through installation of 8K ton press which should drive further market share gains over medium to long term.

Exhibit 7: Ambit Good & Clean Smallcap Fund (Emerging Giants) performance update



*Source: Ambit, Bloomberg *Date of inception=1st December 2017. Returns as of October 31, 2018. Performance is post all fees and charges.*

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