MONTHLY NEWSLETTER

AMBIT
Acumen at work

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AMBIT
ASSET MANAGEMENT

GOOD & CLEAN
by Ambit

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READ ALL SCHEME RELATED DOCUMENTS CAREFULLY BEFORE INVESTNG

After deteriorating macros through the early part of last year, the December quarter saw a favorable macro backdrop. INR appreciated by 4% to $69.5 after reaching all-time low at $74.5 in early October & Brent crude recovered from over $80/bbl to $53/bbl. 10Y bond yields also rallied 60Bps to 7.4% as the RBI undertook several measures to stabilize liquidity post the tightening of financial conditions from IL&FS default.

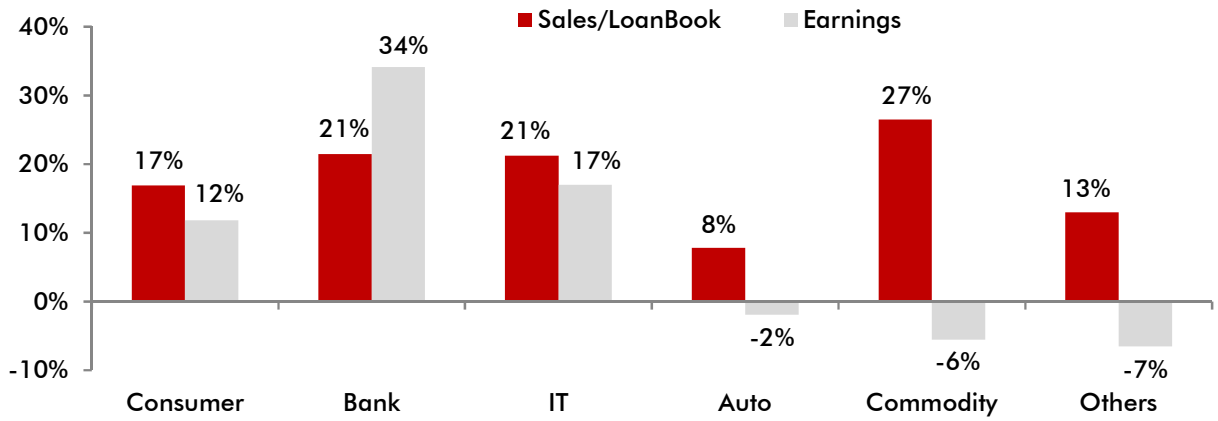
Against the macro backdrop, overall, the quarterly earnings for the BSE Sensex displayed strength led by **corporate lending banks**. In first signs of revival of investment cycle, corporate lenders showed high loan disbursements and the sector signaled the end of NPA cycle. While on the other hand despite lower G-Sec yields, the spreads for **NBFC**'s increased. NBFC earnings were severely impacted by liquidity tightness in wholesale debt markets and the sector showed signs of stress with rising borrowing cost, declining interest margins & declining loan disbursements.

Given that a significant part of **passenger vehicle** is financed by loans from NBFC's, it seems clear that the rise in cost of funding for NBFC's is affecting demand. Volume growth was negative & high promotion expense combined with input cost pressures dented margins for the leading car manufacturer. Even in **2-wheeler space**, rising insurance premiums & fuel costs dented consumer sentiment and the resulting discounts by manufacturers negatively impacted margins.

The resilience of **consumer/FMCG** sector continued. With near normal monsoon, stabilization post demonetization/GST and state intervention to boost farm incomes – consumer companies displayed double digit revenue growth. Further, the cooling off of commodity prices provided strong support for margins expansion.

IT companies continued to deliver strong revenue growth & margin expansion led by strong demand from the US economy & currency tailwinds. Among the other sectors, **Telecom** remained impacted by high competition intensity, discounted pricing & high leverage.

Exhibit 1: BSE 30 Sensex Sales & Earnings growth (Q3-2019 vs. Q3-2018):



Source: Ambit Research; Note: Does not include 6 companies (2 Auto, 3 commodity & 1 other) whose Q3 results have not yet been announced

Interim Budget: The key announcement from the vote on account interim budget was the Rs.6000 handout to small farmers and proposed income tax exemption for up to Rs.5lakh total income. With increased government spending in run up to elections, G-Sec yields are not likely to drop despite the expected RBI rate cuts. All of this will eventually bring more money in the hands of the consumer and signal a huge positive for consumption sector. NBFC sector and consumption growth fuelled by borrowing is likely to continue witnessing a slowdown. Given the deep inter-linkages between NBFC's & real estate, we foresee stress in the NBFC sector to creep into real estate sector as well.

Ambit Good & Clean Portfolio

GOOD & CLEAN by Ambit

Ambit's Good & Clean strategy provides long only equity exposure to Indian businesses that have an impeccable track record of clean accounting, good governance, and efficient capital allocation. Ambit's proprietary 'forensic accounting' framework helps weed out firms with poor quality accounts while our proprietary 'greatness' framework helps identify efficient capital allocators with a holistic approach for consistent growth. Our focus has been to deliver superior risk-adjusted returns with as much focus on lower portfolio drawdown as on return generation. Some salient features of the Good & Clean strategy are as follows:

- **Process-oriented approach to investing**: Typically starting at the largest 500 Indian companies, Ambit's proprietary frameworks for assessing accounting quality and efficacy of capital allocation help narrow down the investible universe to a much smaller subset. This shorter universe is then evaluated on bottom-up fundamentals to create a concentrated portfolio of no more than 20 companies at any time.
- **Long-term horizon and low churn**: Our holding horizons for investee companies are 3-5 years and even longer with annual churn not exceeding 15-20% in a year. The long-term orientation essentially means investing in companies that have the potential to sustainably compound earnings, with this compounding earnings acting as the primary driver of investment returns over long periods.
- **Low drawdowns**: The focus on clean accounting and governance, prudent capital allocation, and structural earnings compounding allow participation in long-term return generation while also ensuring low drawdowns in periods of equity market declines.

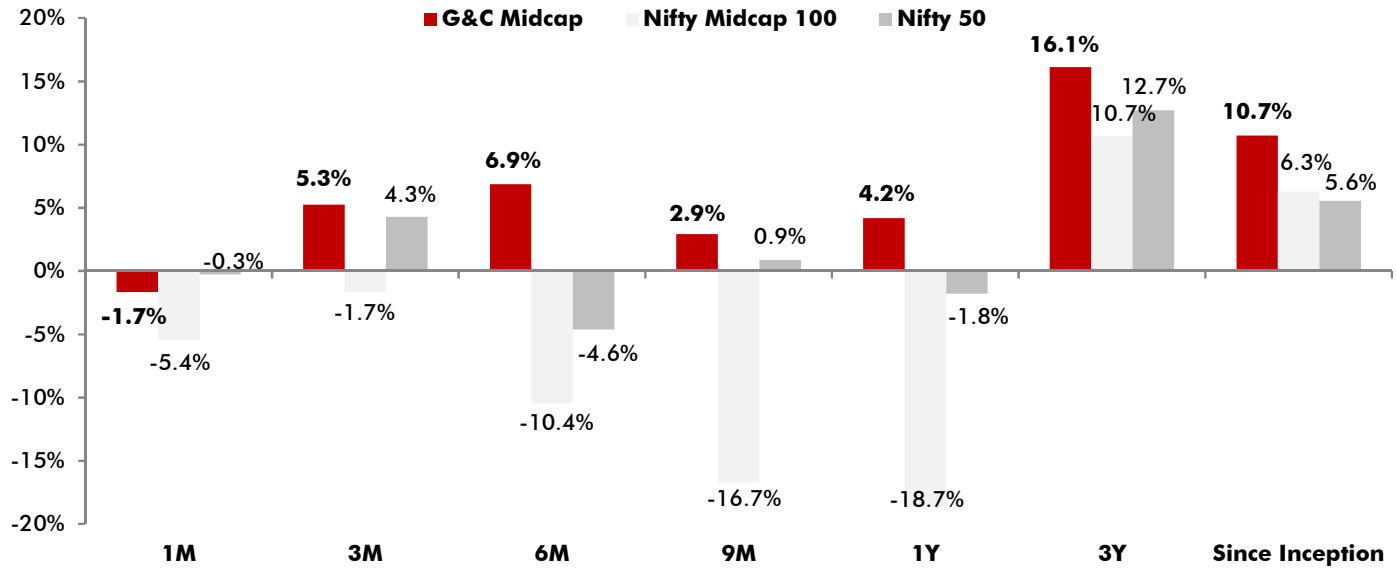
Portfolio update

We made few changes to the portfolio in the past months - we added exposure to an established player in the housing finance space (HFC). While we have been sceptics of HFC space in general owing to huge competition and rising interest cost owing to liquidity crisis, this is one HFC that stands out on our frameworks. This, rajasthan–based HFC primarily caters to low and middle income self-employed customers in tier-3/ tier-4 cities with operations across Rajasthan/Maharashtra/Gujarat (~83% of AUM). With its focus on untapped retail affordable housing the company has created a unique in-house sourcing model enabled by technology and analytics. Key positives are, strong loan book growth (~78% CAGR in FY14-18), ability to raise funds at lower cost, robust credit assessment framework using data analytics (GNPA of 0.34% as on FY18) and parentage of a strong promoter group.

Over the last few months, we have exited two stocks in the auto space, TVS Motors and Mahindra CIE. Given increasing price pressure on European business, Mahindra CIE may witness slowdown in EPS growth and India business may also witness margin pressure. While, we find TVS doing incrementally better on new products than its 2W peers, we remain concerned on margin outlook for 2W OEMs, given big regulatory cost push from new safety and emission norms over 2019-2020, high competitive intensity and rising cost of borrowing.

As laid out in the recent months' newsletters, liquidity environment is getting tighter and thereby increasing volatility in equity markets. Hence investors should be wary of investing in companies/sectors with dubious accounting practices, high leverage and capital miss-allocation. In general, as cost of capital rises and money becomes dearer, investors should become more cognizant of quality. This in turn should hold the Good & Clean portfolio in good stead.

Exhibit 6: Ambit Good & Clean Portfolio performance update



Source: Ambit; Portfolio inception date is March 12, 2015; Returns as of January 31, 2019; Since inception & 3Y returns are annualized returns. ***Returns are net of all fees and expenses***

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