MONTHLY NEWSLETTER

AMBIT
Acumen at work

April 2018

AMBIT

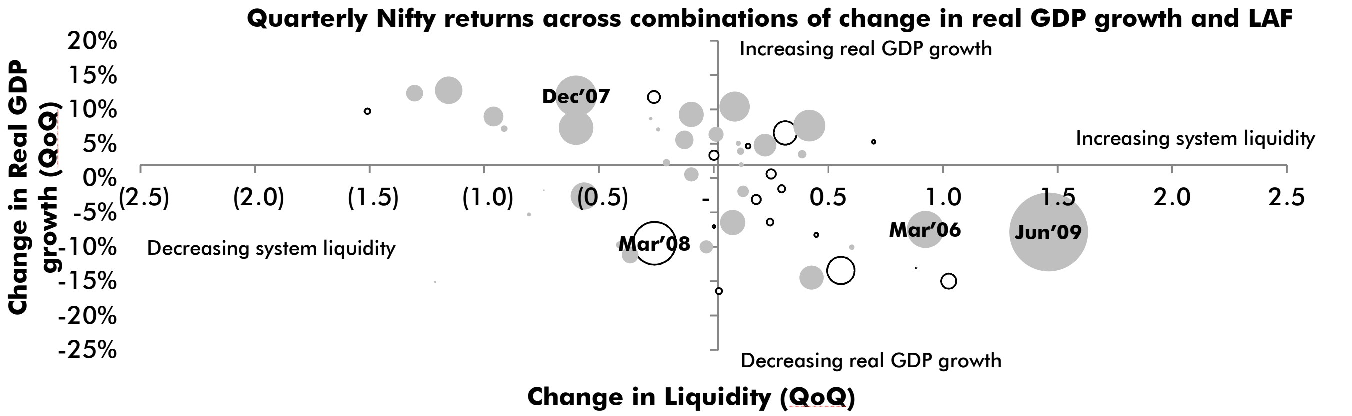
ASSET MANAGEMENT

Macro overview

From liquidity to earnings growth

After a rough first quarter for equity markets, the optimism surrounding Indian equities has given way to despair and fear. Amongst the many worries facing investors today, one very important one is that the recent tightening of system liquidity will derail the bull market in equities. We however think that this notion is completely misplaced and in the context of a recovering economy and improving earnings growth, equity markets should continue doing well. In that context here is an interesting chart from Ambit Capital's institutional research team which shows that historically whenever GDP growth is improving, equity returns are almost always positive even if the system liquidity is decreasing.

Exhibit 1: Positive (quarterly) Nifty returns are mainly supported by increase in real GDP growth



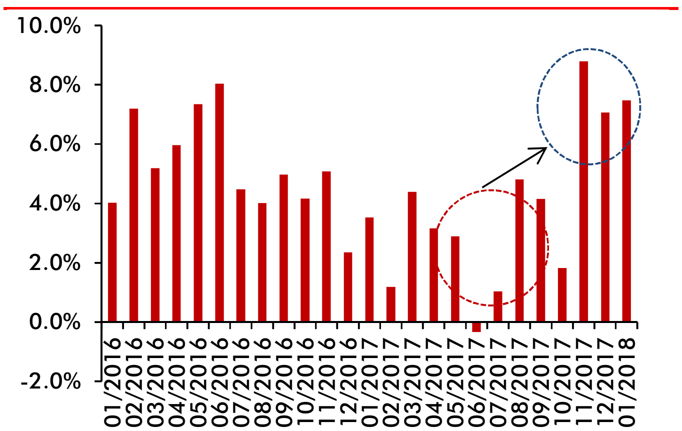
Source: Bloomberg, CEIC, Ambit Capital research. Data used from 31st Mar'05 to 31st Dec'17. Note: Grey bubbles denote positive change in P/E and blank bubbles denote negative change in P/E. Size of the bubble denotes the magnitude of change.

On economic growth, we think that the economy is witnessing green-shoots in the recent months as visible in a host of micro variables like auto sales (more prominently commercial vehicle sales), air passenger traffic growth, SME credit growth and so on. The yield curve is as steep as it has been in the past several years again indicating expectations of a strengthening growth trajectory. Most importantly, the Index of Industrial Production (IIP) has been firmly trending up.

This economic recovery in turn should soon start reflecting in corporate earnings growth that has stayed suppressed for the last decade or so. With disruption around demonetization and GST behind, and positives of the ongoing reform process likely to benefit the organized, listed company universe (not to mention the successful implementation of the e-way bill finally from April 1), we believe earnings are turning the corner.

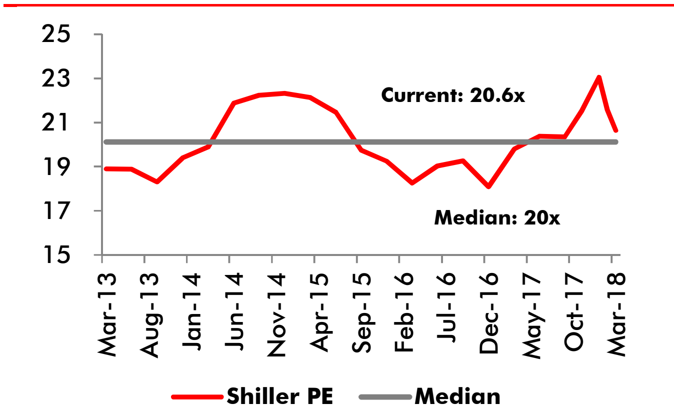
In the context of normalizing earnings growth, the recent correction has brought valuations to attractive levels. The cyclically-adjusted price-earnings (CAPE) ratio is now trading close to the long term historical median. **This combination of earnings recovery and inexpensive valuations makes for a strong case for Indian equities in our view.**

Exhibit 2: Uptrend in IIP in the recent months clearly pointing towards an economic recovery



Source: Bloomberg

Exhibit 3: CAPE ratio has reverted back to the long term historical median multiple



Source: Bloomberg, Ambit

Ambit Good & Clean

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 to 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 earnings compounding 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.

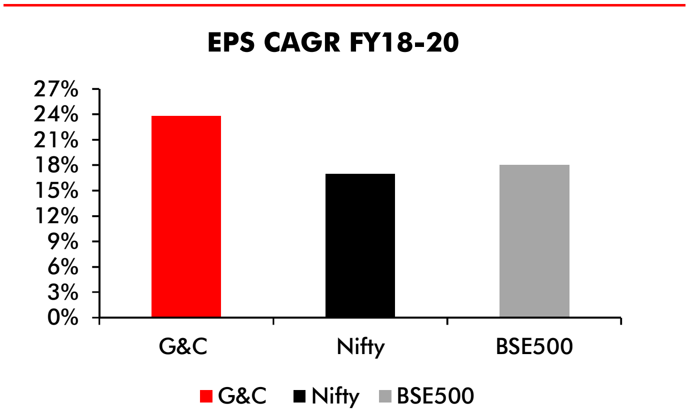
G&C portfolio – combining secular growth with superior return ratios and low leverage

So far in the first three months of CY17, our G&C portfolio has lagged the benchmark Nifty's performance primarily on account of the underperformance in the month of January 2018. As highlighted in our February 2018 newsletter, January 2018 was a very unusual month as: (i) even though headline indices showed a surge, most stocks were down. For instance, about two thirds of the BSE500 companies yielded negative returns (even as that index moved up 2.3%); (ii) Moreover, the slim minority of stocks that surged, were actually laggards of the previous year (CY2017).

While we have done much better than the markets over the past two months, the quarter on the whole has been weak. However, we do not think that this is representative of the long term potential of this portfolio. Here is why we believe G&C should do well going forward:

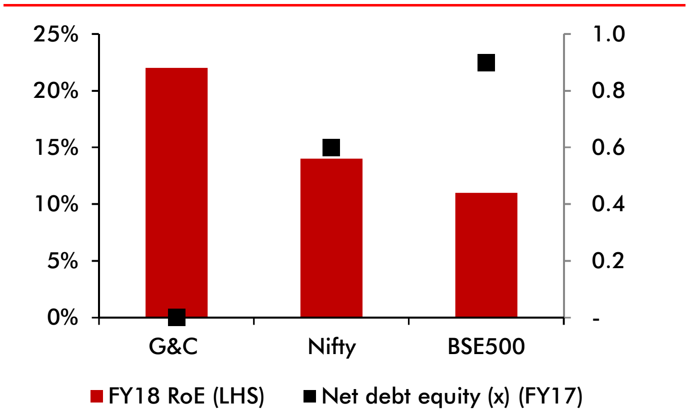
- G&C portfolio is a good mix of consumer discretionary, good quality lenders and light manufacturing based exporters, all of which should benefit in our view in light of a global and local economic growth revival. We expect G&C portfolio to deliver close to 24% net earnings CAGR over FY18-20 much higher than the Nifty or the BSE500.
- The average net-debt equity ratio (March 2017-end data) for the G&C portfolio (excluding banks/NBFCs) is almost NIL, again significantly lower than Nifty's 0.6x and BSE500's 0.9x.
- G&C portfolio enjoys significantly better return ratios than Nifty and BSE500. While the weighted average FY17 RoE for G&C portfolio stood at 22%, that for Nifty and BSE500 stood at a much lower 14% and 11% respectively.

Exhibit 4: G&C 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

Portfolio update – No significant changes

We have made no major changes to the portfolio in the past month – we have started to add exposure to a dominant player in the air cooler space. We believe the growth potential of the air cooler segment is high – only 11% penetration in 250mn Indian households. Additionally, the share of organized players in this nascent segment is still at ~20-25% (was ~10-12% 5 years ago), thus there remains vast long-term potential for organized branded players to gain share from unorganized sellers. The company enjoys strong competitive position due to its strong brand image, wide distribution network, reputation for quality and sole focus on the air cooler segment. Furthermore, asset-light model (outsources manufacturing of air coolers) and negative working capital (uses the cash & carry model for sales) helps it generate market-leading return ratios and maintain dividend payout of ~50% over the years.

On a sectoral basis, discretionary consumption, good quality lenders and light manufacturing exporters comprise a bulk of our portfolio. Some firms that do well on our process include the largest movie exhibitor in the country, a leading two-wheeler company, the world's second-largest manufacturer (and catching up fast with the global leader) of high chrome mill internals, country's leading and the most profitable branded innerwear company, a specialty chemicals company that is the global leader (by a large margin) in its key molecules, amongst others. We believe most of these businesses will keep compounding at growth rates north of 20% for the next several years without taking any undue risks.

Exhibit 6: Returns of our Good & Clean strategy

Returns (%)	**Jan15**	**Feb15**	**Mar15**	**Apr15**	**May15**	**Jun15**	**Jul15**	**Aug15**	**Sep15**	**Oct15**	**Nov15**	**Dec15**	**CY15**
G&C				-4.82	3.92	-2.60	4.12	-0.90	-1.06	1.08	1.66	-0.79	**0.26**
Nifty				-6.77	3.08	-0.77	1.96	-6.58	-0.28	1.47	-1.62	0.14	**-9.45**
Returns (%)	**Jan16**	**Feb16**	**Mar16**	**Apr16**	**May16**	**Jun16**	**Jul16**	**Aug16**	**Sep16**	**Oct16**	**Nov16**	**Dec16**	**CY16**
G&C	-3.83	-8.69	11.4	4.26	3.54	1.07	4.06	2.83	-0.78	3.14	-6.20	-1.00	**8.53**
Nifty	-4.82	-7.62	10.8	1.44	3.95	1.56	4.23	1.71	-1.99	0.17	-4.65	-0.47	**3.01**
Returns (%)	**Jan17**	**Feb17**	**Mar17**	**Apr17**	**May17**	**Jun17**	**Jul17**	**Aug17**	**Sep17**	**Oct17**	**Nov17**	**Dec17**	**CY17**
G&C	6.26	2.24	3.85	3.16	0.81	1.45	0.97	-2.83	0.75	4.80	2.80	5.34	**33.5**
Nifty	4.59	3.72	3.31	1.42	3.41	-1.04	5.84	-1.58	-1.30	5.59	-1.05	2.97	**28.7**
Returns (%)	**Jan18**	**Feb18**	**Mar18**	**Apr18**	**May18**	**Jun18**	**Jul18**	**Aug18**	**Sep18**	**Oct18**	**Nov18**	**Dec18**	**CY18**
G&C	-3.79	-1.12	-3.89										**-8.57**
Nifty	4.72	-4.85	-3.61										-3.96

Source: Bloomberg, Ambit. Portfolio inception date is Mar12, 2015. Returns for Mar'15 have been merged with Apr'16 and the same adjustment has been made to index returns. Returns as of 31st March, 2018

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