MONTHLY NEWSLETTER

AMBIT
Acumen at work

May 2018

AMBIT

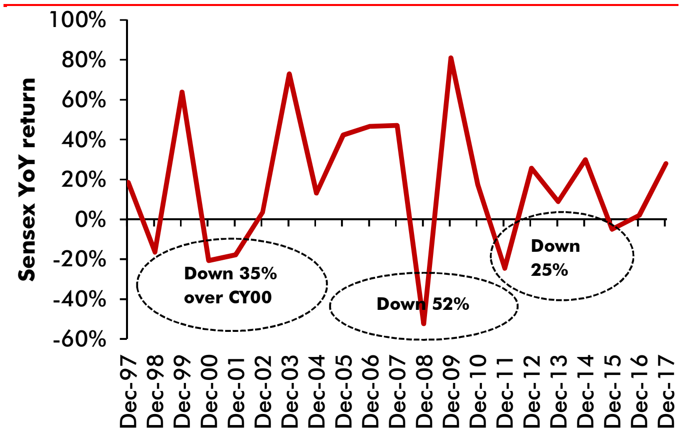
ASSET MANAGEMENT

Ambit Good & Clean

The Noise and the Signal

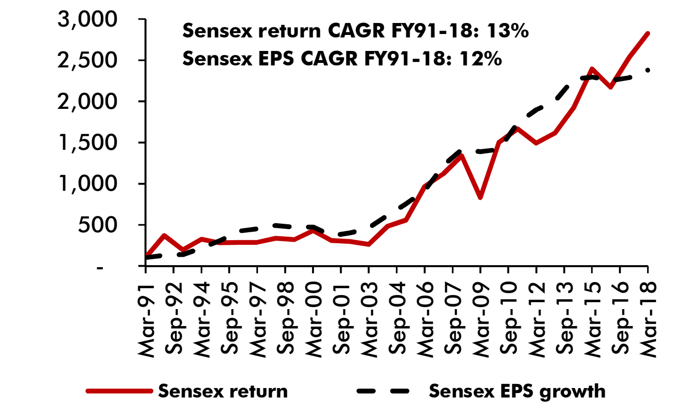
After a weak first quarter, Indian equity markets rebounded sharply in April with the Nifty rising 6.2% for the month. These periodic ups and downs only serve as reminders that volatility is an integral part of equity market investing. With the continued rise in bond yields, increasing cost of money should keep volatility elevated in our view. However, for long term investors most of this is irrelevant. Even with these periodic bouts of volatility impacting short term returns, long term equity returns are primarily governed by earnings growth. Therefore, the ability to see through the near term noise is critical to long term investment success.

Exhibit 1: Equity returns display intermittent periods of volatility…



Source: Bloomberg

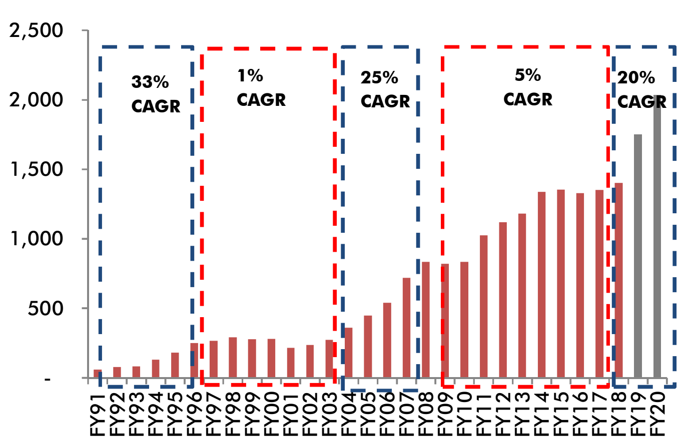
Exhibit 2: …but eventually track earnings growth over the long term



Source: Bloomberg; Cumulative YoY Returns indexed to 100 (March 1991)

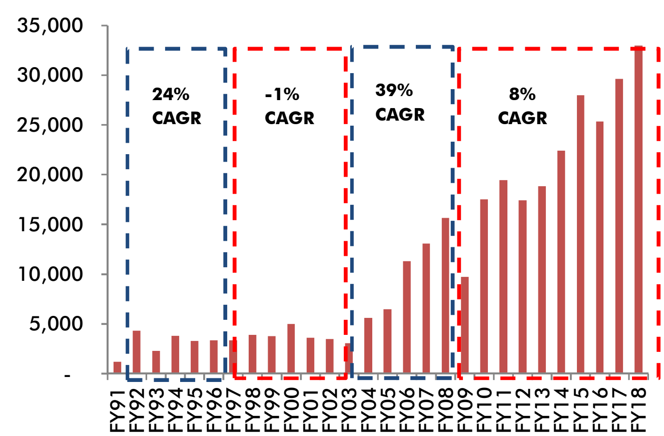
On the subject of earnings, we believe that after a prolonged period of suppressed growth (~5% CAGR on corporate earnings over FY08-18), growth is beginning to normalize. With disruption surrounding GST and demonetisation behind us, the recent government reforms (financialisation of savings, formalisation of the economy) should soon start reflecting in corporate earnings growth. High frequency indicators like the Index of Industrial Production (IIP), auto sales, SME credit growth, etc. are already indicating green-shoots of economic recovery.

Exhibit 3: Expect normalization in earnings growth…



Source: Bloomberg, Ambit; Earnings represented by Annual Sensex EPS (Rs) above

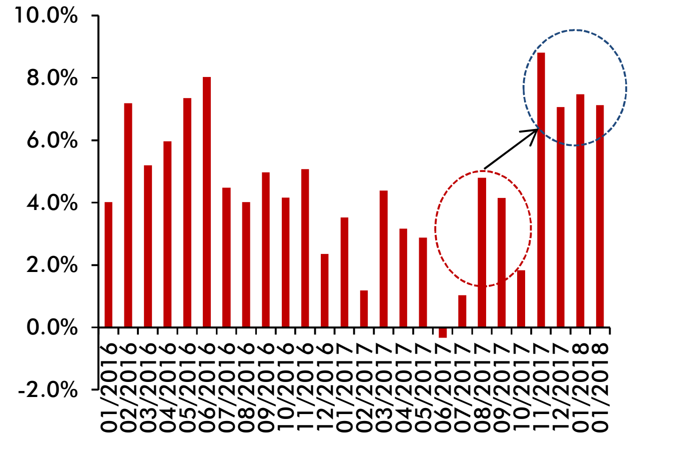
Exhibit 4: …which in turn should drive equity returns



Source: Bloomberg; Equity represented by Sensex above

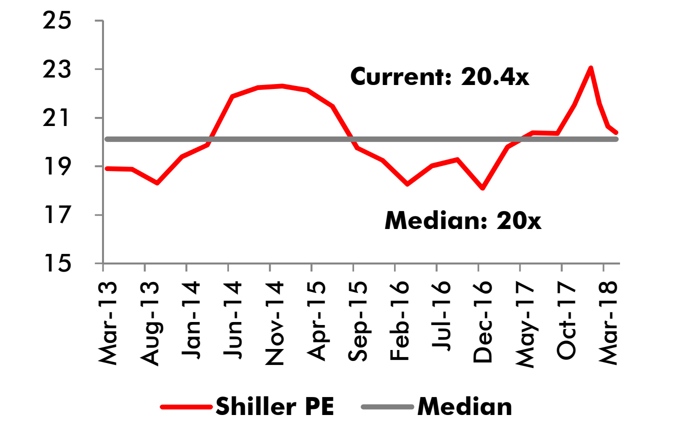
Finally, even with the equity market rally of the past eighteen months, long term valuation measures such as the cyclically- adjusted price-earnings (CAPE) ratio is still close to the long term historical median. This suggests that as earnings growth normalizes, the current valuations leave sufficient room for continued equity market upmove.

Exhibit 5: Rising IIP points to an economic recovery



Source: Bloomberg, Ambit

Exhibit 6: Long term valuation measures supportive of continued equity gains as earnings normalize



Source: Bloomberg, Ambit

Investing in Ambit's Good & Clean Portfolio

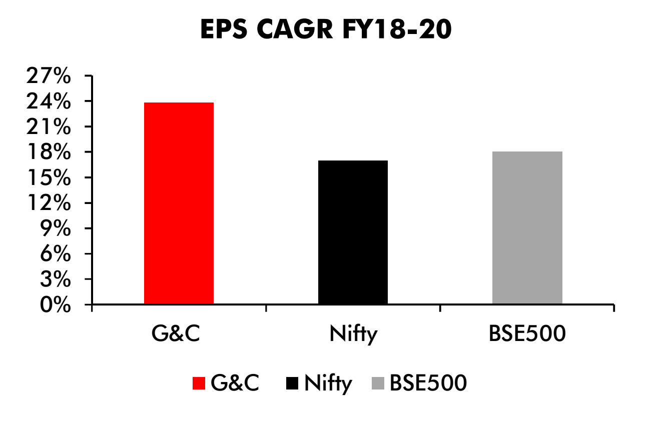
Ambit's Good & Clean strategy provides long only equity exposure to Indian businesses that have an impeccable track record of clean accounting, good governance, and efficient capital allocation. Ambit's proprietary 'forensic accounting' framework helps weed out firms with poor quality accounts while 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.

With our expectation of recovering earnings but rising volatilities, G&C portfolio is strongly positioned for the following reasons:

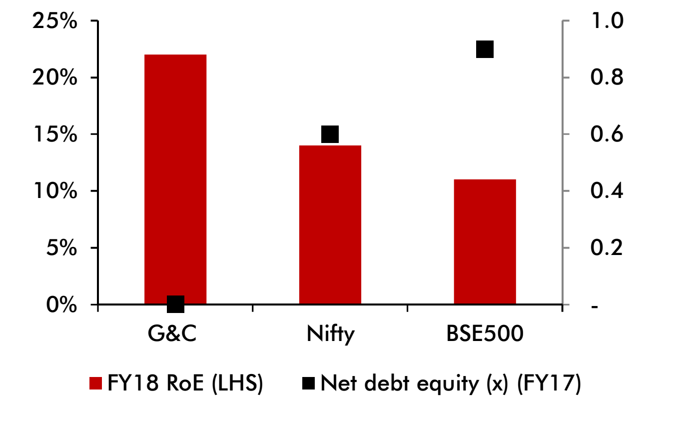
- G&C portfolio is a good mix of consumer discretionary, good quality lenders and light manufacturing based exporters, all of which should benefit in our view in light of a global and local economic growth revival. We expect G&C portfolio to deliver over 24% net earnings CAGR over FY18-20 much higher 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 7: G&C portfolio expected to deliver much higher earnings growth than benchmark indices…



Source: Ambit, Bloomberg

Exhibit 8: …combined with much better RoEs and significantly lower leverage



Source: Ambit, Bloomberg

G&C 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 9: 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	6.89									**-2.27**
Nifty	4.72	-4.85	-3.61	6.19									1.99

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 30th April 2018

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