MONTHLY NEWSLETTER

AMBIT
Acumen at work

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AMBIT

ASSET MANAGEMENT

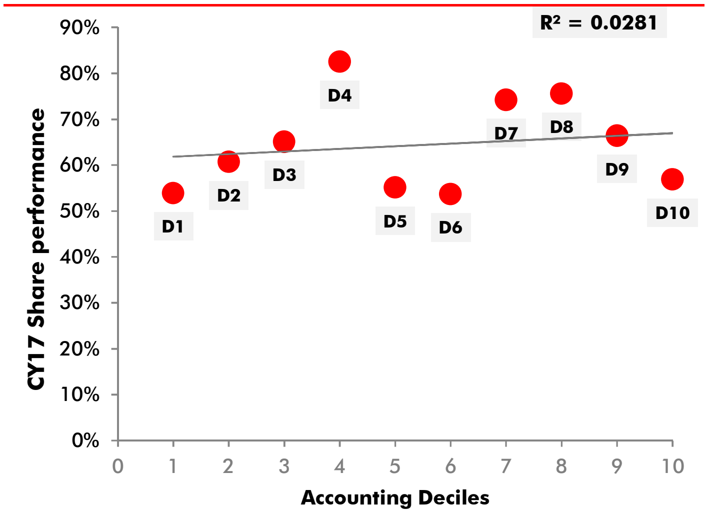
Ambit Good & Clean

Focus back on accounting quality

In the long run, good accounting quality and efficient capital allocation (in some ways reflected in higher ROCEs) define investment success. A look at longer-term stock returns suggests a direct relationship between better accounting quality and superior stock performance. Similarly, over the long run, there is a strong link between ROCEs and share price performance. Yet in the shorter run, markets do have a tendency to test patience even with most time-tested and rational investment methods. For instance, the bull market of CY17 saw speculative excesses being created in lower quality stocks. In CY 2017, the worst 20% stocks on accounting quality outperformed the Sensex by nearly 35% points.

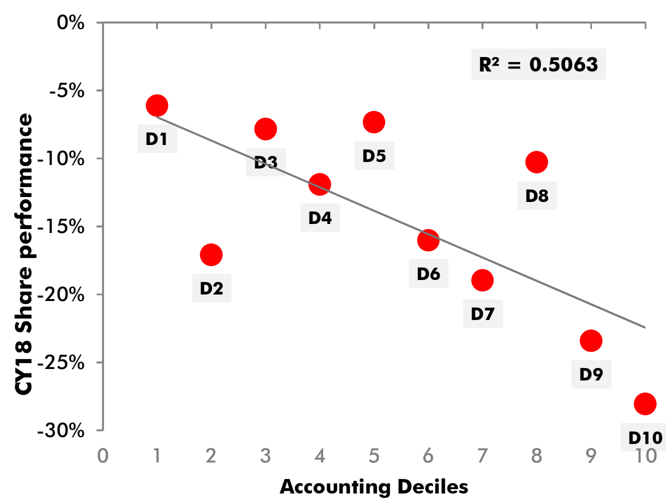
However, things have changed with the onset of CY18. As the cost of capital rose (reflected in the rising bond yields), liquidity started drying up and equity markets turned volatile. This, in turn, has made investors more selective. Recurring news flow on auditor resignations has further spooked investors of late. All of this, in turn, has brought the focus back on accounting quality. This has resulted in good quality companies outperforming their poor quality counterparts by a considerable margin in CY18 so far – clearly, a departure from the trend witnessed in the bull market of CY17. The exhibits below clearly bring out the above divergence.

Exhibit 1: Accounting quality took a back seat in CY17…



Source: Ambit, Ace Equity, Bloomberg

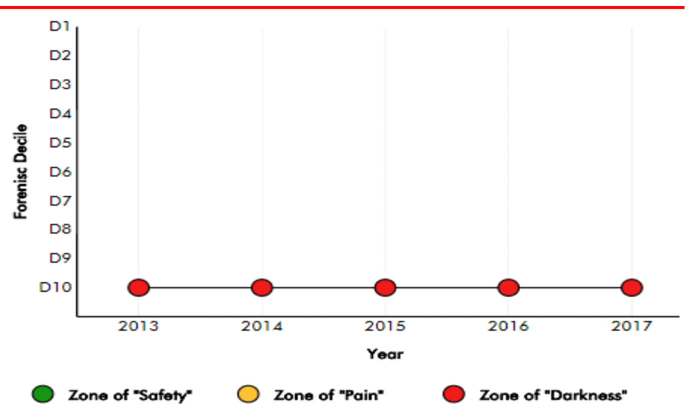
Exhibit 2: …but back in the reckoning in CY18



Source: Ambit, Ace Equity, Bloomberg

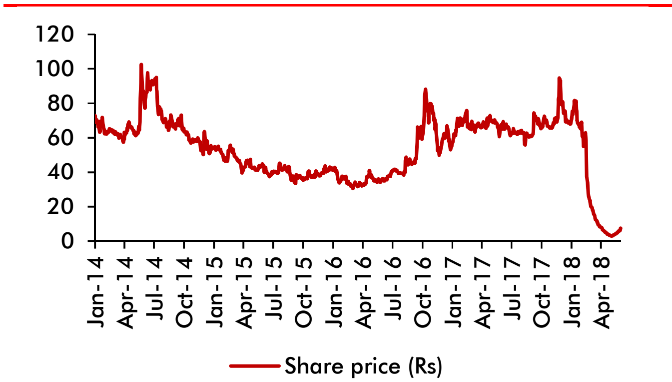
The important take away for investors therefore is that there are prolonged periods when markets deviate from rationality. Sticking to a sensible process in such periods is imperative rather than being bogged down by near-term share price performance. Because when things do revert back to rationality eventually, it is likely to happen at a pace rapid enough to catch everyone unaware. Consider for example the case of a jewellery company that was in the limelight recently for all the wrong reasons. The stock had always been an inferior performer on our accounting frameworks. Yet the stock price more than tripled between 2016 and 2017, before eventually losing 90% within just four months.

Exhibit 3: The Jewellery Company consistently featured in lowest accounting decile in Ambit's accounting framework…



Source: Ambit, Ace Equity, Bloomberg

Exhibit 4: …with its stock price eventually catching up with its poor accounting score



Source: Bloomberg

Good & Clean investing - An essential in the current market environment

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:

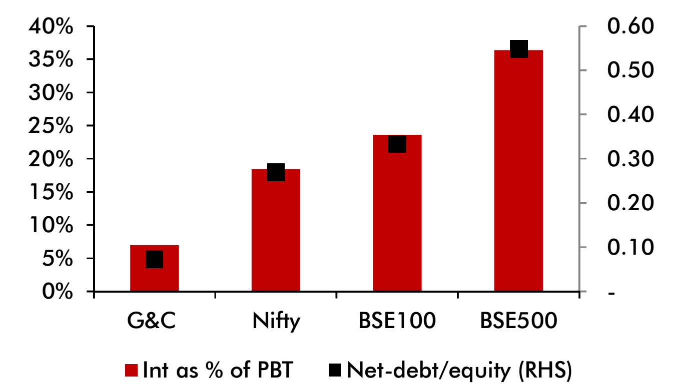
- **Process oriented approach to investing**: Typically starting at the largest 500 Indian companies, Ambit's proprietary frameworks for assessing accounting quality and efficacy of capital allocation help narrow down the investible universe to a much smaller subset. This shorter universe is then evaluated 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.

As laid out in the recent months' newsletters, our view remains that equity markets are moving away from being liquidity supported (as in the recent years) towards being earnings driven. However, the flip side of the same is that being that liquidity environment would get tighter and thereby increase volatility in equity markets. Hence investors should be wary of investing in companies/sectors with dubious accounting practices, high leverage, reliance on wholesale borrowings/asset-liability mismatch (such as housing finance companies) and high exposure to raw material price inflation (for instance, consumer staples with high price-demand elasticity).

On the other hand, we believe the Good & Clean portfolio is well positioned in the current environment due to the following reasons:

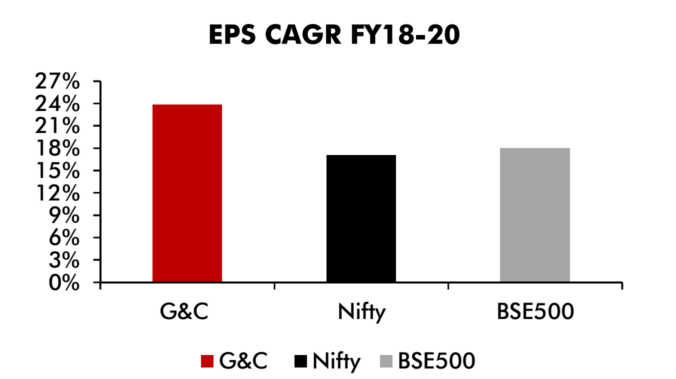
- Within financials, we have exposure to one pan-India private bank, one regional private bank and an auto financing NBFC. As the economy picks up, all three should benefit in our view. Importantly, the NBFC has a decently balanced asset liability profile and should not have the same adverse impacts as discussed in the macro section of this letter.
- Secondly, amongst non-financial companies, our selection framework excludes highly leveraged companies. The average net-debt equity ratio (March 2017-end data) for the G&C portfolio (excluding banks/NBFCs) is 0.07x which is significantly lower compared to that of Nifty, BSE100 and BSE500.
- Thirdly, the 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

Exhibit 5: G&C portfolio has much lower interest costs and net debt compared to benchmark indices



Source: Ace Equity Note: Banks/NBFCs not considered above. Simple average of individual companies' net debt equity ratio

Exhibit 6: G&C portfolio expected to deliver much higher earnings growth than benchmark indices...



Source: Ambit, Bloomberg

G&C Portfolio update – No significant changes

We have made no major changes to the portfolio in the past month – we continue 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.

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 7: 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)	4.16	(0.90)	(1.06)	1.08	1.66	(0.79)	**0.30**
Nifty				(6.77)	3.08	(0.77)	1.96	(6.58)	(0.28)	1.47	(1.62)	0.14	**(9.46)**
Returns (%)	**Jan16**	**Feb16**	**Mar16**	**Apr16**	**May16**	**Jun16**	**Jul16**	**Aug16**	**Sep16**	**Oct16**	**Nov16**	**Dec16**	**CY16**
G&C	(3.83)	(8.69)	11.40	4.26	3.54	4.10	4.08	5.43	0.90	1.74	(4.54)	(1.19)	**16.8**
Nifty	(4.82)	(7.62)	10.75	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	4.47	3.04	1.41	3.60	0.95	0.40	2.52	(1.08)	1.37	4.34	1.44	4.23	**30.0**
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	(3.04)	(0.59)	(3.19)	5.42	(1.46)								**(3.07)**
Nifty	4.72	(4.85)	(3.61)	6.19	(0.03)								**1.96**

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 May 31, 2018.

Disclaimer

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