MONTHLY NEWSLETTER

July 2018

AMBIT

ASSET MANAGEMENT

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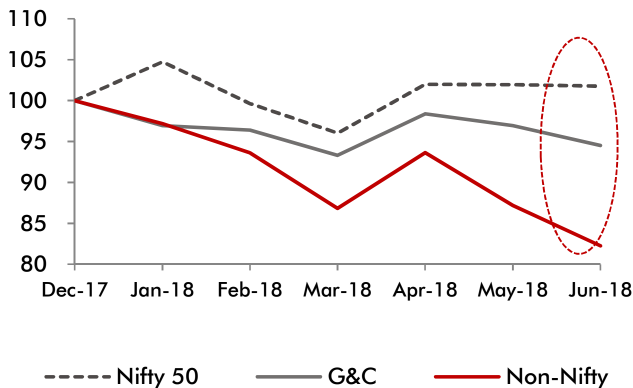
Ambit Good & Clean

A tale of two markets

The big disconnect- Nifty and the broader markets

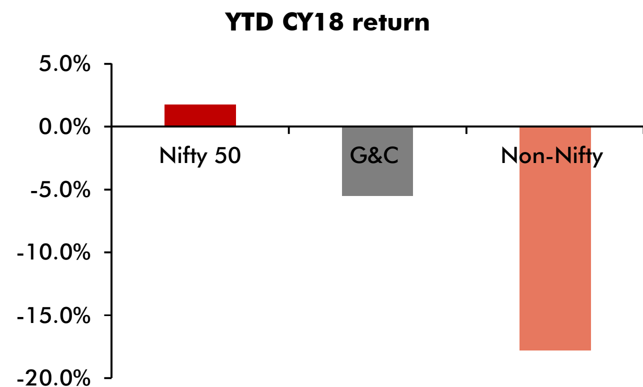
The equity market performance in June 2018 continued to reflect the recent months' trends: headline indices (Nifty/Sensex) showing much greater resilience compared to the broader market. In the calendar year 2018 so far, Nifty has risen by 1.7% as compared to non-Nifty stocks' (above 1000cr market cap) fall of nearly 18% - a divergence of close to 20% points! This therefore has been an extremely challenging phase for investors to say the least. The big question of course is that what is the way forward and what should investors do now?

Exhibit 1: The disconnect between headline indices (Nifty) and broader markets continued to widen in June ...



Source: Bloomberg Note: Non-Nifty stocks above include companies with market cap of >Rs10bn

Exhibit 2: ...with significant divergence in cumulative returns for YTD CY18



Source: Bloomberg, Note: Non-Nifty stocks above include companies with market cap of >Rs10bn

What's driving this divergence?

In our view, the following factors have contributed to the above disconnect

- **The deteriorating macro** characterized by rising commodity inflation and increasing interest rates has brought about concerns on corporate earnings which anyways have been elusive so far. Hence, the incremental inflows are being directed into a relative smaller sub-set of stocks, viewed as relative defensive bets – for instance, TCS, HDFC Bank and HUL which delivered returns of 37%, 13% and 12% respectively for YTD CY18. This handful of stocks in turn is acting to keep the Nifty optically elevated even as the broader markets have been suffering.
- Technical factors such as **SEBI's reclassification** of mutual fund schemes may have led to selling in mid-small stocks.
- Thirdly and perhaps most importantly, the stock market frenzy of CY17 had created **speculative excesses** in certain low quality mid and small caps. The ongoing correction in many such names has been disproportionate- in fact 30% of all stocks (above 1000cr mcap) have lost 30% or more in CY18 so far. Recurring news flow on governance issues such as auditor resignations and the consequent collapse in stock prices suggests that the euphoria of CY17 has now given way to despondency and pessimism.

The way forward

Clearly rising rates and commodity inflation are genuine worries. However, the important thing to note is that the economy is recovering as well. In fact, any economic recovery is bound to be accompanied with rising inflation and rising interest rates.

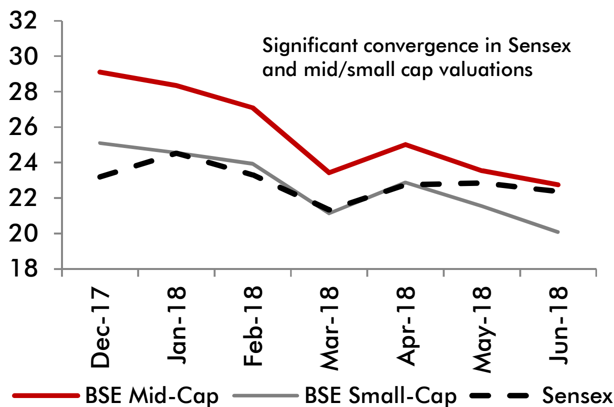
A host of micro variables are pointing to an economic revival- bank credit growth has picked up to highest levels since July 2014 (https://goo.gl/kTgzTu) auto sales, more prominently commercial vehicle sales, are robust (https://goo.gl/dXktSS), air passenger traffic growth, SME credit growth and urban consumption have been recovering strongly. Most importantly, the Index of Industrial Production (IIP) continues to trend up. Along with the pick-up in the real economy, the other positive development for listed companies is that increased GST compliance should lead to market share gains for the organized sector versus the thus-far non-compliant unorganized sector. This is corroborated by the fact that GST collection numbers have been on the rise ever since e-way implementation on April 1st (https://goo.gl/vmTsKs). A combination of rising economy on one hand and market share gains on the other should bring about the much awaited revival in corporate earnings soon.

To add to this, the valuations for mid and small caps are looking interesting again thanks to the correction of the past six months suggesting that most of the froth is out (see exhibit 3). The combination of improving earnings outlook and saner valuations augur well for broader markets in our view.

What won't change?

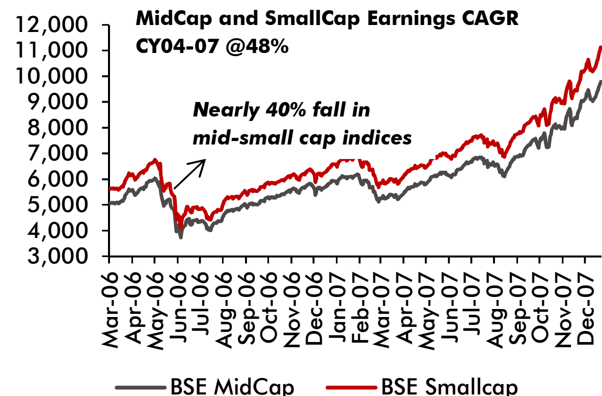
The one thing that investors however will have to be mindful of is that rising rates (which is a natural outcome of an improving economy) are here to stay. And as cost of money stays elevated so should volatility. However, rising volatility doesn't necessarily imply end of uptrend. In the FY02-FY07 period, which was arguably the best period for corporate earnings in India, interest rates and commodity prices were rising all throughout. While it did mean that volatility stayed high, it didn't deter the stock market uptrend. In fact mid and small-caps which typically show greater sensitivity to earnings revival, even withstood episodes of 30-40% stock price corrections (akin to one we are seeing today), only to exhibit even stronger rebounds subsequently (see exhibit 4).

Exhibit 3: The recent correction has made mid-small cap's valuation much more reasonable now…



Source: Bloomberg Note: Trailing twelve months earnings (only for positive earnings companies) considered above

Exhibit 4: Despite intermittent volatilities, Mid/small caps have delivered high returns during earnings recovery



Source: Bloomberg, Ambit; Note: For Earnings mentioned above, Mid-cap defined as stocks with 101-250th rank on market capitalisation and Small-cap as stocks with 251st-500th rank on market capitalisation.

Bottomline

We believe that earnings should inflect soon and therefore broader markets should start performing sooner rather than later. The ongoing correction therefore appears to be a corrective phase in an uptrend. However as markets move from being liquidity driven to earnings driven it's important to stick to Good & Clean as companies with stretched balance sheets and dodgy governance should have no case in a tightening liquidity environment.

Stick to Good & Clean investing

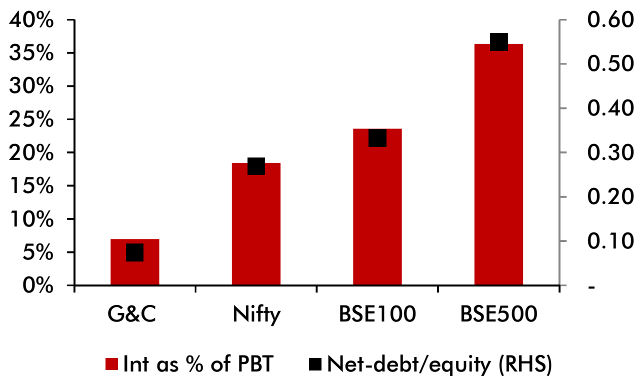
Ambit's Good & Clean strategy provides long only equity exposure to Indian businesses that have an impeccable track record of clean accounting, good governance, and efficient capital allocation. Ambit's proprietary 'forensic accounting' framework helps weed out firms with poor quality accounts while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

We believe the Good & Clean portfolio is specifically well positioned in current environment due to following reasons:

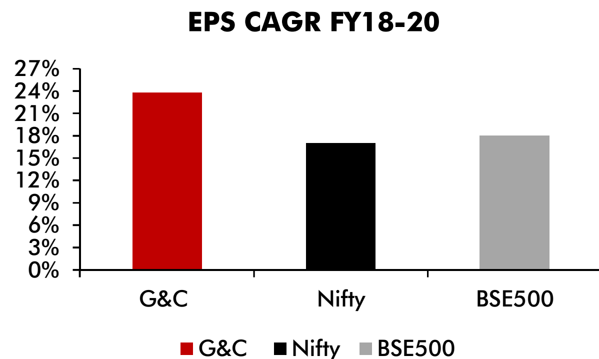
- Within financials, we have exposure to one pan-India private bank, one regional private bank and an auto financing NBFC. As the economy picks up, all three should benefit in our view. Importantly, the NBFC has a decently balanced asset liability profile and should not have the same adverse impacts 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. 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)	(2.47)							**(5.46)**
Nifty	4.72	(4.85)	(3.61)	6.19	(0.03)	(0.20)							**1.75**

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 June 30, 2018.

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