MONTHLY NEWSLETTER

AMBIT
Acumen at work

August 2018

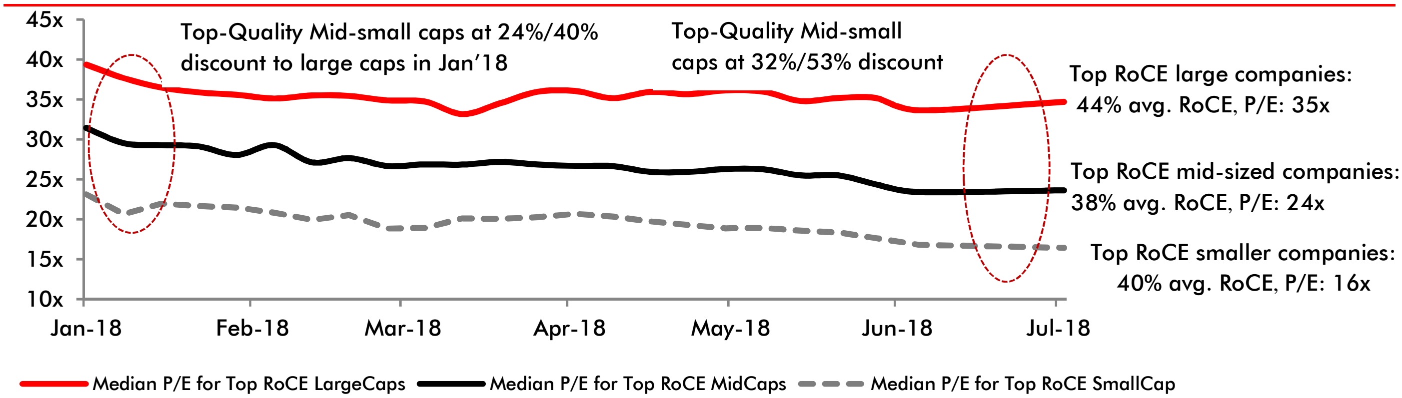
AMBIT

ASSET MANAGEMENT

Ambit Good & Clean

Disconnect between the performance of headline indices (Nifty/Sensex) and the broader markets continued in July 2018. Equity inflows continued to chase a smaller sub-set of stocks viewed as relative defensive bets. Hence benchmark indices like Nifty remained optically elevated even as the broader markets languished. This disconnect has not been restricted to just poor quality companies but even good quality mid and small cap stocks have been witnessing a widening of valuation discount versus their larger cap counterparts. For instance, the top 20% RoCE stocks (averaging close to 40% RoCE) in the BSE large cap space now trade at average P/E (trailing twelve months) of 35x which is substantially higher than 24x average for the mid-caps and 16x for the small caps despite similar return rations and earnings growth.

Exhibit 1: Rising valuation gap in 'good quality' stocks in large cap vs mid/small cap names



Source: Bloomberg Note: Large caps defined as top 250 on market cap (within BSE 500), Mid- caps as next 250 (within BSE 500) and Small-caps are sub BSE 500 in the above chart

As discussed in our July 2018 newsletter, the above divergence may have emanated from macro concerns surrounding rising commodity inflation and interest rates, technical impact of SEBI reclassification of mutual fund schemes (leading to sell off in mid-small cap stocks) and dissipation of euphoria surrounding mid-small stocks. Unfortunately, the investor pessimism has even extended to good quality mid-small cap names (as discussed above) even though they continue to deliver a healthy fundamental performance.

A host of micro variables (bank credit growth, air passenger traffic growth, auto sales and index of industrial production or IIP) are pointing to an economic revival. 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 2, 2018. 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. On the flip side, any economic recovery is bound to be accompanied with rising inflation and rising interest rates which the investors should be wary of.

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.

The combination of improving earnings outlook and saner valuations augur well for broader markets and more **particularly for the good quality mid and small cap names.**

Stick to Good and 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.

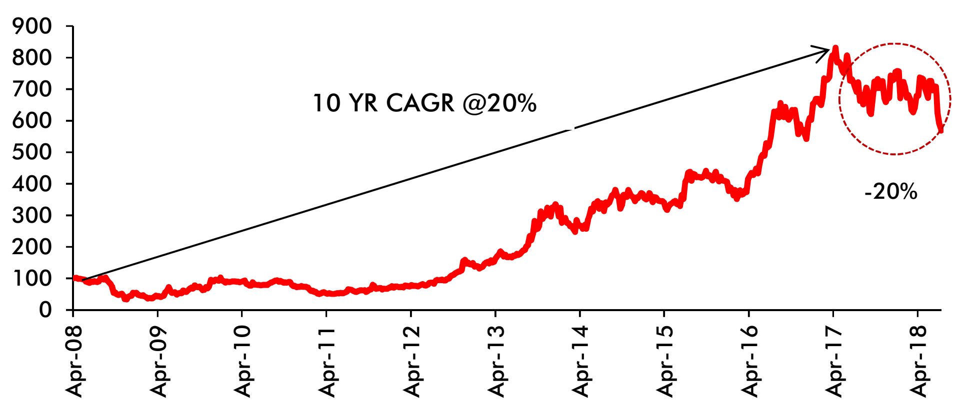
Portfolio insights: What's working, what's not?

We discuss below three specific G&C portfolio stocks which has delivered stellar share price performance historically but have seen weakness in the recent months due to specific events surrounding the industry.

Portfolio stocks which have not been doing well in the recent months

1) **PVR limited**, the largest multiplex chain in India

Exhibit 2: PVR share price performance



Source: Bloomberg Note: Share price indexed to 100 (end-July 2008)

The event

The stock price dropped about 20% last month. While the company recorded a strong revenue/EBITDA growth of 9%/22% in 1QFY19, investor concerns surround the pricing risks/regulatory actions in the Food & Beverage business (contributing 26% of Revenue).

Our take

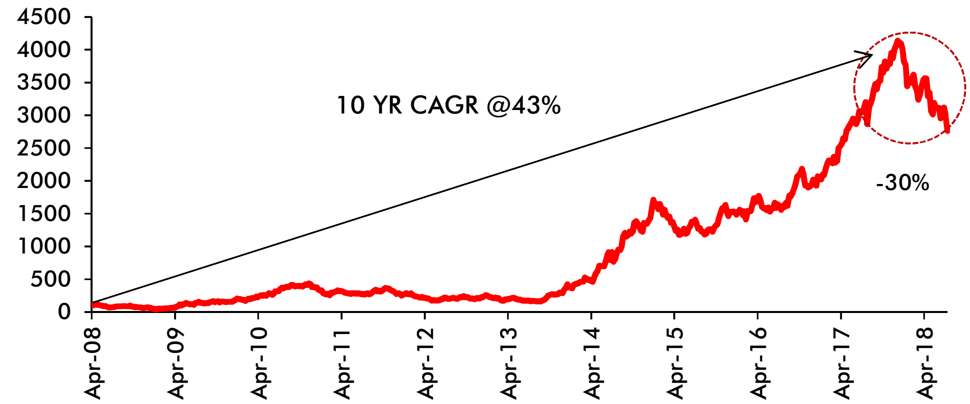
- The Court decision is awaited on the matter soon. While we are no legal experts, chances of regulation look remote going by precedence (for example bottled water in restaurants was eventually allowed to be sold at higher than MRP; Madhya Pradesh has already dismissed a similar petition).
- We believe there are several levers to mitigate any adverse outcome such as (i) rise in ticket prices to compensate for F&B revenue shortfall (10% fall in F&B spend per person can be offset by a 5% rise in

ticket price); (ii) F&B price rationalisation can result in higher volumes; and (iii) other cost/capex optimisation measures.

- Given the secular and discretionary nature of the industry demand, and given PVR's market leadership in an oligopolistic industry, we believe that at less than 24xY20 earnings the stock price is attractive!

2) TVS Motor, a rapidly growing 2W player in India

Exhibit 3: TVS Motor share price performance



Source: Bloomberg Source: Bloomberg Note: Share price indexed to 100 (end-July 2008)

The event

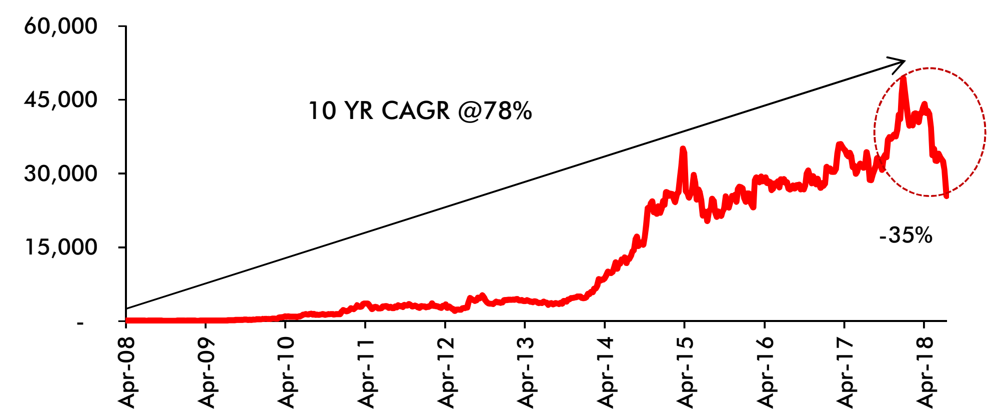
The company continues to witness strong volume growth (16% in 1QFY19). However, the stock price has been under pressure. This is on account of concerns surrounding price war in the industry post Bajaj Auto's aggressive pricing in the commuter bike segment.

Our take

- We believe investor concerns may be overstated given: (i) Success of Bajaj's strategy remains unclear given reports of high dealer inventory of commuter bikes; (ii) Prior experiences in Indian 2W industry indicate aggressive pricing has not necessarily translated into market share gains; (iii) Largest player Hero has refused to engage in price war.
- Given two mega brands in Jupiter and Apache keep the company favorably placed on the rising trends of scooterization and premiumization, at 18x FY20 net earnings, valuation appears extremely attractive.

3) Symphony, the largest branded air cooler player in India

Exhibit 4: Symphony share price performance



Source: Bloomberg Note: Share price indexed to 100 (end-July 2008)

The event

The company's standalone revenues declined by a sharp 25% in the last two quarters given erratic weather (two consecutive years of weak summers).

Our take

- While it is difficult to forecast weather, we do not see any structural issues in the company. The company continues to gain market share in the air cooler space with further opportunities from likely industry consolidation (small players in poor shape).
- Strength in franchise is evident from negative working capital cycle and 100%+ RoCEs.
- The company continues to make efforts for mitigating the revenue seasonality - with recent acquisition of Australian based Climate Technologies - revenues outside India would be 40% of consolidated revenue.
- 28x FY20 earnings, valuations for this high quality consumer franchise are tempting!

And on the positive side…

1. A peep into the recently published annual report suggests **PI Industries**' managerial remuneration declined 5% YoY in FY18 in a year when profitability was muted – we do not see such instances happening much in Indian companies.
2. **Cholamandalam Finance**, a champion in LCV financing, continues to gain market share in non-LCV auto segments as well with a 38% growth in 1QFY19 (vs 20-30% for peers),
3. **Vinati Organic**'s (a global leader in its key chemical offerings) latest annual report suggests it has gained further market share in ATBS (a key molecule, 50% of Vinati's revenues) from 45% globally to 55% globally in the past year.

Furthermore, the portfolio companies that have reported so far have seen healthy revenue growth and strong earnings in 1QFY19 – with median Revenue/EBITDA growth of 12%/22%. We therefore don't believe that anything has fundamentally changed for our portfolio stocks, and hope to recover fast enough.

Exhibit 5: 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	**(9.5)**
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)	**3.0**
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)	0.62						**(4.8)**
Nifty	4.72	(4.85)	(3.61)	6.19	(0.03)	(0.20)	5.99						**7.8**

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 July 31, 2018.

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