MONTHLY NEWSLETTER

AMBIT
Acumen at work

September 2018

AMBIT

ASSET MANAGEMENT

EQUITY INVESTMENTS & PMS ARE SUBJECT TO MARKET RISKS,
READ ALL SCHEME RELATED DOCUMENTS CAREFULLY BEFORE INVESTING

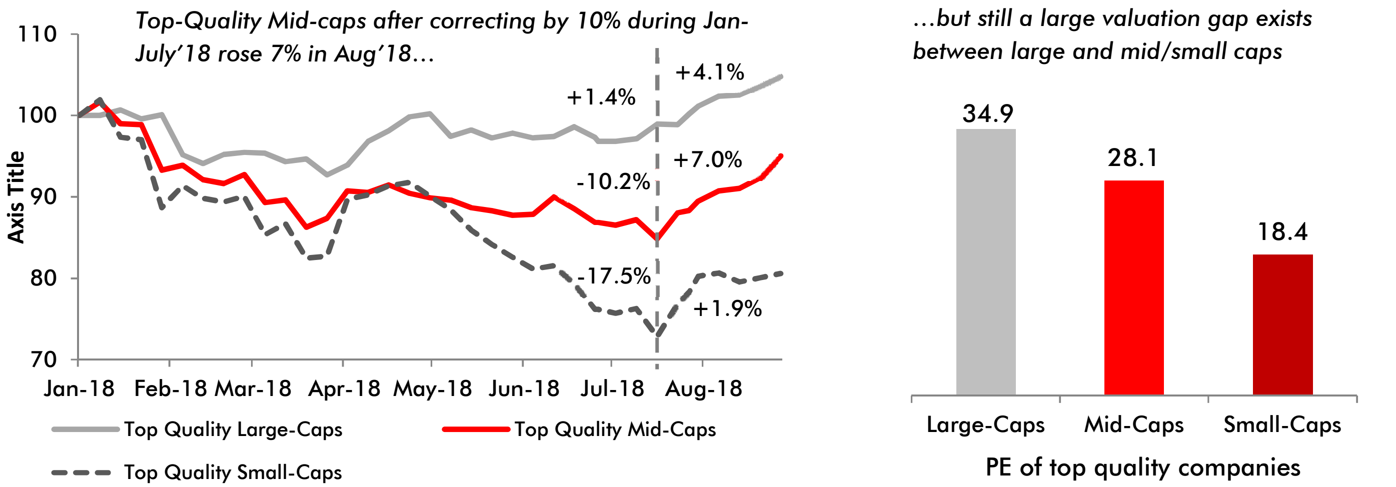
Ambit Good & Clean Midcap Fund

"The big money is not in the buying and the selling… but in the waiting" - *Charlie Munger*

Mid-small caps finally return to life…

In our August 2018 newsletter, we had highlighted that the valuation gap between good quality mid-small cap and large cap stocks had reached extreme and in our view unsustainable levels. At July 2018-end, the top 20% RoCE stocks in the large cap space traded at trailing 12-months P/E of 34x compared to 25x for the top RoCE mid-caps and 18x for the best RoCE small caps. This substantial gap was despite similar return ratios and earnings growth. The month of August 2018 saw a reversal in this trend to some extent with mid cap stocks clearly outperforming their larger cap peers.

Exhibit 1: Despite mid-cap outperformance in August, significant valuation gap still exists between large and mid-caps



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; Top quality stocks signifies companies within top 20% in terms of RoCE and top 50% in our forensic framework. Share price performance indexed to 100 (Jan-18 = 100)

…driven by a long awaited corporate earnings recovery in 1QFY19

Over the past few months, while a host of micro-variables (bank credit growth, air passenger traffic growth, auto sales and index of industrial production or IIP) had been pointing to an economic revival, corporate earnings growth had continued to be elusive. However, the recently concluded earnings season saw corporate India deliver strong earnings performance (G&C portfolio companies delivered a blended revenue growth of 16% YoY and core operating profit (EBITDA) growth of 22% in 1QFY18). This earnings revival brought back a revival in investor interest in good quality mid and small caps, in our view. As a result, the Good & Clean portfolio went to on to deliver a record month with double digit returns for the month.

Earnings momentum to continue but stick to Good & Clean stocks

A combination of improving economy on one hand and market share gains for the organised sector (as better GST compliance kicks in post e-way implementation) should keep corporate earnings strong over the next few years in our view. On the flip side, any economic recovery is bound to be accompanied with rising inflation and rising interest rates. Therefore it is important to stick to Good & Clean as companies with stretched balance sheets and dodgy governance should have no case in a tightening liquidity environment.

Further, despite the outperformance in August 2018, good quality mid and small cap names still trade at a significant 26% and 50% discount to their larger cap counterparts (higher than 24% and 40% respectively at January 2018-end) as shown in the exhibit above.

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

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 highlights from the month

We discuss three stocks here that witnessed interesting developments over the past month.

1) PVR Limited

- **Sweet deals with Bookmyshow and Paytm**: PVR recently renewed its contracts with Bookmyshow and Paytm for 3 years for aggregate consideration of Rs4.1bn – a jump of nearly 2.5-3x compared to last deal over 2015-18. This clearly reflects PVR's strengthening franchise over the years.
- **SPI Cinemas' acquisition** at reasonable valuation through smart funding: PVR recently acquired SPI Cinemas for total enterprise value of Rs10.4 bn. The acquisition would make PVR a clear leader in South Indian multiplex space. The acquisition multiple (at 10x FY20 EBITDA) is at marginal discount to PVR's despite SPI's better profitability and much higher presence in key South Indian markets. Besides, upfront payments from Bookmyshow and Paytm deals described above contributed ~37% to total required consideration implying only marginal equity dilution and debt increase.
- **Benign outcome on the regulatory front**: After wide ranging speculations over the last two months, the matter related to regulating Food & Beverages business is now in Supreme Court. The Maharashtra Government in its affidavit to the Mumbai High Court stated it does not deem it necessary to interfere with ban on outside food in multiplexes due to security concerns – which is a positive development from multiplexes' perspective. Moreover, PVR has already improved the value proposition of its F&B offering by reducing prices by 25-40% for weekday shows up to 6 pm.

2) Vinati Organics

- **A strong 1QFY19 performance**: Vinati reported a strong 1QFY19 with sales/EBITDA/PAT growth of 44%/83%/106% YoY. This performance was driven by strong volumes and realisation in its core product ATBS (~45% of revenue) helped by Lubrizol's exit from the product, which helped strengthen Vinati's global market share from 45% to 65%.
- **Strong medium term growth outlook**: Launch of butylated phenols, custom products, continued market share gains in ATBS, Isobutyl Benzene capacity expansion and potential announcement of PAP (para amino phenol) capex should keep earnings growth above 20% over FY18-23.
- **R&D led portfolio expansion and costs/processes improvement**: Promoter's R&D approach through tie-ups with leading national institutes has not only significantly expanded Vinati's addressable markets (new products,

applications, geographies) but also lent advantages around costs/processes. This has enabled the Company target both import substitution and global clients looking for greener/purer but cheaper processes/products.

3) Torrent Pharmaceuticals

- **Recent revival of investor interest in the pharma space**: The Indian pharma space, after languishing in recent years, has witnessed a revival in the investor interest over the last 2 months driven by a weakening rupee, stabilising US price erosion, positive resolution of certain FDA issues and likely recovery in growth helped by low base of recent years. BSE pharma index is up >20% from its June 2018 lows.
- **Torrent's focus on Indian market**: Torrent derives close to 51% of its revenue from the Indian pharma market while its revenue exposure to US is <20%. Hence, rising competitive intensity and pricing erosion in US market have had relatively lower impact on Torrent compared to most of its US focussed Indian peers.
- **Unichem integration progressing well**: Torrent acquired domestic branded formulation business of Unichem in late 2017 for Rs36bn. Since acquisition, Torrent has been able to successfully turnaround Unichem's portfolio (key products such as Losar ~12% growth v/s 2% pre-acquisition, Unienzyme 25% growth as against de-growth earlier) by stemming the attrition of latter's field force. Unichem EBITDA margins have now crossed 25%, up 500 bps within two quarters of the close of the transaction with further cost synergies expected over the next few quarters.

Exhibit 2: Ambit Good & Clean Midcap Fund performance update

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	(1.44)	(2.47)	0.62	11.3					**5.86**
Nifty	4.72	(4.85)	(3.61)	6.19	(0.03)	(0.20)	5.99	2.85					**10.9**

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 August 31, 2018.

Ambit Coffee Can

'Simple' is harder than 'complex' in investing

"That's been one of my mantras — focus and simplicity. Simple can be harder than complex: You have to work hard to get your thinking clean to make it simple. But it's worth it in the end because once you get there, you can move mountains."- Steve Jobs, BusinessWeek, May 25, 1998

Human ingenuity and the love of making simple matters difficult - an important part of the human psyche - have always tended to make equity investing, more complicated than it ought to be. Lack of simplicity could arise from the constant wandering of mind and the resultant ego. Simplicity, on the other hand, requires three specific traits which are easy to understand, but difficult to practice – a) **Discipline**: the ability to say 'no' when something doesn't fit your plan; b) **Rigour** and strength to stay focused on a singular purpose/philosophy; and c) **Patience**: that allows you to reap the benefits of discipline and rigour.

Consider going to a casino. It seems exciting, even though you lose your money in the process (hence the casino operator earns money). Moreover, a player's bets pay off often enough to keep people coming back seeking such excitement. Similarly, in the stock market, there are several ways to seek excitement – for instance, too many investors trade too much, too often and do not reap the benefits of long-term investing and sensible asset allocation. Repeated trading and modification in investments usually lead to lower returns and higher transaction costs (which are a source of income for brokers and most financial advisors – just like the casino operator). Buying and selling of your investments may be fun, but if you want to benefit from long-term wealth creation, keeping it simple is the key – maintain discipline by focusing on the highest quality of companies, and be patient.

Also, many people make equity investing a complex affair by focusing significantly on predicting the expansion and compression of P/E multiples of stocks. In order to make this simple, let's consider the following basic equation of three variables, applicable to any equity investment:

Change in share price (A) = change in earnings (B) X change in P/E multiple (C)

The targeted change in share price (i.e. variable A on the left hand side of this equation) is similar for most investors – anywhere between 15% and 30% annualized returns. There are two ways to achieve this share price return:

- **The complicated way = weak B and strong C**: Most indices like Sensex or Nifty50 deliver earnings CAGR of 12-13% over long time periods. Hence, if an investor's portfolio of stocks is of average quality and delivers an earnings CAGR of 12-13%, for an investor to earn >15% return from such a stock, he has to generate a positive and healthy contribution from 'change in P/E', i.e. variable C in this equation cannot be negative. This makes things complex, because movement of P/E multiples, both over the short as well as long term, is significantly affected by many non-fundamental factors (in addition to fundamental factors). Some of these factors include liquidity/capital flows, investor sentiment given the outcome of various geopolitical or macro-economic events, etc – things which are difficult to predict for most investors.

- **The simple way = strong B and weak C**: If an investor has a high degree of conviction on his stock portfolio delivering 20-25% earnings CAGR sustainably over long periods of time, then the relevance of change in P/E multiples (variable C) reduces significantly. For instance, halving (or doubling) of P/E over a 10-year period is only a 7% CAGR of negative (or positive) contribution from variable C in the equation above. As long as earnings growth is strong at say 25% for an investor, halving of P/E over a 10-year period will deliver 18% (25%-7%) as the share price return and doubling of P/E multiple over a 10-year period will deliver 32% (25%+7%) as the share price return – both being satisfactory outcomes.

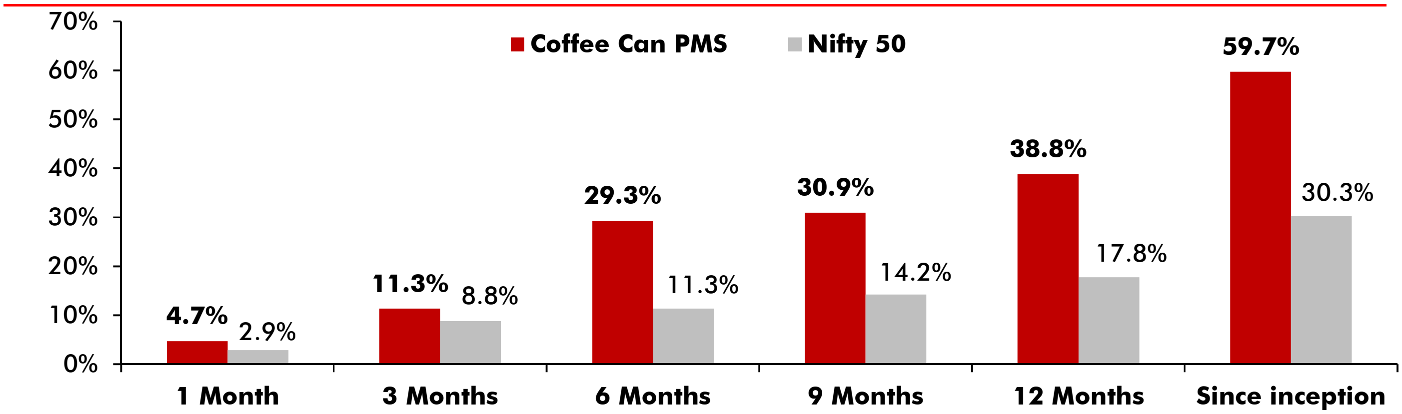
Ambit's Coffee Can Philosophy aims to follow the simple approach highlighted above. For instance, we won't try to pre-empt the outcome of General Elections in India, or the rise/fall in liquidity due to domestic/foreign capital flows, or the next macro-economic change due to a regulatory/monetary policy committee announcement, etc. Also, when we look at valuations of our portfolio companies amidst ongoing market buoyancy, we do not get perturbed by the fact that some stocks in our portfolio or many stocks in the broader market are trading at P/E multiples higher than their last 5/10-year average. Instead, we believe that that despite the 'punchy' P/E valuations of some of our portfolio stocks, their share prices still do not adequately factor in the longevity of healthy earnings/cash flows that these companies are likely to deliver (this is not true for the broader market – which we believe is overvalued). Hence, we don't know if the P/E multiple of our portfolio companies will get affected by the outcome of certain external events like General Elections in India over the next 12 months. We try to keep it simple – as long as our portfolio companies deliver 20-25% annualized earnings growth over the foreseeable future, our clients will compound their wealth at a satisfactory rate despite interim expansion or contraction in P/E multiples.

However, it is worth noting here why simple is harder than complex. Building a portfolio with a high degree of conviction on 20-25% earnings CAGR, and holding onto such a portfolio for periods as long as 5-10 years, is where this 'simple' approach becomes difficult to practice. The only way to overcome this difficulty is to conduct rigourous research into understanding the DNA of such great quality companies which can deliver healthy and consistent earnings growth over long periods of time.

Performance update – Ambit's Coffee Can PMS – as on 31st August 2018

The portfolio consists of 11 stocks of high-quality companies, spread across Financials (2 stocks), Home Building Materials (3 stocks), Consumer Discretionary (3 stocks) and Consumer Staples (3 stocks). **There has been no change in the list of stock holdings (i.e., zero churn) in the portfolio since inception of the PMS.** Our intended average holding period of a stock in our portfolio is longer than 8-10 years, resulting in a churn of less than 1 stock per year on average.

Ambit's Coffee Can PMS performance update (as on 31st August 2018)



*Source: Ambit, Bloomberg; *Date of inception= 6th March 2017; All returns are absolute returns net of fees and expenses*

Ambit Good & Clean Smallcap Fund (Emerging Giants)

Small caps with secular growth, superior return ratios and no leverage

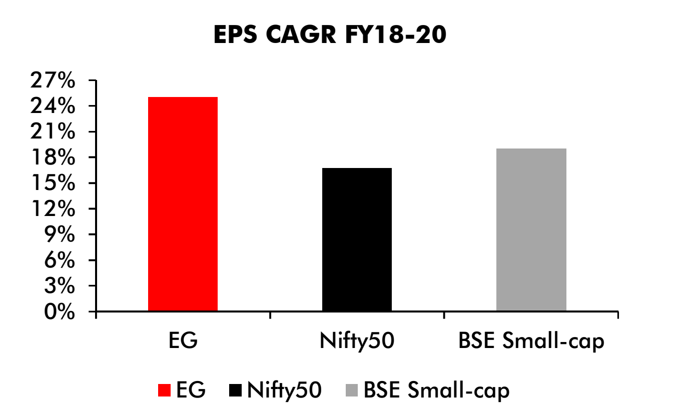
Ambit's Good & Clean Smallcap Fund (Emerging Giants) portfolio aims to invest in small-cap companies with market dominating franchises and a track record of clean accounting, governance and capital allocation. The fund typically invests in companies with market caps less than Rs2,500cr. These companies have excellent financial track record, superior underlying fundamentals (high RoCE, low debt) and ability to deliver healthy earnings growth over long periods of time. However, given their smaller sizes these companies are not well discovered, owing to lower institutional holdings and lower analyst coverage. Rigorous framework based screening coupled with extensive bottom-up due diligence lead us to a concentrated portfolio of 15-16 emerging giants.

- **Rigorous stock selection process:** Starting at a relative large investible universe of about 1,300 small caps, Ambit's proprietary frameworks along with extensive bottom-up research helps create a concentrated portfolio of 15-16 companies at any time. The process focuses on identifying companies which in addition to being clean on governance and accounting, have business models that are profitable, scalable, sustainable and self-funding for their growth requirements.
- **Long term horizon/low churn:** Our holding horizons for investee companies are 3-5 years and even longer with annual churn not exceeding 20-25% 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.

As highlighted earlier, small caps investing can be rewarding. However, at the same time, low research coverage and in some cases, relative young history of operating performance implies a higher degree of diligence required before investing. In this context of opportunities but at the same time perils of investing in small cap space, we believe our Emerging Giants portfolio is relatively well positioned due to the following reasons:

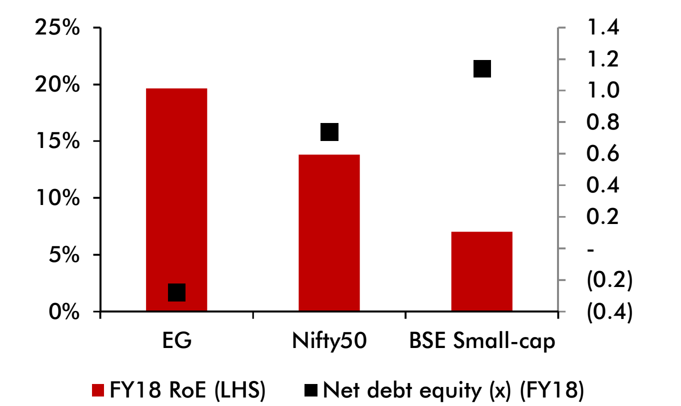
- EG portfolio is a good mix of consumer discretionary, light industrials (including exporters), media, specialty chemicals and good quality lenders, all of which should benefit in our view in light of a global and local economic growth revival. We expect EG portfolio to deliver close to 25% net earnings CAGR over FY18-20, much higher than the Nifty or the BSE small-cap.
- The average net-debt equity ratio (March 2018-end data) for the EG portfolio is almost NIL (infact net cash), again significantly lower than Nifty's 0.7x and BSE Small-cap's 1.1x.
- EG portfolio enjoys significantly better return ratios than Nifty and BSE Small-cap. While the weighted average FY18 RoE for EG portfolio stood at 20%, that for Nifty and BSE Small-cap stood at a much lower 14% and 7% respectively.

Exhibit 3: EG portfolio expected to deliver much higher earnings growth than benchmark indices...



Source: Ambit, Bloomberg

Exhibit 4: ...combined with much better RoEs and significantly lower leverage



Source: Ambit, Bloomberg

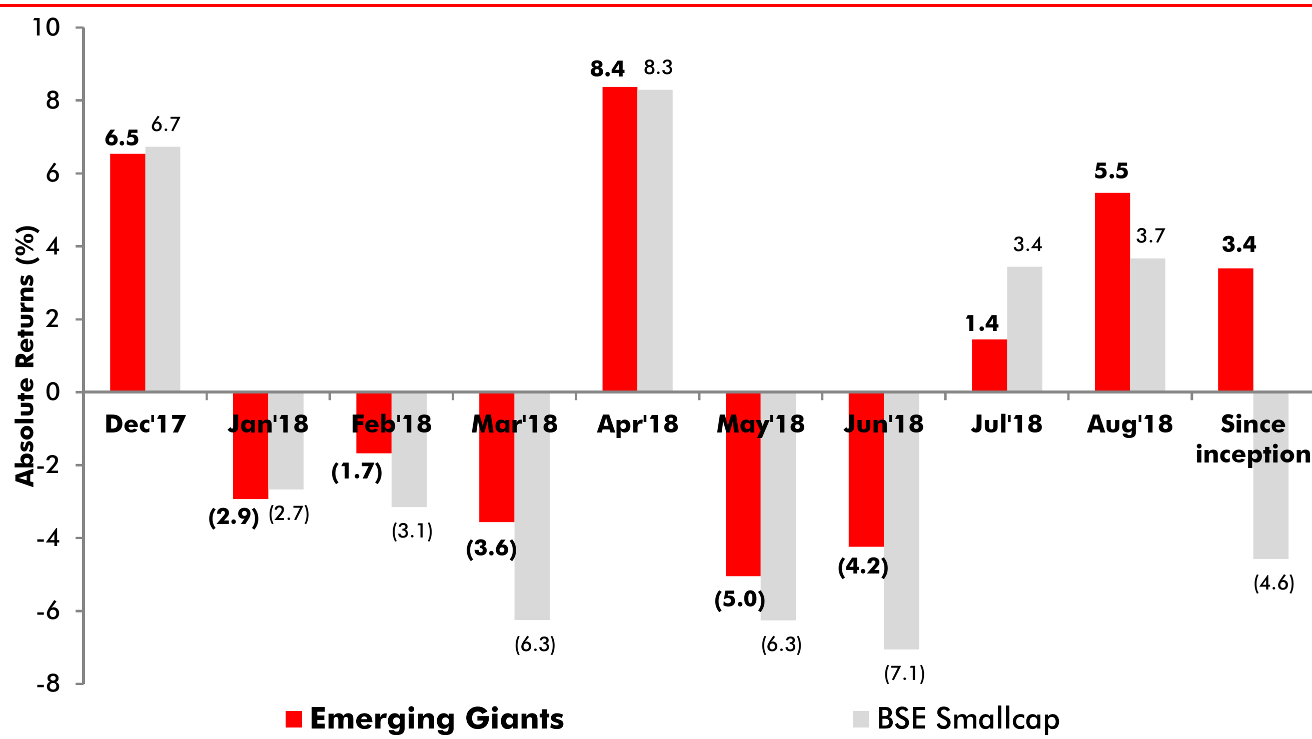
Investing in winners of today and tomorrow – timing is futile

1QFY19 results season panned out well for the Emerging Giants portfolio with portfolio companies delivering a blended YoY revenue growth of 23% and much higher 41% and 60% growth in EBITDA and net earnings respectively. The earnings growth was broad-based across the portfolio with more than 60% of the portfolio companies reporting 25% or more YoY growth in operating profit (EBITDA).

To give a flavour of the kind of stocks we have invested in Emerging Giants portfolio, we highlight below a company from the portfolio. Essentially for well-run market leading franchises, timing the entry is futile.

- **A Gujarat based NBFC:** focused on Microfinance (~65% of book), 2Wheeler (27%) and MSME (8%). Gujarat accounts for ~50% of the AUM of ~Rs4bn, while Madhya Pradesh, Uttar Pradesh and Maharashtra account for 30%/10%/10% respectively. The company's approach to responsible growth/capital allocation is a rare trait in the industry – some instances – (i) it exited segments where it felt the competitive edge is weakening or if the sector is likely to face headwinds, such as consumer loans in FY07 and 3-Wheeler loans in FY13/14; (ii) During demonetisation, it held off on disbursements for 2 months until mid Feb'17, resulting in decline in AUM but this strategy is now allowing company to expand when peers are pulling back after getting impacted by demonetisation. The company's loan book has doubled over the past two years to ~Rs4bn. The company is now targeting a loan book of Rs10bn by FY20, primarily on the back of expansion into new states, the growth of the MSME book and increasing market share in the MFI segment. With a long term track record of superior risk management, the potential to grow its loan book north of 30% over the medium term and a management with the right approach to capital allocation, we believe valuations of ~1.9x FY20 B/V are attractive.

Exhibit 5: Ambit Good & Clean Smallcap Fund (Emerging Giants) performance update



*Source: Ambit, Bloomberg *Date of inception=1st December 2017. Returns as of August 31, 2018*

Ambit Risk Optimizer

Ambit Risk Optimizer PMS is a low-risk offering that seeks to generate superior risk-adjusted returns by optimizing asset allocation to three common asset classes: Equity, Gold and Government Bonds. The fund uses a proprietary framework to decide allocations to these assets, typically in inverse proportion to their risk profiles. The product seeks to enhance debt returns without materially enhancing the risk profile. Basis empirical analysis, typical returns expectation should be about 2.5%-3% better than bonds on a cross-cycle basis, which translates to about 10% net per annum, with a risk profile similar to that of bonds. On most risk measures like standard deviation, maximum drawdown or worst 12 month returns, the portfolio is expected to be similar to bonds.

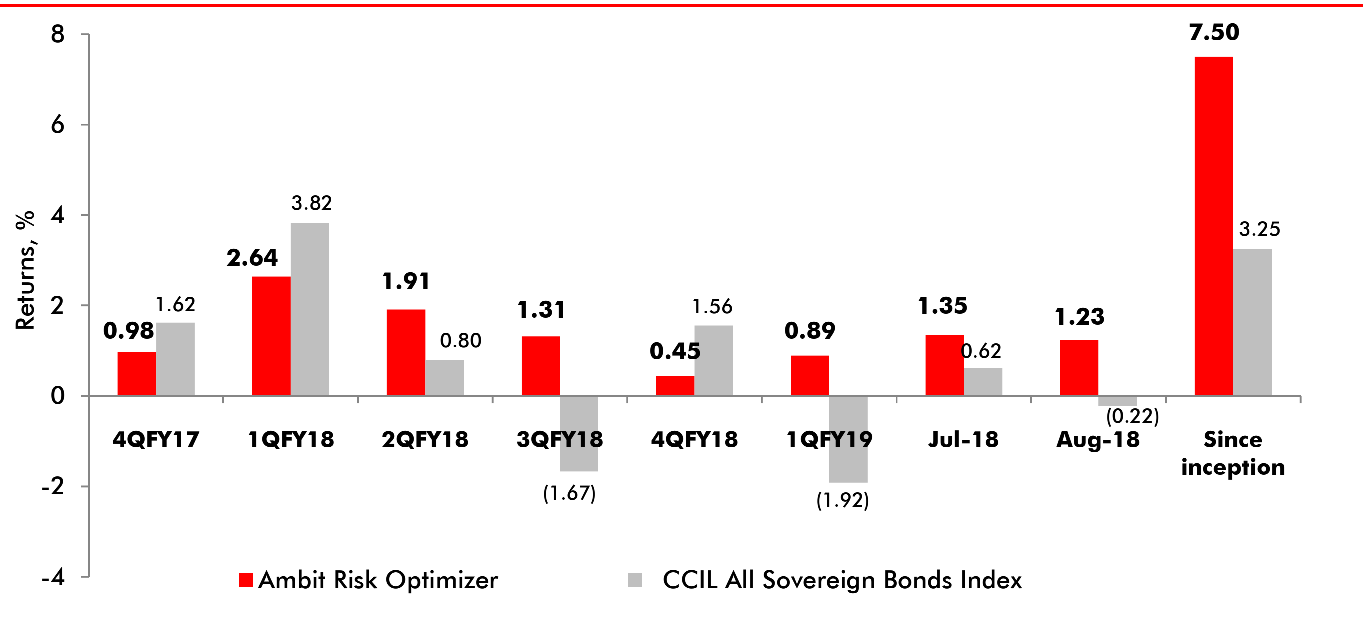
Since going live eighteen months ago, the portfolio has outperformed its benchmark the CCIL bond index by 4.25% (delivered 7.50% annualised return against 3.25% for the bond index) net of expenses.

The low-risk nature of the product arises from diversification benefits achieved through the combination of gold, equities and bonds. For example, even as bonds have continued to suffer past few months while gold has broadly been sideways, a surge in equities has made sure that the cumulative product returns have stayed positive. In the current investment environment, where investors grapple with lofty equity market valuations on one hand and rising bond yields on the other, a process-oriented approach to asset allocation like the risk optimizer approach which ensures low drawdown risk offers a prudent solution in our view.

Allocations

Allocations are a function of risk profiles of the three assets relative to each other (greater allocation to less risky asset classes). However, basis history, 50-80% has been the indicative range of bonds, 10-35% on gold and 10-30% on equities.
The current model allocation is **bonds ~60%, equities ~20%** and **gold 20%**.

Exhibit 6: Ambit Risk Optimizer performance update



*Source: Ambit, Bloomberg *Cumulative since inception on 28th Feb 2017. Returns as of August 31, 2018*

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