MONTHLY NEWSLETTER

AMBIT
Acumen at work

October 2018

AMBIT

ASSET MANAGEMENT

Markets- Volatility creates opportunity

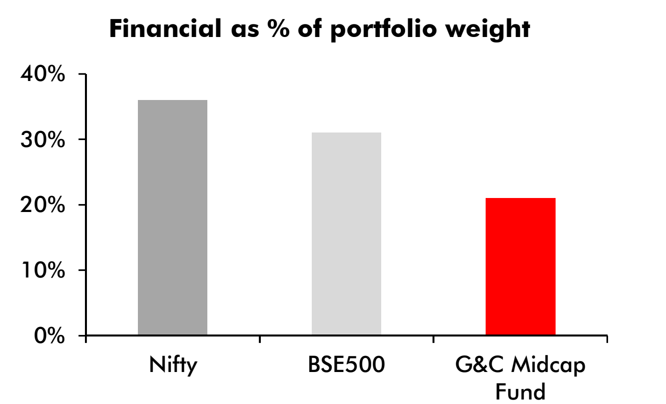
Fears of liquidity freeze cause sharp equity market correction in September 2018

The benchmark index Nifty declined by 6.43% in September 2018. However, pain in broader markets was significantly more pronounced with the BSE MidCap Index and the BSE SmallCap Index declining by 14% and 16% respectively. While liquidity had been tightening for the past several months, specific issues starting with the ILFS default and rating downgrade exacerbated the liquidity crunch in September leading to widespread panic in financial markets. From a stock market point of view, while the decline started with NBFCs, it soon spread to most other pockets. There have been developments over the past week or so aimed at stabilizing the liquidity situation and bringing normalcy to financial markets (some of these being the RBI's recent notification on Liquidity Coverage Ratio which should release liquidity to the tune of Rs 2-Rs2.5 trillion, the government's positive borrowing surprise which implies lower 2HFY19 borrowings of around Rs 200bn, OMO purchases of over 360 bn over the course of October, etc.). Equity markets however don't seem to be stabilizing as yet.

Our portfolios have limited Financials and NBFC exposure

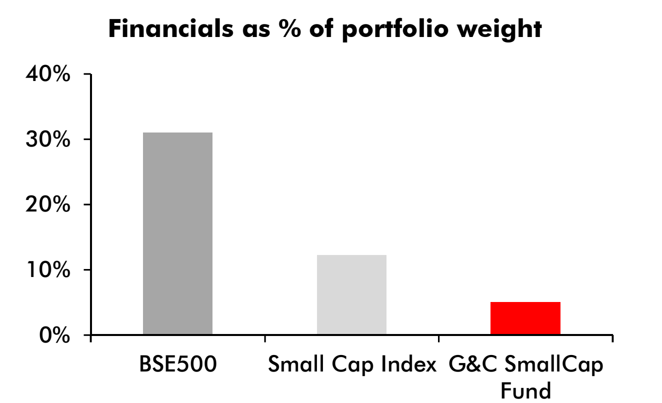
Both the midcap and smallcap portfolios have significantly lower exposure to Banks and Financial Services stocks versus benchmarks (21% and 5% respectively for midcap and smallcap portfolios versus 36% for the Nifty, 31% for BSE500 and 12% for the BSE Smallcap index). Moreover, both portfolios have one NBFC each (at around 5% weight) with strong underwriting track record and pretty well balanced asset liability profiles.

Exhibit 1: G&C Midcap portfolio is significantly underweight Financials ...



Source: Ambit, Bloomberg

Exhibit 2: ... as is also the case with G&C Smallcap



Source: Ambit, Bloomberg

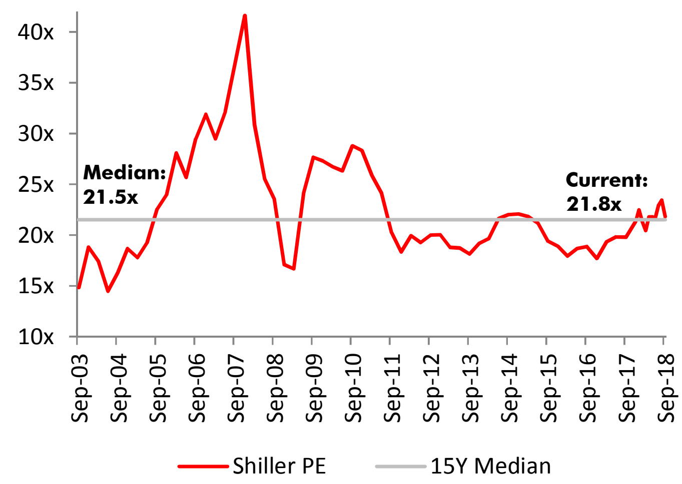
Valuations saner now- back at long term averages on CAPE

As we had highlighted in our earlier months' newsletters, steep yield curve historically has been followed by economic expansion and earnings recovery (with the 2004-2007 periods being a prominent case in point). We discussed how equity markets are now moving away from being liquidity supported (as in the recent years) towards being earnings driven. 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 (Nifty revenue growth of 18% YoY and core operating profit (EBITDA) growth of 27% in 1QFY19).

In the context of normalizing earnings growth, the recent correction has brought valuations to saner levels. The cyclically-adjusted price-earnings (CAPE) ratio is now trading close to the long term historical median.

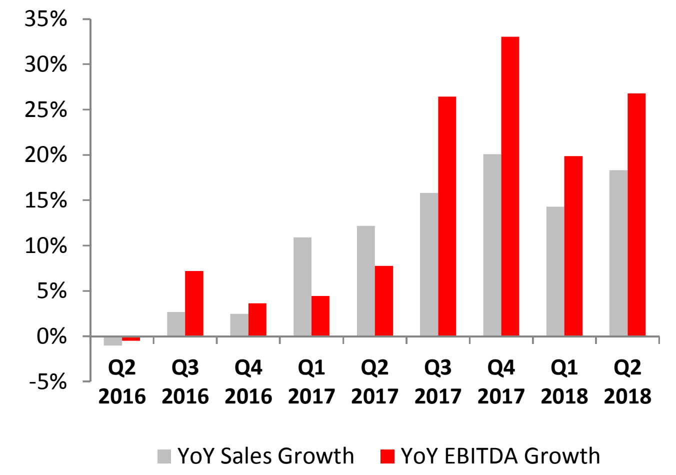
This combination of earnings recovery and better valuations should provide good entry points for long term investors on the other side of this volatility in our view, and more particularly for good quality mid and smallcap names.

Exhibit 3: Cyclically adjusted P/E now trading close to the long term average…



Source: Ambit, Bloomberg

Exhibit 4: …while corporate earnings growth has seen a pick-up recently



Source: Ambit, Bloomberg

…but remain wary of investing in companies/sectors exposed to rising interest rates and inflation

Even as the economy as well as the markets should trend up, in an environment besieged by rising interest rates, inflation and tighter money supply, investors should be wary of investing in certain companies and sectors which would be adversely impacted in our view such as:

- **Avoid suspect governance companies as also leveraged plays:** As interest rates rise and as cost of money becomes dearer, investors will become more conscious of the quality of stocks they buy. Poor accounting and governance firms should continue to be hurt in a tight liquidity scenario. Similarly leveraged plays should continue to be hurt as also weaker companies that do not have market leadership to pass on rising raw material costs to consumers.
- **Stay selective in Financials- continue avoiding HFCs:** The extent of the impact on individual NBFCs would depend on factors like liability mix and Asset-Liability (ALM) mismatch. Within NBFC, housing finance companies and wholesale lenders would stand to lose (>50% wholesale borrowings in their liability mix which is prone to volatility and quick re-pricing, and average ALM mismatch of about 2 years). On the other hand, auto financiers and consumer lenders are better placed in a rising rate environment due to lower reliance on wholesale borrowings and almost perfectly matched ALM.

Ambit Good & Clean Midcap Fund

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:

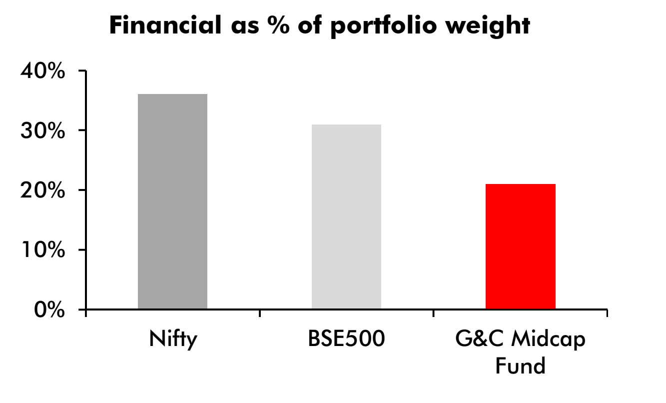
- **Process oriented approach to investing**: Typically starting at the largest 500 Indian companies, Ambit's proprietary frameworks for assessing accounting quality and efficacy of capital allocation help narrow down the investible universe to a much smaller subset. This shorter universe is then evaluated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

In general, as cost of capital rises and money becomes dearer, investors should become more cognizant of quality. This in turn should hold the Good & Clean portfolio in good stead. Further on specifics, here is why we believe G&C should do well going forward.

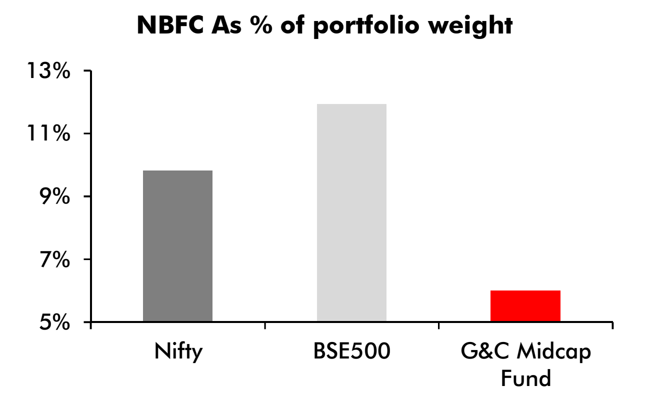
- Within financials, G&C Midcap Fund has exposure to one pan-India private bank, one regional private bank and an auto financing NBFC. As the economy picks up, all three should benefit in our view. Importantly, within NBFCs our exposure is limited to just one Auto financier. This NBFC has a decently balanced asset liability profile with maturity profile on both sides of the balance sheet being 2 to 3 years and therefore should not have the same extent of adverse impact in a rising rate environment as would NBFCs that have asset side significantly higher in maturity versus liability side (such as HFCs). Moreover, the NBFC belongs to a reputed south Indian group, has diversified pan-India presence, and a strong track record of prudent underwriting.

Exhibit 5: G&C Midcap Fund has much lower exposure to the financial sector...



Source: Ambit, Bloomberg

Exhibit 6: ...and even particularly to the non-bank financial companies



Source: Ambit, Bloomberg

- Secondly, amongst non-financial companies, our selection framework excludes highly leveraged companies. The average net-debt equity ratio (March 2018-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.

These characteristics make us believe that G&C portfolio is well positioned in a rising yield, improving economy environment.

Exhibit 7: 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	(1.46)	(2.47)	0.62	11.3	(8.93)				**(3.59)**
Nifty	4.72	(4.85)	(3.61)	6.19	(0.03)	(0.20)	5.99	2.85	(6.42)				**3.80**

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 September 30, 2018.

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