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Ambit
Asset Management

ARE SMALL CAPS OVERVALUED?

MONTHLY NEWSLETTER • JANUARY '24

SMALL CAPS HAVE BEEN ON STEROIDS SINCE THE LAST 9 MONTHS; MARKET CAP OF 251ST COMPANY NOW >RS250BN

Nifty small cap 250 has rallied by 43% in the FYTD24 vs 38% rally for Nifty 100 and resultantly the FY25 PE ratio is now at 27.4x for Nifty small cap 250 vs 20.7x for Nifty 100. As compared to five year average the Nifty small cap 250 trades at a premium of 46% compared to Nifty 100 five year average. Resultantly the 251st company market cap has increased from Rs90bn in FY19 to Rs158bn in FY23 and Rs256bn in Nov'23.

Exhibit 1: Nifty 250 has delivered return of 43% in the last nine months vs 38% for Nifty 100

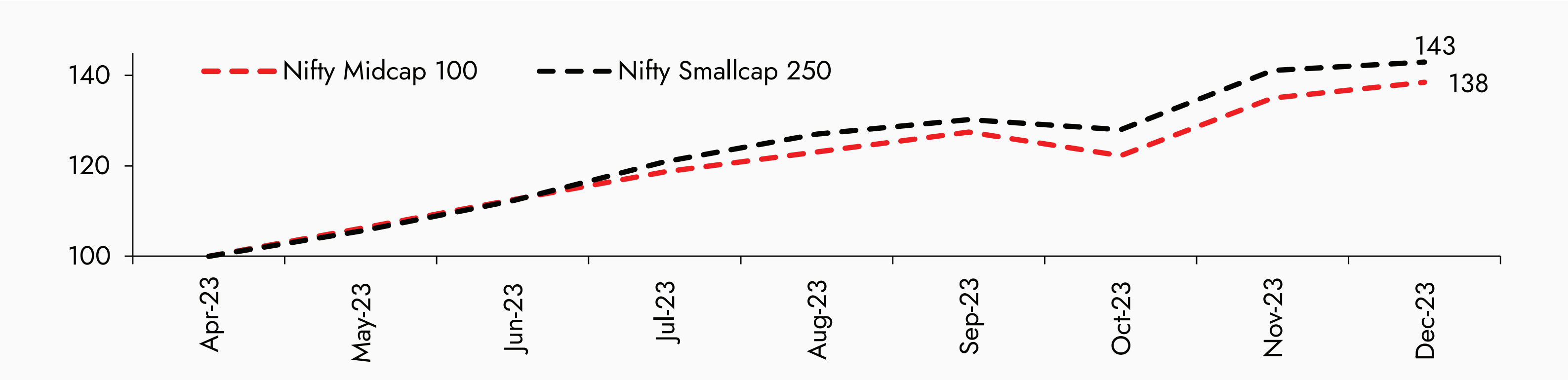


Exhibit 2: Nifty small cap 250 FY25 PE is at 27.4x vs five year average of 23.6x

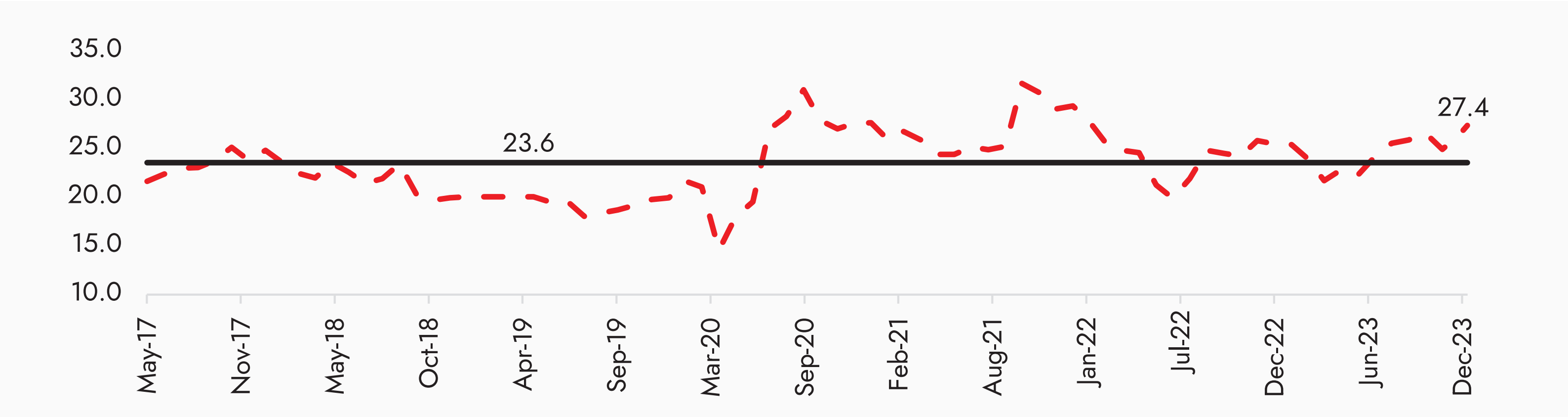


Exhibit 3: Nifty 100 FY25 PE is 20.7x vs 16.1x five year average

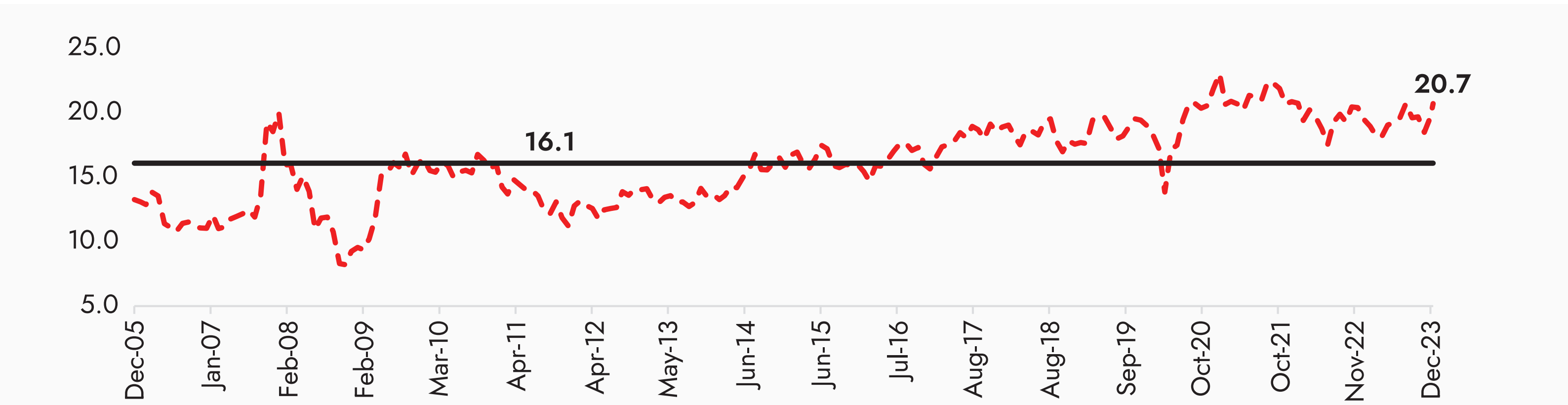
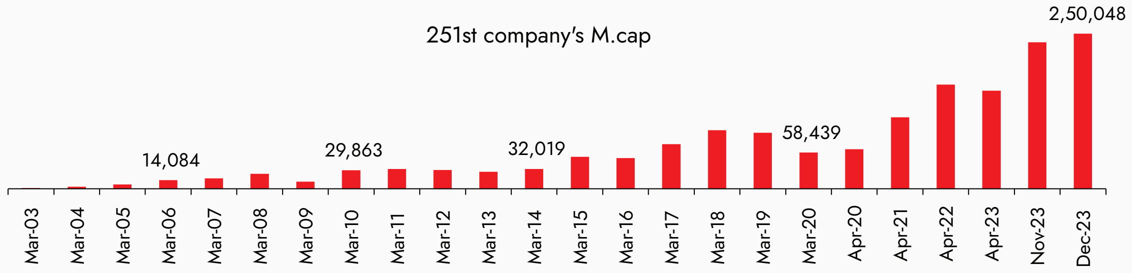


Exhibit 4: Market cap of 251st company in Dec'19 was at Rs82bn which has crossed Rs250bn as on Dec'23



RESULTANTLY THERE IS A LOT OF FEAR AMIDST INVESTORS IN SMALL CAP INVESTING

Our interactions with our investors which includes channel partners, IFAs, investors suggests that there is a lot of fear post the rally in small caps. Several of them were of the view that we should reduce exposure to small caps. We also understand that a lot of mutual Funds and PMS houses have also stopped taking new money into the funds sighting rich valuations. More importantly there is empirical evidence that suggests that after 3 years of rally in small caps the index has corrected meaningfully in the 4th year and returns in the 4th to 6th year have been flattish. Now that we are already in the third year there is a high possibility of drawdown in small caps.

Exhibit 5: Small cap returns in 3 years (>35%) weighs over forward returns

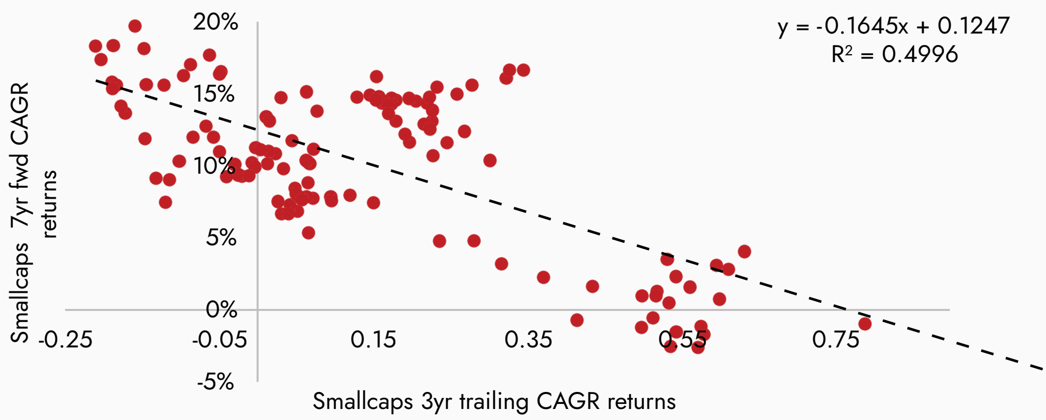
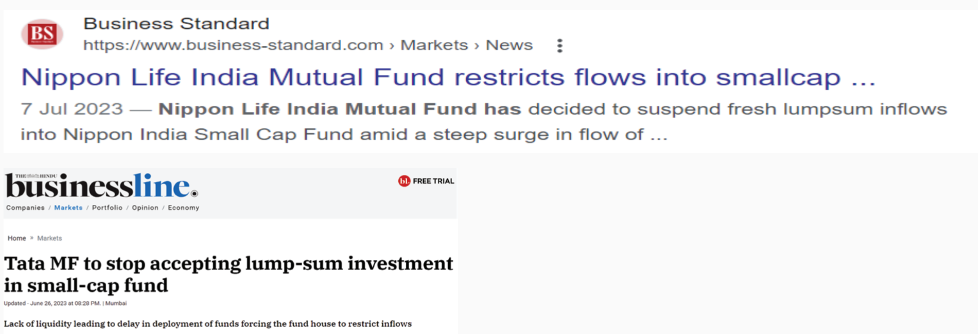


Exhibit 6: Several funds have stopped accepting lump-sum flows into the small cap funds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Nippon Life India Mutual Fund restricts flows into smallcap ...
7 Jul 2023 — **Nippon Life India Mutual Fund has** decided to suspend fresh lumpsum inflows into Nippon India Small Cap Fund amid a steep surge in flow of ...

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Tata MF to stop accepting lump-sum investment in small-cap fund
Lack of liquidity leading to delay in deployment of funds forcing the fund house to restrict inflows

Another point that came across from our interactions is whether the small cap rally is led purely by the significant liquidity that small caps attracted during the last 24 months. If we look at data as of FY24TD, we note that small cap and mid cap funds have seen 32% and 17%, respectively, of overall flows whereas large caps have seen 5% outflows.

Exhibit 7: Small cap fund make for 32% of net flows

Growth/Equity Oriented Schemes	FY24TD	% category
Multi Cap Fund	13,826	14%
Large Cap Fund	(4,668)	-5%
Large & Mid Cap Fund	11,374	12%
Mid Cap Fund	15,946	17%
Small Cap Fund	30,264	32%
Dividend Yield Fund	2,393	2%
Value Fund/Contra Fund	8,138	8%
Focused Fund	(2,898)	-3%
Sectoral/Thematic Funds	16,147	17%
ELSS	(1,307)	-1%
Flexi Cap Fund	6,616	7%
Total	**95,814**	

OUR VIEW IS THAT SMALL CAP SEASON SHOULD CONTINUE

Our view is small cap season should continue if we take cognizance of the fundamental changes that have happened in small cap companies especially in the last 3 years

- **Strong FCF generation has led to significant balance sheet deleveraging for small cap companies over FY20-23:**
  Small cap companies have seen significant growth in free cash flow generation (FCF). FCF over FY20-23 CAGR was at 51% vs -16% during FY17-20. Resultantly the leverage for small cap companies has significantly reduced from 1.4x net debt: equity in FY17 to 0.2x in FY23. Whilst bears might argue that this is a COVID led phenomena our interaction with a few small cap companies which have done debt repayment suggests that they may not take the debt levels back to the earlier times especially given their channel partners are also now accustomed to operating at lower credit cycles

Exhibit 8: FCF generation for small cap companies has been very strong during FY20-23 period...

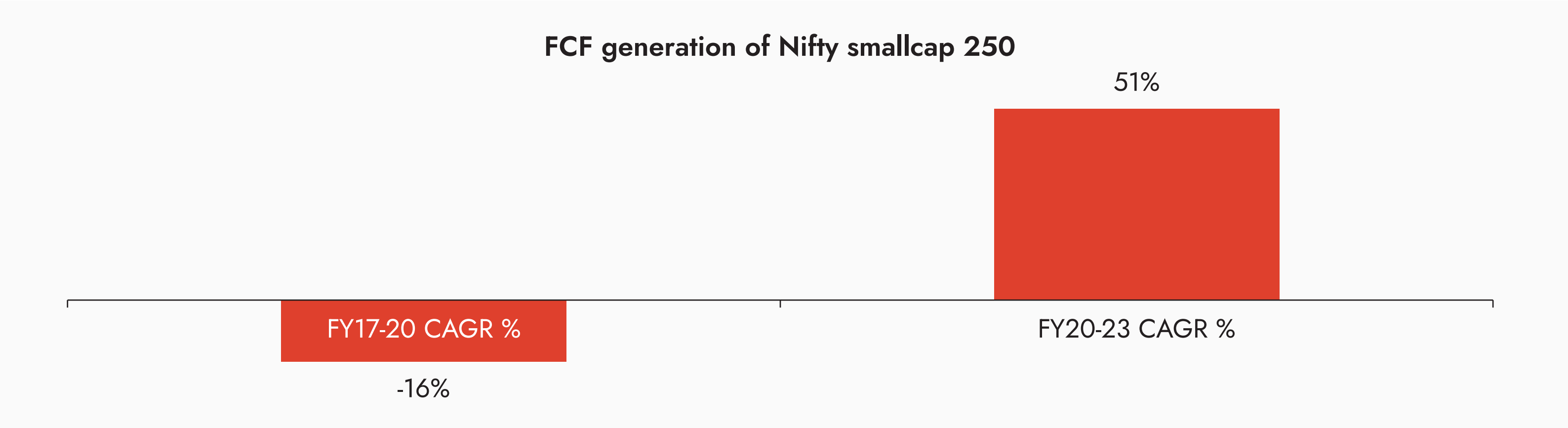
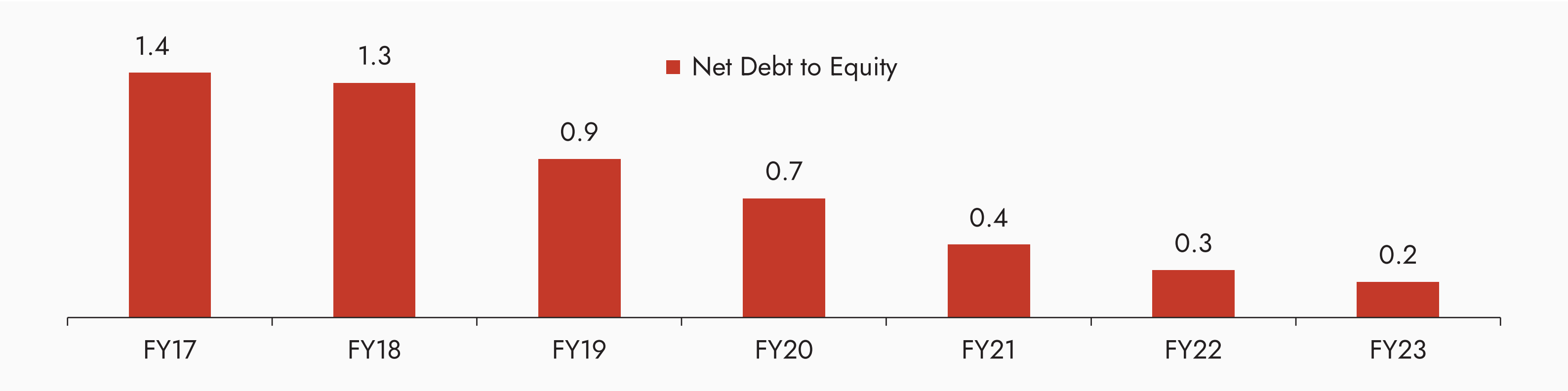
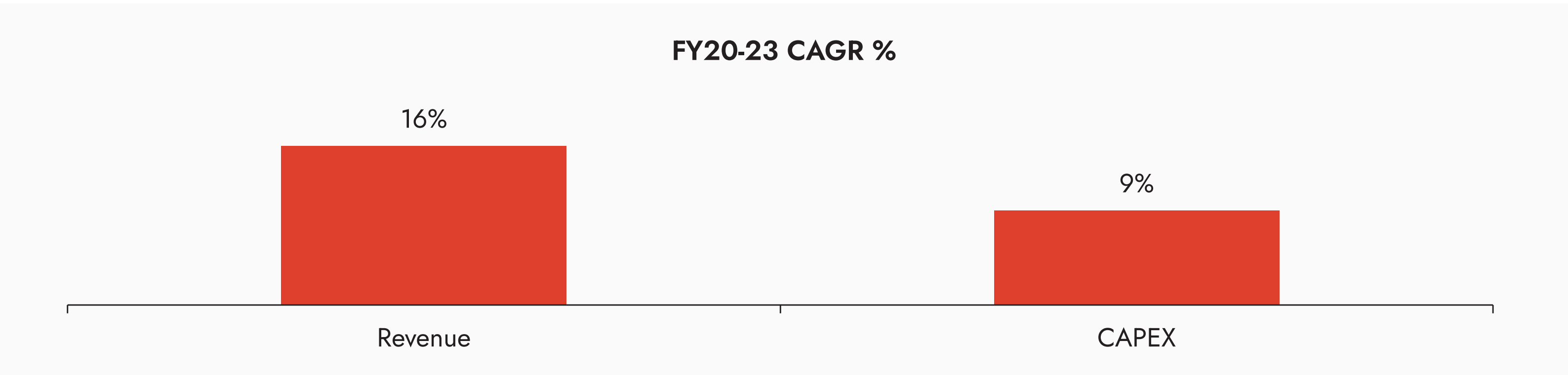


Exhibit 9: ...and this led to significant deleveraging in balance sheets of small cap companies



- **Deleveraged balance sheet should trigger capex spree across small cap companies:** COVID led to deceleration in capex spending amidst small cap companies; CAGR of gross block + CWIP for small cap companies was at 9% during FY20-23 vs 12% during FY17-20. We anticipate a surge in capex across small cap companies given the revenue CAGR over FY20-23 was much higher at 16% (implies higher capacity utilisation) vs capex CAGR of only 9%. The higher capex over FY23-26 should also aid in long term revenue visibility

Exhibit 10: Nifty small cap 250 companies revenue CAGR for FY20-23 has been higher than capex CAGR



Capex deceleration is also witnessed across large cap sectors. Whilst the headline banking credit growth data at ~14% CAGR over FY20-23 looks impressive, it is led by retail growth which was at 17% vs 9% non-retail credit growth implying lower capex intensity post COVID.

Exhibit 11: Banking credit growth over FY20-23 has been led by retail credit growth (figs represent % YoY growth)...

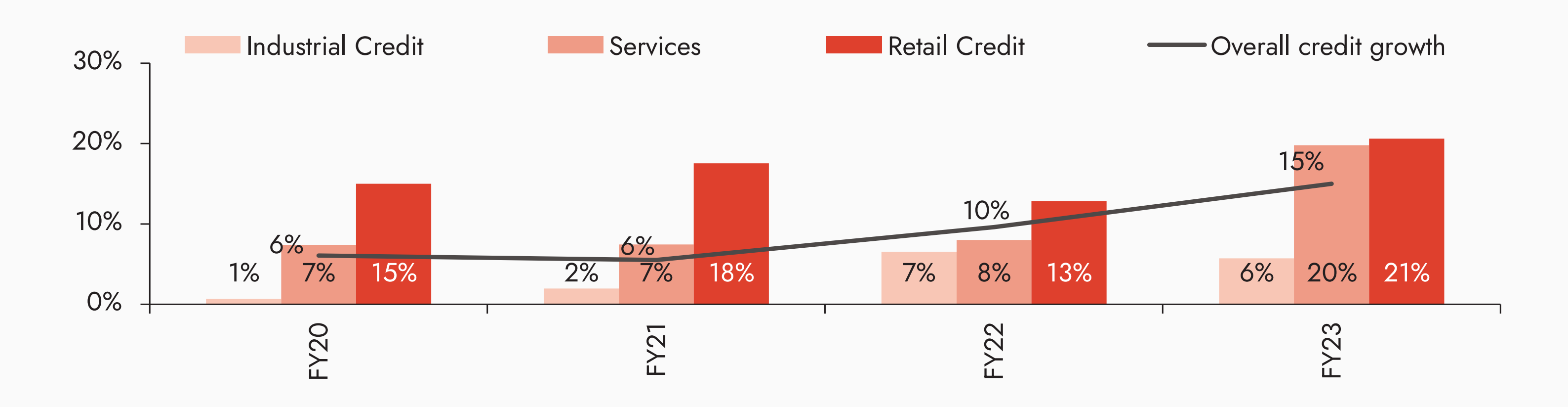
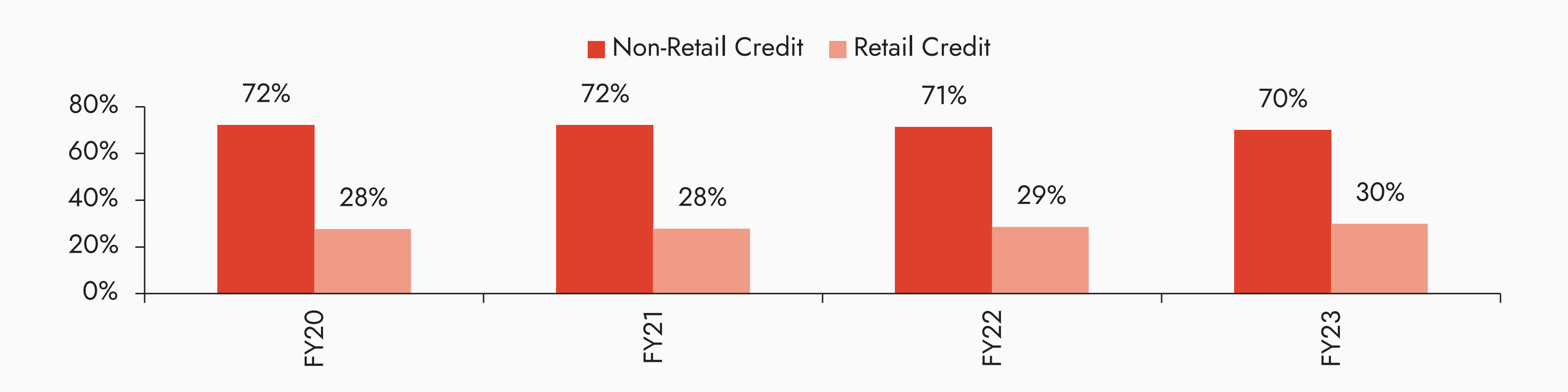


Exhibit 12: ...resultantly the share of retail credit has increased to 30% in FY23 vs 28% in FY20 in overall lending



- **EPS CAGR and ROE for small cap companies has been higher than Nifty 100 and this justifies premium valuation:**
  EPS CAGR for small cap companies has been higher at 20.4% over FY20-23 vs 12.6% for Nifty 100; average ROE over FY20-23 is similar at 9.1% vs 9.3% for Nifty 100 companies. We believe that market does like growth especially when the same is accompanied with growth in FCF as well. Hence we believe that the higher PE for small caps relative to large caps is justified and the same is likely to sustain till the time the growth continues to remain high

Exhibit 13: EPS CAGR for small cap companies has been higher than Nifty 100 across cycles since FY19

	FY20-23 ROE	EPS CAGR FY20-23
Nifty 100	9.3%	12.6%
Nifty Small Cap 250	9.1%	20.4%

- **Promoter holdings in small cap companies is significantly higher than Nifty 100; alignment of interest with minority:**
  Higher the promoter holding in a small company higher is the skin in the game. The reason why we say so is that several promoter of small cap companies have significant wealth in their shareholding unlike large cap companies where there are many companies where there are no promoters – L&T, Infosys etc. Moreover the, average promoter holding as small cap companies has increased to 52.4% in FY24YTD and this increased as compared to 41.6% in FY19 as well. On the other hand promoter holding in Nifty 100 companies has fallen from 5.2% in FY19 to 2.7% in FY23

Exhibit 14: Average promoter holding in Nifty small cap 250 companies has increased over time

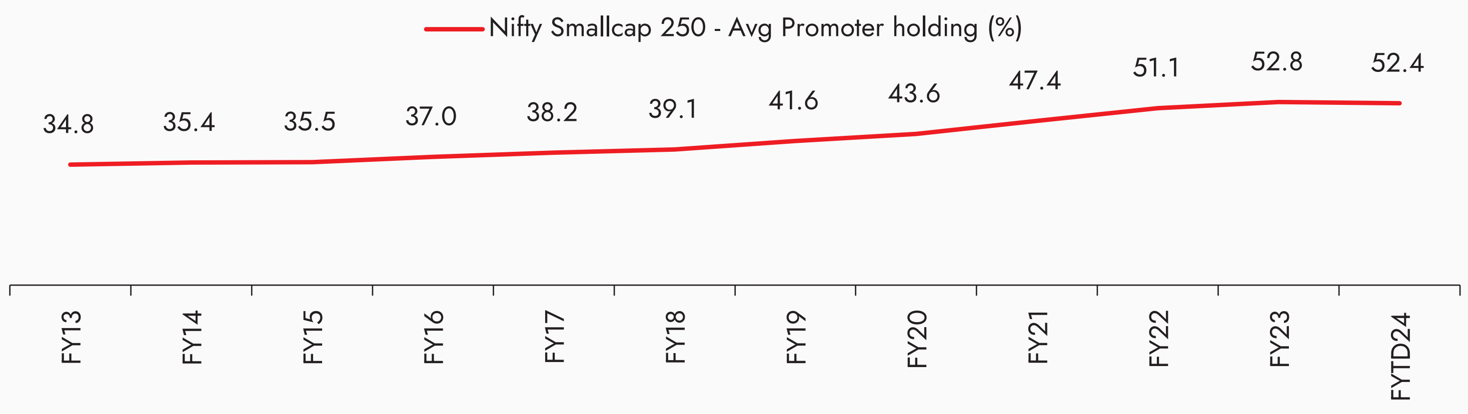
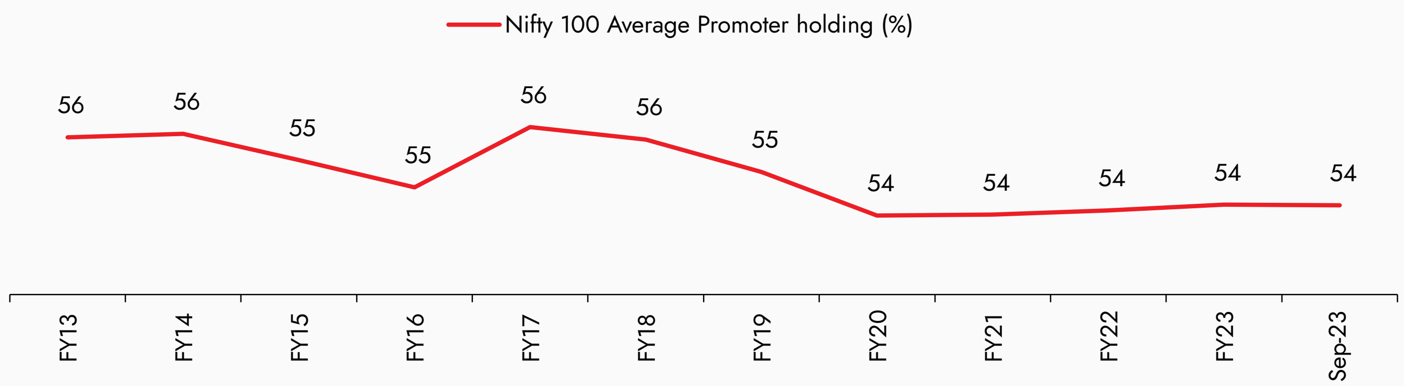


Exhibit 15: Average promoter holding in Nifty 100 companies has fallen over time



- **Several sub-sectors in small caps are oligopolistic in nature lending higher pricing power:** There are several sectors like luggage, bearings, rating agencies, entertainment parks, opal-ware, technical textiles, amines, APIs, glass reactor equipment suppliers, specialty chemicals where in 2-3 companies control large part of the organized market share. Resultantly we believe these companies will continue to enjoy higher pricing power. The oligopolistic nature is on the back of (a) cost leadership led by advantage of scale, (b) strong distribution network (important given India is a large country) and diversified product portfolio (many of these sectors have large number of SKUs).

Exhibit 16: Several companies in small cap sectors are oligopolistic in nature

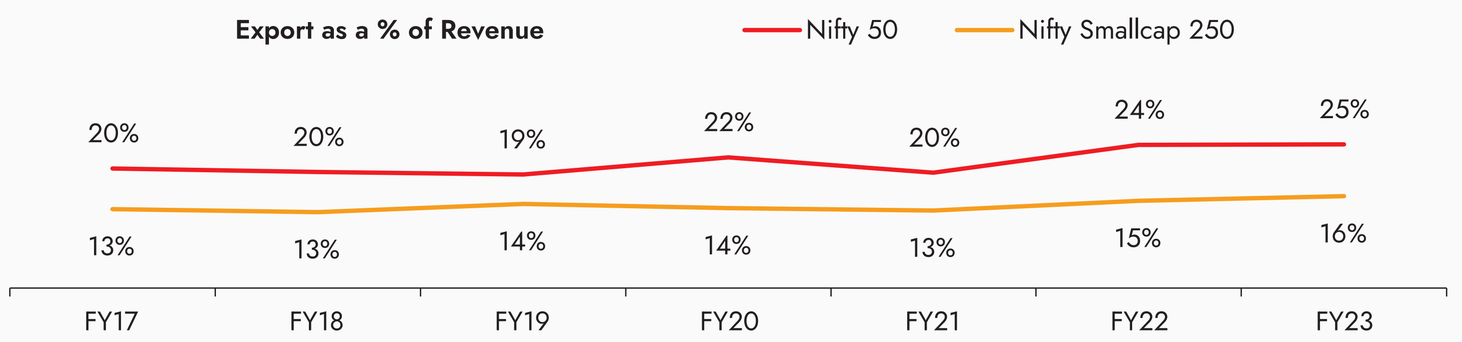
Segments	Top 3 players share of organized market
Luggage	>70%
Glass line reactors	>70%
Opalware	>80%
Bearings	>65%
Amines	>80%
Rating agencies	>70%

- **As a small-caps investor, you can enjoy a lot of diversity when you invest across multiple sub-sectors:** Small caps allow you higher diversity; top 5 sectors in Nifty 100 have a weightage of 63% vs 45% in Nifty small cap 250. Also if we look at the weightage of top 10 sectors in Nifty 100 it is at 83% vs 64% in Nifty small cap 250. Higher diversity reduces the risk of cyclicality and this when combined with oligopolistic nature of several companies in the small cap universe allows you higher revenue and earnings visibility.

Exhibit 17: Small cap allows you option to invest in multiple sectors which is not the case in Nifty 100 companies

% Allocation	Nifty 100	Nifty Small Cap 250
Top 5 sectors	63	45
Top 10 sectors	83	64

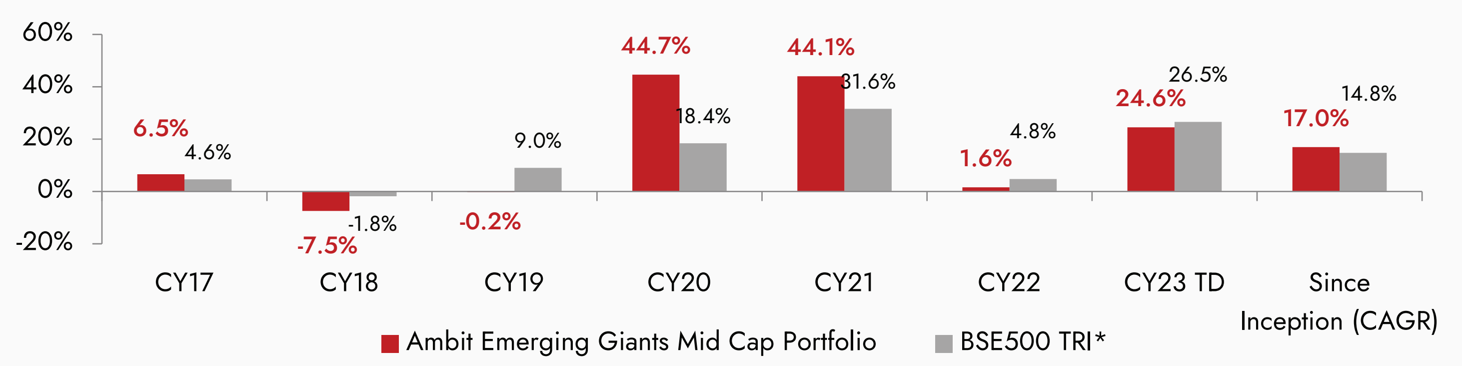
Exhibit 18: Small cap companies have higher exposure to the domestic market relative to the Nifty 100 companies



IN THE EVENT OF ANY DRAWDOWN QUALITY COMPANIES WILL OUTSHINE.

Over time periods quality companies deliver alpha. If we look at the performance of emerging giant companies since inception the return CAGR has been 17.0% (since Dec'17) vs 12.6% for Nifty 250 companies. Notably, the drawdown has been much lower at -27.4% vs -55.7% for Nifty small cap 250.

Exhibit 19: Emerging giant performance has been better than Nifty 250 Index since inception



*BSE 500 TRI is the selected benchmark for the Ambit Emerging Giants SmallCap Portfolio. The same is reported to SEBI. In addition to the same, we have included Nifty Small Cap 250 for information purposes only. The same should not be relied upon for performance benchmarking in any manner.

Exhibit 20: Emerging giant portfolio saw lower drawdown during times when small cap index saw significant decline

	Risk Ratios				
Particulars	Std. Dev.	Beta	Sharpe Ratio	Alpha	Max Monthly Drawdown
Ambit Emerging Giants Small Cap Portfolio	22.4%	0.6	0.4	2.2%	-27.4%
Nifty SmallCap 250	25.9%	1	0.2	NA	-55.7%

One of the main reason for this is the quality of stocks that we own in our portfolio. The EPS growth/ROE for the portfolio for FY24 was at 19.5%/19.6% and this in FY25 should improve to 26%/20.7%. Whilst relative to Nifty 250 the EPS growth for FY25 looks marginally higher at 28.5% for Nifty Small cap vs 26% for EG, we note that RoE is far inferior at 15.8% for Nifty Small cap vs 20.7% for EG. Alongside this the standard deviation is also lower as compared to the index and Sharpe ratio higher as compared to the index.

Exhibit 21: EPS growth/ROE for emerging giant companies for FY25 is higher as compared to FY24

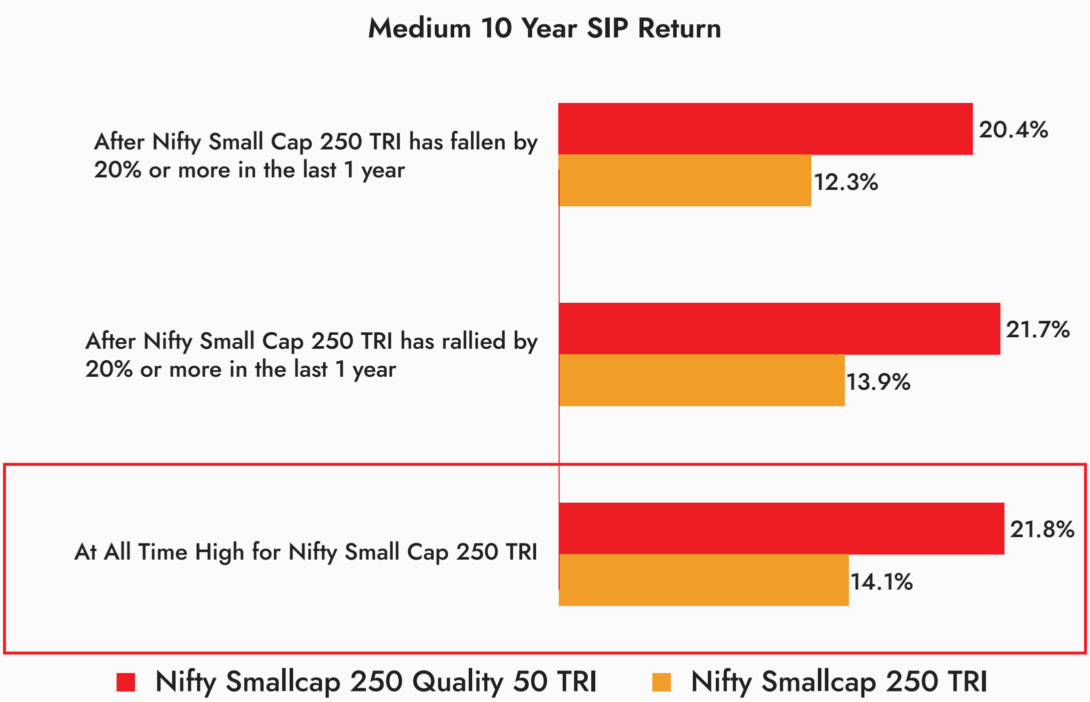
	EPS			PE		Net Debt /Equity	ROE		PEG	
Particulars	F20-F23 CAGR	FY24E	FY25E	FY24E	FY25E	FY23	FY24E	FY25E	FY24E	FY25E
Ambit Emerging Giants Small Cap Portfolio	15.7%	19.5%	26.0%	31.7	25.2	-0.04	19.6%	20.7%	1.6	1.0
Nifty Small Cap 250	20.4%	24.2%	28.5%	27.8	21.6	NA	14.4%	15.8%	1.1	0.8

Lastly, if we see SIP returns in small caps we note that starting a SIP at market highs augurs well from a return perspective because of 3 reasons:

1. Whenever markets fall from peaks you start to accumulate more units (falling NAVs).
2. These higher units will get the benefit of rising NAVs when market rises again.
3. Wealth = more units x higher NAV

Exhibit 22: Small & midcap stocks show low forward returns after a short period of high trailing returns

Exhibit 23: Median 10 year SIP Returns



AS SWIFT AS STABLE

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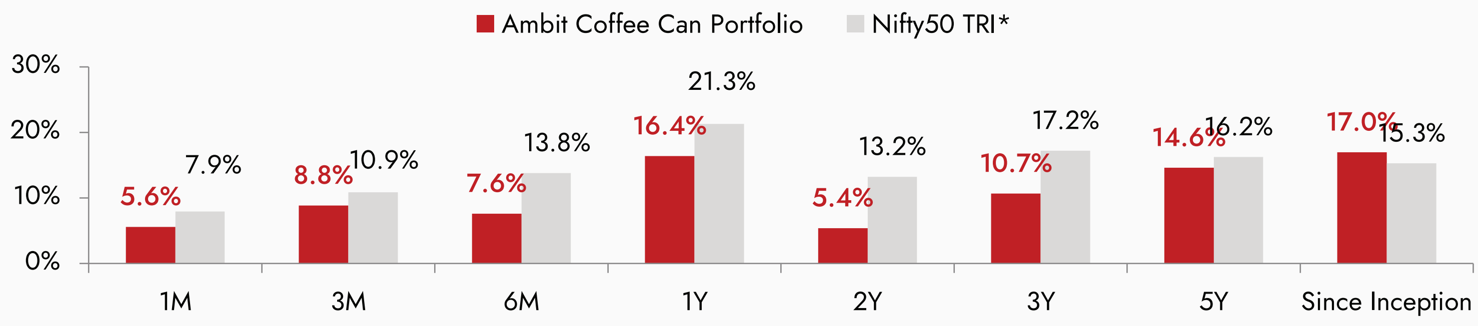
The result?

Consistent growth with an always-available service.

AMBIT COFFEE CAN PORTFOLIO

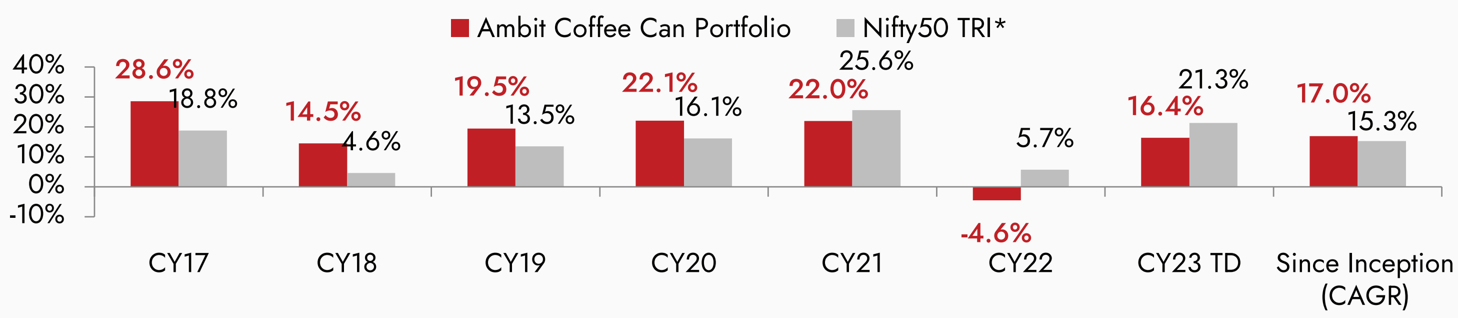
At Coffee Can Portfolio, we do not attempt to time commodity/investment cycles or political outcomes and prefer resilient franchises in the retail and consumption-oriented sectors. The Coffee Can philosophy has an unwavering commitment to companies that have consistently sustained their competitive advantages in core businesses despite being faced with disruptions at regular intervals. As the industry evolves or is faced with disruptions, these competitive advantages enable such companies to grow their market shares and deliver long-term earnings growth.

Exhibit 24: Ambit's Coffee Can Portfolio point-to-point performance



Source: Ambit; Portfolio inception date is March 6, 2017; Returns as of December 31st 2023; All returns are post fees and expenses; Returns above 1 year are annualized; Note: Returns prior to Apr'19 are returns of all the Pool accounts excluding non-aligned portfolio, and returns post Apr'19 is based on TWRR returns of all the pool accounts.
* Nifty 50 TRI is the selected benchmark for the Ambit Coffee Can Portfolio and the same is reported to SEBI.

Exhibit 25: Ambit's Coffee Can Portfolio calendar year performance



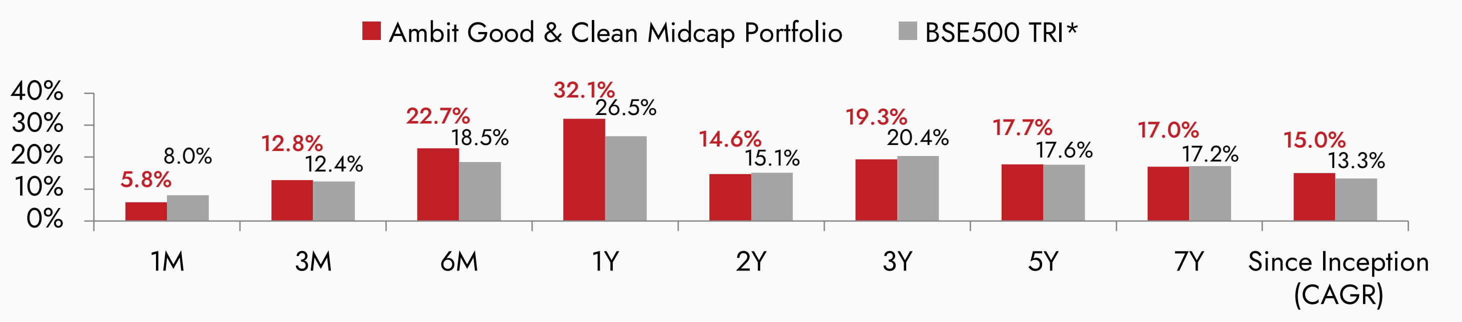
Source: Ambit; Portfolio inception date is March 6, 2017; Returns as of December 31st 2023; All returns are post fees and expenses. Note: Returns prior to Apr'19 are returns of all the Pool accounts excluding non-aligned portfolio, and returns post Apr'19 is based on TWRR returns of all the pool accounts.
* Nifty 50 TRI is the selected benchmark for the Ambit Coffee Can Portfolio and the same is reported to SEBI.

AMBIT GOOD & CLEAN MIDCAP PORTFOLIO

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 for 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:

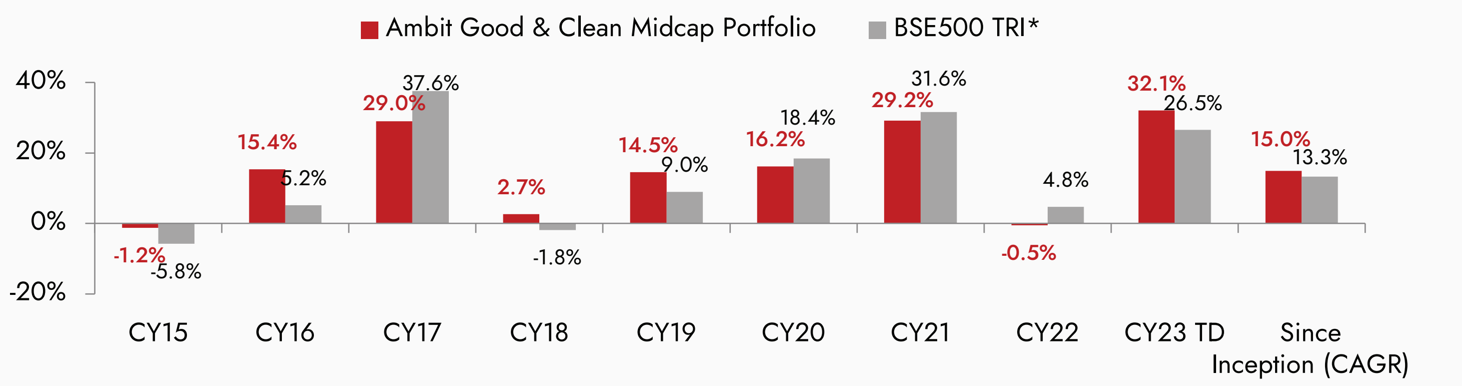
- Process-oriented approach to investing: Typically starting at the largest 500 Indian companies, Ambit's proprietary frameworks for assessing accounting quality and efficacy of capital allocation help narrow down the investible universe to a much smaller subset. This shorter universe is then evaluated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

Exhibit 26: Ambit's Good & Clean Midcap Portfolio point-to-point performance



Source: Ambit; Portfolio inception date is March 12, 2015; Returns as of December 31st 2023; All returns above 1 year are annualized. Returns are net of all fees and expenses.
*BSE 500 TRI is the selected benchmark for the Ambit Good & Clean Midcap strategy and the same is reported to SEBI.

Exhibit 27: Ambit's Good & Clean Midcap Portfolio calendar year performance

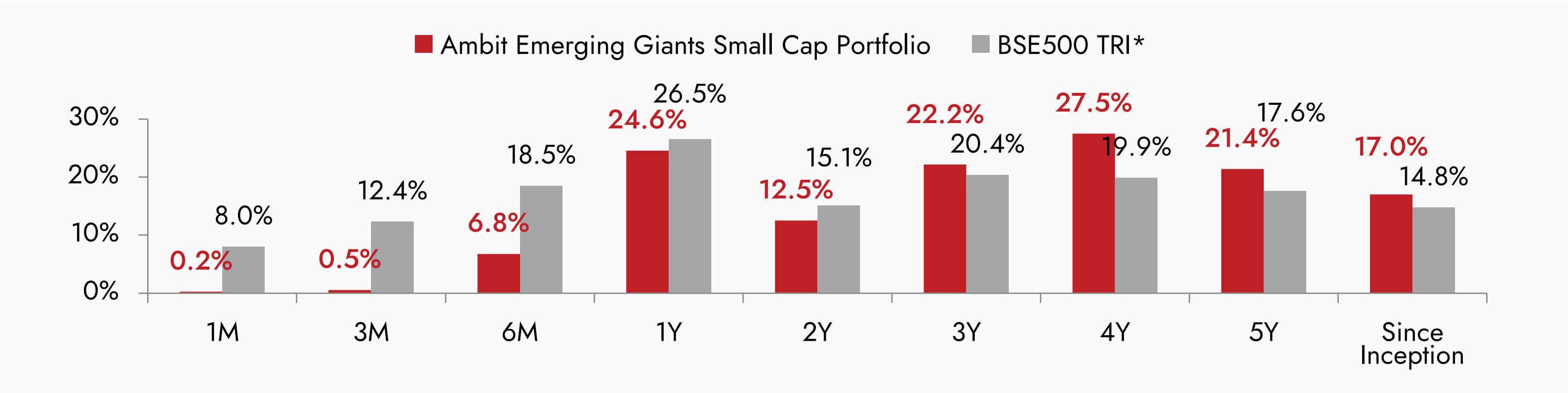


Source: Ambit; Portfolio inception date is March 12, 2015; Returns as of December 31st 2023. Returns are net of all fees and expenses.
*BSE 500 TRI is the selected benchmark for the Ambit Good & Clean Midcap strategy and the same is reported to SEBI.

AMBIT EMERGING GIANTS SMALL CAP PORTFOLIO

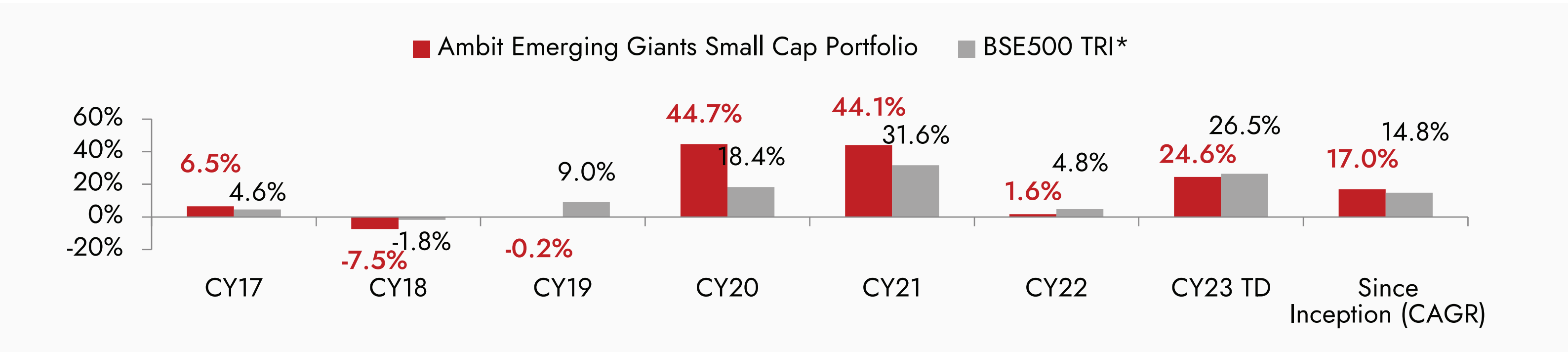
Small caps with secular growth, superior return ratios and no leverage – Ambit's Emerging Giants Small Cap portfolio aims to invest in small-cap companies with market-dominating franchises and a track record of clean accounting, governance and capital allocation. The fund typically invests in companies with market caps less than Rs4,000cr. These companies have excellent financial track records, superior underlying fundamentals (high RoCE, low debt), and the 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 led us to a concentrated portfolio of 15-16 emerging giants.

Exhibit 28: Ambit Emerging Giants Small Cap Portfolio point-to-point performance



Source: Ambit; Portfolio inception date is December 1, 2017; Returns as of December 31st 2023; All returns above 1 year are annualized. Returns are net of all fees and expenses.
*BSE 500 TRI is the selected benchmark for the Ambit Emerging Giants strategy and the same is reported to SEBI.

Exhibit 29: Ambit Emerging Giants Small Cap Portfolio calendar year performance



Source: Ambit; Portfolio inception date is December 1, 2017; Returns as of December 31st 2023. Returns are net of all fees and expenses.
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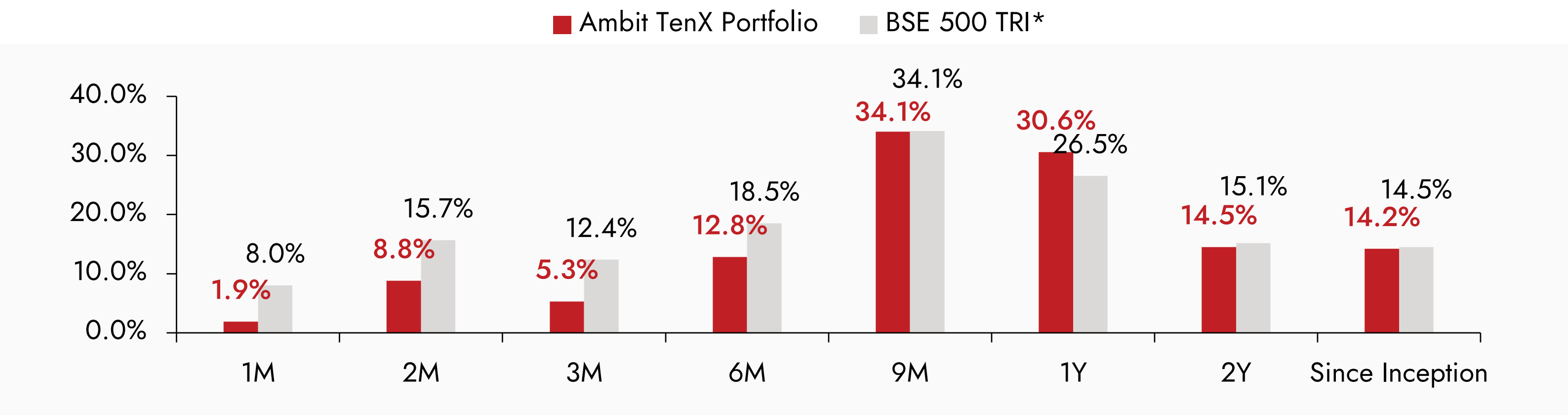
AMBIT TenX PORTFOLIO

Ambit TenX Portfolio gives investors an opportunity to participate in the India growth story as the Indian GDP heads towards a US$10tn mark over the next 12-15 years. Mid and Small corporates are expected to be the key beneficiaries of this growth. The portfolio intends to capitalize on this opportunity by identifying and investing in primarily mid & small cap companies that can grow their earnings 10x over the same period implying 18-21% CAGR. Key features of this portfolio would be as follows:

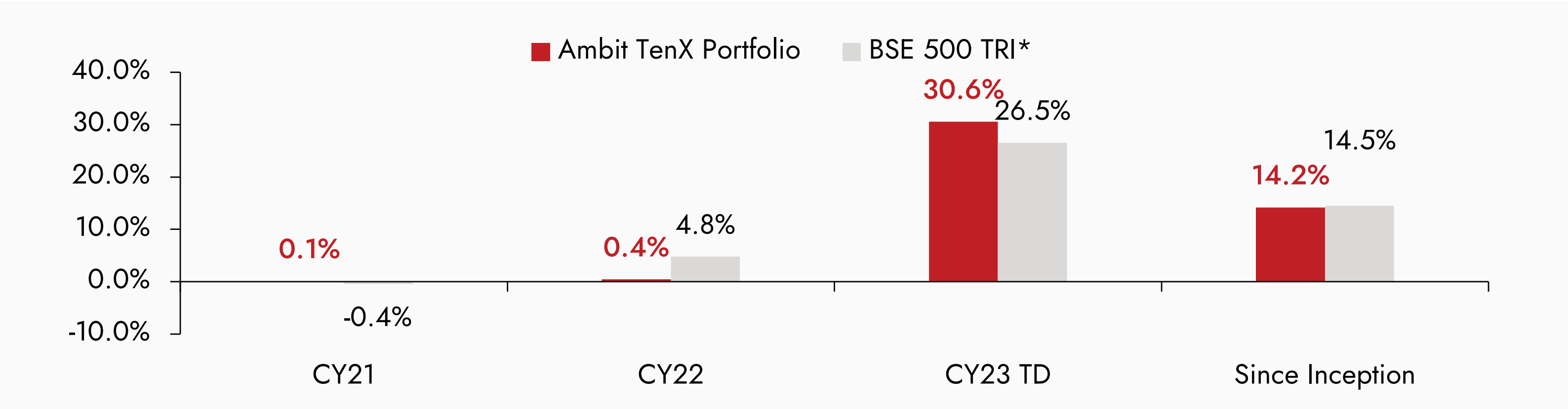
- Longer-term approach with a concentrated portfolio: Ideal investment duration of >5 years with 15-20 stocks.
- Key driving factors: Low penetration, strong leadership, light balance sheet
- Forward-looking approach: Relying less on historical performance and more on future potential while not deviating away from the Good & Clean philosophy.
- No Key-man risk: Process is the Fund Manager

Exhibit 30: Ambit TenX Portfolio point-to-point performance



Source: Ambit; Portfolio inception date is December 13, 2021; Returns as of December 31st 2023; Returns are net of all fees and expenses
*BSE 500 TRI is the selected benchmark for the Ambit TenX Portfolio and the same is reported to SEBI.

Exhibit 31: Ambit TenX Portfolio calendar year performance



Source: Ambit; Portfolio inception date is December 13, 2021; Returns as of December 31st 2023. Returns are net of all fees and expenses
*BSE 500 TRI is the selected benchmark for the Ambit TenX Portfolio and the same is reported to SEBI.

For any queries, please contact:
Umang Shah - Phone: +91 22 6623 3281,
Email - aiapms@ambit.co
Registered Address: Ambit Investment Advisors Private Limited -
Ambit House, 449, Senapati Bapat Marg,
Lower Parel, Mumbai - 400 013

Corporate Address: Ambit Investment Advisors Private Limited -
2103/2104, 21st Floor, One Lodha Place,
Senapati Bapat Marg, Lower Parel, Mumbai - 400 013

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