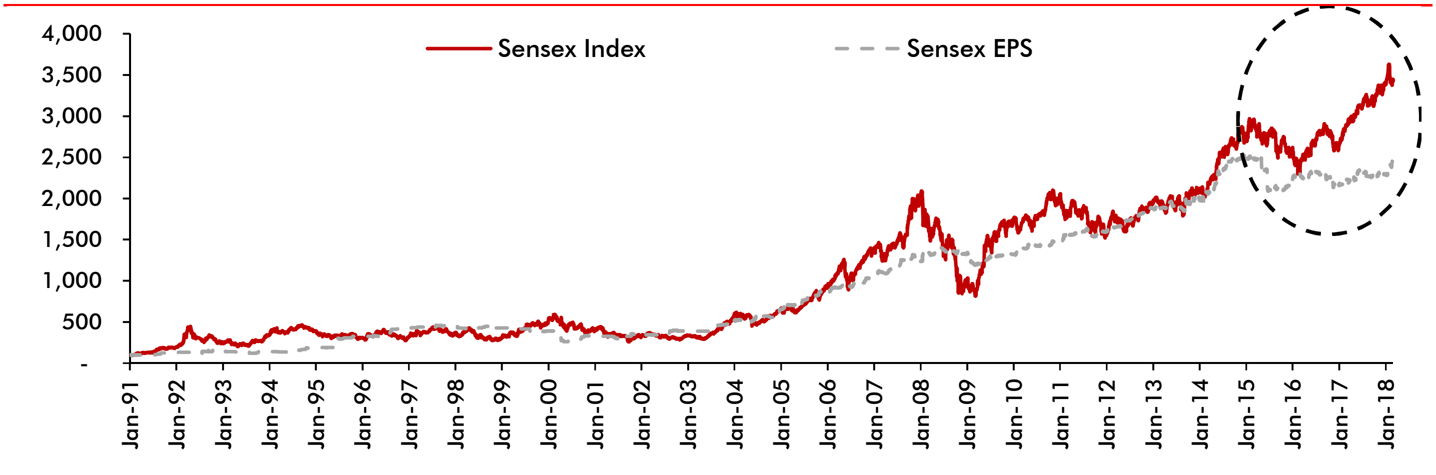
Ambit Coffee Can Newsletter – Mar'18

CCP stocks vs Sensex - Do fundamentals support current valuations?

Several factors affect short-term share price performance but (see Exhibit 1) earnings are the biggest driver of stock market returns over the long term. However, over the three-year period of FY15-18 (until 28 Feb 2018), the Sensex Index has registered a 7.1% CAGR despite delivering -0.6% earnings CAGR (i.e. declining earnings). This led to Sensex's trailing P/E increasing from 19x to 24x over this three-year period as a **gap opened up between the Sensex price trajectory and the Sensex earnings trajectory over the past 3 years.** Historically, this phenomenon has reversed as earnings and price have converged in the years following the opening up of such a gap between the two.

Exhibit 1: Sensex returns have mirrored earnings growth in the long term; divergence has emerged over the past 3 years



Source: Ambit, Bloomberg, Ace Equity; Sensex Index (price) and Sensex EPS are both rebased to 100 as on January 1991

In this backdrop, as Ambit's Coffee Can PMS (CCP) completes its first year in Mar'18, it is worth understanding how well CCP's performance has been supported by fundamentals / earnings growth of the portfolio stocks. CCP has delivered an absolute return since inception of 23.6% and outperformance of 650bps vs Nifty50. The portfolio comprises 11 stocks of high-quality companies spread across Financials, Home Building Materials, Consumer Discretionary and Consumer Staples. There has been no change in the list of holdings (i.e. zero churn) since inception.

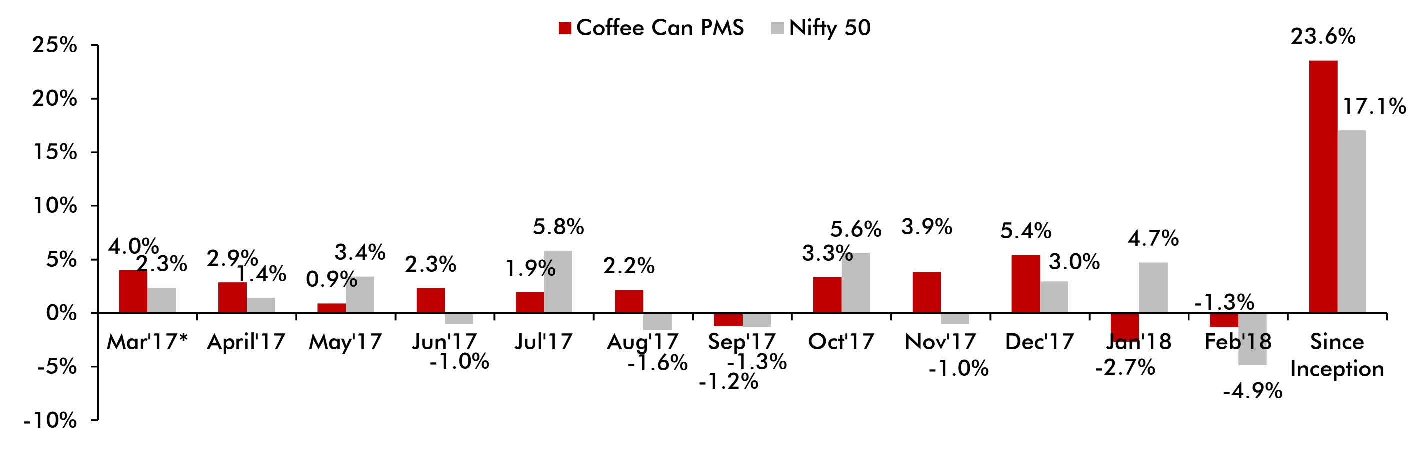
Exhibit 2: Fundamental performance of Coffee Can PMS stocks and Sensex since FY15

	Coffee Can PMS stocks (weighted by portfolio allocations)					Sensex
	FY15 (YoY)	**FY16 (YoY)**	**FY17 (YoY)**	**FY18E (YoY)**	**FY15-18E (CAGR)**	**FY15-18E (CAGR)**
Revenue Growth**	18.3%	10.6%	10.1%	15.1%	**11.9%**	**7.1%**
Average ROE	32.9%	31.2%	29.1%	27.7%	**30.2%**	**13.6%**
PAT Growth	20.4%	23.4%	16.7%	14.4%	**18.1%**	**-0.6%**
Share price change (Index value for Sensex)*	74.8%	4.9%	28.2%	20.7%	**17.5%**	**7.1%**
P/ E Multiple*	49.7	44.8	47.6	50.0	**48.0**	**21.2**
Growth in P/E multiple*	46.2%	-9.9%	6.3%	5.2%	**0.2%**	**7.6%**

*Source: Ambit, Company, Bloomberg; CCP constituents' historical data has been computing using allocation weights in the current model portfolio; FY18E financials = Bloomberg consensus estimates; *FY18 share price data = absolute (not annualized) returns from 1st April 2017 till 28th Feb 2018; For the two BFSI companies in the portfolio, we have used loan book growth as a benchmark for revenue growth and have used 31st Dec 2017 YoY loan book growth for FY18E.*

Exhibit 2 above shows that CCP portfolio stocks have delivered a healthy fundamental performance, significantly superior to the broader market (i.e. Sensex) both in FY18 and over FY15-18 consistently. As a result, **whilst Sensex's returns since FY15 have been entirely driven by an increase in its P/E multiple (there has been no earnings growth), performance of CCP stocks has been entirely driven by their earnings growth.** It is important to note that, over the past 3-4 years, there have been a series of disruptions which have affected the consumption and financial services sectors more adversely than the rest of the economy. Some of these disruptions are expansion of e-commerce, GST, demonetization, rise of Patanjali, payment banks, growth of the corporate bond market as a substitute to bank lending, etc. Despite such high frequency of disruptions, Ambit's CCP portfolio (which is exposed only to consumption and financial services stocks) demonstrated resilience in fundamental performance – a trait which is essential for delivering consistent fundamentals over long periods of time.

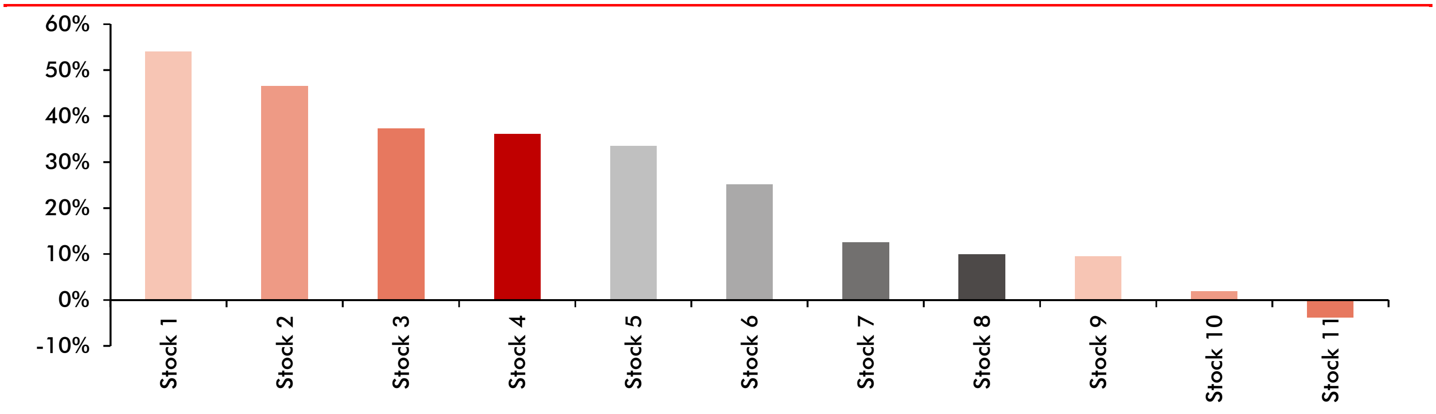
Exhibit 3: Ambit's Coffee Can PMS performance since inception (as on 28th February 2018)



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

The performance of 23.6% return delivered by CCP since inception has been broad-based across the portfolio constituents, with nine of the 11 stocks held in the portfolio delivering more than 10% total shareholder returns (including dividends reinvested once received) since inception (see Exhibit 4 below).

Exhibit 4: Most stocks in Coffee Can PMS have delivered healthy returns since inception (6th March 2017 to 28th Feb 2018)



Source: Bloomberg, Ambit; Absolute Total Shareholder Returns (including dividends reinvested once received) for the period of 6th March 2017 to 28th Feb 2018

We expect robust financial performance of CCP stocks to deliver resilient share price returns even if the broader market undergoes a stressful phase

Ambit's Coffee Can philosophy shows commitment to franchises that consistently sustain their competitive advantages despite being faced by disruptions at regular intervals. Hence, we expect our portfolio companies to gain market share and capitalize on the opportunities created by evolutionary / disruptive changes in the economy. We expect our portfolio companies to deliver average 3-year earnings CAGR of 20-25% over FY18-21. As these firms consistently deliver healthy financial performance, their share prices remain resilient even during periods of market stress either because: a) their earnings growth more than offsets their P/E multiples' deflation which a broader market crash brings about or b) their P/E multiples do not de-rate during periods of stock market stress because the market incrementally factors in longevity of earnings for these companies.

Regards

Rakshit Ranjan

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