Ambit Coffee Can Newsletter – October'18

Worsening macros – Why are we not worried about CCP stocks?

''Studying companies in an extreme environment is like conducting a behavioral-science experiment or using a laboratory centrifuge – throw companies into an extreme environment, and it will separate the stark differences between greatness and mediocrity.''

- Collins and Hansen in their book 'Great by Choice'.

Over the past three years (FY15-18), the Indian economy and the stock market has benefited from strong macro tailwinds due to a combination of low interest rates, crude oil prices, inflation, stable INR, and improving fiscal deficit and current account deficit. All these macro factors are likely to reverse in the next three years, as highlighted in the exhibit below. The RBI has already forecast a rise in inflation which could result in a fall in financial savings and in turn relatively bleak financial markets. The INR has depreciated by ~15% against the USD since the start of CY18, while crude oil prices have jumped ~40% since Jul-17. With the General Assembly elections around the corner, the Government's decisions to spend generously will probably add to the fiscal deficit and complete the picture of a weak economic environment that might exist for a few years.

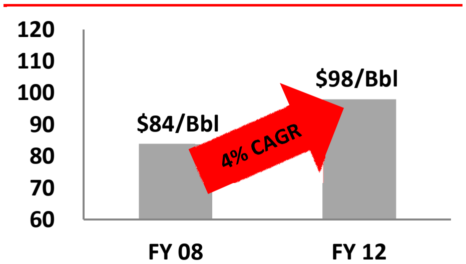
Reversal of Macros

Last 3 years	Macro-economic factor	Next 3 years
Low	Inflation	Moderate - High
Stable & Low	Interest rates	Rising
Falling	Crude Oil Prices	Rising
Strong Rupee	Currency rates	Weak Rupee
Stable	Fiscal deficit	High
High Financial savings	Household savings	Low Financial savings

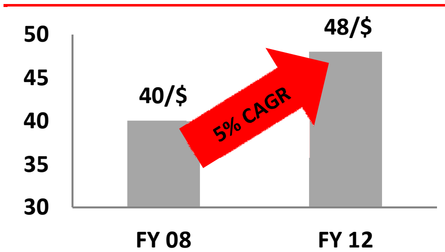
Source: Ambit Capital Research, Bloomberg

Macro headwinds help separate the wheat from the chaff: While it is possible for even mediocre companies to thrive during periods of macro tailwinds, a tough macro environment separates the companies with strong pricing power from the rest of the pack. This is because such companies are either able to pass on the adverse impact of a tough operating environment to their customers/suppliers or they are able to bring about operating efficiencies or competitive advantages to help sustain earnings growth even amidst macro headwinds. Asian Paints is such an example of high pricing and great competitive advantages. As shown in the charts below, during FY08-12, crude oil prices increased from \$84/barrel (average price in FY08) to ~\$100/barrel (average price in FY12); and INR depreciated from an average rate of Rs40/USD to Rs48/USD (exceeding Rs51/USD by the end of 2012). Despite ~35% of raw material cost linked to crude oil price and ~20% of raw materials which are imported, Asian Paints was able to increase its profits from ~Rs400 crores in FY08 to ~Rs1,000 crores in FY12, an earnings CAGR of 25%.

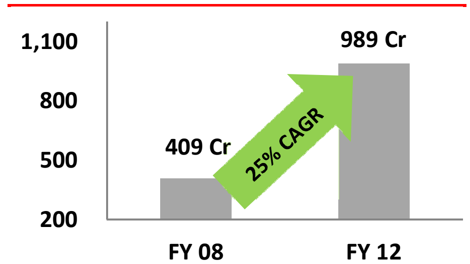
Average Crude Oil Price (FY08-12)



Average Rupee-Dollar Rate (FY08-12)



Asian Paints Profit (FY08-12)



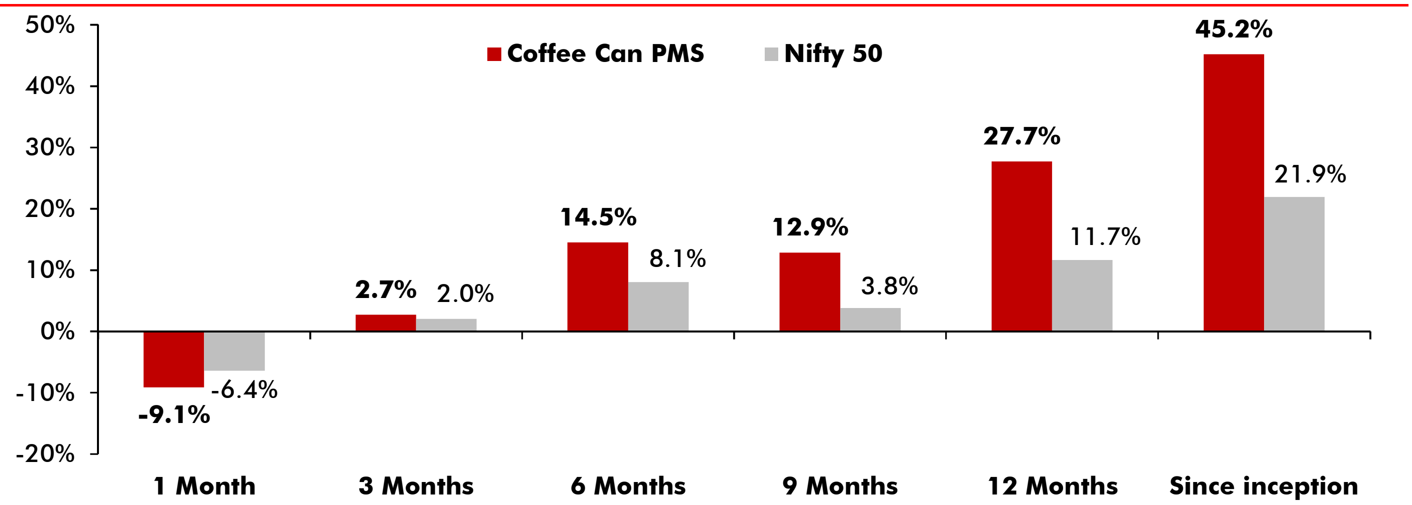
Source Ambit Capital Research, Bloomberg

Ambit's Coffee Can Portfolio has a high direct exposure to some of the key macro factors discussed above - consumer and home building material stocks in our portfolio are dependent on crude-based derivatives and imports, which make up the bulk of their raw material costs. Similarly, tightening liquidity and rising interest rates affect cost of borrowing for the banking and financial services sector. However, we believe that the pricing power and competitive moats of our portfolio companies are significantly strong, just like the example of Asian Paints above, in order to help them generate healthy earnings momentum over the next 2-3 years despite the prevalence of macro headwinds.

Performance update – Ambit's Coffee Can PMS – as on 30th Sep 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 30th September 2018)



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

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