Ambit Coffee Can Newsletter – November'18

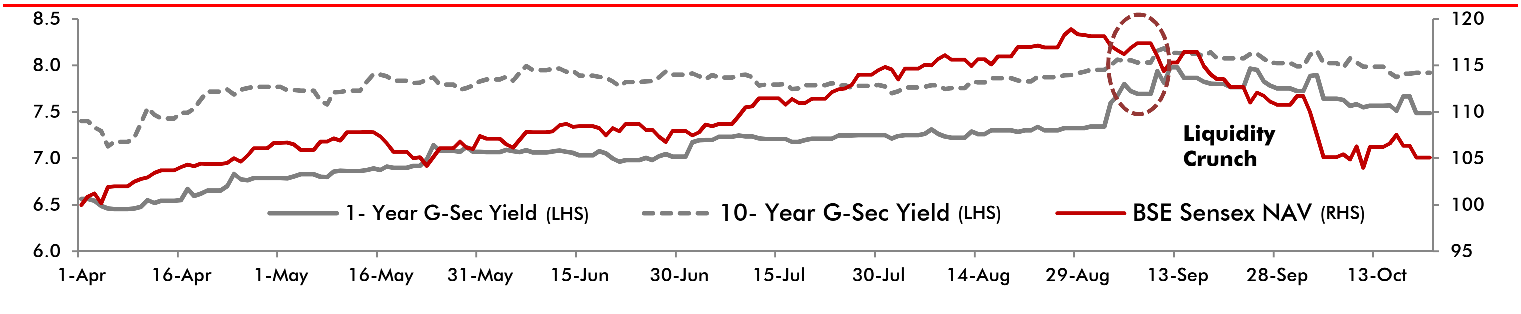
Coffee Can Portfolio: Liquidity Proof

"The propensity to swindle grows parallel with the propensity to speculate during a boom….the implosion of an asset price bubble always leads to the discovery of frauds and swindles."

- Charles P. Kindleberger in his book 'Manias, Panics and Crashes'

In the previous newsletter (https://bit.ly/2qoiaiN), we had highlighted rising interest rates as one of the reversals of macro tailwinds that is expected over the next 3 years. In the past month, the major phenomenon impacting the equity capital markets has been the "Liquidity Crunch". The trigger for the liquidity crunch was pulled by the default of IL&FS leading to widespread redemptions in the wholesale debt markets. The first round effect of these developments has been a sharp spike in short-term rates and tightening liquidity. As shown in the Exhibit 1 below, in the last 7 months, the 1-year G-Sec and 10-year G-Sec yields have risen by over 50bps (4-year high) and over 20bps (2-year high), respectively. Due to the ensuing uncertainty, BSE Sensex has fallen by over 10% in the last 2 months.

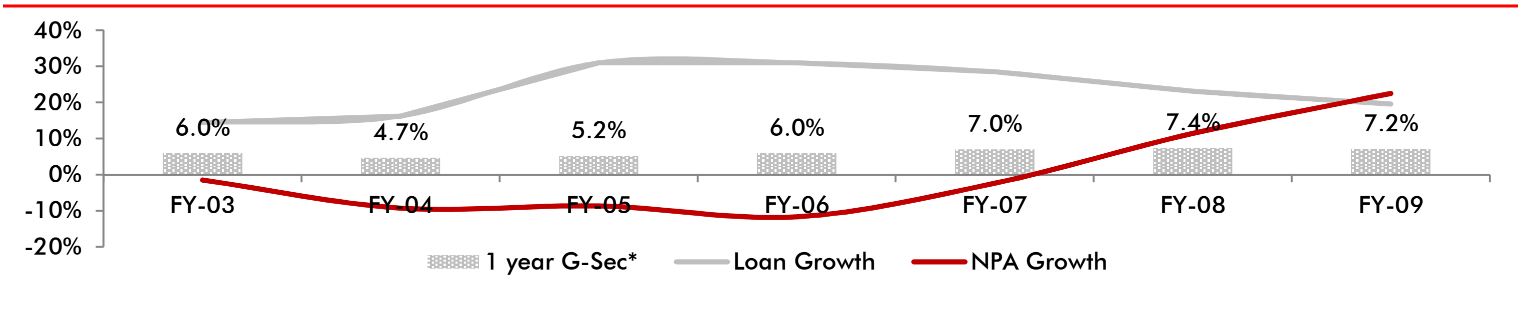
Exhibit 1: Yield Spread & BSE Sensex (Apr-Oct' 18)



Source: Ambit Capital research, Bloomberg, BSE Sensex NAV rebased to 100 on 1 April 2018

We believe the BFSI sector is likely to be the first casualty of rising interest rates and tightening liquidity. In general, during the boom periods of low/falling interest rates, greed to show loan growth overtakes fear and discipline. The resulting poor credit standards in boom years reflect as bad loan write-offs when the tide turns and interest rates begin to rise. Further, as liquidity tightens, banks and NBFCs face rising cost of borrowing and their profitability comes under tremendous stress. Specifically, in the current scenario, NBFCs who have grown their loan book by relying on wholesale debt markets for short-term funds face risk of default as investors are fleeing from debt and money markets and refinance of short-term borrowing is unavailable or available only at steep short-term rates. Depicting this cyclicality in Exhibit 2, the loan growth and growth in NPAs for the banking sector has been analyzed for the period FY03 to FY09. While the 1-year G-Sec yield* was low at less than 6% for the period FY03 to FY06, there was a corresponding sharp increase in the rate of loan growth from 14% in FY03 to over 31% in FY06. However, when the interest rate cycle turned and started to rise from FY06 to reach 7.2% in FY09, the current period loan growth slowed and unchecked growth of the past period led to spike in NPAs with the NPA growth rate touching 23% in FY09.

Exhibit 2: NPA & Credit Cycle of Banking Sector (FY-03 to FY-09)



*Source: RBI, Bloomberg, *G-Sec rates calculated based on daily average for the financial year*

CCP BFSI exposure - a structural play in a cyclical sector: CCP companies in the BFSI space have been exceptions to this general norm and have demonstrated consistently strong performance even in stressful times. A leading housing finance company in the subprime lending space (let's say company A), which is part of the coffee can portfolio, is such an example of a strong structural story in an otherwise cyclical space. The exhibits 3(a) & 3(b) show company A's performance across two periods of significant liquidity stress (2008 Lehman crash and 2013 taper tantrum crisis). Despite significant increase in 1-year G-Sec yield* across both periods (from 6% in FY06 to 7.2% in FY09 & from 6.5% in FY11 to 8.5% in FY14), company A was able to grow its loan book consistently at rates of 20-30%, while pricing power, strategic access to low-cost source of funds and disciplined lending ensured consistently high RoEs. Company A has been able to achieve this due to a strong parentage, competitive advantage arising from years of experience in subprime lending and disciplined focus on retail housing loans - unlike other peer group companies who have grown much faster in recent years by giving out real estate developer loans using cheap short-term money, thereby exposing themselves to the risky real estate cycle (Refer Exhibit 4).

Exhibit 3(a): Company A loan growth & RoE (FY06-FY09)

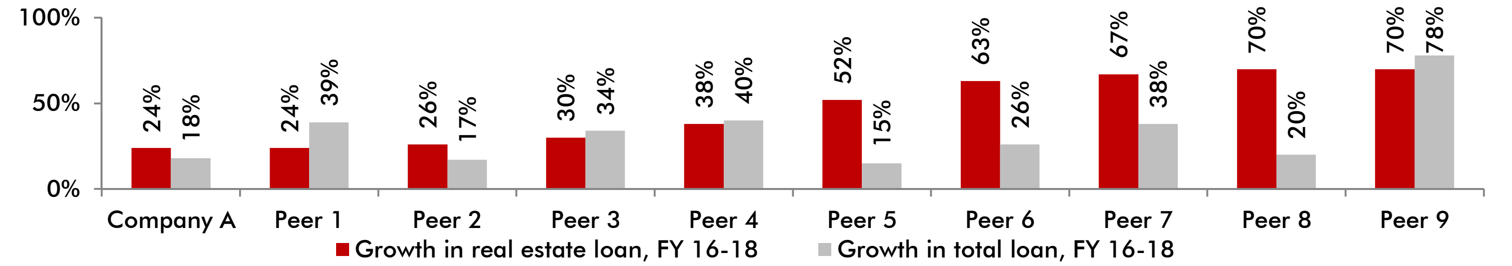
Particulars	FY-06	FY-07	FY-08	FY-09
1 Year G-Sec*	6.0%	7.0%	7.4%	7.2%
Loan Growth	31%	29%	29%	18%
ROE	**27%**	**24%**	**24%**	**24%**

**G-Sec rates calculated based on daily average for the Financial year.*

Exhibit 3(b): Company A loan growth & RoE (FY11-FY14)

Particulars	FY-11	FY-12	FY-13	FY-14
1 Year G-Sec*	6.5%	8.3%	8.0%	8.5%
Loan Growth	30%	28%	34%	29%
ROE	**31%**	**34%**	**33%**	**32%**

Exhibit 4: Except Company A, most HFCs have seen high growth in risky real estate developer loans over the last two years



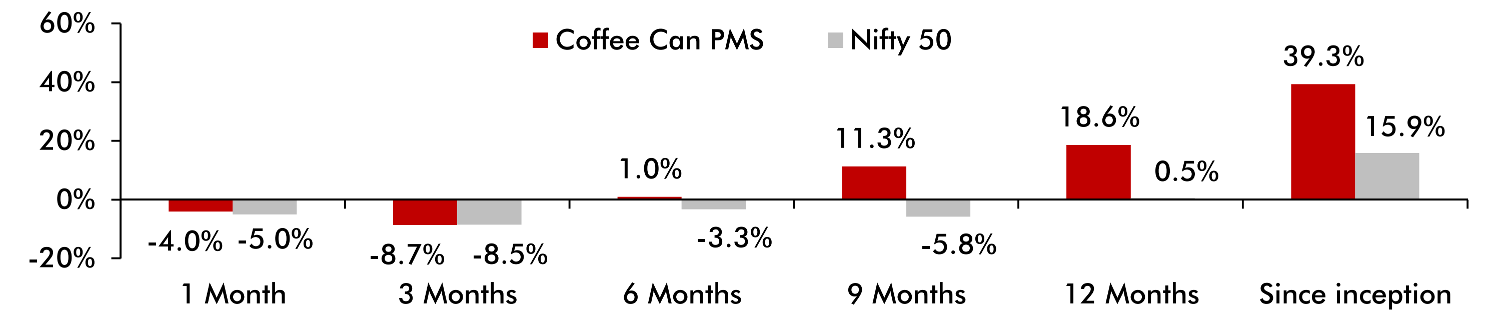
Source: Ambit Capital Research, CLSA. Company A has <5% exposure to real estate developer loan compared to sector average of ~20% as at Mar 31, 2018.

Stressful times lies ahead for the BFSI sector due to the ongoing liquidity crisis and rising interest rates. However, we believe that competitive moats and uncompromised lending discipline of CCP portfolio companies, just like the example of Company A above, will enable them to overcome the adverse environment and deliver strong & consistent performance over the next 2-3 years.

Performance update – Ambit's Coffee Can PMS – as on 31st Oct 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.** The 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 an average.

Ambit's Coffee Can PMS performance update



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

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