Ambit Coffee Can Newsletter – Dec'17

Share prices of great companies remain resilient even during market stress!

"Only when the tide goes out do you discover who's been swimming naked" - Warren Buffett. When the broader market is undergoing a euphoric or bullish phase, most stocks do well regardless of the quality of their underlying fundamentals. However, when the euphoria ends, stocks with poor underlying fundamentals are decimated, resulting in significant capital erosion for investors who did not adequately understand the weak fundamentals of their portfolio companies. On the contrary though, there are certain types of stocks which show remarkable resilience even during stressed market conditions. Let's look at Asian Paints as an example - the histograms below draw a comparison between the Sensex and Asian Paints's share price returns in each of the last 25 financial years. There are two key observations from these histograms.

Observation #1: Sensex gave positive returns in 15 years out of the past 25 years. However, Asian Paints gave positive returns in 21 out of these 25 years, making Asian Paints' histogram skewed more towards the right.

Observation #2: There have been several years (the six green-shaded cells) in which Asian Paints gave positive returns despite the Sensex giving negative returns in these years.

As a result of these two aspects of its performance, Asian Paints's delivered 23% share price CAGR over 1992-2017 vs 11% for Sensex's. Also, it was a futile exercise, trying to time the entry and exit into Asian Paints' stock based on expectations of the broader stock market's direction.

Exhibit 1: Sensex histogram of annual returns

Negative Returns				Positive Returns			
					FY98		
					FY05		
					FY07		FY94
			FY97		FY08		FY00
		FY95	FY99		FY11		FY04
FY93		FY03	FY02	FY96	FY14		FY06
FY09	FY01	FY12	FY16	FY13	FY17	FY15	FY10
Less than -30%	**-20% to -30%**	**-10% to -20%**	**0% to -10%**	**0% to +10%**	**+10% to +20%**	**+20% to +30%**	**More than +30%**

Source: Bloomberg, Ambit; FY = Financial Year

Exhibit 2: Asian Paints histogram of annual returns

Negative Returns				Positive Returns			
							FY94
							FY00
							FY02
							FY04
					FY95		FY06
					FY96	FY05	FY08
				FY93	FY98	FY11	FY10
		FY97		FY03	FY07	FY12	FY13
FY09		FY99	FY01	FY16	FY14	FY17	FY15
<< -30%	**-20% to -30%**	**-10% to -20%**	**0% to -10%**	**0% to +10%**	**+10% to +20%**	**+20% to +30%**	**>> +30%**

Source: Bloomberg, Ambit; FY = Financial Year; Green shaded cells = years when the stock delivered positive returns despite Sensex returns being negative

So why has Asian Paints's share price demonstrated such resilience? It is due to two factors as illustrated in Exhibit 3:

Exhibit 3: Drivers of Asian Paints's positive share price returns in years when Sensex reported a decline

	FY03 (factor 1)	FY16 (factor 1)	FY12 (factor 2)
Asian Paints's EPS growth	27%	25%	17%
Asian Paints's P/E rerating*	-21%	-15%	10%
Asian Paints's Share price growth	1%	7%	28%
Sensex EPS growth	13%	-10%	6%
Sensex P/E re-rating*	-22%	1%	-16%
Sensex price growth	-12%	-9%	-10%

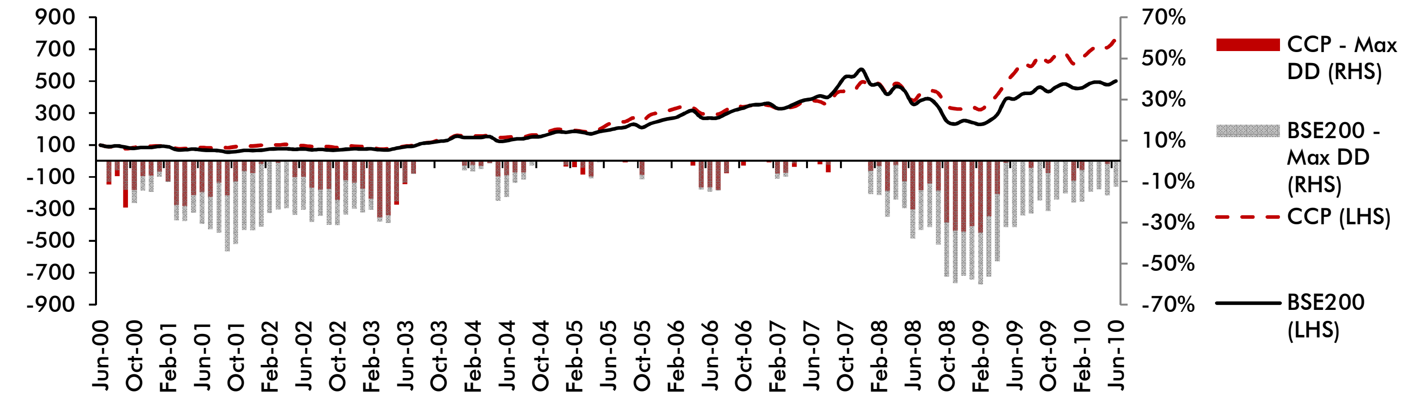
*Source: Company, Bloomberg, Ambit; *Negative values indicate a de-rating*

Factor #1 - Earnings growth more than offsets the P/E de-rating: Stressed periods of the stock market usually occur due to weak earnings growth for the market compared to what is already factored into the share prices. Asian Paints managed to maintain healthy earnings growth even in a disruptive environment. Hence, the ripple effect of a stressed stock market's P/E multiple de-rating has been more than offset by Asian Paints's earnings growth during the same period. Therefore, in FY03 and FY16, the share price of Asian Paints gave positive returns despite Sensex reporting a decline.

Factor #2 - P/E does not de-rate because the market incrementally factors in longevity of earnings: As firms like Asian Paints deliver consistent revenue and earnings growth during periods of weakness in fundamentals for the broader market, it is likely that P/E multiples of such companies start factoring in a greater degree of sustainability of earnings growth over the longer term in future. This is highlighted in the table above where Asian Paints's P/E multiple expanded by 10% in FY12 with an EPS growth of 17% in a year when the Sensex declined by 10%.

Ambit's Coffee Can philosophy shows commitment to such high quality franchises (like Asian Paints) that consistently sustain their competitive advantages, despite being faced by disruptions at regular intervals. As a result, most companies in Ambit's Coffee Can Portfolios tend to demonstrate the resilience highlighted using Asian Paints's example above. As shown in the Exhibit 4, during periods of market stress, the performance trajectory of the Coffee Can Portfolios (CCPs) consistently generates the following outcomes: **1)** The CCPs tend to fall less than the overall stock market; and **2)** The recovery following the crash is faster and stronger for CCPs compared to that of the broader market. Also, not only do the CCPs outperform the Sensex/BSE200 consistently, **but trying to 'time' the entry and exit from a CCP based on the expectation of forthcoming stock market stress, is also a futile exercise.**

Exhibit 4: Coffee Can Portfolios suffer much lower drawdowns than the BSE200 index (highlighting CCP 2000 iteration here – for similar charts on all historical iterations of CCP, please refer to Ambit Capital's 17th Nov 2017 Coffee Can research note)

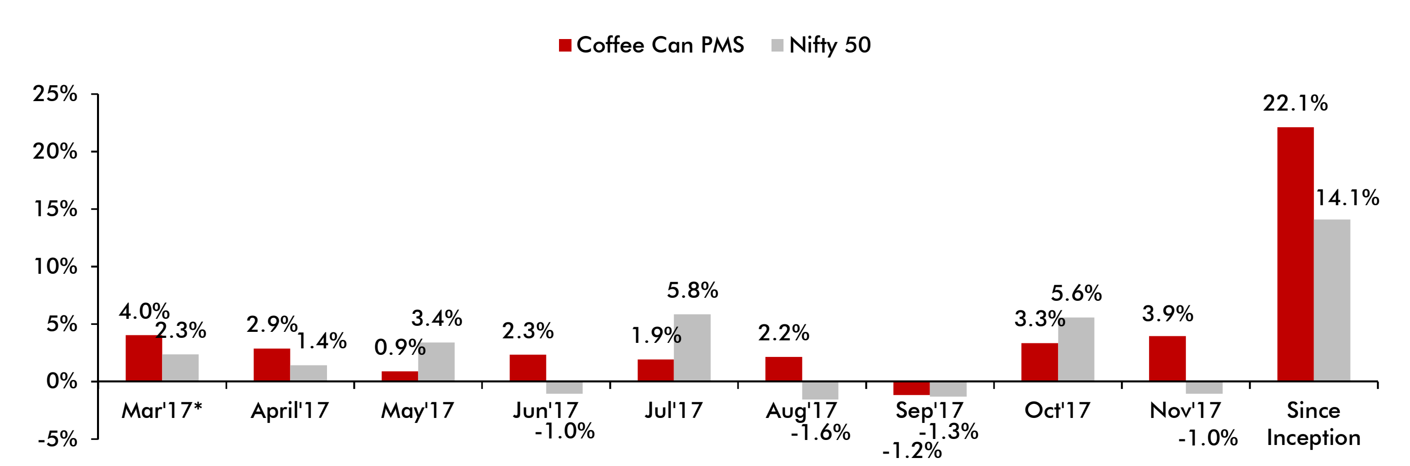


Source: Bloomberg, Ambit Capital research. Note: The maximum drawdown is calculated as drop in value from the peak to the period concerned. For example, in Nov'08 the maximum drawdown of 59.5% denotes a drop in value of 59.5% in BSE200 index from the peak achieved in Nov'07.

Performance update – Ambit's Coffee Can PMS

Exhibit 5 shows the performance of Ambit's Coffee Can PMS. 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. **Over the past three years (ending 30 Sept 2017), the average EPS CAGR of our PMS portfolio companies (weighted for allocation) has been 14.3% compared to -1.1% CAGR for the Sensex.** Going forward, earnings growth rates of our portfolio companies should accelerate to above 20%, as they benefit from the ongoing disruptive changes like GST, whilst further strengthening their moats.

Exhibit 5: Ambit's Coffee Can PMS performance update – absolute returns (as on 30 November 2017)



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

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