AMBIT
Acumen at work

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AMBIT
ASSET MANAGEMENT

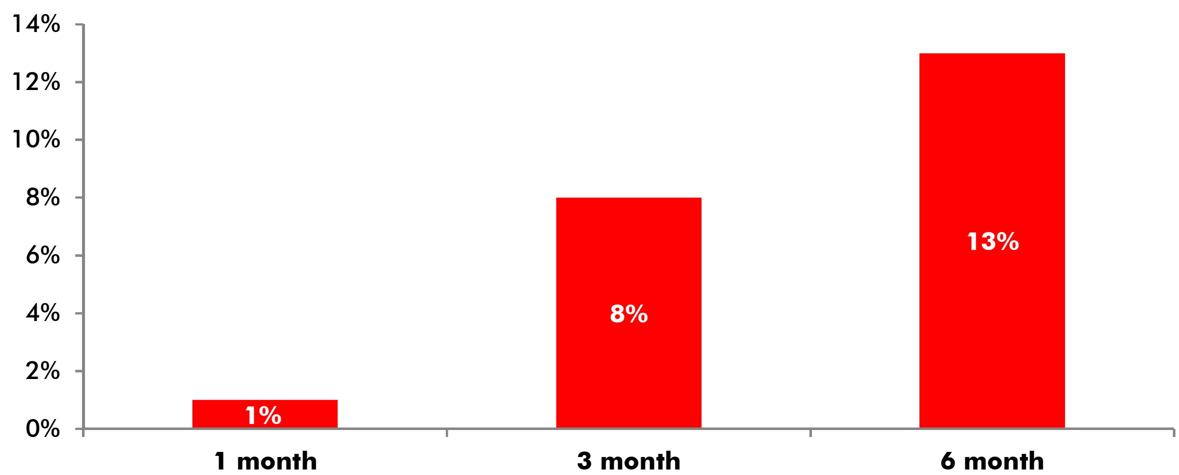
Emerging Giants:
G&C Small Cap

Dear Investor,

In our recent interactions with you and company managements, a frequent area of discussion has been the probable outcome of ongoing elections and its impact on country's economic progress & stock market returns. Factoring in a stable majority government, markets are currently assuming robust economic development for the next five years. This is reflected in recent market performance, Nifty has already delivered 8% returns in the last three months and 13% in the last six month.

We believe that long-term development and economic progress does get impacted by elections albeit to a minor extent. Policy formulation, implementation and execution do take time but once implemented these are irreversible in nature. Such irreversibility also restricts deviations in project executions which in most cases run over years, thereby reducing the impact of change in government. This also ensures continuity in business operations for well-run business focused on capital allocation and profitability; this remains the core of our investment philosophy.

Exhibit 1: Nifty has a fairly strong run in the last few months!



Source: NSE

Consider the ongoing Dedicated Freight Corridor (DFC) project for railways, aimed at reducing logistics cost and transportation time on two congested rail routes, Delhi-Mumbai and Delhi-Howrah. The project was started in 2010 with completion expected by 2016-2017. However, the project is still ongoing with first sections of DFCs now completed. Delays in projects are largely due to hurdles in land acquisition, environmental clearance & slow pace of construction due to congestion on the routes. Clearly, incoming and outgoing governments have not derailed the project in the last eight years but have indeed made policy changes simplifying land acquisition process and faster environment clearances. To identify and address critical bottlenecks in development policies is the true role of the government and we have seen that occurring in the last two decades.

During the NDA government in 1999-2004, the two most successful projects were Golden Quadrilateral & the Pradhanmantri Gramin Sadak Yojna. Both projects had a multiplier effect on economy. Golden Quadrilateral project was launched in 2001 and completed in 2012 during the tenure of UPA-II.

During the UPA government in 2004-2014, focusing on rural growth, two long-term enabling schemes were National Rural Employment Guarantee Scheme (NREGA) and National Skill Development Mission. Both these schemes still continue and remain important for financial inclusion of rural India.

During the NDA government in 2014-2019, perhaps the most important reforms were passing of GST bill and implementation of Insolvency and Bankruptcy Code (IBC). Both reforms have faced multiple execution challenges which will get smoothened out over the course of next few years. In 2000, the then government set up a committee to design GST. In 2006, GST appeared for the first time in budget speech. In 2011, government tabled 115th constitution amendment bill in Lok Sabha for bringing GST. In 2015, Lok Sabha passes GST Constitutional Amendment Bill and in 2017, GST was finally rolled out. Clearly, this was a humongous effort and successive governments played a key role in finalizing the GST. Now, both reforms highlighted above are irreversible.

Similarly the Direct Benefit Transfer mechanism which was conceptualized in the UPA regime was successfully executed to a mass level by the outgoing NDA government aided by adoption of Aadhar and opening of Jan Dhan Bank accounts. The mechanism now covers 55 ministries and 440 schemes.

Further, roll back of few landmark reforms such as repealing of outdated laws, bidding based allocation of natural resources, RERA etc.; seems very difficult by any incoming government. The increase in tax base and resulting increase in direct and indirect tax collection will only increase and grow from here.

As highlighted above, economic progress and development continues irrespective of political outcomes. Well run businesses will adapt to short term challenges by varying capital allocation. Key themes that will drive business trajectory and will also require focus from the government will be:

- Stricter enforcement of E-way bill to ensure GST becomes a success
- Faster resolution of pending cases in IBC and in helping Banks to come out of the NPA cycle
- Completion of DFCs and increasing Waterway developments
- Reducing dependency on Crude Oil with increasing focus on renewable and nuclear energy
- Revival of public & private capital expenditure (capex) cycle
- Revival of Housing market
- Increasing focus on skilling youth in India

We believe that the above highlighted focus points are recognized by all political parties as key areas. Abovementioned focus areas are not short term resolution points; they are already work-in-progress points and will be executed in next 1-2 years irrespective on the outcome of central elections. Progressing on focus areas remain important to increase country's GDP growth to 9-10% and above.

Lastly, we would also highlight that India remains a domestic consumption story. With low per capita income but high savings rate, consumption theme will continue in India. Policy implementation will help in increasing the per capita income in medium to long term. Capex cycle recovery should add to the growth. These will be core drivers for the businesses in India and will determine our investment evaluation process of investible companies.

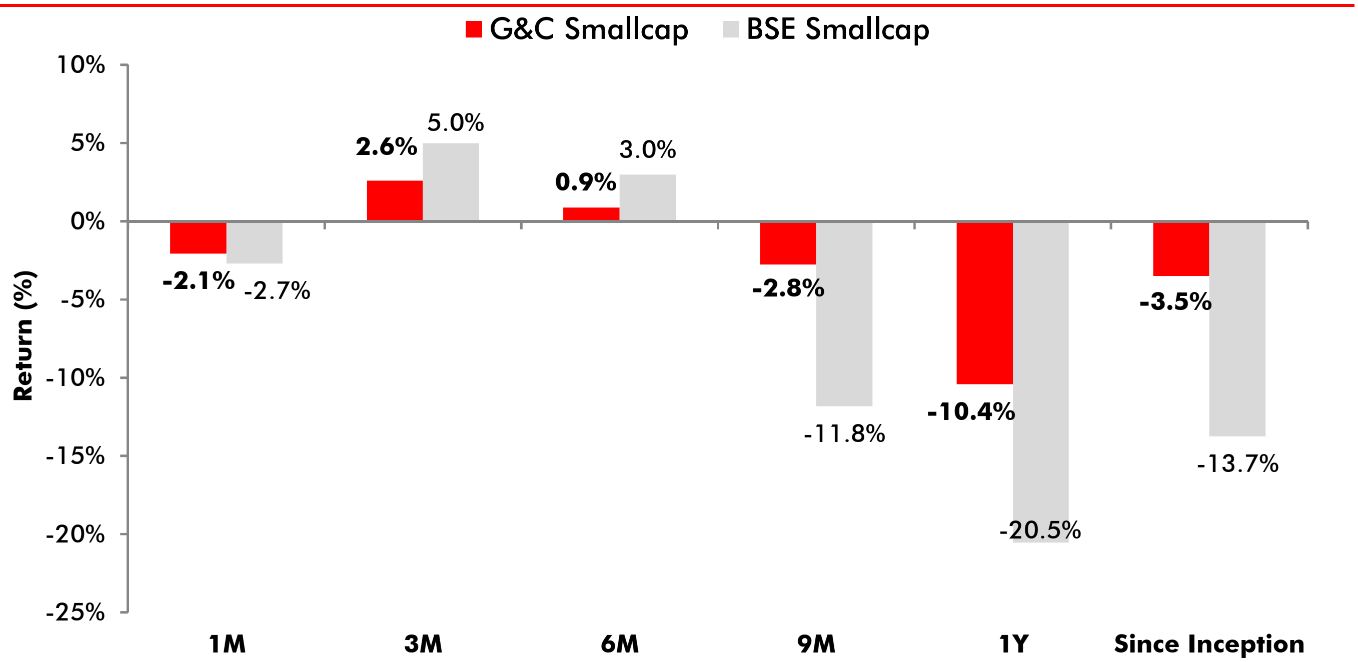
Emerging Giants: G&C Small Cap

Smallcaps with secular growth, superior return ratios and no leverage

Ambit's Emerging Giants 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 record, superior underlying fundamentals (high RoCE, low debt) and 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 lead us to a concentrated portfolio of 15-16 emerging giants.

- **Rigorous stock selection process:** Starting at a large investible universe of about 1,300 smallcaps, Ambit's proprietary frameworks along with extensive bottom-up research helps create a concentrated portfolio of 15-16 companies at any time. The process focuses on identifying companies which in addition to being clean on governance and accounting, have business models that are profitable, scalable, sustainable and self-funding for their growth requirements.
- **Long-term horizon/low churn:** Our holding horizons for investee companies are 3-5 years and even longer with annual churn not exceeding 20-25% in a year. The long-term orientation essentially means investing in companies that have the potential to sustainably compound earnings, with the compounding earnings acting as the primary driver of investment returns over long periods.

Exhibit 2: Ambit' Emerging Giants: G&C Small Cap performance update



Source: Ambit; Portfolio inception date is December 1, 2017; Returns as of April 30, 2019; Since inception returns are annualized. ***Returns are net of all fees and expenses***

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