Ambit Asset Management

MONTHLY NEWSLETTER

DECEMBER 2021

THE GREAT DISRUPTION

Dear Patron,

In the last 4-6 quarters, corporations globally have been disrupted largely because of COVID led uncertainty and the ensuing lockdowns which led to an uncertain demand environment and revenue volatility. As COVID restrictions eased over the last 2 quarters, and demand returned back to pre-COVID levels, corporates were faced with supply disruptions leading to increased freight and raw materials cost that ate into the margins and impacted profitability even as sales returned to - or even surpassed - pre-COVID levels. Our portfolio companies surpassed their respective benchmarks on revenue growth, however earnings growth was impacted due to the above reasons as corporates tried to find a fine balance between Demand and Margin.

In this month's newsletter, we take a closer look at the near-term headwinds in each of the major sector, its impact and how companies are addressing the same. **Current disruption holds all the more importance in current context of rising inflation trend, should it continue in the near-term.**

Exhibit 1: Health revenue growth across portfolios with gradual price hikes expected to aid earnings in near term

	Net Sales YoY%			EBITDA YoY%			PAT YoY%		
Ambit Coffee Can PMS	**Q2FY22**	**Q1FY22**	**Q2FY21**	**Q2FY22**	**Q1FY22**	**Q2FY21**	**Q2FY22**	**Q1FY22**	**Q2FY21**
Weighted avg	27%	60%	5%	27%	122%	16%	27%	105%	2%
Median	24%	37%	5%	14%	89%	18%	12%	54%	3%
Nifty	23%	31%	-10%	26%	45%	-10%	42%	45%	-10%
Ambit Good & Clean Midcap PMS	**Q2FY22**	**Q1FY22**	**Q2FY21**	**Q2FY22#**	**Q1FY22**	**Q2FY21**	**Q2FY22**	**Q1FY22**	**Q2FY21**
Weighted avg	30%	53%	5%	43%	162%	15%	39%	77%	68%
Median	27%	30%	14%	19%	41%	27%	31%	29%	11%
Nifty Midcap 100*	-15%	13%	8%	16%	53%	14%	36%	57%	7%
Ambit Emerging Giants PMS	**Q2FY22**	**Q1FY22**	**Q2FY21**	**Q2FY22#**	**Q1FY22**	**Q2FY21**	**Q2FY22#**	**Q1FY22**	**Q2FY21**
Weighted avg	39%	103%	7%	37%	100%	25%	32%	64%	11%
Median	37%	60%	0%	6%	92%	22%	7%	81%	-3%
BSE smallcap	35%	47%	-3%	27%	137%	48%	12%	60%	29%

Source: Ambit Asset Management, Bloomberg
Sharp difference between Median and weighted avg for Q2FY22 EBITDA / PAT for Emerging Giants and G&C Midcap portfolio is because of base effect.
*Indices data is from Bloomberg. Nifty Midcap 100 median / weighted avg. revenue growth as per our calculation of individual constituents was **18%/33%**

THE SUPPLY DILEMMA – WHAT TRANSPIRED ?

During COVID, demand for several industries disappeared overnight with corporates struggling to predict the future outlook as the situation was very grim. While everyone predicted a recovery, few expected it to be this swift and sharp. The ensuing demand has positively surprised almost every industry as months of savings – owing to lower discretionary spends – gave way to 'revenge' spending. As restrictions started to ease, consumers spent heavily on discretionary products such as home improvement, consumer durables, jewelry etc. While this strong demand came as a breather to the corporate world, the pace of it – which not many anticipated – led to sudden supply side pressure which led to shortage of key raw materials leading to input cost increase across industries. Also, inadequate shipping capacity to service the demand has led to frequent delays and sharp rise in container cost **(Refer to Exhibit: 2)**.

This sharp price increase has dented the margins of key industries and created a dilemma for the management whether to take a steep price hike or face margin contraction. The situation becomes even trickier when cost inflation is to the tune of 30-60% as passing this quantum of price increase may not only unsettle the demand but also affect competitive landscape in the industry. While some companies have resisted price hikes given the temporary nature of inflation, others have had to bite the bullet.

Exhibit 2: % increase in container freight rates from March-2020 to Aug-2021 from Indian ports to leading global ports

Origin	Destination	%Inc in container	Freight rate from Mar-20 to Aug-21
Cochin	Melbourne	700%	1,000%
Cochin	Hamburg	1027%	873%
Cochin	Tokyo	233%	155%
Cochin	Penang	383%	267%
Cochin	Rotterdam	1,140%	873%
Cochin	Los Angeles	717%	650%
Cochin	Cape Town	900%	900%
Mundra	Montreal	352%	314%
Mundra	Hamburg	854%	759%
Mundra	New York	592%	650%
Mundra	Baltimore	462%	311%
Mundra	Ho Chi Min City	329%	329%
Mundra	Yokohama	167%	245%

Source: Ambit Asset Management, Indian Spice & Foodstuff Exporters' Association

Exhibit 3: ~70% increase in Bloomberg Commodity Index – that tracks prices of key global commodities – from COVID bottom

Source: Ambit Asset Management, Bloomberg

1. FMCG/Paints saw the surge in raw material prices

Gross Margin contraction was the major point of discussion during earnings calls across companies in the consumer sector. There was a median GM compression of ~450bps across large FMCG and paint companies (~250bps for large FMCG cos) **(Refer to Exhibit: 5)**. Companies have resorted to various measures to tackle the same:

A. Prices of Titanium Di-oxide, (a key raw material for paints) has increased by >50% YoY resulting in ~200bps GM contraction for Asian Paints despite a 7% price hike in H1 FY 22. The company has taken 2 more price hikes (of approx. 7-9% and 4-5%) post Q2 to mitigate the impact of the same.

B. Similarly for Pidilite, prices of Vinyl Acetate Monomer or VAM (primary raw material) has increased from $900 in Q2 FY 2021 to $2000 in Q4 FY 2021. Pidilite management has taken price hikes to cover ~70-75% of RM inflation.

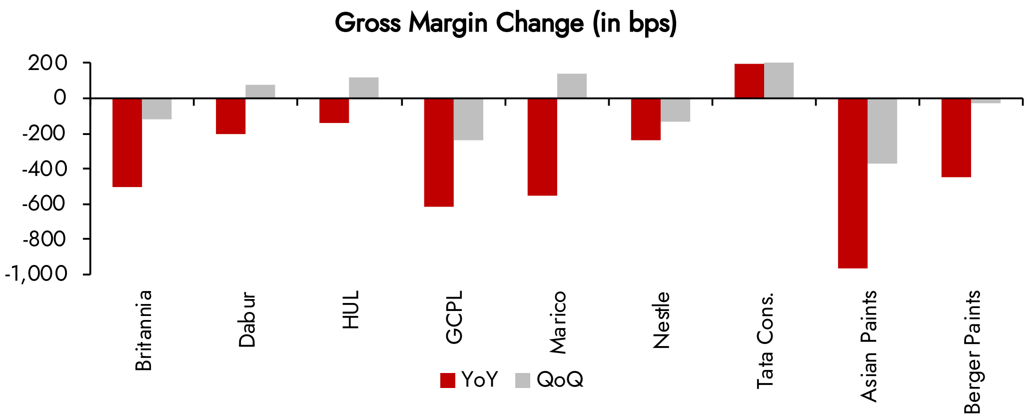
Most of the RM prices have started to peak out and should correct over the coming quarters providing some breather. Managements expect to recover to pre-COVID Gross Margins by 4QFY22 through a mix of pricing action and cost savings initiatives.

Exhibit 4: Sharp commodity Inflation in H1FY21

Commodity	Category impacted	3QFY21	4QFY21	1QFY22	2QFY22	YTD 3QFY22
Sugar	Food items	-2%	-4%	-2%	3%	8%
Crude Oil	Packaging & logistic	-21%	50%	112%	77%	92%
Wheat	Food items	-10%	-10%	-2%	0%	4%
Palm Oil	Food items	39%	66%	88%	62%	59%
SMP - International	Milk & derivatives	-4%	14%	33%	23%	28%
PFAD	Soaps	44%	43%	82%	64%	67%
Tea	Beverages	48%	54%	33%	-33%	-36%
Coffee	Beverages	11%	-2%	-5%	9%	13%
Copra - Calicut*	Hair oil	26%	25%	17%	11%	
LLP*	Hair oil	12%	29%	50%	51%	
India WPI Alkyl Benzene	Detergents	-2%	12%	41%	35%	33%
Barley	Beer	-32%	-2%	29%	56%	62%
Rectified Spirits	Spirits	4%	1%	0%	0%	1%
Titanium Dioxide	Paints	9%	27%	56%	58%	57%
HDPE	Packaging	35%	51%	51%	33%	37%

Source: Ambit Asset Management

Exhibit 5: ...led to severe Gross Margin stress across consumer companies



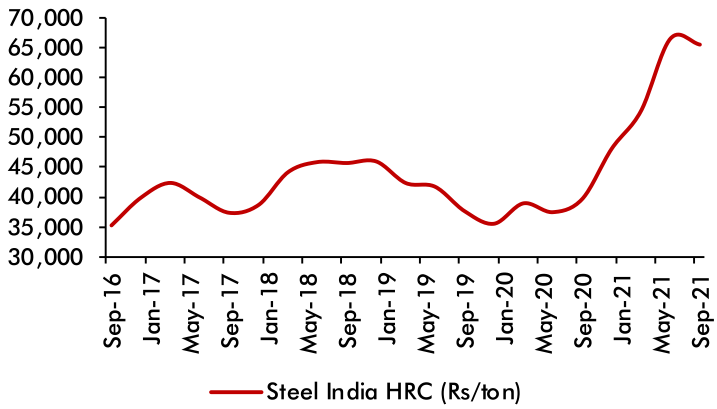
Source: Ambit Asset Management, Company

2. Auto sector plagued by rising raw material costs

A. Commodities across the board such as steel, aluminum, plastics, rubbers etc. saw their prices increase by ~30-70% from 1QFY21 - 2QFY22, impacting profitability. EBITDA margin declined YoY for most companies except TVSL (+30bp) and Ashok Leyland (+ 20bp) on better revenue growth. Companies that disappointed were Maruti Suzuki (-50bp QoQ), M&M (-140bp), Bajaj Auto (-100bp). It was tricky for Auto OEMs to pass on the prices as the sector had already seen 30-35% increase in upfront vehicle cost led by the BS6 transition.

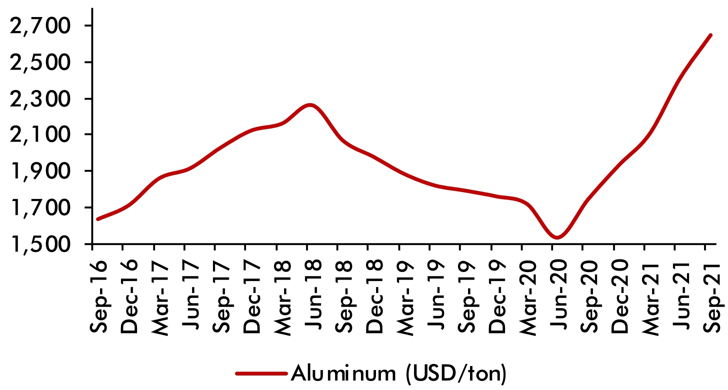
B. Semiconductor shortage persisted in 2QFY22 as well impacting production majorly for OEMs like M&M and Maruti in 4 wheeler space and premium motorcycle players like Bajaj Auto and Eicher Motors in 2W. Eicher couldn't produce enough of its Royal Enfield motorcycles while Bajaj Auto talked about 50% demand-supply gap. In the CV space too, players like Ashok Leyland struggled to meet LCV demand. However, the chip manufacturing companies are reportedly back to normal levels of production and hopefully the supply issue should normalize from hereon.

Exhibit 6: Prices of Steel (~40% of RM used in Autos) have risen by ~75% 2QFY22



Source: Bloomberg, Ambit Capital Research

Exhibit 7: Aluminium prices have also continued to move up; by ~75% over 1QFY21-2QFY22



Source: Bloomberg, Ambit Capital Research

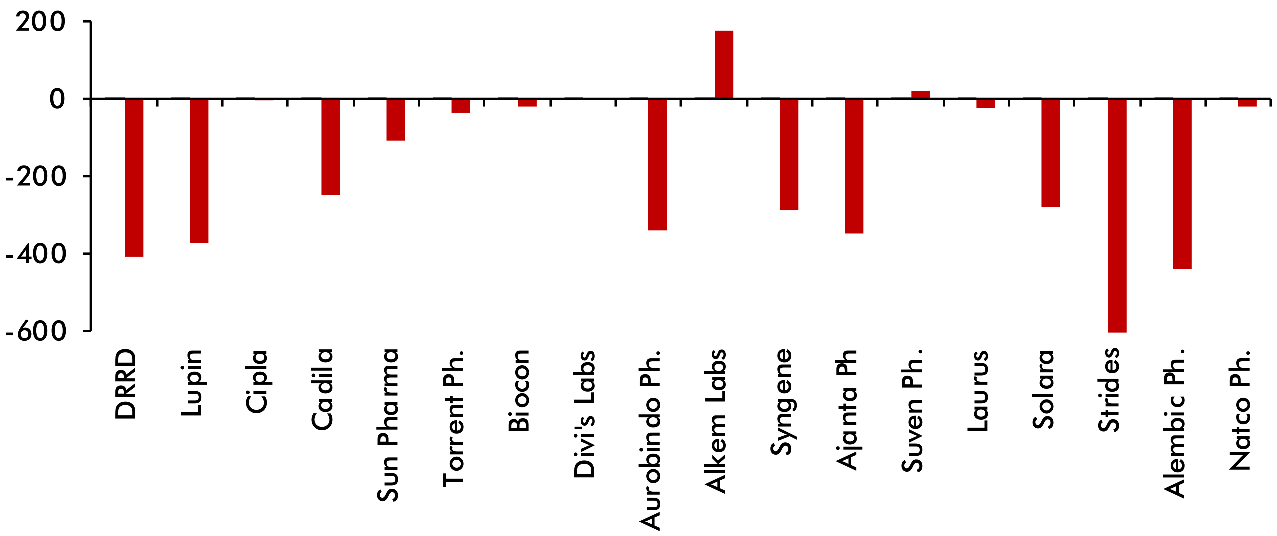
3. **Cost escalation for pharmacy to the world:** Indian pharmaceutical companies faced extreme cost pressure in H1FY22. On-going supply restrictions in China led to sharp price increase of certain Chemicals (up to 200% in certain cases) while also impacting availability. This had a median impact of ~250bps YoY on Gross Margins of leading pharma companies in Q2FY22 **(Refer to Exhibit: 8).**

   A. Margins of B2B companies contracted much sharply as most of them have long-term contracts with clients with limited room for price renegotiation.

   B. The impact was much more for API companies that saw a median revenue fall of –9% YoY as customers de-stocked excess inventories built-up during COVID induced lock downs.

   C. Domestic B2C companies that had sufficient inventories and ability to take price hikes were much less impacted. These companies saw a median revenue growth of +19% YoY led by recovery in acute therapies as patient footfalls inched back towards normalcy

Exhibit 8: Domestic focused companies were far better placed as compared to API / formulations exporters

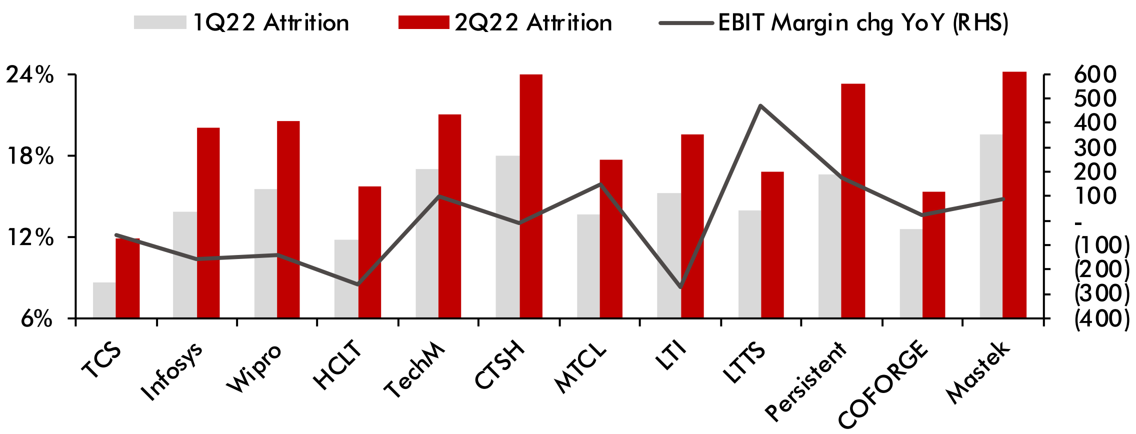


Source: Ambit Asset Management, Company

4. **Services industry is not un-touched! :** IT companies are also facing supply side challenges, albeit of a different kind. Increased pace of digital adoption during COVID to ensure (a) Business continuity (b) Omni-channel interaction with customers, has spurred the demand for IT services and subsequently Tech talent.

A less-optimistic business environment pre-COVID resulted in tepid hiring and lack of talent build-up. As a result, companies resorted to lateral hiring at elevated cost, which shot up attrition numbers and impacted margins in the latest quarter **(Refer to Exhibit: 9).** In addition to wage hike and bonuses, companies are focusing on other benefits such as (a) On-the-job Learning & Development; (b) ESOPs. Persistent Systems, for e.g, rolled out the most inclusive ESOP programme by any IT company in India, covering 80% of its employees. These challenges are expected to last for the next 3-4 quarters as companies train the newly hired freshers and look to fill the attrition gap organically.

Exhibit 9: Sharp jump in Attrition across Tier 1&2 IT companies was the main drag on Margins



Source: Ambit Asset Management, Company

CONCLUSION

A number of companies have highlighted that they haven't seen such sharp commodity inflation, across products, in decades. While the situation was challenging for everyone, we have seen further signs of **K-Shaped** recovery playing out. Market leaders, backed by their strong Balance Sheet and better working capital management, have been able to whether the impact much better than smaller /unorganized players that have struggled to manage supply chain, build inventory and take price-hikes. Imports from China, too, have cooled down during this period, benefitting domestic manufacturers. This resulted in market share gains for industry leaders such as Asian Paints, Titan, Relaxo, Safari, during these tough times.

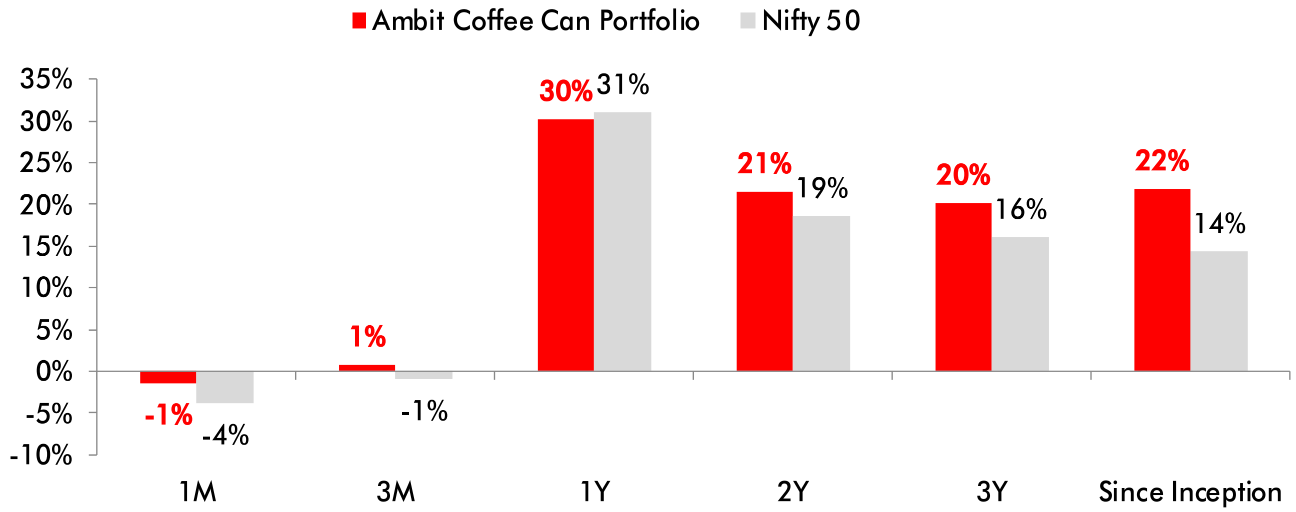
In last few weeks, prices of several commodities and shipping rates have started to cool off. Managements across industries expect the situation to normalize and to reach pre-COVID gross margin by Q4FY22.

This situation, may infact, turn out to be a blessing in disguise for Indian Corporates, helping them prepare for and better manage future cost inflation should the current rising inflation trend become more 'structural' than 'transitory', just like how the ILFS crisis proved to be a blessing in disguise for BFSI companies to help them better manage loan book stress during COVID.

AMBIT COFFEE CAN PORTFOLIO

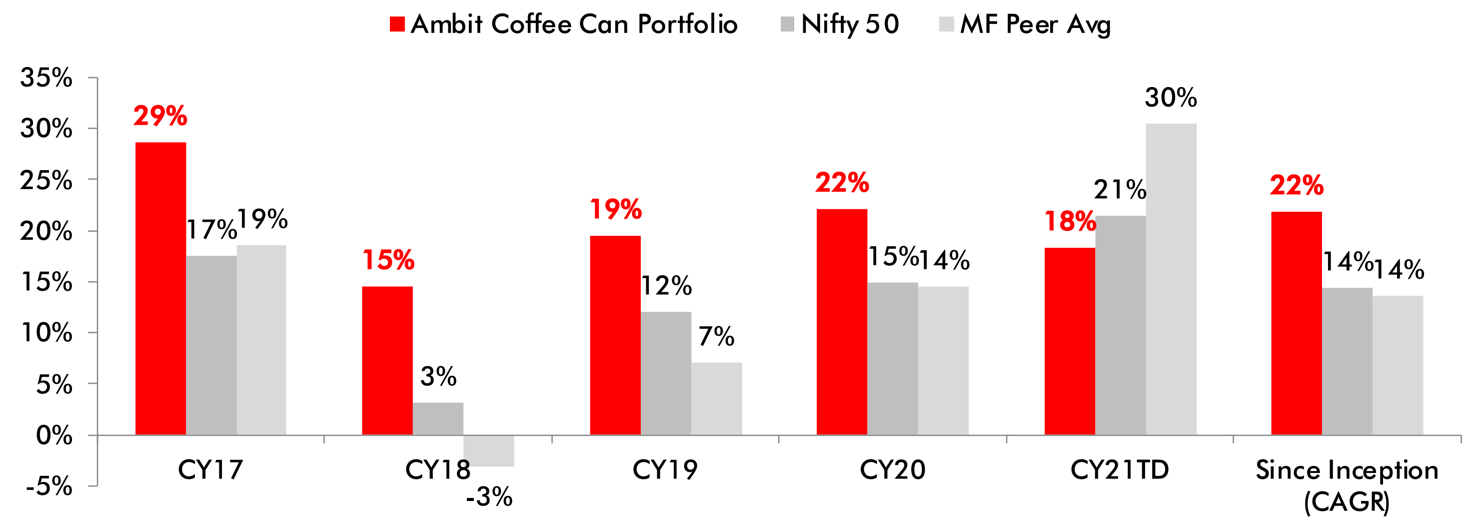
In Ambit Coffee Can Portfolio, we do not attempt to time commodity/investment cycles or political outcomes and prefer resilient franchises in the retail and consumption-oriented sectors. The Coffee Can philosophy has unwavering commitment to companies that have consistently sustained their competitive advantages in core businesses despite being faced by disruptions at regular intervals. As the industry evolves or is faced by disruptions, these competitive advantages enable such companies to grow their market shares and deliver long-term earnings growth.

Exhibit 10: Ambit's Coffee Can Portfolio point-to-point performance



Source: Ambit; Portfolio inception date is March 6, 2017; Returns as of 30th Nov, 2021; All returns are post fees and expenses; Returns above 1-year are annualized; **Note:** Returns prior to Apr'19 are returns of all the Pool accounts excluding non-aligned portfolio, and returns post Apr'19 is based on TWRR returns of all the pool accounts.

Exhibit 11: Ambit's Coffee Can Portfolio calendar year performance



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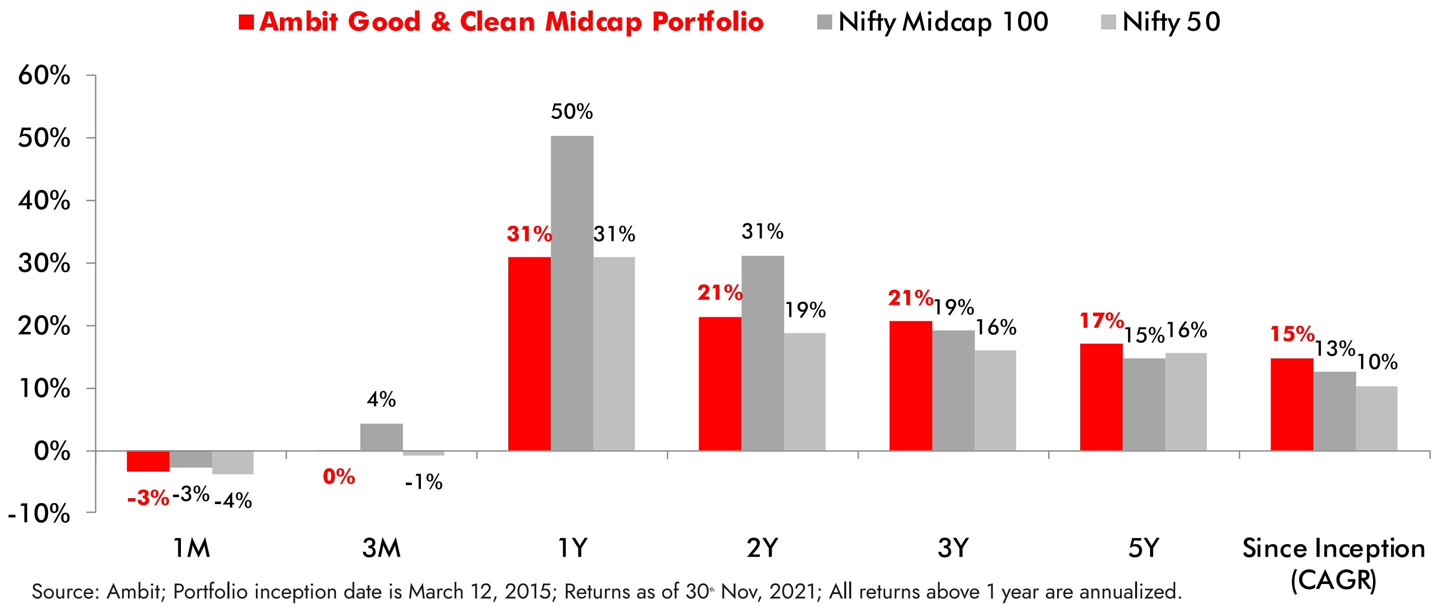
AMBIT GOOD & CLEAN MIDCAP PORTFOLIO

Ambit's Good & Clean strategy provides long-only equity exposure to Indian businesses that have an impeccable track record of clean accounting, good governance, and efficient capital allocation. Ambit's proprietary 'forensic accounting' framework helps weed out firms with poor quality accounts, while our proprietary 'greatness' framework helps identify efficient capital allocators with a holistic approach for consistent growth. Our focus has been to deliver superior risk-adjusted returns with as much focus on lower portfolio drawdown as on return generation. Some salient features of the Good & Clean strategy are as follows:

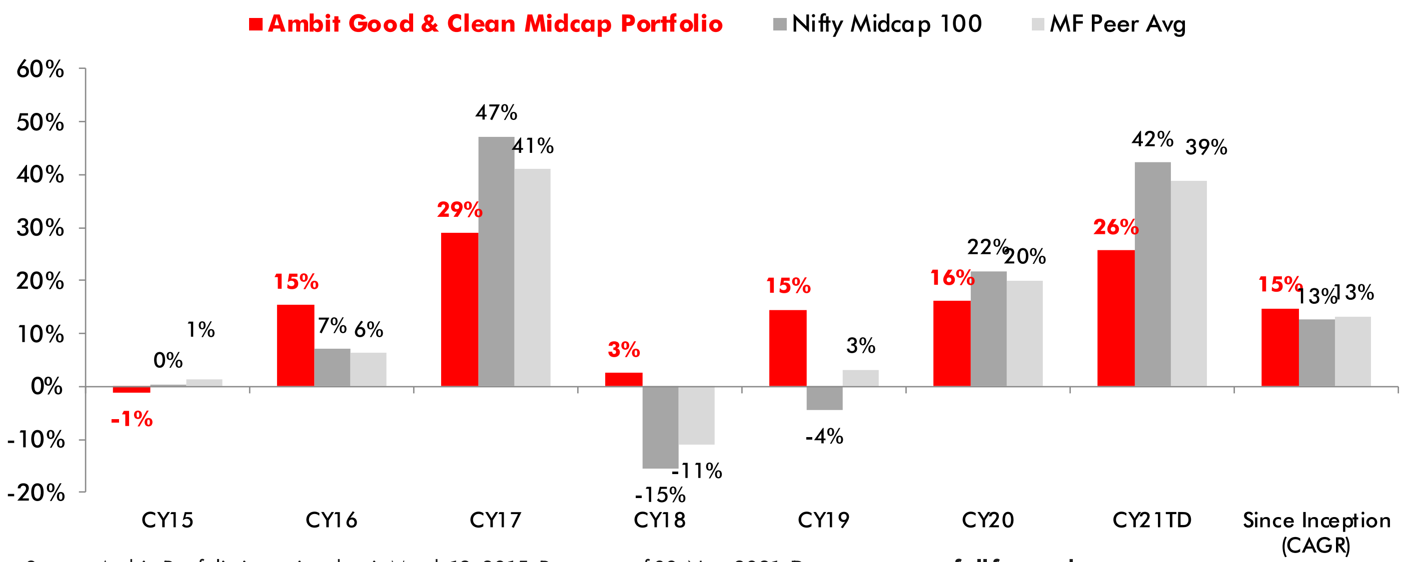
- **Process-oriented approach to investing**: Typically starting at the largest 500 Indian companies, Ambit's proprietary frameworks for assessing accounting quality and efficacy of capital allocation help narrow down the investible universe to a much smaller subset. This shorter universe is then evaluated on bottom-up fundamentals to create a concentrated portfolio of no more than 20 companies at any time.
- **Long-term horizon and low churn**: Our holding horizons for investee companies are 3-5 years and even longer with annual churn not exceeding 15-20% in a year. The long-term orientation essentially means investing in companies that have the potential to sustainably compound earnings, with this compounding earnings acting as the primary driver of investment returns over long periods.
- **Low drawdowns**: The focus on clean accounting and governance, prudent capital allocation, and structural earnings compounding allow participation in long-term return generation while also ensuring low drawdowns in periods of equity market declines.

Exhibit 12: Ambit's Good & Clean Midcap Portfolio point-to-point performance



Source: Ambit; Portfolio inception date is March 12, 2015; Returns as of 30th Nov, 2021; All returns above 1 year are annualized.
Returns are net of all fees and expenses

Exhibit 13: Ambit's Good & Clean Midcap Portfolio calendar year performance

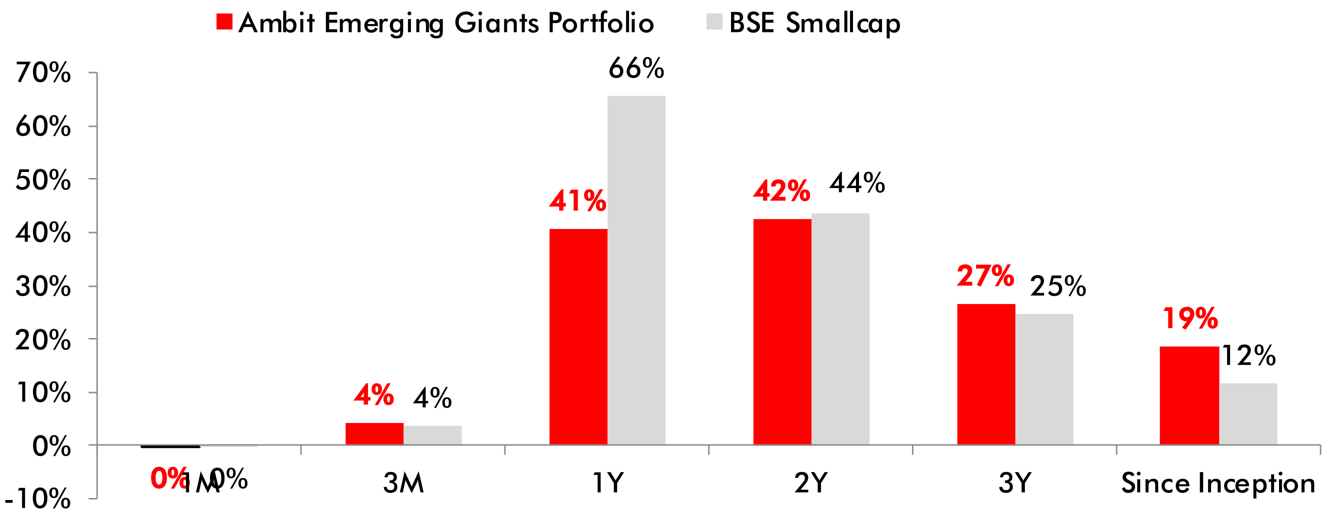


Source: Ambit; Portfolio inception date is March 12, 2015; Returns as of 30th Nov, 2021. **Returns are net of all fees and expenses**

AMBIT EMERGING GIANTS

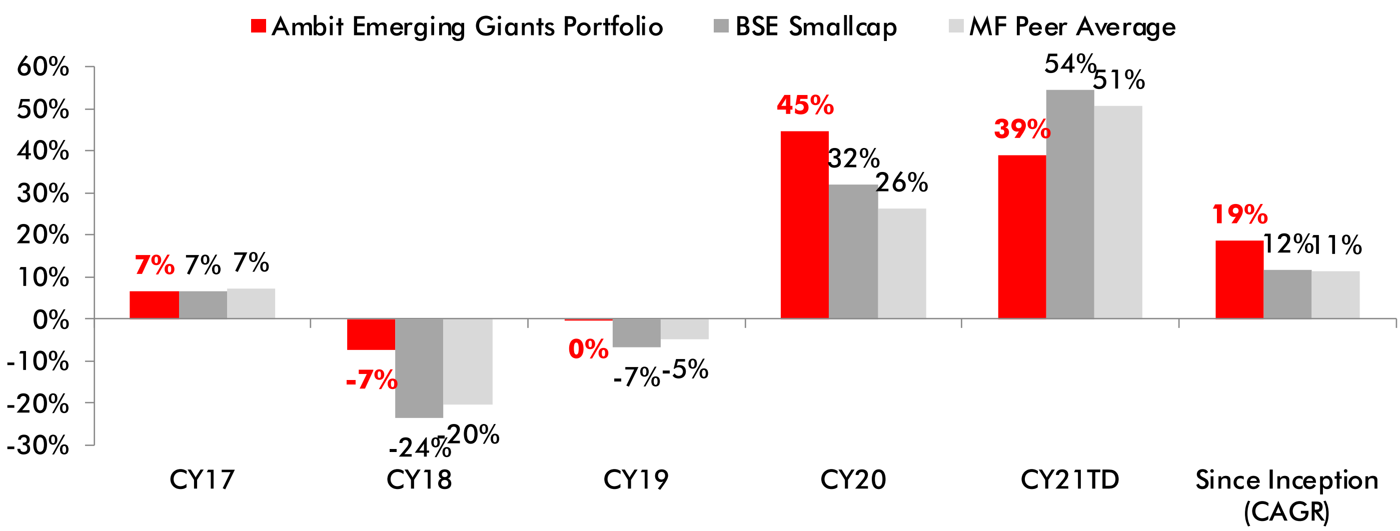
Smallcaps with secular growth, superior return ratios and no leverage Ambit's Emerging Giants portfolio aims to invest in small-cap companies with market-dominating franchises and a track record of clean accounting, governance and capital allocation. The fund typically invests in companies with market caps less than Rs. 4,000cr. These companies have excellent financial track records, 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.

Exhibit 14: Ambit Emerging Giants Portfolio point-to-point performance



Source: Ambit; Portfolio inception date is December 1, 2017; Returns as of 30th Nov, 2021; All returns above 1 year are annualized. **Returns are net of all fees and expenses**

Exhibit 15: Ambit Emerging Giants Portfolio calendar year performance



Source: Ambit; Portfolio inception date is December 1, 2017; Returns as of 30th Nov, 2021. **Returns are net of all fees and expenses**

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The performance data for coffee can product between 6th march 2017 - 19th June 2017 represents model portfolio returns. First client was onboarded on 20th June 2017. The performance data for G&C product between 1st June 2016 to 1st April 2018 also includes returns for funds managed for an advisory offshore client. Returns are calculated using TWRR method as prescribed under revised SEBI (Portfolio Managers) Regulations, 2020