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AMBIT ASSET MANAGEMENT

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MONTHLY NEWSLETTER

GOOD & CLEAN
by Ambit

Ambit Good & Clean Portfolio

Ambit Coffee Can Portfolio

Ambit Emerging Giants Portfolio

2020- Another chance to get it right?

Dear Investor,

While we are eternal believers in the Indian growth story we are cognizant that the economy in its current state is facing certain deep rooted challenges. Government target of a $5 trillion economy by 2024, would necessitate steady real growth of at least 8-9 % pa here on which is presently not the case. A quick look through the rear view mirror can help give us some perspective on how we got here and what lies ahead.

1. Legacy Problems inherited by the Narendra Modi government in 2014

- Several infrastructure projects had stalled due to difficulty in land acquisition, lack of inputs such as coal/gas and slow pace of regulatory approvals.
- Power producers were running into difficulty as heavily indebted power distribution companies delayed payments or stopped buying further, thereby leading to surplus power while demand was unmet.
- Agriculture suffered over the years due to dominance of middlemen and lack of access to better seeds/technology. Inefficient schemes like loan waivers had a short term focus rather than addressing the long term issues of the sector.

2. Key areas of success of the Modi government since 2014

Exhibit 1: Brief overview of some of the biggest and boldest initiatives under the Modi

Initiatives	Highlights	Pending challenges
IBC	▪ IBC framework was introduced to promote ease of doing business ▪ It simplified the winding up process in respect of companies, which was earlier fragmented due to multiplicity of statutes as well as jurisdictions.	▪ Delays in judgement and admission of cases ▪ Periodic reinterpretations of the law
GST (Goods and Services Tax)	▪ It helped subsume a complex web of taxes into a single tax called GST levied on supply of goods and/or services. It also allowed the provision for availing input tax credit. ▪ This helped create a single/uniform national market	▪ Adaptation issues for SME and MSME's ▪ Frequent changes in processes/ requirements
RERA	▪ Creation of institutional infrastructure for protecting the interests of consumers ▪ Promoting the growth of real estate sector in an environment of trust and credibility.	▪ Liquidity crunch, inventory sold at discounts to meet funding shortfall. ▪ Unfinished projects
Ease of doing business	▪ India jumped to 63rd position on the World Bank's ease of doing business ranking. India has improved its rank by 79 positions in last five years. ▪ Make in India has been the poster for reforms in India	▪ Can be made more broad based, specially land & labour reforms ▪ Frequent change in taxation/tariffs
Redistribution of wealth	▪ Jan-dhan, Swach Bharat, Ujjwala Yojana, Ayushman Bharat, Direct Benefit transfer, NREGA have brought more efficiency into government payments	▪ Private sector receivables stretched as government delay payments

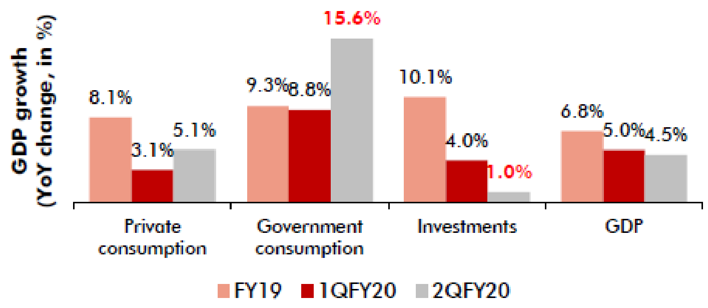
Source: Ambit Asset management

3. Story in charts: State of the Economy

- The Indian economy and Indian business has been facing a tough time despite the all-time high equity indices. A dismal GDP growth (4.5% in 2QFY20) has been driven largely by an unsustainable growth in government consumption. If we were to remove this impact GDP growth (ex-government) would be even lower at 3.1 %.(Ref Exhibit 2 & 3)
- A Government which was hoping to boost revenue from an ambitious disinvestment target of ₹1.05 tn for FY20 has so far managed to garner only ₹173.64 bn so far. Privatization of Air India, BPCL and Concor are key to achievement of this target as we near 31st March 2020.

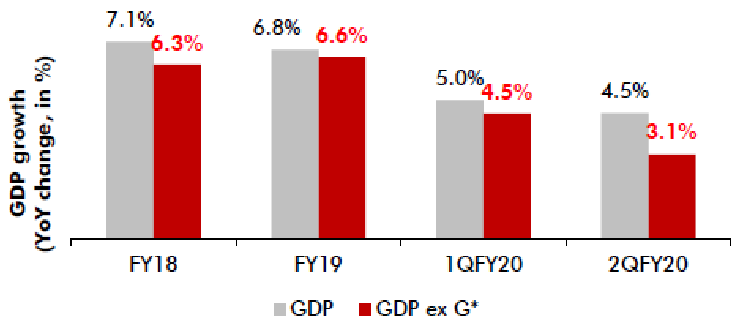
- Inadequate disinvestment can further curtail the government's ability to meet the fiscal deficit target of 3.3% GDP, in a year where both direct and indirect tax collections have been well below expectations. (Ref Exhibit 4)
- Since government finances remain under some pressure, there remains almost no space for fiscal manoeuvring. On the other hand limitations of transmission and already low interest rates leave limited room for monetary stimulus too. (Ref Exhibit 5)

Exhibit 2: GDP growth in 2QFY20 fell to a 26 quarter low led by slowdown in investments growth



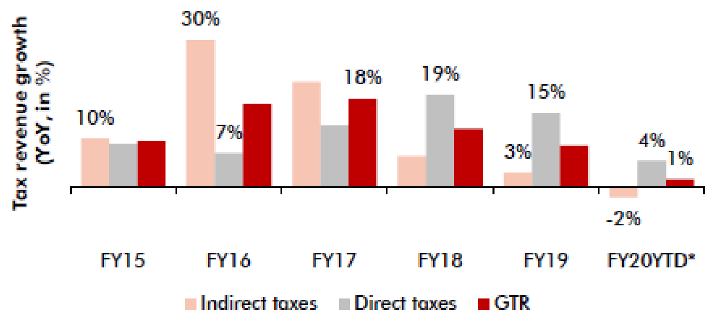
Source: Ambit Capital research

Exhibit 3:...GDP growth ex government fell to a multi decadal low



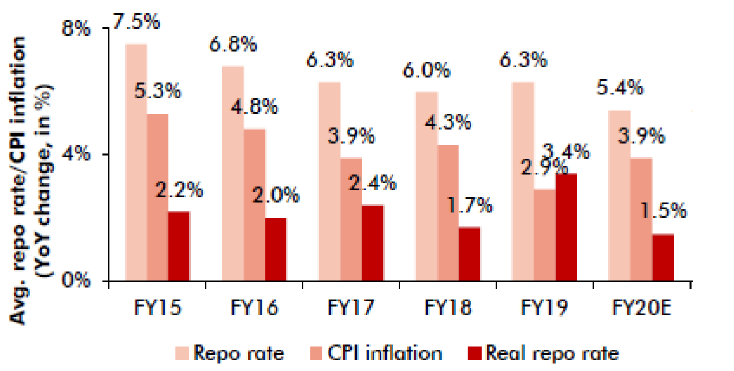
Source: Ambit Capital research

Exhibit 4: Gross tax receipts remain at low levels



Source: Ambit Capital research, FY20YTD till October 2019

Exhibit 5:...Real Repo rates are at lowest levels in the past few years



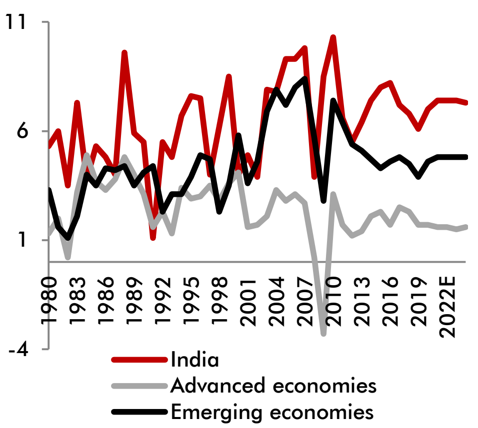
Source: Ambit Capital research

4. Where do we go from here?

A) It's all relative:

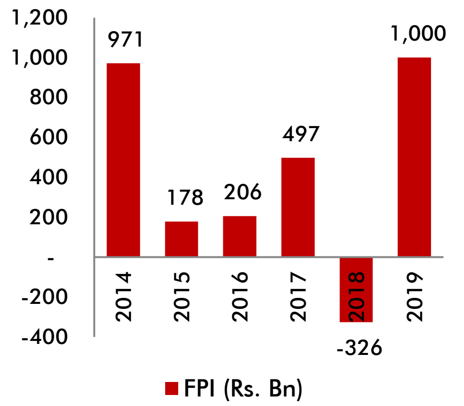
- **GDP Growth has been slow in silos but at a better pace than peers:** The RBI's latest projection pegged the growth of GDP at 5%. The IMF has retained India's economic growth forecast at an optimistic 6.1% for FY20 with risks to outlook tilted downward. Relative to emerging market peers India is still ahead. (Ref Exhibit 6)
- **This means FPI Inflows will continue to assist DII inflows:** Besides the improved global backdrop and government efforts to arrest slowdown with a broad brushed approach (such as tax cuts), the rally in stocks was on the back of strong FPI inflows assisting DII inflows. FPIs have re-initiated their buying streak in 2019 after taking a halt in 2018. Infact the flows in 2019 have been the highest in last 6 years.(Ref Exhibit 7 & 8)

Exhibit 6: Indian GDP growth rates remain highest despite recent slowdown



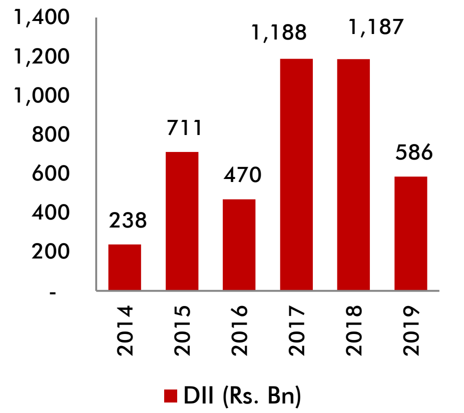
Source: Ambit Asset management

Exhibit 7: FPI net inflows have increased in CY19 assisting DII inflows



Source: Ambit Asset management, Note: Data upto 24th December 2019, Periods taken are CY ending December 31st

Exhibit 8: Net DII (Domestic MF) inflows have remained strong even if lower in CY19



Source: Ambit Asset management, Note: Data upto 24th December 2019, Periods taken are CY ending December 31st

B) Consolidation in progress: The Big get bigger, corporate Tax cuts:

- Corporate tax cuts and manufacturing incentives for corporates putting up new capacities will be utilised towards (a) paying back debt (b) passing on benefit to customers/dealers to boost demand, and (c) capex. The tax cut should thus lead to a consolidation in sectors be it in the form of:
    1. A switch from unorganised to organised
    2. Larger gains for the biggest players in the organised segments at the cost of smaller players, till new business models evolve to compete back

C) Sector specific reforms needed to spur revival, some examples:

- A massive thrust on reforms to address sector specific troubles will probably be more effective than broad based reforms (e.g. recent infrastructure related announcement).
- Although the troubles in construction, real estate and NBFC's are well known and well documented these are areas which need the attention of policy makers presently. Telecom is another such sector where a lot more needs to be done.
- Another area which needs special mention is the power sector which required urgent reforms, be it in areas of expanding power generation capacity, addressing the problem of stressed assets, dealing with the payments collectively owed by discoms (almost Rs 700bn) to conventional power generating companies. This trouble has further been exacerbated by a contracting electricity sector which shrunk by close to 12% in October on a YoY basis (according to IIP numbers) while figures released by the Central electricity authority show that generation capacity has remained flattish over the last year.

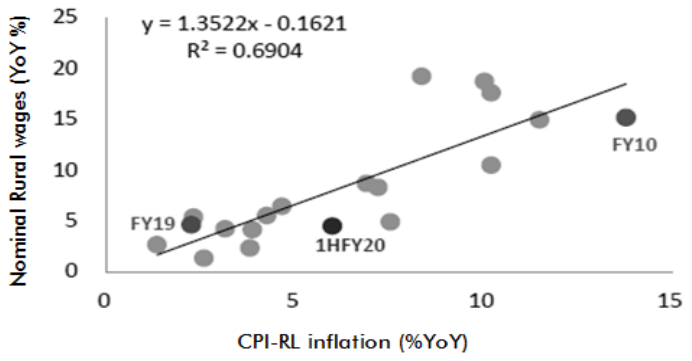
D) Rural recovery likely to progress well

Overall, while the sharp contraction in headline real rural wages presents a worrying trend, details convey a totally different picture – an optimistic one. There are sufficient initial signs pointing out that the rural sector may have bottomed out.

1. <u>Rural wages:</u>

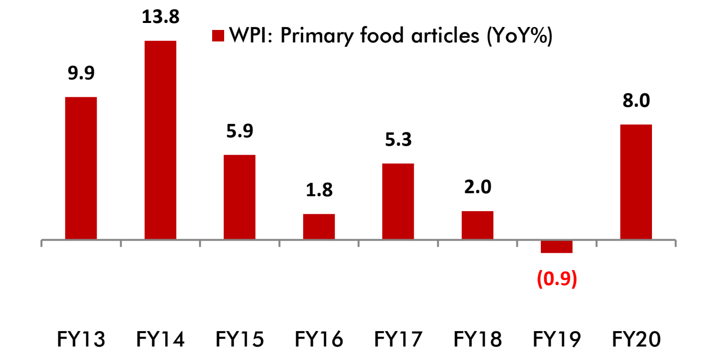
- In Rural India nominal rural wages and rural inflation share a very strong and positive correlation (~70% over the past two decades-Ref Exhibit 9 &10)
- Rural inflation has been moving up, increasing to 6% YoY in 1HFY20. Thus, we believe that it may be just a matter of time before nominal wage growth starts to grow as well.

Exhibit 9: Rural wages share high positive correlation with rural inflation…



Source: Ambit Asset management, Note: RL stands for Rural labourers

Exhibit 10: …and at wholesale level, food prices have grown steeply in FY20

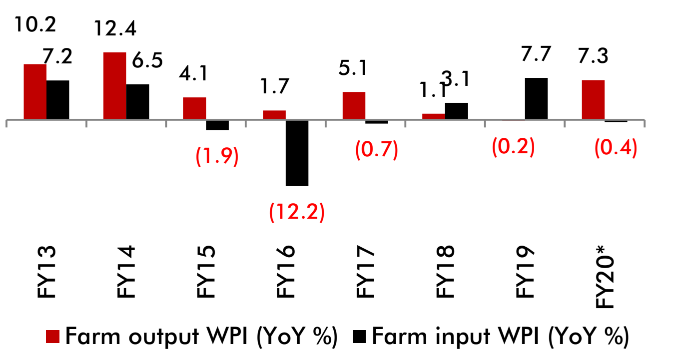


Source: Ambit Asset management

2. **Agri:**

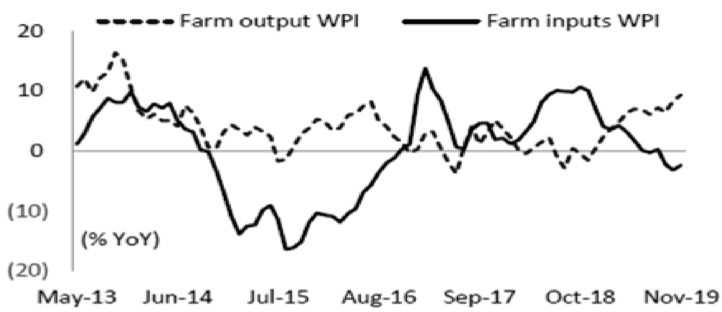
- During the first eight months of FY20, while farm output prices grew 7.3% YoY, marking the highest pace in six years, farm input prices declined 0.4% during the corresponding period.
- This has led to a favourable output to input ratio giving more savings/earning in the hand of the farmer. (Ref Exhibit 11 & 12)

Exhibit 11: Terms of trade for the agricultural sector improving in FY20…



*Source: Ambit Asset management, Note: * April-November 2019*

Exhibit 12:…led by combination of rising farm output prices and declining farm input prices

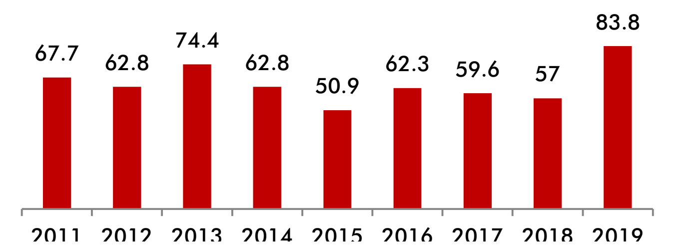


Source: Ambit Asset management

3. **Monsoon/Water**

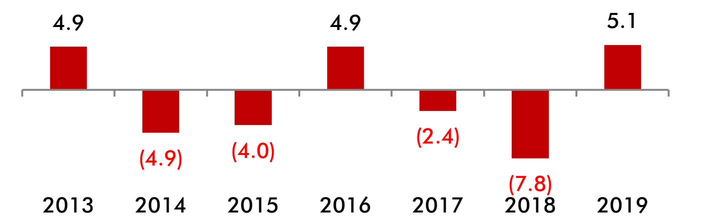
- The water reservoir level in the week ending 12th Dec'19 was at an unusually high level of ~84% against the 10-year average of 65.4%. During the past 5 years, by mid-December, the water level is ~50-63% of the total live storage in the country.
- Not surprisingly then, the area sown under Rabi season till 12th Dec'19 was ~5% higher than a year ago, marking the best growth in the past seven years after two consecutive declines. (Ref Exhibit 13 & 14). This again leads to higher earning and consequently improved spending power.

Exhibit 13: Water reservoir levels (% of live storage) are unusually strong…



Source: Ambit Asset management, Department of Agriculture

Exhibit 14:…So Rabi area sown till mid-December (% YoY) is high-leading to higher farm income potentially



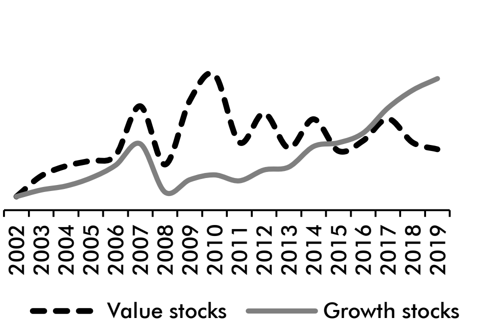
Source: Ambit Asset management, Department of Agriculture, IMD

All in all what this leads us to believe is that there is a case for higher nominal rural wages on account of inflation. On the rural farm side incomes can rise on account of higher income from a favourable input to output ratio and better income from Rabi crop sown as water levels are supportive. All these 3 data points can help revive rural consumerism based on higher income in the hand of the consumer.

5. Conclusion: Emerging themes

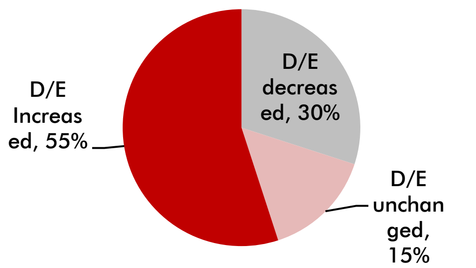
A) Invest in low leverage + higher earnings growth +Invest long term: In uncertain times the best risk cover is to be invested long term in companies which have: (1) Have Good & Clean managements, (2) Possess sustainable competitive advantages, (3) Showcase strong earnings growth trajectory and (4) Take on low leverage given that debt magnifies not only returns but also losses (which are a more likely possibility during a slowdown).

Exhibit 15: Growth stocks outperformed value over a decade, some quality mid and small cap names can start to look attractive across value stocks in 2020



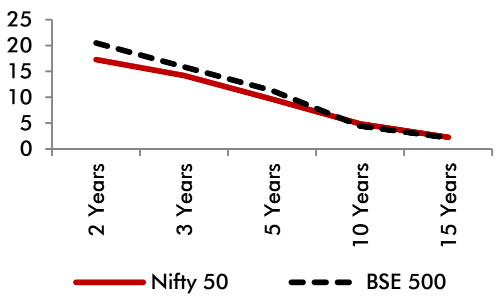
Source: Ambit Capital research, Note: Value and growth stock returns have been indexed to 100 with the base year taken as 2002 for this comparison

Exhibit 16: 55% of higher debt companies saw their debt to equity increase in FY19 vs FY18



Source: Source: Ambit Capital research, High debt companies have been classified as those with D/E ratio of >1 for this exercise

Exhibit 17: Rolling standard deviation since inception suggests volatility reduces as holding period increases



Source: Ambit Asset management, ICRA online Ltd, Note: Rolling standard deviation data since 26 July 1991(Nifty 50) and from 28th Feb, 200 (for BSE 500.) Data is updated till January 1st 2020

B) Invest based on expected changes:

- Shift from unorganised to organised sector
- Consolidation of sectors in favour of dominant sectoral leaders
- Derive benefit from possibility of rural growth

C) Avoid Investing against the flows: The relative attraction of Indian markets as an investment destination remains intact. Inflows in good quality companies with able managements and superior relative performance remains the preferred choice for investors. Many of these companies will continue to exhibit a 'Quality premium' and reduces chances of valuation derating caused price correction.

D) Invest in sectors where Government takes action: What remains of utmost importance is the government's action plan for revival of the economy as a whole through redressal of sector specific issues which are dragging down growth and consumerism. One must watch out for such opportunities and study on a case by case basis before taking any investment decision.

Our Investing strategy remains unchanged

While many changes are upon us, our stance on investing in well run companies with low debt and high earning growth remains unchanged, and as highlighted in our 13th December note the below lessons for investment are a good reminder to set the ball rolling on 2020.

***Lesson 1:** Equity investments traditionally outperform other asset classes*

***Lesson 2:** Starting early with a long term horizon can multiply wealth exponentially!*

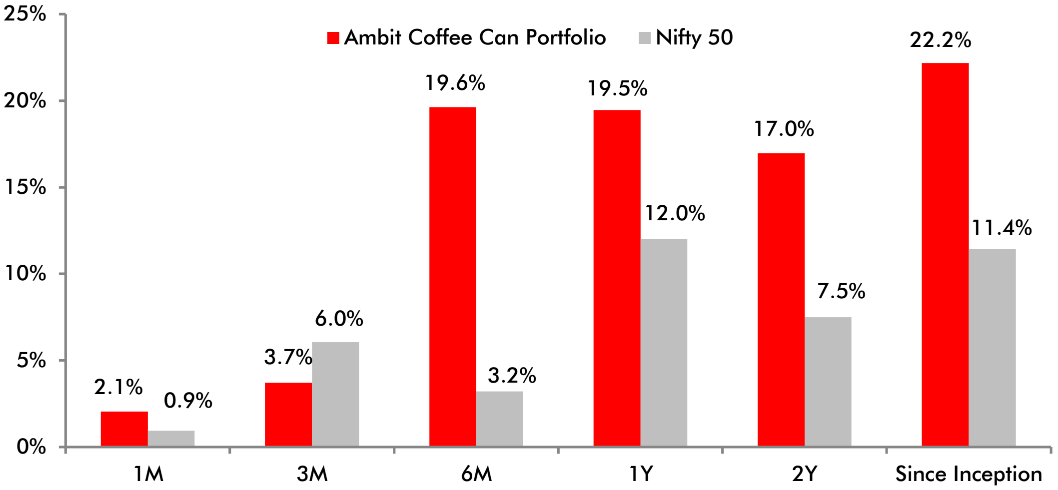
***Lesson 3:** EPS not PE is relevant for long term investing, long term horizon and investing in companies with competitive advantages and enjoying high EPS growth reduce risks*

***Lesson 4:** Investment into high PE companies with the certain characteristics (Chiefly Good management, clean accounting, and sound earning growth) is justifiable given focus on longevity of earning growth, reinvestment risk of value traps, continued fund inflows and long term investment focus*

Ambit Coffee Can Portfolio

At Coffee Can Portfolio, we do not attempt to time commodity/investment cycles or political outcomes and prefer resilient franchises in the retail & 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 18: Ambit's Coffee Can Portfolio performance update



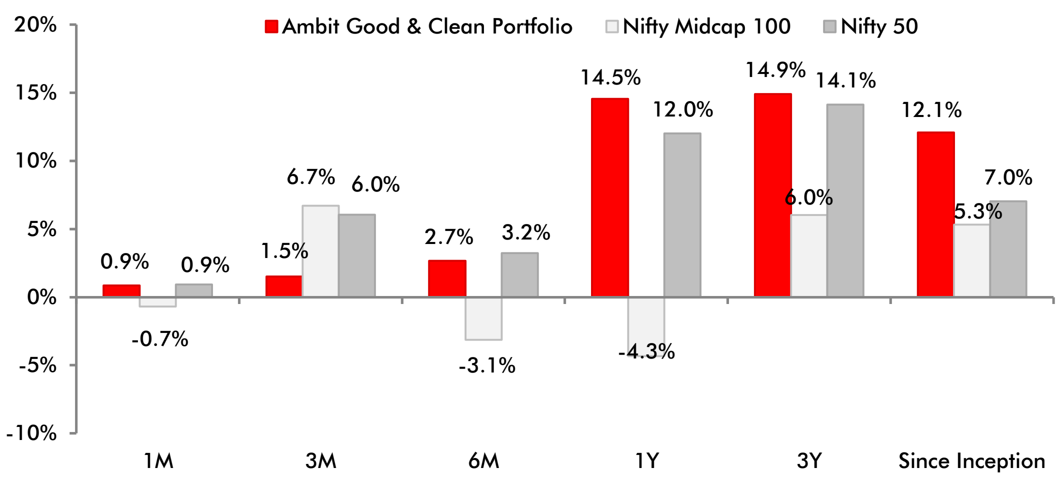
Source: Ambit; Portfolio inception date is March 6, 2017; Returns as of Dec 31, 2019; All returns (except 2Y and Since inception) are absolute returns net of fees & expenses; **Note:** *Returns prior to Apr'19 are returns of all the Pool accounts excluding non-aligned portfolio, and returns post Apr'19 is based on TWRR returns of all the pool accounts.*

Ambit Good & Clean 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 19: Ambit's Good & Clean Portfolio performance update



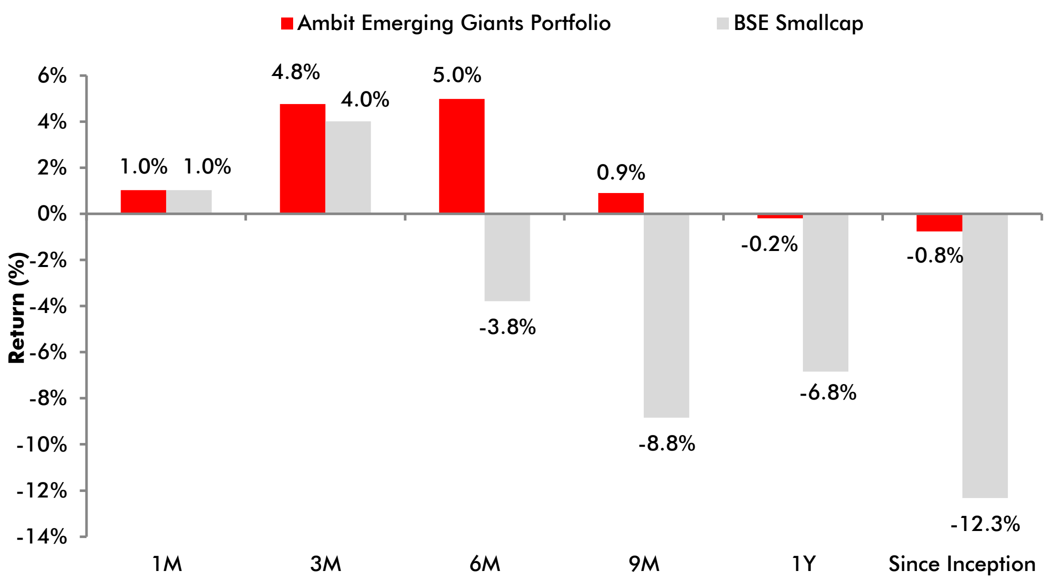
Source: Ambit; Portfolio inception date is March 12, 2015; Returns as of Dec 31, 2019; since inception & 3Y returns are annualized returns. ***Returns are net of all fees and expenses***

Ambit Emerging Giants

Ambit Emerging Giants Portfolio

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 20: Ambit Emerging Giants performance update



Source: Ambit; Portfolio inception date is December 1, 2017; Returns as of Dec 31, 2019; since inception returns are annualized. ***Returns are net of all fees and expenses***

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