

# LITTLE CHAMPS PMS\*

AN INVESTMENT STRATEGY FOR INDIAN SMALL CAPS FROM  
MARCELLUS INVESTMENT MANAGERS



 MARCELLUS

  
EQUANIMITY

*\* Please note that this portfolio is no longer taking any inflows*

MARCH 1, 2022

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**Contact :**

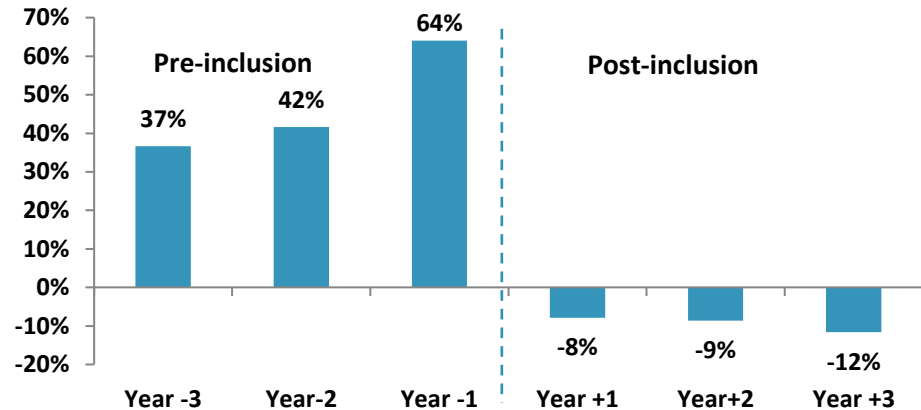
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# SMALL CAP INVESTING: OPPORTUNITIES

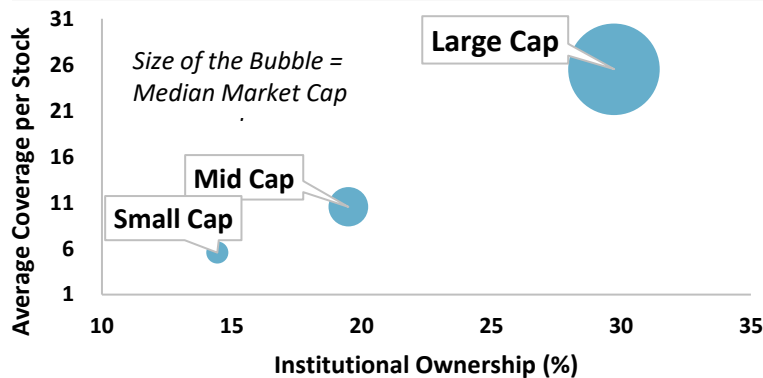
## Significant outperformance of stocks before inclusion in BSE 500

- On an average over the last ten years, about ~50 stocks have entered/exited BSE 500 every year indicating a high degree of churn.
- The biggest part of the relative outperformance for a stock entering BSE 500 occurs in the years preceding the inclusion.

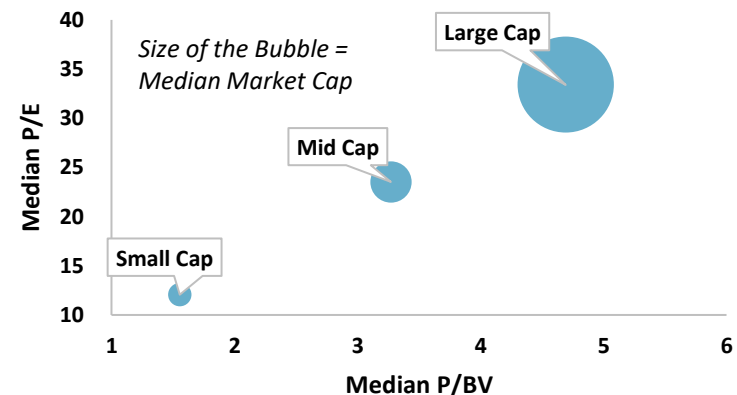


Source: Bloomberg, Ace Equity. Relative returns (to BSE 500) are medians CAGR of stocks that have been included in the BSE 500. For prior returns, returns are measured until 1 quarter preceding the quarter of entry. The above returns calculation is for the entries from June 2003 to June 2020

## Small Caps are under-researched and “under-owned”...



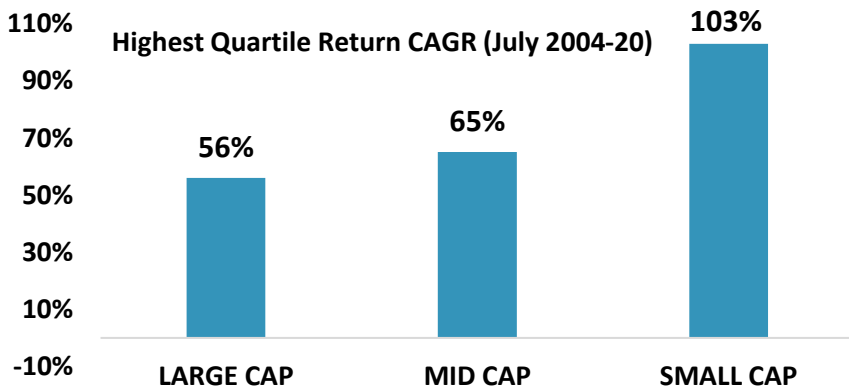
## ...resulting in significant valuation gaps vs Large caps



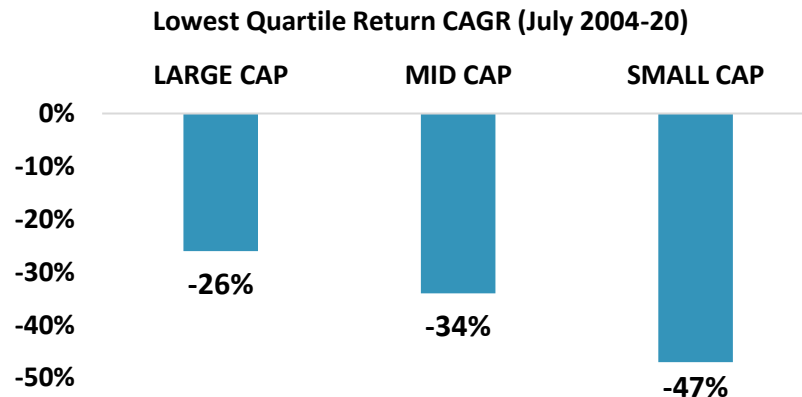
Source: Ace Equity, Bloomberg. Note: (1) We classify companies with market cap of >Rs150bn as Large Cap, between Rs30bn to 150bn as Mid Cap and below Rs30bn as Small Cap; (2) Market cap, analyst coverage and share price data as of July 31, 2020; (3) Institutional ownership data as of June 30, 2020; (iv) EPS and Book value considered for FY20

# KEY IS TO 'IDENTIFY' THE RIGHT STOCKS AND 'AVOID' THE WRONG ONES

**'Champion' Small Caps (highest quartile) deliver significant outperformance vs comparable Large caps and Mid Caps...**

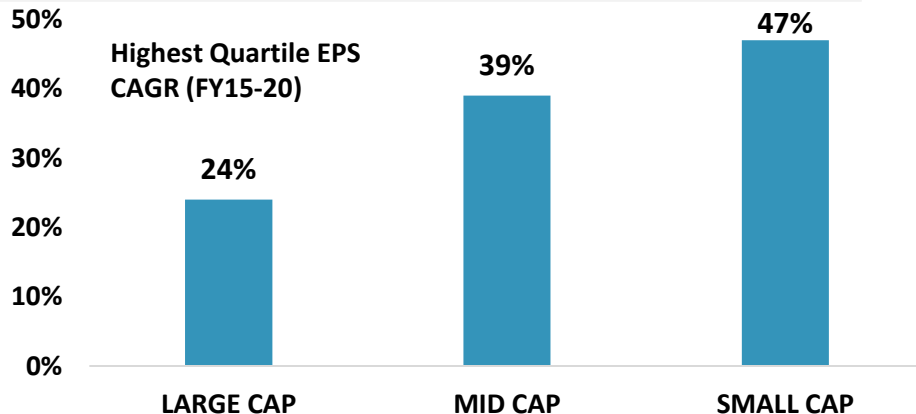


**...but 'worst performing' Small caps (bottom quartile) result in much higher wealth erosion than Large/ Mid caps**

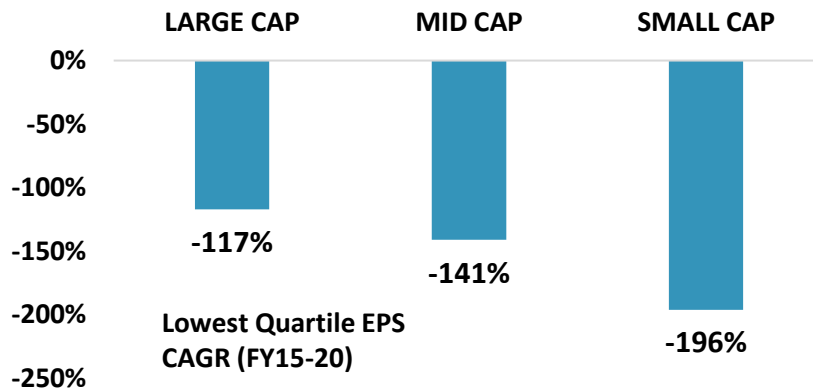


Source: Ace Equity Note: (1) We classify companies with market cap of >Rs150bn as Large Cap, between Rs30bn to 150bn as Mid Cap and below Rs30bn as Small Cap; (2) Returns calculated for three baskets (Large, Mid and Small cap) with equal allocation to each stock within those baskets. Stocks rebalanced annually at July-end based on market cap criteria; (3) No dividends, transactions costs and other charges considered in the above returns calculations.

**'Champion' Small caps deliver much higher earnings growth than comparable Large and Mid Caps ...**



**...but weakest Small Caps significantly lag Large and Mid Caps in earnings performance**

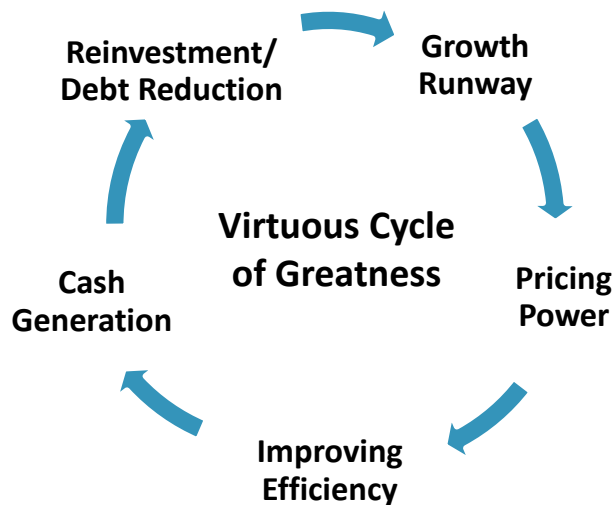


Source: Ace Equity Note: (1) We classify companies with market cap of >Rs150bn as Large Cap, between Rs30bn to 150bn as Mid Cap and below Rs30bn as Small Cap; (2) Earnings growth calculated for three baskets (Large, Mid and Small cap) with equal allocation to each stock within those baskets.

# LITTLE CHAMPS: A PORTFOLIO OF NICHE COMPANIES WITH STRONG MOATS & SUSTAINABLE GROWTH

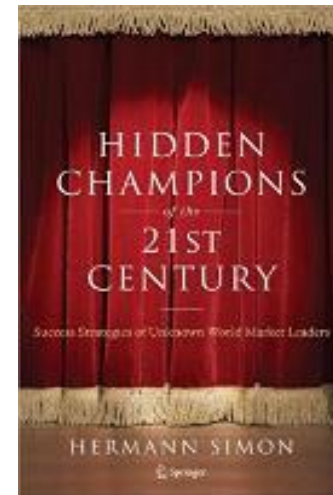
## Little Champs

- Identity small-cap companies (market cap <US\$500 million) with excellent corporate governance and capital allocation track record and strong sustainable competitive advantages built around brands, business processes and strategic assets.
- Characteristics of a typical portfolio company:
  - Sector leading franchise with stellar track record of capital allocation;
  - Clean accounts and corporate governance; and
  - High growth potential.



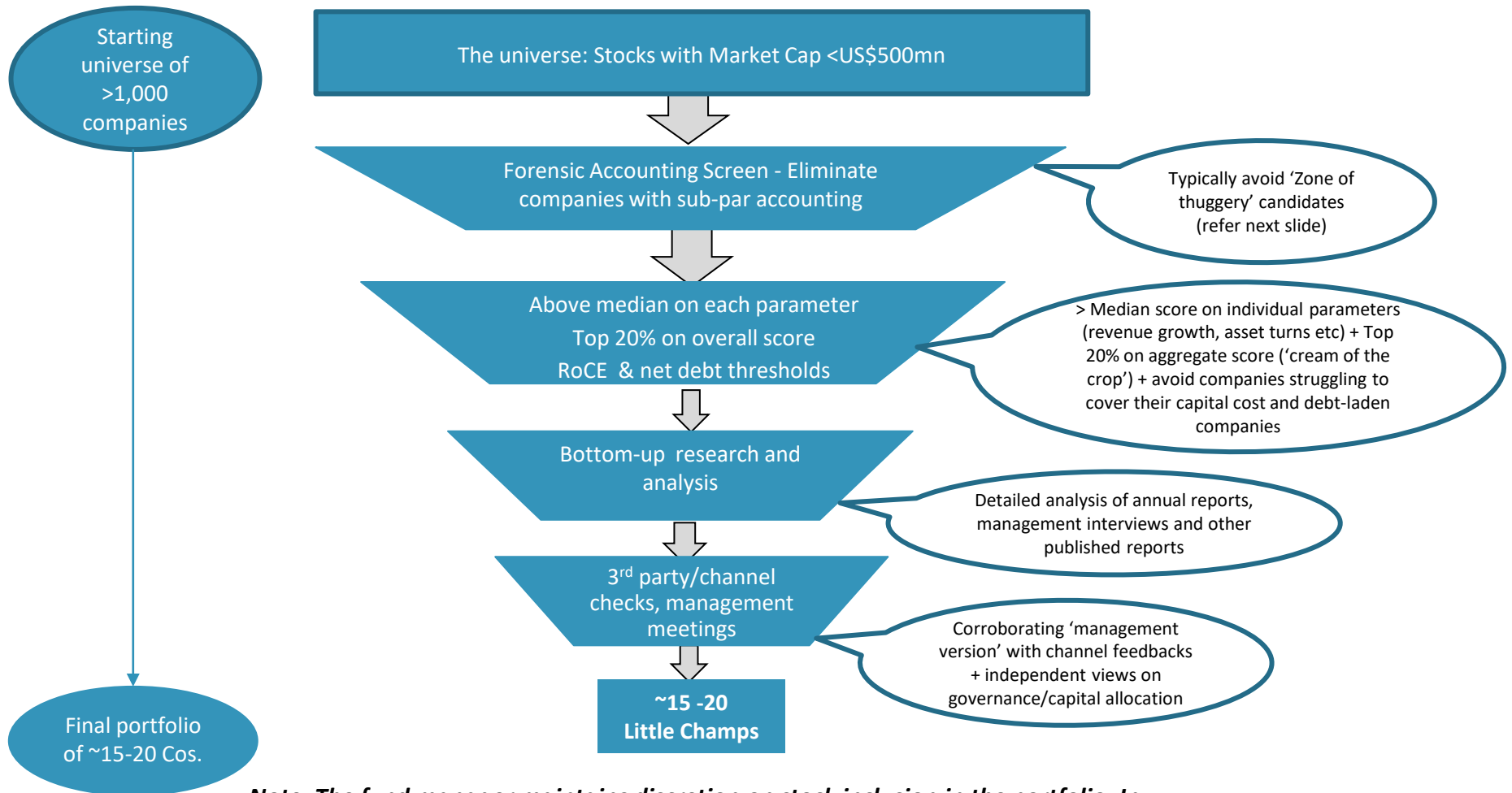
## Look for Hermann Simon's celebrated 'Hidden Champions'

- SMEs, often family owned, producing inconspicuous products but ranked top globally for that product.
- Normally work in niche markets for which they design unique products often using proprietary process.
- Operate extremely close to their customers who depend on their products and cannot easily change their source.
- Competitive advantages of such firms are rarely because of cost leadership but more because of quality, total cost of ownership, high performance, and closeness to the customer.



Source: *Hidden Champions of the 21<sup>st</sup> Century*, Hermann Simon

# RIGOROUS SCREENING AND DUE DILIGENCE TO IDENTIFY THE RIGHT STOCKS AND AVOID THE WRONG ONES



**Note: The fund manager maintains discretion on stock inclusion in the portfolio. In case, a stock does not clear the above filters, the fund manager must record and present to the Investment committee for approval, the reasons for such inclusion.**

# USE FORENSIC ACCOUNTING TO WEED OUT NAUGHTY COMPANIES

## Methodology

12 accounting ratios covering income statement (revenue/earnings manipulation), balance sheet (correct representation of assets/liabilities), cash pilferage and audit quality checks.

Six years of historical consolidated financials.

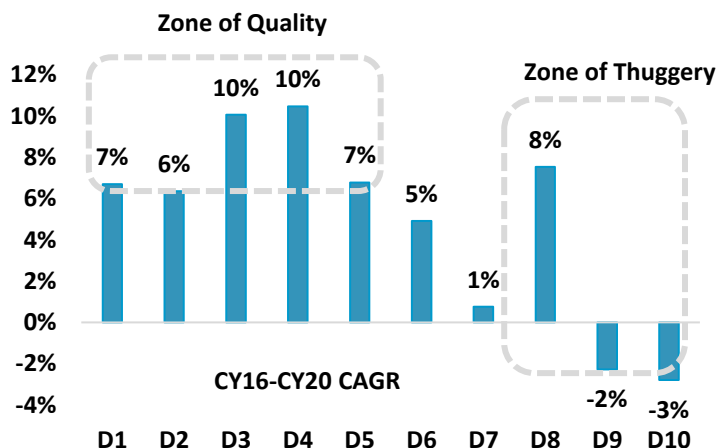
First rank stocks on each of the 12 ratios individually (some examples outlined in the table on the right). These ranks then cumulated across parameters to give a final pecking order on accounting quality for stocks.

Selection of these ratios has been inspired by Howard M. Schilit's legendary forensic accounting book 'Financial Shenanigans'.

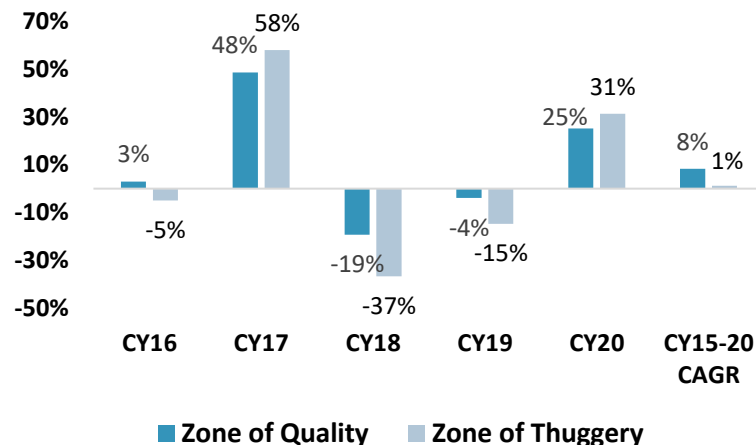
## A few of our forensic ratios

Checks	Ratios
Income statement	1) Cashflow from operations (CFO) as % of EBITDA 2) Provisioning for debtors
Balance sheet	3) Yield on cash and cash equivalents 4) Contingent liabilities as % of Networth (for the latest available year)
Cash theft	5) CWIP to gross block
Auditor	6) Growth in auditors' remuneration to growth in revenues

## Strong correlation between accounting quality and shareholders' returns

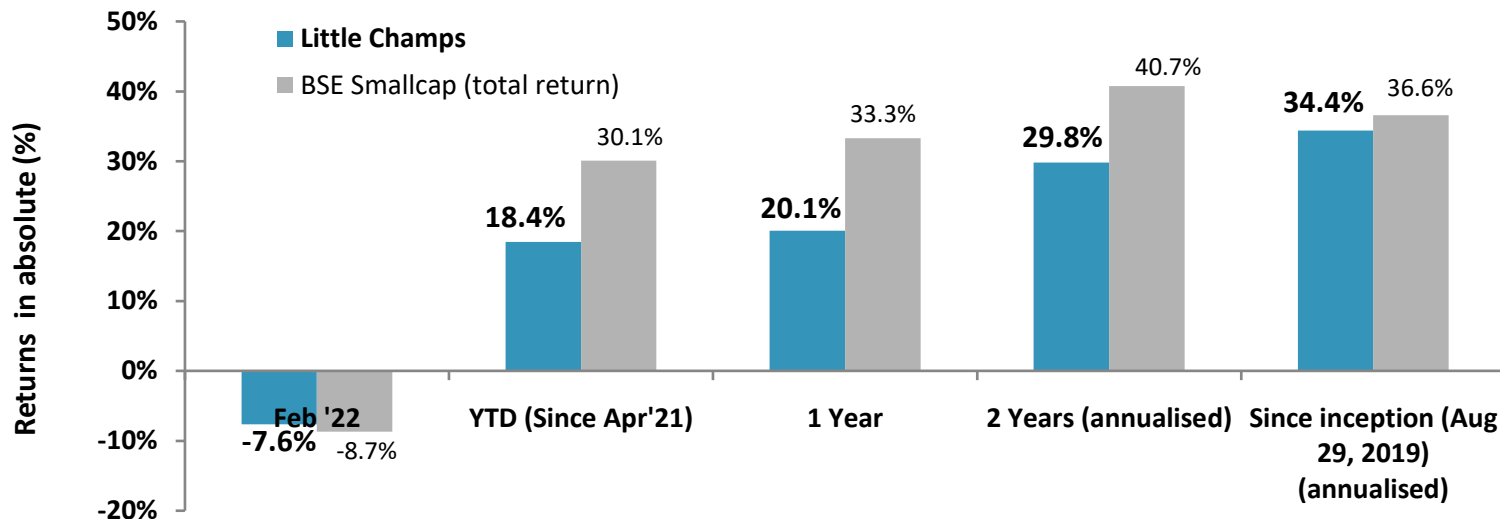


## Quality wins and wins big over the long term



# LIVE PORTFOLIO PERFORMANCE AND COMPARISON WITH BENCHMARK

## Little Champs vs. Benchmark BSE Smallcap



Source: Marcellus Investment Managers. Note: (i) Portfolio inception date is August 29, 2019. (ii) Returns as of February 28, 2022. (iii) All returns are net of fixed fees and expenses charged till 31st December, 2021. Since performance fees for Little Champs Portfolio are charged on cumulative gains at the third anniversary of the respective client account, the effect of the same has not been incorporated in the performance returns. (iv) Returns shown above are net of transaction costs and includes dividend income. (v) Total returns index considered for BSE Smallcap above.

## Little Champs' returns and drawdowns vs Nifty/BSE smallcap

Performance (Since Inception)	Return since inception (annualised)	Maximum Drawdown
<b>Little Champs</b>	<b>34.4%</b>	<b>-37%</b>
<b>Performance of benchmarks</b>		
BSE Smallcap	36.6%	-45%
Nifty	19.5%	-38%

Source: Ace Equity Note: Maximum drawdown based on daily returns from Aug 29, 2019 to February 28, 2022



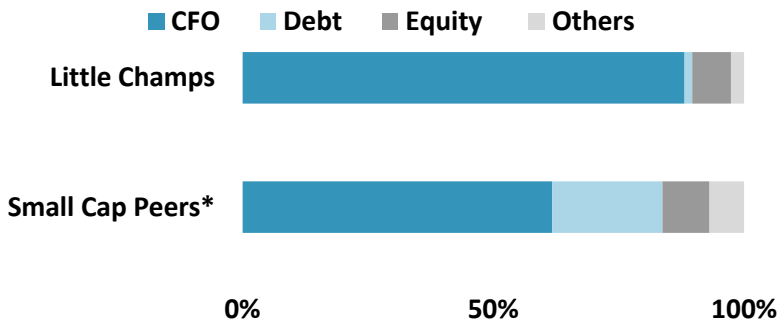
# LITTLE CHAMPS' SUPERIOR FUNDAMENTALS VS KEY INDICES

## Little Champs vs Indices

	Mkt cap (Rs bn)	EPS CAGR (FY15-21)	RoCE (FY21)	Net debt (cash)/ equity (FY21)	P/E (FY21)	P/B (FY21)
<b>Little Champs*</b>	<b>78.6</b>	<b>22%</b>	<b>24%</b>	<b>(0.1) x</b>	<b>48.1x</b>	<b>10.2x</b>
BSE Small Cap**	NA	10%	3%	0.8 x	36.5x	4.7x
Nifty	NA	3%	12%	0.5 x	31.3x	3.7x

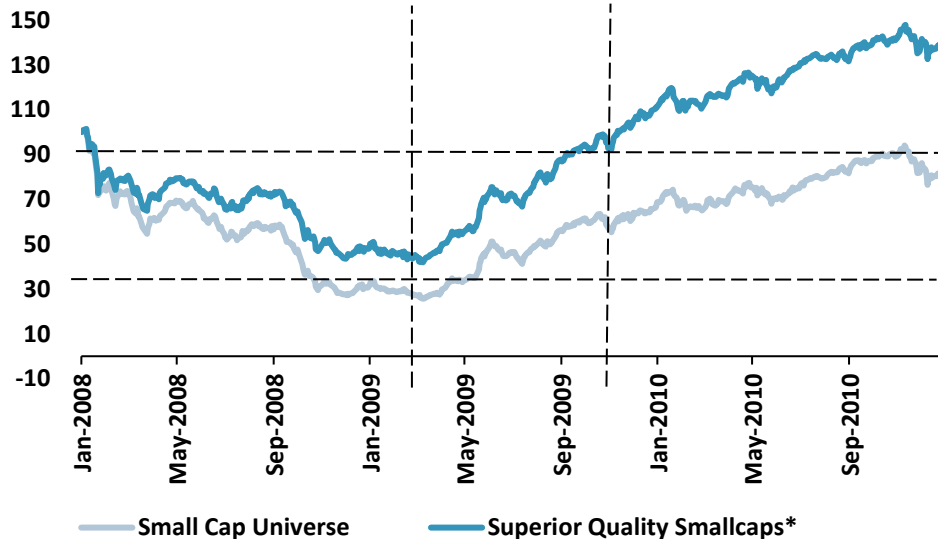
Source: Company, Ace Equity Note: \* Little Champs numbers are on weighted average; \*\* BSE Small cap EPS figures only for companies with positive earnings; Price related figures upated as of February 28, 2022

Little Champs – Higher RoCE enables sufficient internal accruals to fund growth



\* Small peers considered are below US\$1bn market cap cos forming part of BSE Smallcap. The calculation shown above is for FY14-19

Superior quality small caps fall less and recover faster out of an economic crisis (GREAT FINANCIAL CRISIS 2008 EXAMPLE)



Source: Ace Equity, Marcellus Notes: (i) We consider companies with market cap between Rs1bn to Rs35bn as smallcaps for the above charts; (ii) \*We define 'Superior quality smallcaps as meeting three criteria – a) FY04-08 median RoCE of 20%; (b) Earnings growth over FY03-08 of 15%+; and (b) FY08-end net debt equity of 1x and below

# WE PROACTIVELY SEEK TO INFLUENCE CHANGE

Area of engagement	Desired outcome
<p>Corporate governance</p>	<ul style="list-style-type: none"> <li>• If we spot diversion on a meaningful scale, we exit</li> <li>• If we spot the beginnings of what look like small scale diversion, we speak to the ‘Promoter’ and explain to her why her wealth creation can be compromised</li> </ul>
<p>Succession planning</p>	<ul style="list-style-type: none"> <li>• Through our discussions with suppliers, customers and competitors of a company, we keep a close eye on whether the ‘promoter’ is on top of his game.</li> <li>• If his successors either do not exist or have not been groomed adequately, we discuss the matter and its consequences with him.</li> </ul>
<p>Capital allocation</p>	<ul style="list-style-type: none"> <li>• If we see a company either hoarding cash or moving into an unrelated, we engage with the ‘promoter’ to understand her thinking on capital allocation.</li> <li>• If we are not convinced about the fitness of what she’s doing, we present our point of view (arguing in favour of a different capital allocation strategy)</li> <li>• If six months later we see that our engagement has made no difference, we consider exiting</li> </ul>
<p>Regulatory constructs</p>	<ul style="list-style-type: none"> <li>• By being a part of multiple regulatory committees, by writing in the press and by being vocal on social and broadcast media about regulatory reform, we have sought to improve transparency in the fund management industry in India</li> </ul>

# THE TEAM AND CONSULTANTS



Saurabh Mukherjee, FRSA



Pramod Gubbi, MBA, CFA



Rakshit Ranjan, CFA



Ashvin Shetty, CA, CFA



EQUANIMITY



Rajesh Sehgal, MBA, CFA



Mark Mobius, Ph.D



Shilpa Sehgal, FCA



Vivek Saxena, MBA



## FUND MANAGERS – 1 OF 2

**Saurabh Mukherjea, FRSA:** Saurabh is the CIO at Marcellus. He is the former CEO of Ambit Capital and played a key role in Ambit's rise as a broker and a wealth manager. When Saurabh left Ambit in June 2018, assets under advisory were \$800mn. In London, Saurabh was the co-founder of Clear Capital, a small cap equity research firm which he and his co-founders created in 2003 and sold in 2008. In 2017, upon SEBI's invitation, he joined SEBI's Asset Management Advisory Committee. In 2019, Saurabh was part of the five man Expert Committee created by SEBI to upgrade & update the PMS regulations. Saurabh has written four bestselling books including Gurus of Chaos (2014), The Unusual Billionaires (2016) and "Coffee Can Investing: The low risk route to stupendous wealth" (2018). Saurabh was educated at the London School of Economics where he earned a BSc in Economics (with First Class Honours) and MSc in Economics (with distinction in Macro & Microeconomics). He is Fellow of the Royal Society of Arts.

**Pramod Gubbi, CFA:** Pramod is the Head of Sales at Marcellus. He is CFA charter holder with a B.Tech from NIT, Karnataka and a Post-graduate Diploma in Management from IIM, Ahmedabad. In the final two years of his 8-year stint in Ambit Capital Private Limited, he was Managing Director & Head of Institutional Equities (from 2016 to 2018). Prior to that he, served as the head of Ambit's Singapore office from 2013-2016. Before joining Ambit, He has also worked across sales and research functions at Clear Capital, a British equity research firm. Besides being a technology analyst, he has also served in technology firms such as HCL Technologies Limited and Philips Semiconductors' Indian arm in Business Development and Engineering respectively.

## FUND MANAGERS (CONTINUED) – 2 OF 2

**Rakshit Ranjan, CFA:** Rakshit is a Portfolio Manager at Marcellus Investment Managers. He holds a degree in B.Tech from IIT (Delhi) and is a CFA charter holder. Rakshit spent 6 years (2005-2011) covering UK equities with Lloyds Bank (Director, Institutional Equity Research) and Execution Noble (Sector Lead analyst). During these six years, he was ranked amongst the top-3 UK Insurance analysts (Thomson Reuters Extel survey) in the mid-cap space. Since 2011, Rakshit led Ambit Capital's consumer research franchise which got voted as No.1 for Discretionary Consumer and within top-3 for Consumer Staples in 2015 and 2016. He launched Ambit's Coffee Can PMS in Mar'17 and managed it till Dec'18. Under his management, Ambit's Coffee Can PMS was one of India's top performing equity products during 2018.

**Ashvin Shetty, CFA:** Ashvin is a Portfolio Manager at Marcellus Investment Managers Private Limited. Ashvin has more than 10 years of experience in equity research, having led the coverage on automobile sector at Ambit Capital from 2010 to 2017. He was ranked in Starmine Analyst Awards 2013 and 2016 for his stock picking abilities during this stint. He thereafter worked as a senior analyst for Ambit's mid and small-cap portfolio management services till November 2018. Prior to joining Ambit, he worked with Execution Noble as an analyst covering consumer and media space. He has also worked with KPMG and Deloitte as statutory auditor from 2004 to 2007 gaining extensive experience across Indian accounting standards and financial statement analysis.

# PMS STRUCTURE *(PLEASE NOTE THAT THIS PORTFOLIO IS NO LONGER TAKING ANY INFLOWS)*

**Marcellus offers the Little Champs Strategy in a PMS construct**

## Fees

- **Fixed fees:** 1.5% per annum (charged quarterly)
- **Performance fees:** 20% profit share above a 10% hurdle. Performance fees will be charged on cumulative gains at the third anniversary\*. Performance fees will be charged without catch-up i.e. the first 10% return per annum (net of fixed fees) will not be subject to performance fees. High water mark applies for performance fees.

*\*If redeemed prior to the completion of three years, performance fees will be charged as on redemption date*

**Exit Load: 3%, 2% and 1% if redeemed in the first, second and third year respectively**

**Minimum investment:** INR 50 lacs

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