FLASH NOTE!!

14-Mar-2024

Yesterday, the stock market experienced a significant fall: Nifty50 -1.5%, Nifty SmallCap 100 -5.3% and Nifty Midcap100 -4.4%. The price correction was quite intense in Small & Midcaps.

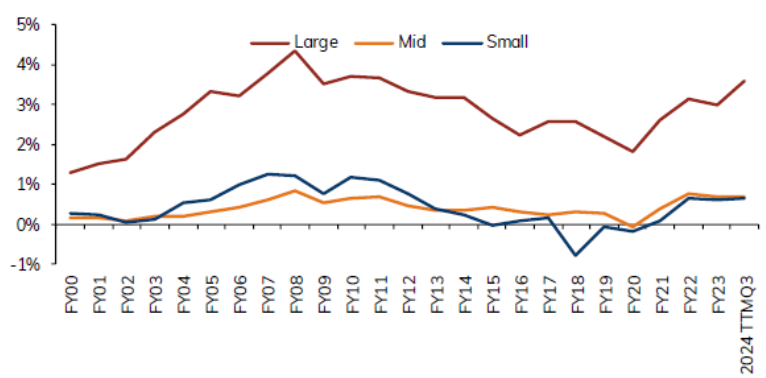
There are multiple reasons for this fall and below are our thoughts on the same:

- There have been statements from SEBI that they are seeing signs of manipulation in SME listings and a bubble in mid-cap and small-cap spaces. Links to some of the news stories are: ET, Business Standard, Moneycontrol. We feel that our esteemed regulators have infinitely more data than any of the other market participants. Hence, when they say something, everyone must listen and pay attention.
- Few of the large mutual funds have stopped taking subscription into small or mid-cap schemes (ET). This clearly distorts the normal flow of buying/selling in these scrips as this may could cause DIIs to turn net sellers as opposed to net buyers till last month.
- There have been quite a few block deals where the foreign promoters have taken advantage of the price rally in Indian markets and trimmed their holdings due to significant valuation differential between the parent and the Indian subsidiary e.g. Whirlpool parent selling stake in Whirlpool India, BAT selling stake in ITC.
- There has been an indirect effect of RBI/SEBI action on NBFCs/Banks to curtail flow of credit. In Jan/Feb, RBI had raised caution on rising personal loans in the system. Later they acted against PayTM Payments Bank, IIFL Finance, JM Financial etc. While these are not directly related to the stock market fall, but an indirect impact of the "kink" in credit flow on stock market is highly likely.

Our sense is that in this nervousness, one should also pay attention to the fundamentals. We would like to highlight two data-points that clearly demonstrate that the rally in Indian stocks in general, and Small-Midcaps in particular has been accompanied with expansion in earnings.

- PAT/GDP ratio for listed cos post Q3 FY24 earnings has reached 4.9% Vs 4.3% at the end of FY23, indicating earnings continue to expand at a faster rate than the nominal GDP. This makes us more confident of our investments. The primary reason for this is the reduction in financial leverage, better operating leverage for companies and reduction in input commodity prices. Please refer Exhibit 1 below.

Exhibit 1: PAT/GDP is rising in all cases (Large, Mid and Small-caps)



Source: Capitaline, Bloomberg, I-sec research

Note: Large-cap – top 100 companies by market-cap rank, mid-caps – next 150 companies (101-250th rank) and rest from 251st rank – small caps.

804 Lodha Supremus, 2 Senapati Bapat Marg, Lower Parel (West), Mumbai 400013
+91 72084 77618 | cs@moneygrowindia.com | www.moneygrowindia.com

- The EPS of NIFTY Midcap 150 and NIFTY Smallcap 250 Index have shown robust growth, increasing by 67% and 53% respectively over the last two years, as illustrated in Exhibit 2. Therefore, the rally is substantiated by strong earnings growth rather than mere PE expansion.

Exhibit 2: Small & Midcap rally driven by earnings.

Small & Midcap rally driven by earnings

EDELWEISS MUTUAL FUND

Nifty Midcap 150 index in last 2 years			
Date	Index Value	Trailing P/E	EPS
28-Feb-22	10,621	26.83	396
29-Feb-24	17,831	26.96	661
Change	68%	0.50%	67%

P/E has remained the same in last 2 years

Earnings have grown by 68% in last 2 years

Nifty Smallcap250 index in last 2 years			
Date	Index Value	Trailing P/E	EPS
28-Feb-22	8,887	26.16	340
29-Feb-24	14,965	28.85	519
Change	68%	10.30%	53%

P/E has expanded by just 10% in last 2 years

Earnings have grown by 53% in last 2 years

Small & Midcap cap indices have risen 68% in the last two years, this upswing has been driven largely by earnings growth rather than P/E expansion.

Source: NSE. EPS is derived using P/E levels.

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Source: Edelweiss Mutual Fund

Conclusion

It is important to recognize both sides of the arguments regarding the rally in Small & Midcaps. One cannot paint a picture that everything is full of froth, and one also cannot conclude that there is no froth. <u>Hence, it is important to review the earnings outlook on a bottom-up case-by-case basis.</u> We are doing the same for all our portfolio companies.

We remain extremely constructive of the earnings outlook for our portfolio companies from a 2-3 years' perspective.

Will be happy to discuss your specific portfolio anytime at your convenience.

Warm regards,

Manish Gupta, Viraj Mahadevia & entire MoneyGrow team

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