

EQUITREE QUARTERLY

NEWSLETTER

— December 2023 —



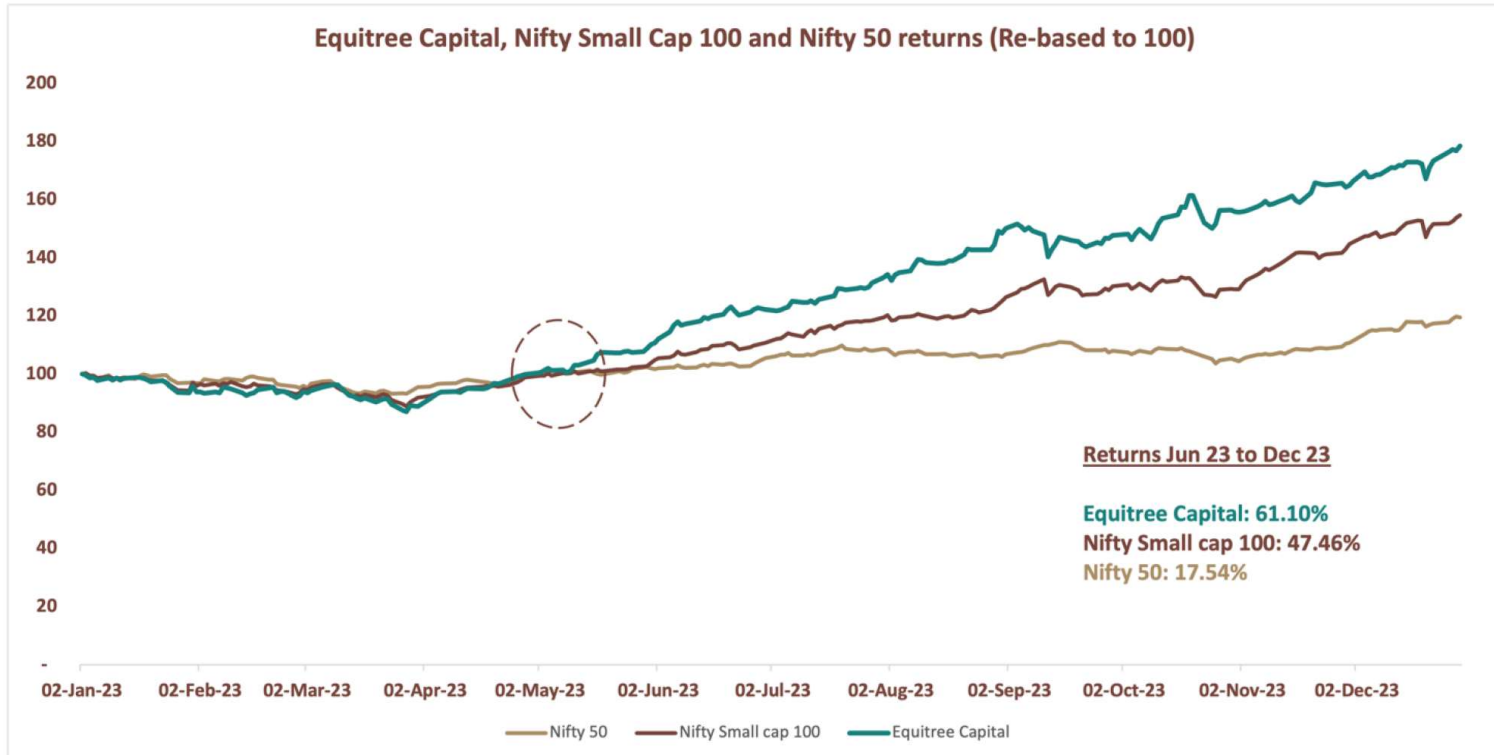
“Far more money has been lost by investors trying to anticipate corrections, than lost in the corrections themselves.”

— Peter Lynch

Dear Investors,

CY2023 has played out to perfection as mentioned in our [June 2023 newsletter](#) that Small Caps were slated for a significant outperformance to Nifty. Extract of the same is reproduced below:

“We strongly believe that we should see a mean reversion where the Small Cap index returns should not only catch-up Nifty but should exceed the same – this may happen either by Nifty correcting substantially or the Small Cap Index delivering better returns from hereon. We tend to believe the latter is more likely to happen – still leaving enough upside in the broader markets.”



Source: NSE, Equitree Capital

Our performance:

In this backdrop, we are glad to share that Equitree emerged one of the **BEST PERFORMING PMS** in India across all strategies for yet another year, delivering ~ 80% return in CY2023:.

Investment period	1 M return	3 M return	6 M return	1 Y return	2 Y return	3 Y return
Equitree Emerging Opportunities	7.91%	20.87%	45.70%	79.71%	36.59%	48.93%
BSE 500 TRI	8.03%	12.35%	18.51%	26.55%	15.15%	20.41%
Outperformance	-0.12%	8.52%	27.19%	53.16%	21.43%	28.52%

As on 31 Dec 23. Not verified by any regulatory authority/SEBI. Returns are computed on TWRR basis net of expenses. Returns over 1 year are compounded annually. Individual portfolio performances may differ. Benchmark changed from Nifty Smallcap 100 to BSE 500 TRI vide circular no SEBI/HO/IMD-PoD-2/CIR/2022/172 dated 16 December 2022.

It is now 4th year in a row that Equitree has been amongst the top performing PMS's in India consistently across all strategies:

Equitree's Ranking	1 Y	2 Y	3 Y	4 Y
As per PMS Bazaar (out of 335 schemes)	6 th	9 th	5 th	NA
As per APMI (out of 862 schemes)	11 th	17 th	11 th	13 th

Source: PMS Bazaar, APMI, Equitree Capital

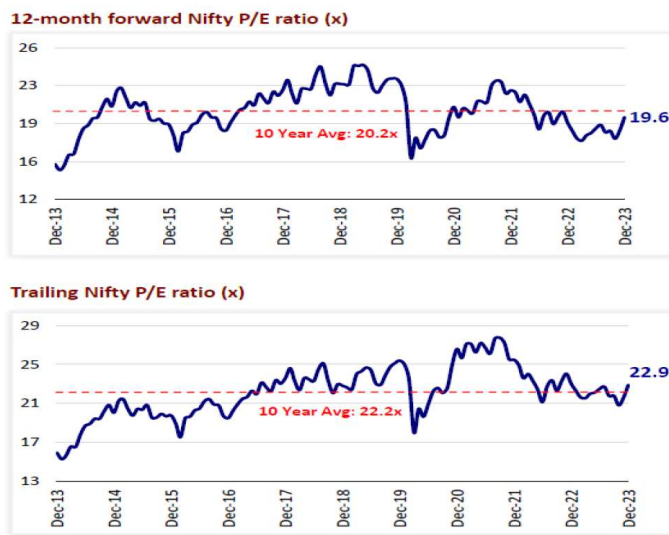
Despite the recent rise in small cap stocks in general and our portfolio in particular, we still remain very comfortable with the business visibility and valuation of our portfolio. **The median valuation of our portfolio is 11x FY25 (more on this hereunder) and is expected to show a median profit growth of 30% in FY25. This leaves significant upside still to happen in our portfolio companies!**

Small Caps: Just the Beginning or End of the Road?

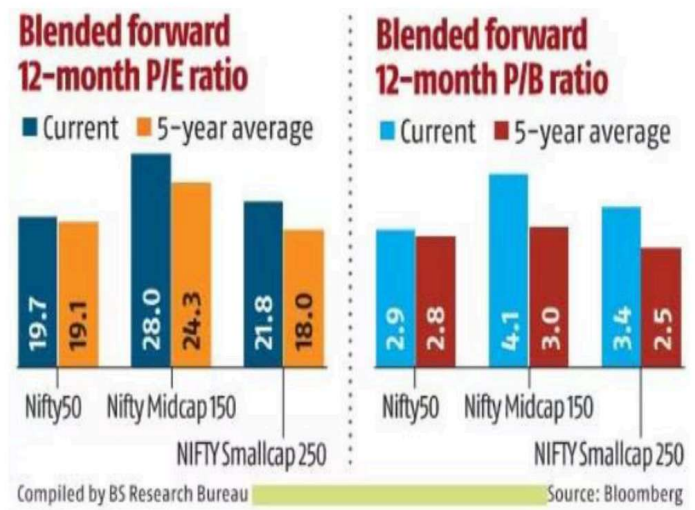
There has been increased media frenzy on how Small Caps have become extremely expensive and vulnerable with more and more people recommending shifting to Large Caps instead. We take this opportunity to reflect upon some of facts and share our perspective on the same hereunder:

1. Breaking the valuation labyrinth – our genre of companies still trading at reasonable valuations

With the markets creating new high on the headline index there has been increased noise on the valuations being rich across the board with media reports suggesting that large cap companies are better poised in terms of valuations now than the small caps, primarily because of the run up in Small Cap companies. However, one needs to understand this in right context. We present hereunder valuation of large caps and Small Caps as shown in different media:



Source: Motilal Oswal, Business Standard, Equitree Capital



As can be seen from above, the consensus seems to be that Nifty currently trades at 12-month forward P/E of ~ 19.6x which is below its 10-year average of 20.2x and marginally higher than its 5-year average of 19.1x. Likewise Nifty Small Cap 250 index seems to be trading at 21.8x currently which is higher than its 5-year average of 18x.

In our opinion, 5-year average may not be a right indicator of valuation matrix to begin with as it includes the black swan event of Covid making the averages quite erratic. Further, while one looks at the benchmark index as a lighthouse to get a sense of valuations, however, that itself has limitations due to smaller representation of companies which could again present very erratic outcomes.

We analyzed broad base of companies based on their market cap to get a better sense of where we stand vis-à-vis 10-year valuation. The result is summarized here:

Market cap range (Rs. In crores)	No of Companies	Median		Premium
		Current PE (TTM)	10 yr PE	
More than 50,000	145	44.2	36.8	20%
20,000 to 50,000	133	51.7	39.4	31%
5,000 to 20,000	341	40.7	36.1	13%
200 to 5,000	1109	31.9	30.0	7%

Source: Ace Equity, Equitree Capital

It is interesting to note that the larger Small Caps / Mid Caps / Large Caps (market cap with more than Rs. 20000cr) is trading at 20%-30% premium to their 10yr averages! The Small Caps – more particularly our focus genre of companies in the market cap range of Rs. 200-5000cr is trading at a mere 7% premium to its 10yr average PE multiple!! It is this genre where we still continue to find enough and more opportunities.

While at that, there is indeed exuberance in some pockets of the market which we discuss hereunder.

2. Exuberance indeed – but only in certain pockets

We have seen massive liquidity chasing stocks in certain pockets of the market which has led to exuberance in these pockets. These include:

i. SME Exchange:

Over the last year, SME Exchange has seen over 164 IPOs which were looking to raise Rs. 4,425cr cumulatively received bids worth Rs. 280,000cr! We share a sample of some of the IPOs recently conducted and their performance:

Total IPO							
Company	Listed on	subscription (x)	Issue price	Listing day	Listing gains	Current price	Profit/Loss
Goyal Salt	11-Oct-23	295	38	136	258%	233	513%
Sungarner Energies	31-Aug-23	152	83	262	216%	250	201%
Basillic Fly Studio	11-Sep-23	359	97	285	193%	459	373%
Oriana Power	11-Aug-23	177	118	317	169%	542	359%
Anlon Tech Solutions	10-Jan-23	429	100	264	164%	263	163%
CPS Shapers	07-Sep-23	254	185	473	155%	391	111%
Srivari Spices	18-Aug-23	450	42	107	154%	269	540%
Infollion Research	08-Jun-23	260	82	199	142%	237	189%
Rockingdeals Cirucular	30-Nov-23	214	140	315	125%	474	239%
Net Avenue Tech	08-Dec-23	511	18	40	122%	29.25	63%
Paragon Fin	03-Nov-23	206	100	214	114%	180	80%
Vinyas Innovative	06-Oct-23	43	165	347	110%	680	312%
Krishca Strapping	26-May-23	337	54	113	109%	261	383%
SAR Televenture	08-Nov-23	288	55	110	101%	250	355%
Innokaiz India	11-May-23	95	78	156	99%	663	750%

Source: Fyers Research, Economic Times, Equitree Capital

For relatively smaller companies with limited existential history and paltry profits, this kind of exuberance is surely unnerving. We have seen stocks going up 3-10x over the last year in this segment without any substantial change in fundamentals – just future promises being sold.

We are very wary of money being made so easily luring a lot of retail investors in this genre of investing – a perfect recipe for an accident in the making.

ii. Larger Small Caps / Mid Caps:

With SIPs seeing a record of Rs. 17,610cr for the month of Dec'23, we have seen increased participation from retail investors. Overall SIPs have seen a staggering 23% growth from Rs. 149,437cr in CY22 to Rs. 183,741cr in CY23.

Interestingly, a major chunk of this has found its way to Small Cap, Mid Cap, Value / Contra Fund as shown hereunder:

Equity Oriented Mutual fund Schemes	Net inflow/Outflow from April to Dec 23 (INR Cr)
Small Cap Fund	34,103
Sectoral/Thematic Funds	22,153
Mid Cap Fund	17,339
Multi Cap Fund	15,678
Large & Mid Cap Fund	13,713
Value Fund/Contra Fund	9,407
Flexi Cap Fund	7,704
Dividend Yield Fund	2,672
ELSS	-1,621
Focused Fund	-3,389
Large Cap Fund	-4,949

Source: AMFI, Equitree Capital

Likewise, Small Cap focused PMS's have also seen major traction during the last year and have seen assets swelling substantially.

A close analysis of these “Small Cap” Mutual funds suggest that most of these are focused on relatively larger small caps / mid-caps with an average market cap of focused companies ranging from Rs. 4000cr-20000cr.

Scheme	AUM (INR Cr)	No of stocks	Avg Mcap
Quant Small Cap Fund	13,002	93	21,292
Nippon India Small Cap Fund	43,816	203	18,315
HSBC Small Cap Fund	13,231	94	16,378
Tata Small Cap Fund	5,819	52	7,513
HDFC Small Cap Fund	26,837	74	11,559
Edelweiss Small Cap Fund	3,002	75	16,513
Canara Robeco Small Cap Fund	9,175	91	22,157
Franklin India Smaller Companies Fund	11,398	88	15,355

Source: Value Research, Equitree Capital

Needless to say that this excess liquidity has gone in to chasing the same stocks which most of these funds / PMS's are already invested in with little new additions. **It is these stocks again where one has seen significant re-rating of companies driving the valuations to levels where future gains will be curtailed.**

It's worth highlighting that at Equitree, our average market cap is positioned at Rs.1,700cr, markedly below the target range of these Small Cap Mutual Funds / PMSs. The median institutional holding in our portfolio companies is just 3.6%, indicating that these entities are still in the early stages of attracting significant institutional investment, thereby shielding them from the current market's liquidity-driven fervor. We anticipate that as our companies evolve and mature, they will attract increased attention from larger investors, potentially leading to a revaluation of our portfolio.

iii. Margin funding touching all time high:

Margin funding where brokers / NBFC's fund investors for buying of shares against ~ 25% margin contribution has been on rise reaching Rs. 54,537cr as of Jan'24, significantly higher from Rs. 29,500cr last Jan and Rs. 7,100cr in Feb'20!

This only shows the kind of exuberance from the recent upside in the market leading people to leverage and invest more in hope of making faster money – this kind of greed can never be sustainable in the long run.

3. Liquidity is here to stay.

Despite the continuous doubts being raised on sustainability of domestic inflows in the markets, we have seen the SIPs only increasing month after month. We believe that there have been structural changes on the ground ensuring this increased participation and strongly feel that this is going to only get better in times to come. We enumerate some of these changes:

i. Newgen moving away from parallel economy

As the Millennials and GenZ take over reins of family wealth from the Baby Boomers and GenX, there has been an increased affinity to move away from parallel economy. This shift of wealth to formal economy has led to increased participation in financial assets with a large chunk finding its way to the capital markets.

ii. Increasing education and awareness

"Mutual Funds Sahi hai" has become a kind of clarion call in recent times! The effort taken by the regulators in creating mass awareness as well as availability of multiple educational platforms has ensured rise of a more informed investor class who is ready to navigate volatility of capital markets and yet not just keep

his calm but also increase participation in such scenarios. This has been a striking contrast from the past where the retail investors would generally be the first ones to lose confidence and sell off at the slightest of volatility.

iii. A Shift from Traditional Investment

The headline Nifty 50 index has delivered returns of 15% CAGR over the past two decades and significantly outperforms real estate's modest returns of 9% and even gold's 11.2% during the same period (Source: Statista, NSE). This consistent higher returns from equity markets has ensured reallocation amongst asset classes in favor of financial assets. The fact that financial assets are much easier to handle and liquidate has been a strong driving factor for the shift of household savings to capital markets.

iv. Improved Regulatory landscape and Ease

The e-KYC system has had a transformative impact on market access. As of April 2023, the cumulative number of Aadhaar e-KYC transactions surpassed 14.95 billion, expanding market reach, even in remote areas thereby making it very easy for retail investors to participate in capital markets.

Simultaneously, the Securities and Exchange Board of India (SEBI) has played a pivotal role in implementing crucial regulatory reforms to ensure market fairness. Measures like banning brokers from using client securities for their own loans, limiting exposure on stock leverage, linking F&O exposure to stringent margins, proactive steps to curb insider trading etc. have gone a long way to safeguard investor assets and inspire confidence in market participants.

All this is at the retail level alone.

One also needs to understand that FII's have been continuous sellers in the Indian markets for the last 3 years in a row selling to the tune of Rs. 387,639cr cumulatively and have further sold stocks worth Rs. 23,583cr until 20th Jan'24 itself. **As India emerges as one of the fastest growing economy in the world and we see interest rate reversals coming about in later part of the year, we believe that we will also see buying coming about by the FIIs.** This should further add to the liquidity and buoyancy in the markets.

4. Corporate earnings in a buoyant mode – remember 2003-07?

In our newsletter for [Jun'22 quarter](#) end, we had spoken about expected buoyancy in corporate profits leading to significant wealth creation in capital markets similar to 2003-07 era. We are glad to share that even this prediction is playing out to perfection as reflected in Q2 / H1 FY24 reported numbers:

Market cap wise (Ex BFSI)	Q2 FY24 compared to Q2 FY23		H1 FY24 compared to H1 FY23	
	Net Sales	PAT	Net Sales	PAT
Equitree Capital (15)	4%	41%	6%	40%
BSE 500 (418)	0%	49%	2%	42%
Nifty (39)	2%	26%	2%	27%
Large Cap (74)	3%	34%	3%	31%
Mid Cap (118)	0%	72%	1%	64%
Small Cap (1,536)	-2%	14%	2%	-8%
All Companies (1,728)	1%	36%	2%	28%

Figures in bracket indicate no. of companies

Source: Ace Equity, Equitree Capital

Large cap = 1-100 companies, Mid cap = 101-250 companies, Small = 251 onwards. (Based on mcap as on 15th Nov. 23)

We expect this growth trend to continue further albeit on a lower growth rate given the higher base now. Nevertheless, we should see corporate profits delivering CAGR growth of ~ 18-20% over the next couple of years which should continue to fuel the markets further.

5. While Small Caps have surely outperformed the Nifty in recent times, their 6-year performance still trails behind the Nifty.

This year, the Small Cap Index has risen by 62%, significantly outshining the Nifty's 20% gain. Despite this, Small Caps have displayed a robust performance over the past three years. However, it's worth noting that such short-term gains often overshadow longer-term performance.

A closer look reveals that 57% of Small Caps' gains in the last three years occurred in the previous year, and 94% of the six-year returns accumulated in the last year alone, amounting to a modest 5-6% annual return in the preceding five years. Even with this year's stellar performance, Small Caps have not surpassed the six-year returns of Large Caps, as illustrated below.

Our perspective is that the underperformance observed cannot be rectified by a mere 1-2 years of outperforming trends. Despite volatility, we foresee the Small Caps outperforming in the next 2-3 years as part of a mean reversion over a decade, ultimately leading to their long-term outperformance.

Absolute Returns	Nifty 50	Nifty Smallcap 100
Last 1 year	20%	62%
Last 3 years	47%	109%
Last 6 years	97%	66%
Last 10 years	242%	348%

Our conviction in small cap stocks has been bolstered by robust investor interest in sectors like Engineering, Manufacturing, Infrastructure, Capital Goods, Railways, and Defense, which are underrepresented among Large Caps. These sectors, which are also our core investment focus, have substantial growth potential ahead.

“A market downturn doesn’t bother us. It is an opportunity to increase our ownership of great companies with great management at good prices.” – Warren Buffett

Outlook on CY24

In 2024, we foresee a shift from sector-led rallies to selective stock picking driving wealth creation. While 2023 saw a general uptick across sectors, this may lead to a more cautious approach in the new year. Even as IT, Chemicals, and Textiles have not led the charge, we expect individual companies within these sectors to become key wealth generators in 2024.

2024 is starting on the backdrop of good returns. After these kind of returns it wouldn’t be out of context for the market to take a breather before it moves ahead, and this may call for a time correction and / or an absolute correction. **We believe that a 5-7% correction in the headline indices is not out of context and with that small caps may also see a drawdown of around 20-25% in the worst scenario.**

Markets have factored in a lot of positives already right from expected reduction in interest rates, growth in corporate earnings, a stable government coming back post elections, normalization of geo-political issues et al. Any negative surprises in any of these may bring in huge volatility during the year.

We believe that if such an opportunity arises, one should be ready to lap it up and build a portfolio of high-quality businesses to create wealth from a mid to long term perspective.

How are we positioned in the current market?

Given the low base of last year coupled with margin recovery in most business on account of raw material stabilization, as expected, we saw a very good growth in PAT for Q2 FY24. **In fact, the buoyancy in businesses in some of our portfolio companies have positively surprised us,**

far exceeding our expectations! This has led us to revise our profit estimates upwards for these companies.

The most comforting fact was outperformance of our core portfolio companies which fired during Q2 reporting an aggregate growth of 41% in PAT (our top 15 holdings which constitute about 87% of the portfolio ex-cash).

True to our core principles of deep value investing we have completely exited from a couple of our investment as their valuations ran up beyond our comfort zone and have added a new company as well in the core portfolio. We will continue to monitor the portfolio and book partial / complete profits wherever we see the valuations running ahead of our comfort zone.

For now, we remain super excited about the near term business visibility of our portfolio companies and given the undemanding valuations and very low institutional holding in most of them, believe that there is still significant upside yet to happen in our portfolio.

We continue to cautiously build up on our portfolio companies and look forward to leverage the volatility to add more, should one arise!

For any inquiries or feedback, please contact us at pawan.b@equitreecapital.com or skabra@equitreecapital.com.

Follow our [LinkedIn](#) page for ongoing updates on our performance and market insights!

Warm regards.

TEAM EQUITREE