"The big money is not in the buying and selling, but in the waiting."
— Charlie Munger

Dear Investors,

We're pleased to share Equitree Capital's Q2 FY25 results and insights. Despite recent market volatility, our PMS scheme "Emerging Opportunities" continues to demonstrate strength, ranking consistently among the **Top 10 Performing PMS** across all time frames over the **past five years**.

Market Performance Overview

For **Q2** FY25, we **outperformed** the benchmark BSE 500 TRI index by **3.35%**, despite volatility in small and micro caps. Over the **past five years, we've delivered a ~38% CAGR**.

Portfolio Performance Summary

Equitree's Portfolio Returns (%)							
Investment Period	1 month	3 months	6 months	1 Year	2 Year	3 Year	5 Year
Emerging Opportunities	-1.21	11.00	49.76	71.31	58.86	39.45	38.25
BSE 500 TRI	2.09	7.65	20.20	41.11	28.73	18.40	22.40
Outperformance	**-3.30**	**3.35**	**29.56**	**30.20**	**30.13**	**21.05**	**15.85**

As of September 30, 2024
Source: Nuvama Custodian Services, Equitree Capital
Returns are computed on TWRR basis net of fees/expenses, Returns over 1 Year are annualized, Not verified by any regulatory authority/SEBI
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.

After the September quarter, broader markets experienced a sharp correction, with indices like the **Nifty and BSE 500 dropping approximately 9% from their 52-week highs.** A closer look reveals an even steeper decline across broader segments, with around **68% of companies down over 20% from their peaks.** This correction aligns with our forecast in the June 2024 Newsletter, where we projected a 5-7% index decline and a 15-20% correction across broader bases

Our portfolio, despite a ~7% correction from its 52-week high as of October 28, 2024, has remained steady **amid steep declines in micro and small-cap** stocks. This stability reflects the effectiveness of our strategy in selecting fundamentally strong companies

Key Highlights from Q2 Newsletter:

1

Small Cap Potential

Small-cap investing is far from dead. Despite short-term volatility, small caps have historically delivered over 25% CAGR, consistently emerging as top wealth creators.

We believe this trend will continue, with these high potential emerging businesses positioned to capture growth in key sectors!

2

Growth

Investors consistently favor companies with high growth, and small-cap profits are outpacing those of large and mid caps.

Growth will be driven by manufacturing, engineering, and infrastructure sectors (44% of the Microcap index). Business expansion is now being funded by internal accruals instead of bank debt.

3

Liquidity

FIIs sold over ₹1 lakh crore in Oct '24, raising concerns, but this represents under 0.25% of the market cap—far from significant. DIIs have offset much of this with ₹97,000 crore in investments, while Indian funds still hold >₹2 lakh crore in cash reserves.

With India's MSCI EM index weight now at 20%, future FII flows are set to increase.

4

Our Approach

We anticipated the market correction, kept substantial cash reserves, and are actively buying deeper into our portfolio companies which are now attractively valued at 18x FY25 PAT!

We have also shortlisted new businesses over the past year and will begin investing as they are now approaching our valuation comfort zone.

Is Small Cap Investing Dead? Not Quite - Buckle up for Wealth Creation!

With the ongoing sell off in small cap stocks and the increasing concern on valuations, media and a lot of market men have already started writing obituary for small cap genre of investing. We have spoken at length about our thoughts on likelihood of a bubble creation and valuation in our earlier newsletters for Mar-24 as well as Dec-23 respectively and maintain our views.

Empirical Evidence: Small Caps as Leading Wealth Creators

- Historical data supports that, despite short-term volatility, small caps have generated the most substantial returns over time. Of the **top 250 current stocks in India, 112 (~45%) had an average market cap of ₹2,500 crore in 2005. Over 20 years, these companies reached an average market cap of ₹90,000 crore, providing investors with a ~20% CAGR,** equating to a **~36x increase** in invested capital.

- However, It's essential to remember that the journey to significant wealth creation in small caps is marked by volatility, with many companies turning out to be value destroyers. This is precisely where **our investment approach—deeply understanding each business—becomes critical in separating hidden opportunities from risks.** Small-cap investing requires an extremely ground-up approach to capture outsized wealth creation while mitigating unforeseen accidents.

- Several of our portfolio companies have **grown from market caps of ₹400-500 crore to ₹12,000-15,000 crore over the past 6-7 years**, despite market volatility.

Growth and Liquidity: The Holy Grail of Wealth Creation

Investors reward companies that demonstrate consistent growth, and when this is combined with ample market liquidity, the potential for exponential returns emerges—something we've observed increasingly over recent years.

In this light, we tried testing **both parameters (growth and liquidity) for Small Caps** and the results have reassured our belief that this is a genre for substantial wealth creation in the coming time.

- **Small Caps Lead in Growth (But Only if One Digs Deeper)**
    - We analyzed data for all companies for growth during post-COVID era (last 4 years):

Market Segment	Large Cap	Mid Cap	Small Cap	Equitree's Emerging Opportunities
PAT CAGR (Ex-BFSI)	14%	12%	10%	28%

*Large-cap: 1st-100th by market cap, Mid-cap: 101st-250th by market cap, Small-cap: 251st and below, up to ₹200 Cr market cap, Excluding BFSI.

    - At first glance, the top 100 companies (Large Caps) reported the highest earnings growth, followed by Mid Caps, with Small Caps appearing to lag. However, over the past three years, Small Caps have drawn substantial attention and liquidity. This is because, although around **1,200 companies** in this segment show modest aggregate growth, **nearly 40% of these small caps achieved growth exceeding 20%, attracting significant investor interest.**

- **Our portfolio** has demonstrated this strength, **delivering a 28% CAGR over the last three years and resulting in a 39% TWRR.**
- Notably, we've seen this similar trend in Q1FY25 as well where the profits of Small Cap companies have surged way ahead of their Large and Mid Cap peers as shown hereunder:

Market Segment	Large Cap	Mid Cap	Small Cap	Equitree's Emerging Opportunities
Total PAT Growth	-6%	-4%	29%	39%

- **What is Driving Small Cap Growth? Why Not Large Caps?**

  - Despite concerns about a global economic slowdown, we have been maintaining that **growth will primarily come from sectors such as manufacturing, engineering, and infrastructure, where momentum is strongest.** India's **"China+1"** and **"Europe+1"** strategies, along with government's focus on infrastructure spend and manufacturing incentives like PLI schemes, continue to drive expansion in these areas.

  - To gain further insight, we analyzed **export data for key sectors** benefiting from these tailwinds. Below is data on some of the segments that have **experienced high growt**h over the past three years.

Indian Export Data over last 3 years (2021-2024)

Commodity	CAGR	FY 2024 (Mn $)	FY 2021 (Mn $)
Electronic Goods	38%	29,109	11,088
Engineering Goods	13%	1,09,222	76,476
Organic/Inorganic Chemicals	10%	29,344	22,060
Defence	38%	2,546	978
Auto Components	17%	21,200	13,300
Textiles (Ready-made)	6%	14,500	12,300

  - High-growth sectors like **manufacturing, infrastructure and engineering are heavily weighted within small caps,** positioning them well for future growth. Compared to large caps, small caps have a stronger representation in these sectors, as seen in the sectoral compositions below:

Sector Composition: Nifty 50 vs. Nifty Microcap 250

Sector	Nifty 50 Weight (%)	Nifty Microcap 250 Weight (%)
Financial Services	32.92%	9.46%
Manufacturing & Engineering	18.41%	44.14%
Information Technology	12.75%	1.30%
Oil, Gas & Consumable Fuels	11.25%	1.11%
FMCG	8.58%	5.75%
Healthcare	3.92%	10.25%
Service	0.92%	10.93%
Other	Various	Various
Total	**100.00%**	**100.00%**

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- The Nifty 50 is heavily weighted towards sectors like Financial Services, IT, and FMCG, which have been under pressure due to the global slowdown and sluggish domestic consumption. **In contrast, small caps, represented by the Nifty Microcap 250, include 44% in manufacturing and engineering, sectors that have shown strong growth.**

- **Ground-Up Investing: Capturing Outperformers**

Our ground-up approach to stock picking, focused on **granular business analysis,** has allowed us to identify companies that consistently **outperform broader sector** trends:

i. **Garment Exports:** While the overall industry has shown a ~6% CAGR in revenue, one of our portfolio companies, a fully backward integrated apparel exporter, has achieved ~20% CAGR in the same timeframe.

ii. **Auto-Ancillaries:** An auto-ancillary company in our portfolio grew export revenues by ~21% CAGR, outperforming the industry's 17% growth rate.

- **The Big Question: Is This Growth Sustainable?**

- In our Mar-24 newsletter, we highlighted how government infrastructure spending and increased gross capital formation have supported growth in manufacturing, engineering, and ancillary sectors. **To assess corporate readiness for sustained growth, we analyzed capacity expansion trends, particularly in engineering and manufacturing, where companies have invested significantly in upgrading their capabilities:**

Corporate Capacity Expansion and Leverage Reduction Across Market Segments (FY21 vs. FY24)

	Gross Block (₹ Cr)			Gear Ratio		
Segment	FY 21	FY 24	% Change	FY21	FY24	% Change
Large Cap	5,418,509.01	7,160,723.00	32.15%	0.95	0.37	-60.93%
Mid Cap	662,277.18	884,763.56	33.59%	0.44	0.35	-20.50%
Small Cap	678,850.41	816,216.15	20.24%	1.66	0.49	-70.63%
Emerging Opportunities	7,199.34	8,910.87	23.77%	0.3	0.25	-17.80%

*Large-cap: 1st-100th by market cap, Mid-cap: 101st-250th by market cap, Small-cap: 251st and below, up to ₹200 Cr market cap, Excluding BFSI.

- Historically, Indian entrepreneurs relied heavily on bank debt for capacity expansions where there have been little heed paid to business visibility as the intent largely was to create long term family assets with borrowed capital. However, this **cycle of expansion has been largely funded by internal accruals or equity infusions,** reflecting greater confidence among promoters in business potential. **When promoters commit their own capital, it often signals strong confidence in sustainable growth.**

- We strongly believe these capacity expansions will see operating leverage playing out over the next couple of years and should continue to drive growth in the foreseeable future.

- **Will Foreign Institutional Investors (FIIs) Selling Deplete Market Liquidity?**

  In October, FIIs pulled back significantly, with net sales reaching over ₹1 lakh crore—a record monthly outflow in Indian market history!

  While this significant withdrawal has raised concerns about liquidity depletion and potentially deeper market corrections, several factors indicate that market liquidity remains stable:

  - **Proportion of Market Cap:** While ₹1 lakh crore appears substantial, it represents only 0.25% of the total market cap, a relatively small impact.
  - **Domestic Institutional Investors (DIIs):** DIIs invested nearly ₹97,000 crore during the same period, a trend of sustained domestic liquidity that has persisted for three years, offsetting FII outflows.
  - **Minimal Small Cap Exposure:** FIIs hold limited positions in small caps, so their selling has a minimal direct impact on this segment's fundamentals.
  - **Continued Small Cap Inflows:** Small-cap funds have seen capital inflows grow 3.85x over the last four years. In H1 FY25 alone, net inflows into small-cap funds totalled approximately ₹15,000 crore, underscoring sustained confidence in the segment.

Net Inflows in Indian Equity Funds (INR Crore)

FY	Small Cap	Total Market
FY20	10,431	84,094
FY21	-3,035	-25,966
FY22	10,116	1,64,405
FY23	22,104	1,46,754
FY24	40,189	1,84,091
FY25*	15,586	2,03,994

Source: AMFI, Equitree Capital

Additionally, mutual funds, PMSs, and AIFs hold approximately **₹2 lakh crore in cash**, providing ample dry powder for market support. India's **increased weighting in the MSCI Emerging Markets Index (now ~20%)** is also likely to attract renewed FII interest.

The surge in domestic liquidity we've witnessed over the past few years hasn't yet faced a significant market correction. **How these new-age investors respond to sharp market drawdowns will be crucial in determining future liquidity conditions.** This remains the key factor to monitor, as it will likely shape market direction in the near term

- **Regulators Act to Stabilize Markets**

  Proactive steps were taken by SEBI to maintain stability by removing over 1,000 companies from the list of securities approved for margin funding, which reduces over-leveraged positions and minimizes the risk of panic selling. Most of our portfolio companies are not on this list, lowering the chance of margin-induced selloffs. Additionally, tighter regulations in derivatives and stricter IPO norms for SMEs are expected to ensure stability in Indian equity markets!

How Are We Navigating This Volatility?

At Equitree, we've experienced two significant market drawdown cycles over the last 12 years, yet we've consistently delivered an XIRR of ~32% during this period. We understand that volatility is an inherent part of the markets, and we believe it should be leveraged as an opportunity for wealth creation rather than a cause for concern.

Anticipating a potential correction, **we took a cautious approach in our deployment strategy.** We maintained a **cash reserve of approximately 40-60% for new investors** and around **15% across our overall PMS** (individual portfolios may have different allocation levels based on start date). We have been **using this correction to buy deep** in to our own portfolio companies which have been **exhibiting very strong earnings momentum**.

We expect our portfolio to deliver approximately **30% PAT growth for FY25**, with current valuations at an attractive **~18x FY25 PAT**—close to the 10-year average.

We have also been **exploring new opportunities** and have shortlisted several businesses, like:

- An auto ancillary company
- An EPC company focused on material handling and related services
- A water industry component manufacturer
- A hospital business
- An EPC company in the telecom sector
- A leading lubricant manufacturing company

We **plan to initiate investments** in these businesses as they approach our valuation comfort levels.

We anticipate that current market volatility may persist until the end of earnings season and the U.S. election outcomes, with stabilization likely thereafter. Broader market performance in Q2 earnings has been mixed, which may drive further corrections as valuations adjust to reflect underperformance. Amidst this, **our portfolio companies remain on track to meet growth targets, and we expect renewed buying interest as earnings are reported.**

Looking ahead, we encourage investors to adopt a balanced perspective on returns and investment horizons. **With the growth potential and reasonable valuations of our portfolio companies, we are confident in achieving at least a 25% IRR from a long-term perspective. We strongly recommend using this correction as an opportunity to strengthen your portfolio for sustained wealth creation.**

We wish you all a very Happy Diwali and a prosperous Samvat 2081!

For any feedback or further information, please feel free to contact us at pawan.b@equitreecapital.com or skabra@equitreecapital.com.

Sincerely,
Team Equitree