CAPGROW CAPITAL

10th February, 2024

"Over the years, our endeavour has always been to build resilient portfolios, enhance the value proposition, achieve long-term financial success, and serve our clients.

"The Illusory Wealth"

Dear investors,

It has been a while since I have been planning to pin down my thoughts on the state of the markets. This has been further necessitated by numerous calls and discussions with existing and potential clients. Everyone is converging on the same million-dollar question: Is the market currently overvalued? Is it Toppy? The answer is a mixed one. No, because there are still ample opportunities available for investment managers to create wealth.

Let me touch upon the global macro first. The U.S. economy seems to be on a soft landing and looks like it has avoided recession. The US CPI is stagnating, and inflation is also moderating, while the global interest rate cycle seems near its peak. The US Fed maintained the status quo in their November meeting, followed by a similar stance by the Bank of England and other Asian banks. All this, along with some stability in the economic data, has raised hopes of a rate cut in the later part of the year.

On the domestic front, the economic data is quite strong. Q2 FY24 GDP growth was 7.6%, led by strong investment-led growth, even though consumption is still sluggish. The real GDP growth expectations are close to +6.5%, and with buoyant tax collections and GST monthly collections, the government has more room to be financially prudent and continue growth momentum through higher Capex and Infra spending. Both the fiscal and current accounts are well within the comfort levels and do not pose any significant threat to the India growth story. The markets have been on an upswing, supported by robust economic fundamentals, healthy earnings growth, and strong domestic inflows into equities. We are entering the election period and the probable period of higher volatility. The large caps have underperformed, while the price momentum in small and midcap stocks has been quite strong. The key question from here on is: What next? To construct the investment journey ahead, I would segregate the market into three buckets for ease of understanding for our investors.

Bucket A: ***The Investible*** *(50–55% of the market cap)*: The large caps, the likes of HDFC Bank, Kotak Mahindra Bank, Bajaj Finance, or the Levers of the world, have not delivered anything. Or rather, if you take a 3-year performance, the returns are flattish, so best to say that despite the profits showing a healthy growth of 30–50% on an absolute basis, a lot of the companies on this bucket list are the foundations of India's growth story. Let us take a few examples, the most prominent ones, and talk of the town names. - HDFC Bank's profit is 2x (including HDFC) while the market cap has been the same in the last 3 years; Kotak Bank profits are 1.7x with no change in stock price; Maruti Suzuki profits are 2.7x while the market cap has increased only by ~23%. A similar story of no change in market cap exists in a lot of other names, including Dabur India and Hindustan Unilever, where the business outlook has improved with increasing profits while the stock prices have not changed. There lies a compelling opportunity to identify stocks for attractive investment returns and wealth creation.

Bucket B: ***The "Reasonable Basket*** (15-20% of the market) The opportunity exists in both the mid-cap and large-cap names. The structural changes that have happened in the Indian economy have enabled a lot of companies to enhance their growth trajectory. These companies are no longer price-takers and have been expanding capacity to boost volumes. They are the beneficiaries of either government spending or export-driven strategies, whether they are China+ or Europe+1 strategies. In this bucket, we should look for quality cash flows, good corporate governance, and realistic earnings goals. The valuations of such companies in this bucket are not cheap, but they are near the historical averages or within one standard deviation, but the structural changes underlying the economy and other company-specific factors will help these companies post higher growth in the future. We are not a big fan of the current favourites of the market—the defence, railways, or PSUs' valuations—as they factor in unsustainable growth assumptions and are not correctly reflecting the ground realities of the regulated businesses.

Bucket C: ***The Untouchables*** – *Remember The Snake Ladder Game, where the monstrous snake in the 90s is waiting for its turn to bring you back to negative territory*. This is the infected area, and in our sense, this basket is 30–35% of the market. This is where the maximum disconnect exists between the stock prices and what is happening inside the company. And I am sure a lot of the readers are more interested in knowing the opportunity of finding multi-baggers or, maybe, on the other side, the extent of overvaluation or risk in this market segment. We believe that a significant part of the micro-cap, small-cap, and some part of mid-cap is covered with frothy valuations, the magnitude of which varies across sectors and names. Right now, the equity market is flogged by retail investors who are too focused on the day-to-day movements in prices and are ignoring the value of the underlying businesses. There is an interesting observation that I had while pinning down this note: I can smell a few rotten eggs in this basket, and a whiff of fraudulent companies—the mountains of high hope that are being created out of nowhere. And the shenanigans are flooding social media—the WhatsApp University—with all kinds of messages that have no basis and no relevance. To give you an example, a stock with "Railway" attached to its name has a market cap close to Rs 1000 crores (~ 40x in 3 yrs) with almost no business, and a renewable energy company has a market cap close to $1.0 billion (~200x in the last 3 years) with limited support from fundamentals. Similarly, just a cursory glance gives us names in the rising sectors—cloud computing, infrastructure, renewables, railways, defence, drone manufacturing, etc.—all the sunrise sectors, and the roadmap is to buy listed companies with low floating stock, introduce these lucrative businesses in those companies, and build market cap. All these are hope (or rather hopeless) trades that are bound to fail, and retail investors are paying a huge premium ($100 mln to $ billion) for just a fashionable name with no real economic business. A disaster waiting to happen, similar to the SPACs in the US markets, but there the real money existed in the bank accounts, while here only the market cap exists, and both did not have any business to support.

We have always believed that small caps perform in cycles, and we are near the end of their life cycle. Each cycle near the peak has similar characteristics like the run-up is very fast, unknown companies are clogging returns while blue-chip companies are flattish, incremental retail money is flowing into these stocks, and any negative news leads to sharp reactions (recent Paytm and Zee episodes). Risk is at its highest level, while investors are focusing on the daily or weekly returns. And all this makes a lot of intuitive sense if we think broadly. Otherwise, where can you make a 20–30% absolute return on a stock in a few weeks or even days when the average long-term annual returns are in the range of 14–15%?

All these excesses will clear out and be followed by a period of negative returns to bring the return numbers back to long-term averages. And we can visualise the emotions in these stocks as oscillating between "excessive greed to make a quick buck" to "the fear of missing out" on the rising markets. And both are fret with danger. "This time it is different" is a common theme that gets repeated across such periods of high speculation. Our past experiences tell us that the situation can turn ugly quickly, and these excesses will get punished.

The attention of the retail investors is being misdirected, which reminds us how susceptible and prone the human mind is to paying attention to rumours and greedy, unrealistic bets. Another fallacy that the retail bandwagon is suffering from is "recency bias"—they are extrapolating their recent returns and taking additional risks to produce more returns. They believe their recent experiences with the small-cap higher returns scenario is the "new normal" based on positive political commentary and the news flow. We

strongly believe that this is a false notion that we don’t subscribe to at all. We believe the epicentre of any correction will be Bucket C—the speculative stocks that had huge runs and have no fundamentals—while the other two buckets deserve to be in the investible portfolio.

What should one do? Where do we go from here?? Our advice is to stay invested in buckets “A” and "B” which offer compelling opportunities. Our CapGrow portfolios for all our clients are synchronised with this philosophy. We do not carry the risks of "Bucket-C" but believe that the collapse of speculative stocks may have some spillover effect on the SIPs, market liquidity, sentiment, and slight collateral damage to the overall market. The indices may stay in a narrower range over the next few months before the uncertainty over elections and until the global dust settles down. We are entering a period of higher volatility, with elections around the world due this year, including in the U.S. and India. The Buffett indicator is close to 125% (Mcap/GDP ratio) and is at a premium to the historical average of 86. The valuation of the Nifty50 is ~19x FY25, close to the historical average. The FII flows were negative in January ($3.2 bln). We are cautious and focused on large caps in banking, financials, IT, pharma, building materials, and metals. As always, we continue to be vigilant and keep looking for any dislocations to identify money-making opportunities for our clients.

Arun Malhotra
Founder & CIO