

Will the sun stop shining on Indian small and midcap stocks?

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Synopsis

India has taken a pause on interest rates and the country has seen significantly higher interest rates in the past, and hence both the Indian govt. and corporations are more resilient to any slowdown due to higher interest rates.



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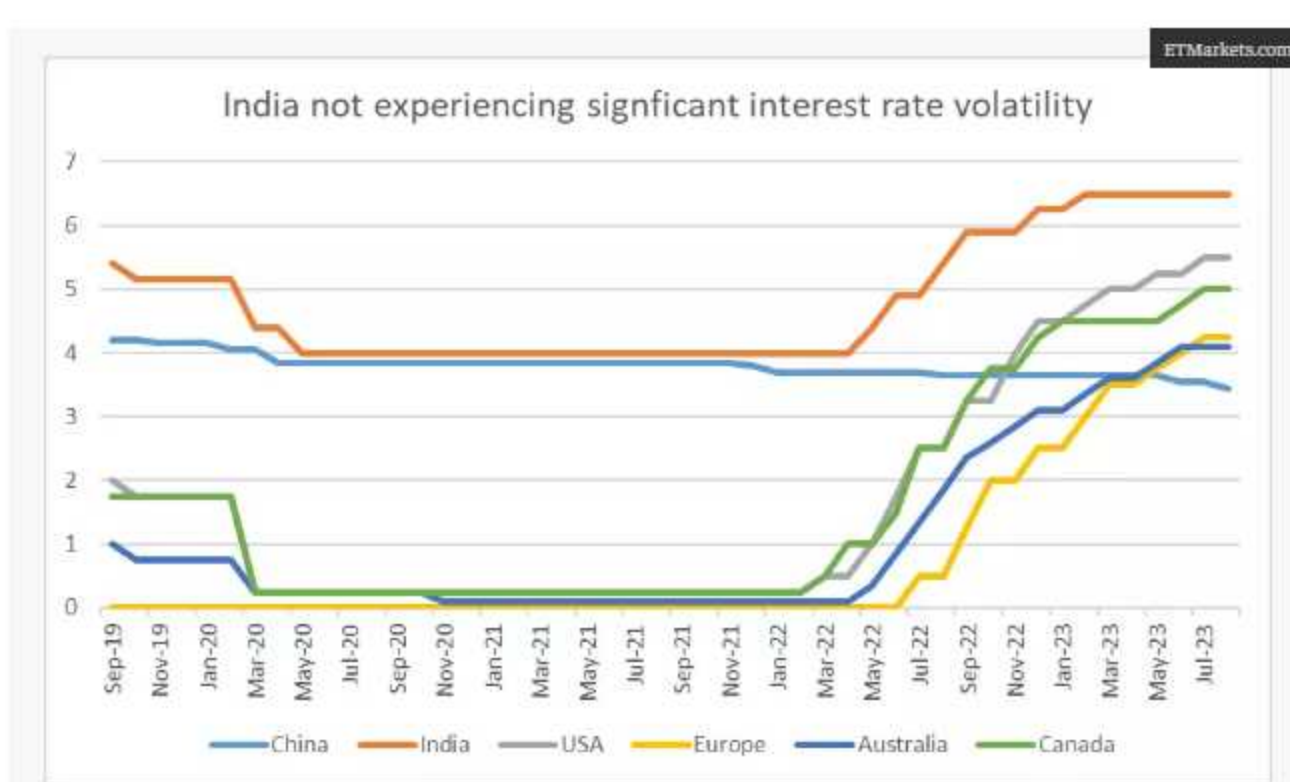


Jaising has over 26 years of experience in the Indian equity markets. He serves as a Managing Director... Show more »

India's small and mid-cap sectors, after a tough 2022 have been on a roll in 2023, up over 27%; more than twice as much as the MSCI World index; beating every other global index. This has led to investor concerns, rightly so on valuations in this space, aggravated since the interest rates in most parts of the world are high compared to their past and still increasing. India has taken a pause on interest rates and the country has seen significantly higher interest rates in the past, and hence both the Indian govt. and corporations are more resilient to any slowdown due to higher interest rates.

Index / Sector	Returns %								
	3m	6m	CYTD	FYTD	1Y	5Y CAGR	CY21	CY22	CY23
NASDAQ	1	22	33	14	21	12	21	-33	
MSCI World	0	12	13	6	14	6	17	-20	
MSCI India	8	20	9	18	8	11	27	2	
BSE 500	10	23	14	21	13	13	30	3	
BSE Midcaps	16	35	28	35	24	15	39	1	
BSE Smallcaps	18	39	31	40	26	18	63	-2	

Source- Bloomberg



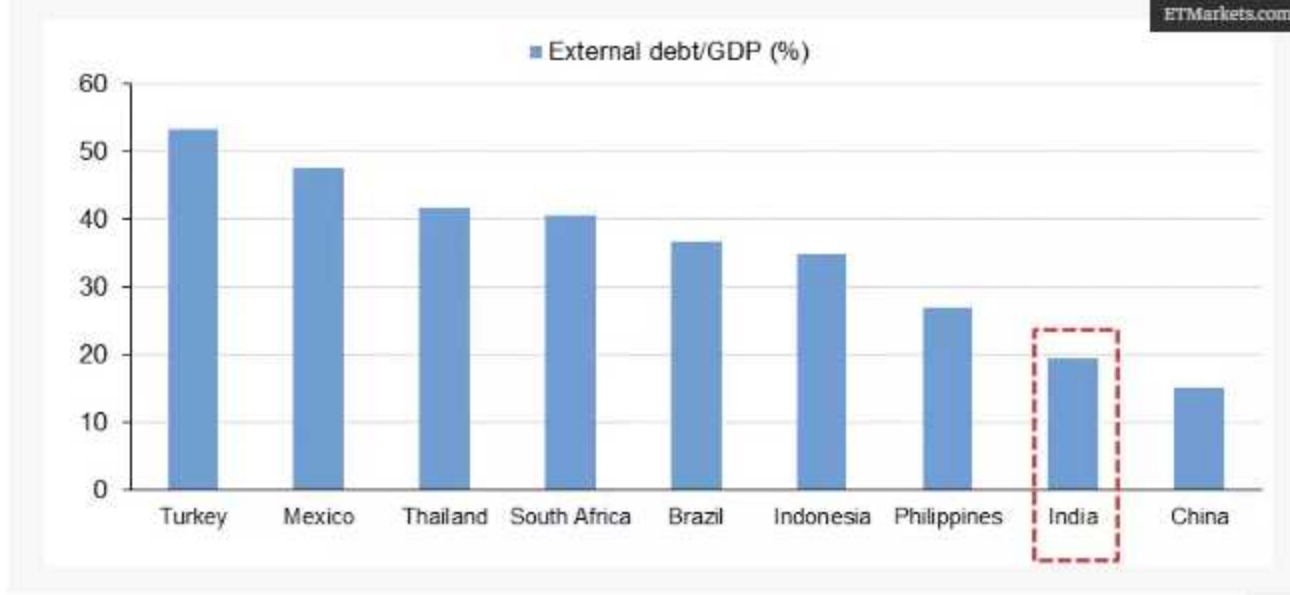
Source- Bloomberg

Change in Interest Rates	China	India	USA	Europe	Australia	Canada
From 2000	NA	-3.50	-1.00	-0.25	-1.90	0.25
From 2010	NA	0.75	5.25	3.25	-0.40	4.75
From 2016		0.45	-0.25	5	4.2	2.1
Aug 23 vs Dec 22		-0.2	0.25	1	1.75	1

Source- Bloomberg, JM Financial Research

We continue to believe India's decoupling with the world as far as equity markets are concerned which has started in the last 6 months will be sustained, because of the country's resilient economic growth of 6-7% p.a. more than twice as much relative to the world; lower foreign debt dependence for its growth and very strong corporate profitability growth of over 15% CAGR next three years.

In the longer run over a 20-year period history has shown all three sectors in India have given robust and similar returns to investors, ranging from a cagr of 15% to 17%. Hence we believe it is more important for investors to look at investing in the right companies as against focusing on their market caps.

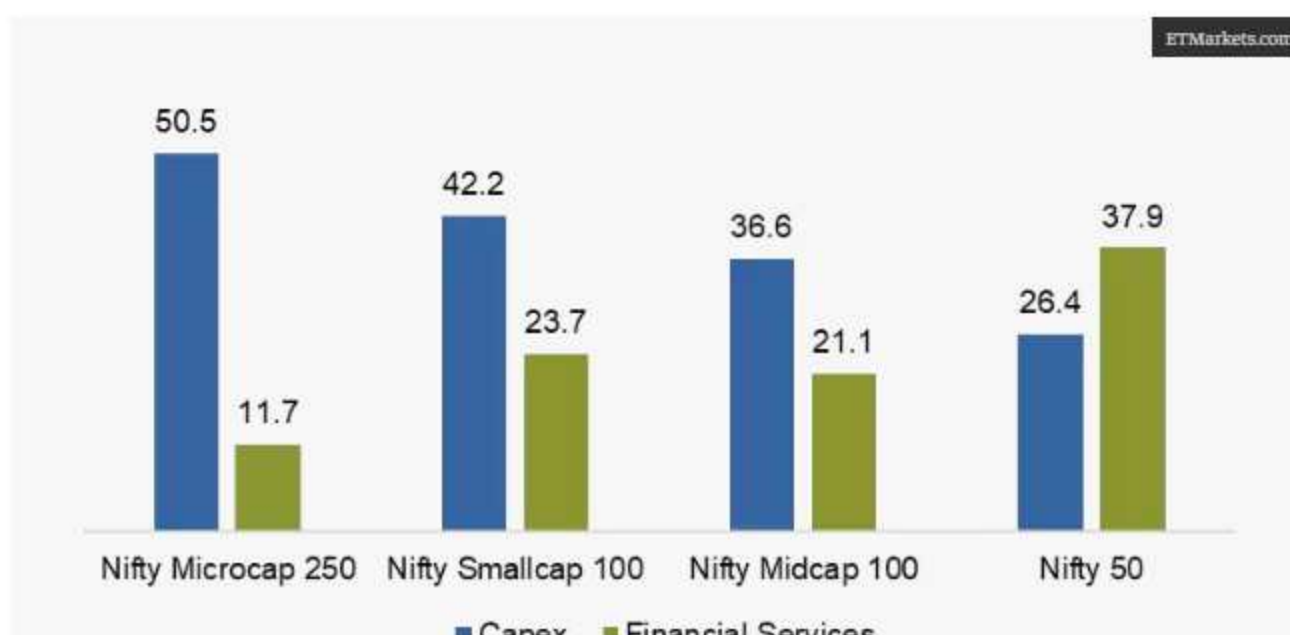


Source- World Bank, JM Financial Research

Corporate India is witnessing double-digit growth in the last three and we estimate it will extend in the next three years. The financial sector has in the last 3 years post-COVID increased its contribution in earnings to indices to 33%. We are bullish on the loan book growth which has been a steady 15-16% in the last 15 months as against 11-12% historically. However, we believe NIMs seem to have peaked out in the near to medium term. Finance Companies will also largely normalize their earnings from F2024 hence on a YoY Basis Loan book growth should largely equate to net profit growth. Historically the growth in Net profit for the financial sector F20-23 was 37% cagr as against our estimates of 12-15% F23-25. Hence though we like some of the larger banks we see higher earnings growth in the niche microfinance sector and also in the Non-financial domestic-facing sector. We think the profit contribution for the Index is changing from incrementally Financial sector to Capex relative sectors like Auto, Capital goods and industrials, Cement, and Telecom. (Source- JM Financial research)

We believe the Indian Capex cycle is readying to take off. The total credit growth in India has grown from high single digits YoY, a decade ago to over 15% currently. However, the Corporate contribution has almost halved from over 35% a decade ago to 20% currently. The corporate loan book growth to banks had become Negative 2.6% at the peak of the COVID wave has now inched up to ~6%, on the back of a start of a capex cycle. The Indian government in the Budget 2023 has announced an increased impetus towards capex. Based on our estimates the capex spent by the government including the Public Sector Companies in F2024 should increase from 4.1% of GDP to 4.9%. The overall Government share in capex is expected to grow from Rs11.3trn in F2023 to Rs14.9trn in F2024. Five sectors where we can witness the capex cycle playing off are a) Defence; b) Power; c) Railways; d) Water treatment and e) PLI-led Manufacturing. (Source- JM Financial research)

The large indices in India are tilted towards the financial services sector which contributes as much as 35-40%; as against 11-12% contribution from the small and mid-cap indices. Capex and capex-related companies constitute as much as 40%-50% of the profit pool in small and mid-cap sectors. The visibility of their earnings too is much better than it historically was. Thus right stock selection may make us earn relatively higher alpha, especially from the small and mid-cap sectors. (Source- JM Financial research)



Source- JM Financial Research

Interestingly even the Equity flows of largecap have been drying up and small and mid-cap increasing. In the last 3 years, the overall AUM contribution of largecap has fallen from 19% to 14% currently. Smallcap and midcap have both increased their share by 2-3% each. This technical factor too should help the sun shine sustain in the smallcap and midcap sectors.

Scheme Name	Incremental Flows (%)	Overall AUM (%) Aug 23	Overall AUM (%) Aug 22	Overall AUM (%) Aug 21	Overall AUM (%) Aug 20
Equity Oriented Schemes					
Multi Cap Fund	17%	5%	4%	2%	2%
Large Cap Fund	-2%	14%	16%	17%	19%
Large & Mid Cap Fund	10%	9%	8%	8%	8%
Mid Cap Fund	12%	13%	12%	12%	11%
Small Cap Fund	21%	10%	8%	8%	7%
Dividend Yield Fund	2%	1%	1%	1%	1%
Value Fund/Contra Fund	7%	6%	6%	6%	7%
Focused Fund	-2%	6%	7%	7%	7%
Sectoral/Thematic Funds	24%	11%	11%	11%	9%
ELSS	0%	10%	10%	12%	13%
Flexi Cap Fund	11%	15%	16%	17%	17%
TOTAL	100%	100%	100%	100%	100%

Source- AMFI, JM Financial Research

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