

India Playbook 2024: Where to invest conundrum?

ET CONTRIBUTORS • Last Updated: Jul 01, 2024, 02:16:00 PM IST

Synopsis

Retail investors favor small-cap stocks due to high returns. Large-caps trade at a valuation discount to small-caps. Domestic ownership prevails in small-caps, with retail investors holding a significant share. Opportunities exist in Finsumption, Capex, and Make in India themes favoring small and mid-cap companies.



Vinay Jaisingh

MD and Co-Head, Portfolio Management Services, JM Financial



Vinay Jaisingh is a CFA Charter Holder and holds a double Master's degree, both in Finance and Scienc...Show more »

The Indian equity markets have been the best performing globally over the past year, with MSCI India growing by over 36%. This surpasses the performance of NASDAQ, up 31%, MSCI World up 20%, and MSCI EM up 10%, while China saw a decline of 2.5%. Within India, returns have been skewed, with the large-cap NIFTY 50 rising by a healthy 26%, whereas small and mid-cap indices have surged by more than twice as much, at 63-65% respectively.

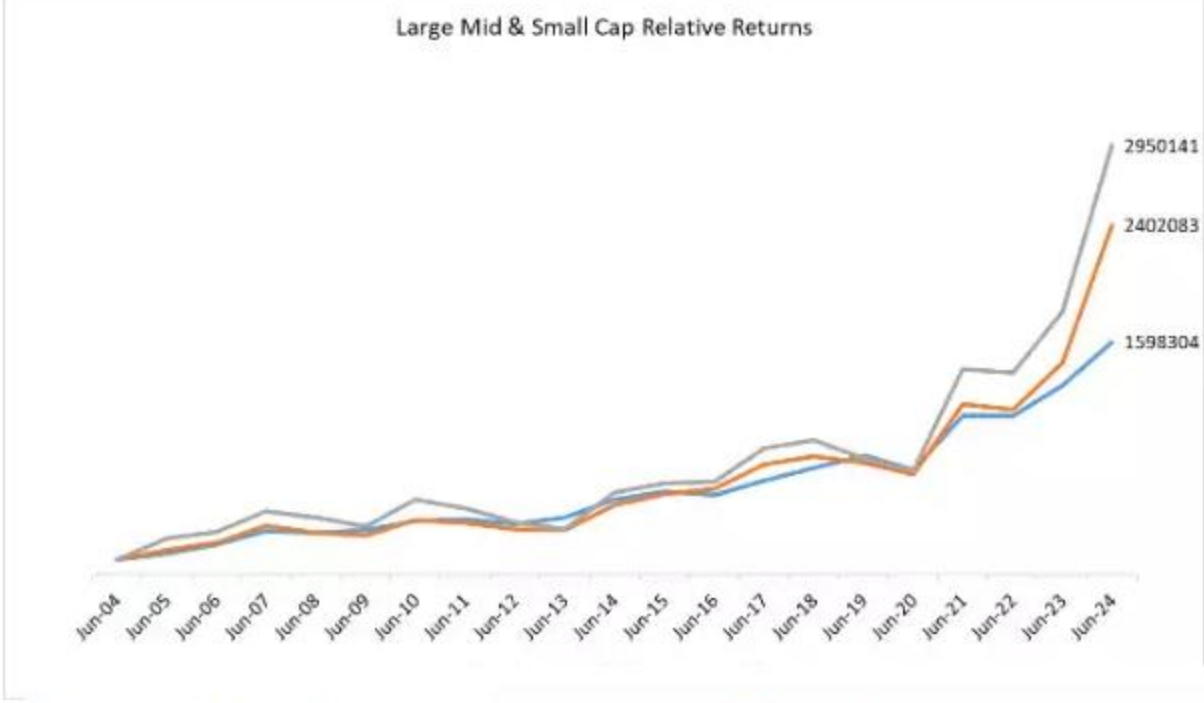
Looking at trailing data since 2017, large-cap stocks have experienced a de-rating of 12%. In

contrast, mid-cap stocks have been re-rated by over 50%, while small-cap stocks are trading in line. Our advice to investors is to avoid any biases based on market capitalization and instead focus on individual stock analysis from a bottom-up perspective. We see opportunities in themes such as Finsumption, Capex, and Make in India, which predominantly favor micro, small, and mid-cap companies over larger-cap firms.

(Source: Bloomberg, AMFI, JM Financial Research)

Paradigm shift: Today's definition of a small-cap company was the definition of a large-cap company back in 2019

India has delivered robust stock market returns to equity investors over the last 20 years, with large-cap investors achieving a compounding rate of 15%, mid-cap investors 18%, and small-cap investors an impressive 19%. In the first 15 years of this period, there was not much difference in performance among these categories. However, over the last 5 years, small-cap and mid-cap returns have been twice as strong as large-cap returns, despite similar compounded annual growth rates (CAGR) in earnings of 22-24%. For instance, an investment of Rs 1 crore in 2004 would have grown to approximately Rs 30 crore in small-cap stocks compared to around Rs 16 crore in large-cap stocks over the last 20 years.



The definition of large-cap companies in India includes the top 100 companies by market capitalization (with occasional adjustment cycles). Mid-cap companies are categorized as the next 150 companies, while small-cap companies comprise the remaining firms. Currently, India boasts a market capitalization of US\$ 5.3 trillion, spread across more than 5000 companies. Small-cap companies alone represent a substantial US\$ 1 trillion of this market capitalization, which is comparable in size to the mid-cap segment. Each of these segments constitutes over a quarter of India's GDP. India's market cap to GDP today stands at 148%, with each segment contributing its highest percentage of GDP; large at 92%, mid and small at 28% each.

(Source: Bloomberg, AMFI, JM Financial Research)

Market Cap	2024	2023	2022	2021	2020	2019	2018	2017
Cut Off (\$ Bn)								
Large Cap	11.2 & Above	8.1 & Above	6.1 & Above	6.4 & Above	3.9 & Above	3.8 & Above	4.2 & Above	4.5 & Above
Mid Cap	3.7 - 11.2	2.6 - 8.1	2.1 - 6.1	2.2 - 6.4	1.1 - 3.9	1.2 - 3.8	1.3 - 4.2	1.3 - 4.5
Small Cap	Below 3.7	Below 2.6	Below 2.1	Below 2.2	Below 1.1	Below 1.2	Below 1.3	Below 1.3

(Source: CapitalLine, AMFI, JM Financial Research)

The large-cap has seen a churn of 30% in the last 7 years which strictly does not make valuation comments or profit growth comparisons comparable to its past. Mathematically the five-year CAGR of the top 100 m-cap companies of 2017 would have grown at a CAGR of 17% against 23% of their newer constituents.

(Source: AMFI, CapitalLine, JM Financial Research)

Valuation argument suggests largecaps over smallcaps, but smallcap breath is much larger

Based on valuations, large-cap discount in valuation over small cap has been the largest during this period with them trading at 44% discount to small cap currently. However, the breath of smallcap of almost Rs 4,800 companies and \$1 trillion of mcap gives investors more to select from.

PE x	2024	2023	2022	2021	2020	2019	2018	2017
Large Cap	25.2	25.1	26.3	35.9	32.7	27.9	30.6	27.2
Mid Cap	35.4	33.6	26	37.8	44.4	28.2	36.1	29.1
Small Cap	45	35.7	32.9	80.8	-236.2	23.7	40.3	43.2
TOTAL	29.2	27.9	27.1	39.4	39.2	27.4	32.5	29.2

(Source: AMFI, CapitalLine, JM Financial Research)

Domestic ownership of smallcap the highest; direct retail appetite the most

Though Foreign Institutional Investors (FIIs) own 16-17% of the overall Indian public space, in small cap their ownership is just 8%. Domestic ownership non-promoters is a staggering 37% or almost 82% of the overall free float of smallcaps. The biggest chunk of about 58% is directly held by retail.

		% of Free Float				% of Total Market Cap			
Tn Rs	Free Float Market Cap %	FII %	MF %	Other Insti %	Retail %	FII %	MF %	Other Insti %	Retail %
Large Cap	51%	39%	17%	18%	21%	20%	9%	9%	11%
Mid Cap	44%	32%	22%	16%	30%	14%	10%	7%	13%
Small Cap	46%	18%	15%	8%	58%	8%	7%	4%	26%
TOTAL	49%	35%	18%	16%	28%	16.8%	8.6%	7.9%	13.8%

(Source: Bloomberg, AMFI, CapitalLine, JM Financial Research)

Buy what you want to hold long term and don't let market cap bias your decision

Over the last 5 years, retail investors have shown a bias towards small-cap stocks, which have rewarded them handsomely in the stock markets. We advise investors to focus on themes and stock ideas they believe in, rather than being overly influenced by market capitalization.

In the current environment, we prefer to invest in largely domestic-facing sectors over global ones, particularly due to strong economic tailwinds domestically and global headwinds suggesting a slowdown in growth.

In domestic-facing sectors, we believe India's growing per capita income and demographics bode well for both the financial sector and the consumption space, often referred to as "Finsumption".

The BJP party in their manifesto gave a three-prong strategy A) Continue the demonstrated path of Responsible Growth – Fiscal Prudence, Low Inflation and High Growth B) Make Bharat a Global Manufacturing Hub through a series of initiatives for simplification of regulatory processes and investment in capacity building C) Focus on improving the investment cycle through policy initiatives of Make in India and PLI (Production Linked Incentives)

Our understanding of their manifesto suggests the following Focus Sectors which would bolster India's capital expenditure (CAPEX) growth and capital goods companies are poised to benefit significantly. This growth trajectory is expected to create high-value and mass job opportunities, catering to what is currently the world's largest incremental workforce.

- Manufacturing: DefenCe; APIs, Semi-Conductors (EMS), Food-Processing, Shipbuilding, Textiles, Electric Vehicles;
- Sustainable Energy: Solar, Wind, Green Hydrogen, Natural Gas, Nuclear;
- Infrastructure: Roads, Railways; Water Security, Airports.
- Services: Housing & Real Estate, Tourism, Healthcare

With the Indian government's emphasis on boosting capital expenditure at both state and central levels, we favor the industrial and capital goods sectors. However, we remain cautious about the valuations in this sector, considering its strong performance over the past 12-18 months. It's crucial to exercise careful stock selection and diversify portfolios across a broader range of stocks and sectors, given the recent market gains.

The next theme we are focused on is "Make in India", particularly in sectors directly involved in niche exports where India holds a competitive edge, or in industries that substitute imports, such as defense, pharmaceuticals, and chemicals.

Interestingly, due to the broader range of small-cap stocks available, there are significantly more options to explore themes within the small-cap space compared to large-cap stocks.