



## Strait of Uncertainty

*The strait of Hormuz could open up after the current impasse. We are not sure when and how. What looks clear is that the framework under which the maritime trade functioned under an international rules-based order is in jeopardy. The initial impression about the direction of the changes afoot indicates that trade will become more expensive. Supply chains may not remain seamless and cannot be taken for granted. India will have to secure its own interests in energy and other commodities and there will be costs and opportunities. Amidst all this, Indian market is staring down its own strait of uncertainty. That runs all the way to the previous highs above 26000 which were rejected twice in two years. In the last two years, it has been in this zone with the indices going nowhere. Now, we have earnings challenges ahead. While this is what seems to be in store, we see the glass as half full. More pertinently, what is inside the glass has potential. This is materially different from what we articulated in much of 2024 and in 2025. Here is why*

- 1. The world has taken a lot on its chin and has survived. A mercurial US administration is part of this cocktail. We have to believe that the markets would have priced in this uncertainty. Globally and in India. From here, things cannot get much worse and stay there. They can get better.*
- 2. India has been battered and bruised. Much of what has happened in geopolitics in the last two years has not been good for India. Having said that, India has shown resilience at a cost. The cost has been paid through currency depreciation (which has diminished the purchasing power of local savings and wealth). The cost has also been paid through growth cut and earnings cut for the market. Make no mistake. These costs are painful and are still being paid. We are not echoing the cliched optimism that it is India's decade. We are however advocating that we as investors should position ourselves in the limited number of opportunities that are there.*
- 3. On the positive side, we have managed the energy disruption rather well considering our vulnerability. Livelihoods have been protected. The wheels of the economy have been grinding on. Which is a relief. Any large scale outages led by supply chains seizing up and excessive restrictions would already have caused vicious cycles to be set into motion. In short, India has given itself a chance for bouncing back strongly.*
- 4. The market has gone through a massive sideways correction with lot of churn. While we believe the domestic investors are not right in taking the view that India is an especially exciting growth market deserving a special premium, things can improve steadily but gradually.*
- 5. The post war scenario will inevitably bring the focus on certain key themes including self-reliance, energy security and defence (though this looks an overcrowded trade).*

*The environment is ripe for us as investors to get to the desk and do some hard work. We can find a way to put money into work so that two or three years down the line, we might well look back and conclude that this was indeed the right step.*

*We reiterate there is a cost that India (and the world) will pay because someone started what is widely believed to be a needless war. This is baked into the heady mix now. For India, inflation is of material consequence. While the extent will be clearer in the weeks to come, it is safe to expect that input cost inflation will be an issue for companies. Wage inflation will likely follow. Sectors and companies facing demand headwinds will now face margin pressures. There are some investment implications that follow. The very same forces put asset owners in a better place. We can own asset owners. This market had romanticized asset light models. In the current scenario, asset is king.*

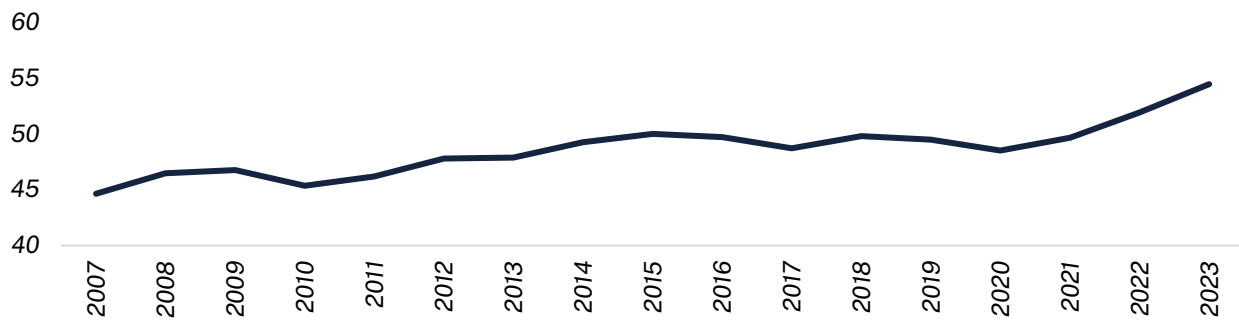
*There is the good, the bad and the ugly. The good is worth a look. We have been emphasizing the risks involved in remaining invested in illiquid positions for long. Correspondingly and for other reasons, we have liked larger companies. This gives us the currency and leeway to reposition portfolios to prime ourselves for the opportunities that will light up. Here are some pointers on what looks interesting.*

## Energy security

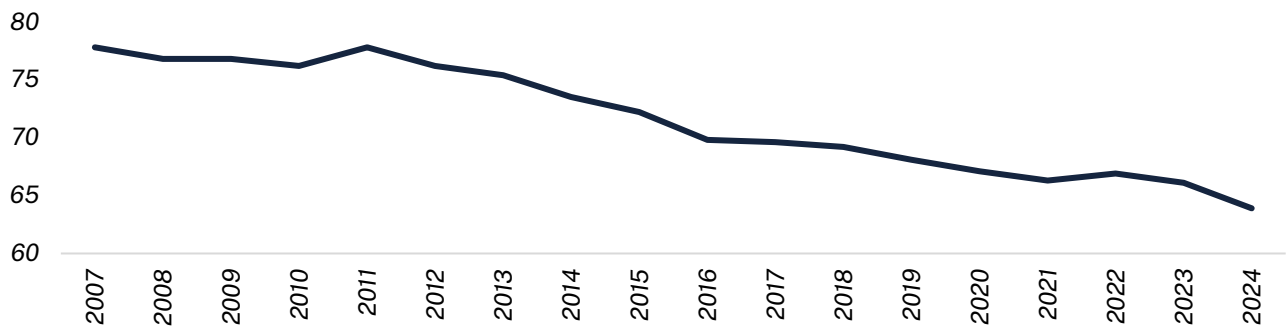


Everyone has talked about this. Let us cut to the chase. The metaphorical oxymoron notwithstanding coal looks beautiful now.

India's energy needs met from Coal (%)



China's energy needs met from Coal (%)



Source: National Bureau of statistics of China, IEA, Spark Fund research

What is important from these charts is not what is obvious. The important number is that China still meets over 65% of its needs from coal. India does less. But India has coal. India does not have too much of fossil fuels. Coal production and usage can go up.

India			
Coal Reserve as on	Bn tonnes	Coal Production	Bn tonnes
1st April 2021	352.13	FY21	0.72
1st April 2022	361.41	FY22	0.78
1st April 2023	378.21	FY23	0.89
1st April 2024	389.42	FY24	1.00
1st April 2025	400.72	FY25	1.05

Source: Ministry of Coal, Spark Fund research

There has been much resistance from the environment lobby against coal. Coal stocks have been blacklisted in the past by many foreign institutions. In this regard, the following point exemplifies the double standards and hypocrisy. More than a decade back, yours truly has faced a lot of resistance from Scandinavian ESG screens while investing in a stock like L&T because the company had a minor percentage of revenues from defense. Look at what kind of destruction the developed world has wreaked using weapons of all kinds in Eastern Europe and in the Middle East. For now, virtue signaling over ESG is going into the back burner. Environmental concerns are for real. Existential and livelihood issues will take precedence. China has always



managed to steer clear of these pressures when it came to its own interest. India will need to focus on what is good for itself. India has plenty of sun and wind. They ought to have a key role in India's energy mix while hydrocarbons cannot play a strategic role as India does not have enough of them. At the core however, coal will clearly be key for energy security. Further, the broader issue of energy security will have investment implications. There are opportunities out there from all of this.

### Atmanirbhar Bharat

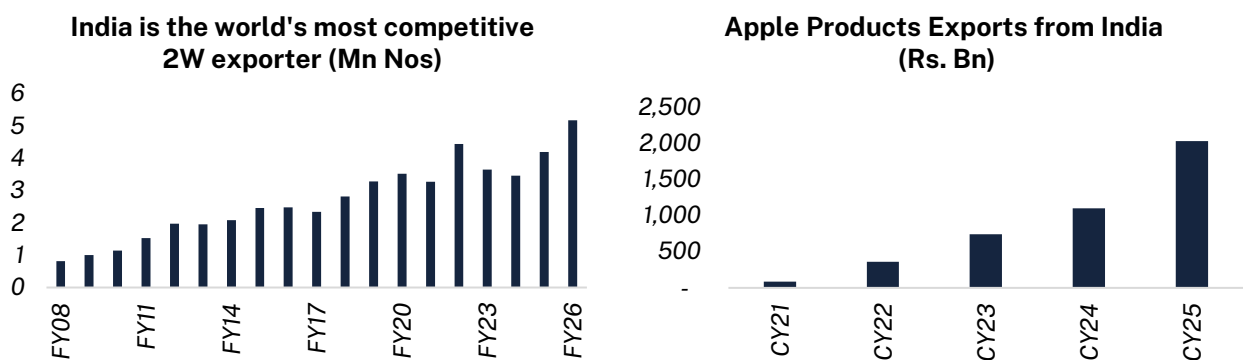
The world has been increasingly looking inward in recent years. Now, the trend is sealed when it comes to strategic interests. Trade and exports will still remain relevant and free trade agreements are being accelerated as many countries want to diversify supply sources. Every large nation will try to mitigate risks from dependency on global sourcing and supply chains. India is a large market and leveraging that, it can be a dependable supplier of many goods. On the other hand, India has to work on securing its own strategic interests. For instance, India's food security is well-served by our buffer stock even though we need to import some of our requirements. In relative terms, India is better placed as a big consumer of food. India will no doubt try to reduce the dependency further. Food security implies stress on fertilizer availability and India imports some of its requirements. There are compelling investment opportunities amidst all this.

Countries	% of Food Import
India	~10–15%
China	~25–35%
Japan	~60–62%
Europe	~15–25%
US	Net Exporter

Source: Media Articles, Spark Fund Research

Going forward, manufacturing (production of physical goods) will be a key focus area. Given our ability to develop scale economies on the back of our large domestic market, manufacturing exports should be an interesting space to examine. This dovetails into the point made about asset owners earlier in this piece.

### Power of the Domestic market



Source: PL institutional Equities, Media Articles, Spark Fund Research

### Technology, digitization & automation

While we made the point on the over-exuberance towards asset-light models, productivity will be key in a relatively inflationary scenario. We are concerned about wage inflation, and our February newsletter



brought out this point eloquently. We are wary of businesses that aim to boost revenues with headcount addition. Automation and technology adoption will drive sweating of assets. Sweating of soft assets is included in this. AI adoption fits in here. We emphasize again that over-hyped services with the risk of wage pressure hanging over it like the sword of Damocles will be risky for investors. This includes low end services directed at domestic investors where labor discontent is already visible. After decades, India is facing organized labor protests. Though this might sound counter-intuitive, we like businesses which increasingly look to use less of labor and deploy productivity tools.

### The bad & the ugly

We have been talking about these for long now. Quite a lot of this has played out. We believe businesses with high valuations and competitive intensity will be under pressure. Somehow, many asset-light models have also been more vulnerable to disruption and the new age businesses in India have done precisely that. They have disrupted existing models of distribution or customer access using technology. Thanks to readily available risk capital, they have gone ahead and taken undue amount of risk. We are nearing the end of that rope and many cracks are widening.

We observed one more disturbing phenomenon during the sell-off in March. The midcap and to some extent small cap indices outperformed the Nifty. This was interpreted as resilience. We beg to disagree. Those who want to exit cannot simply sell the small/midcaps and we are talking about large investors. We reckon that many institutional portfolios are loaded with stocks that are overvalued and illiquid. There is heavy dependency on the feel-good from narrative peddling. This is also the situation in many newly listed IPO stocks. We have repeatedly shown the data on the fate of most IPOs involving offer for sale a few quarters after listing. It does not look pretty. These are some of the bad and ugly facets of the price discovery mechanism in Indian market. We are concerned about the asymmetric risk that builds up when investors (the market) at large confuse short term momentum in stocks with long-term quality and resilience.

Mid Cap Valuations in various markets	Trailing PE (x)	1YR Fwd. PE (x)	Comments on Constituents of index
India	~32	~24	Me-too businesses. Linked to macro/Govt. spending. No IP
USA	~21	~16	World leader in innovation – Tech/Biotech/Healthcare
China	~23	~17	Midcap Transformation. Volume leadership. Presence in robotics, EV batteries, high-tech. Medium IP
Japan	~20	~15	Always had leadership in Miniaturization / Pharma IP. Declining but niche.
South Korea	~23	~11	KOSDAQ constituents are an integral part of memory/electronics/AI chain. High on R&D
Taiwan	~28	~18	Strong in chip design/Semiconductors. Key beneficiary of AI. Manufacturing IP.

Note: Trailing P/E and 1Yr. Forward P/E as on 30-04-2026  
Source: Bloomberg, Spark Fund Research

Indian small/midcaps operate predominantly in areas which are geared to linear economic growth momentum and/or government spending. They have hardly created any IP. They trade at valuations that are significantly higher than regional peers and against their own history. In our assessment, they are merely benefiting from the flow effect from domestic investor interest in equities through mutual funds. Disruptors using capital and technology use cases are mistakenly seen to possess sustainable leadership moats. Mere ability to acquire customers is confused with customer loyalty. While there are companies that can become leaders, no reasonable valuation proposition seems to point to investor returns even if we assume flawless and liner execution (taken for granted here) over 3-4 years. Many IPOs are in small/midcap space. The whole space is setting up for big trouble. Caveat emptor.



### In uncertainty lies the opportunity

While comparisons can be odious, we are in a somewhat similar situation that came about in the aftermath of GFC. Back then, the policy makers were tardy in recognizing the inflation risk. The political leadership tried to sweep the issue under the carpet. The problem snowballed. It took a toll on markets and on the currency. Institutional memory and lessons learned may lead to a better response this time. We may be able to mitigate the damage and avoid the pitfalls.

On the other hand, we have a far more expensive market right now in most segments. Financials could be an exception. Interestingly, the banking sector was in the eye of the storm fifteen years back and later when the contagion fanned out. We have much better asset quality and better recognition standards right now. Policy has been proactive. We have seen preemptive and targeted intervention which in turn has preserved the health of the credit delivery system even as errant players got punished. The bank balance sheets, particularly those of the PSU banks, are better right now. Banks have borne the brunt of FPI selling (HDFC bank – FII ownership down by some 30%). The pendulum may have swung to the other side in many instances. PSU banks may have room for enough upside from here and so also some select private banks.

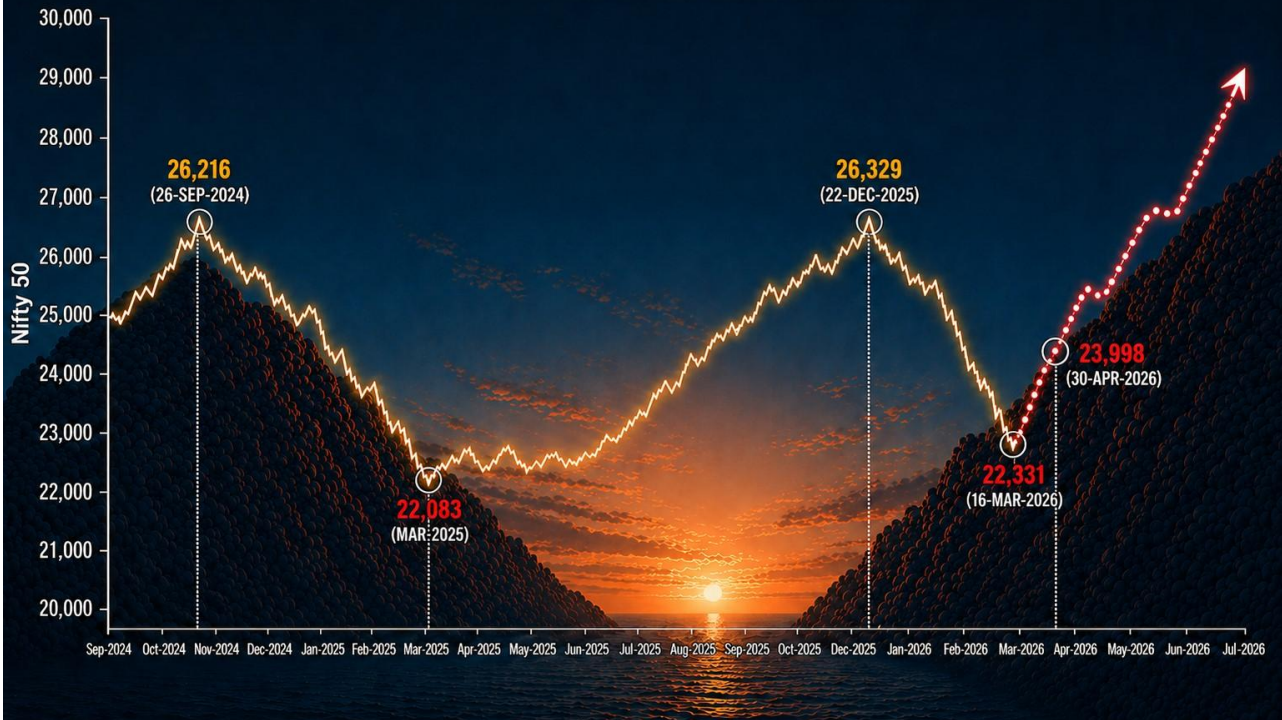
% Companies	MCAP		PAT		GNPA	
	FY21	FY26	FY21	FY26	FY21	FY26
Top 5 Pvt Banks	69.2	55.6	61.7	38.9	11.2	21.6
Top 8 PSU Banks	18.5	32.4	33.4	48.3	67.2	58.5
Others (PSU + Private)	12.3	11.9	4.9	12.8	21.6	19.9
Total	100.0	100.0	100.0	100.0	100.0	100.0

Note: Top 5 Pvt bank consist of HDFC, ICICI, Kotak Mahindra, Axis, IndusInd bank. Top 8 PSU Bank consist of SBI, BOB, PNB, BOI, Canara Bank, Indian Bank, Union Bank of India, Bank of Maharashtra  
Source: Bloomberg, AceEquity, Spark Fund Research

On balance, the current uncertainty provides an opportunity. It was reassuring to note that the Nifty did not breach 22000 on the way down. While we do not want to wade into the jargon used by technical analysts, the market has support at lower levels. The domestic narrative that we do not need foreign investors is flawed. In the long run, foreign capital sets the benchmark on valuations in all markets simply because it does not need to be in any one market and exercises that choice. This is as against domestic money which has already caused valuation distortion in mid/small caps/IPOs because it is piling up on the same domestic equities through glib selling and perceived lack of alternatives. Having said that, the foreign investors, who have been persistent sellers in India, might engage again on the positive side as we move forward. Not because we are an exciting growth story. Or that we are a must-have (We ARE NOT). But because the whole world is staring at a sea of red and India is a large autonomous growth story. The impact of the war will reverberate everywhere and in months to come. The US economy will also feel the heat. **India is very vulnerable to a global supply squeeze but is relatively resilient to global demand shocks.** The current supply crunch is already leading to demand destruction in the developed world. India will silently move up the pecking order. Investors should prepare for the return of foreign investors. Perhaps later in the year or a bit later. We need to be there well before then and few can time it to perfection. As the market negotiates the strait of uncertainty which it has formed for itself, these are times when investors can put long-term capital to work.



## THE CLIMB BACK UP TO THE MARKET HIGHS IS NOT EASY – BUT POSSIBLE



Warm regards,  
P Krishnan (CIO) and Team Spark Fund



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