THE CHEMISTRY OF FLOWS

Indian equities have given stellar returns over most time periods. The Indian mutual funds have created long term wealth for retail investors and the power of compounding over a two-decade timeframe has made a meaningful difference to investor wealth. The narrative around this is indeed compelling.

The above set-up makes it difficult to argue against the bull. Or questioning flows into equities. Any fall therefore is deemed as a Buy on dips. Everyone is bullish on Indian equities in the long run. Any other proposition runs the risk of being seriously off-the mark. The protagonists of the equity market narrative make a living out of the markets. Be one with the bull. That is safe.

This is the perfect setting for a possible bull trap. Sample these pertinent facts.

1. EV/EBITDA multiples that analysts assign to companies nowadays make target multiple based on PE look juvenile. There is no reasoning why such a high EV/EBITDA valuation is attached. There is no precedent anywhere which lasted for long periods of time. There are no parallels now anywhere else.
2. Revenue growth over the last half year and the last four years are trending below nominal GDP growth for numerous bellwether stocks. No one is questioning why they should get elevated premium multiples. Nor is there any analysis that gives a clear path to a sustainable and strong revival in top-line. In fact, the next six months look shaky. While we have no reason to be bearish on a rolling basis, there is nothing that any expert has put out (including managements) that suggest there is a steep recovery in growth ahead for now. Recovery is possible but nothing to warrant a steep growth curve in many of these cases. Can marginal improvement to growth from low single digits justify higher and higher valuations, even from elevated levels?
3. We are hearing this refrain that valuations are just one standard deviation above mean and are now converging towards the mean with the market down by 10%. We are constrained to call out that this data is hugely misleading. We scanned several marquee fund portfolios for the top holdings. Most of the holdings (ex-financials) are trading way above the mean. The table below shows how headline valuations look lower than the real thing.

Company	TTM PE (x)	Company	TTM PE (x)
Coal India	7.3	Maruti Suzuki	24.8
ONGC	7.9	Reliance	25.7
Tata Motors	8.7	Bajaj Finance	26.1
BPCL	9.7	Infosys	28.6
State Bank of India	11.5	TCS	32.6
Hindalco Industries	11.8	Asian Paints	52.1
NTPC	18.5	Hindustan Unilever	57.1
HDFC Bank	20.8	Bharti Airtel	80.4
ICICI Bank	21.0	Titan Company	88.9

Note: PE for banks is standalone basis. Data as on Nov 29, 2024.
Source: Ace Equity, Spark Fund Research

It is clear that the valuations are brought down by banks and select PSUs. PE is not the preferred metric to value banks. P/B is a long-standing metric of choice across markets. Maybe an HDFC Bank and a few other private banks score well on this count. Not by much though. On the other hand, the top holdings of the funds are other stocks which are valued way higher. This is not by itself alarming. The worrying claim is that the market is just one standard deviation above mean (mean itself is elevated because of upwardly mobile valuations over the last few years lifting the same). Therefore, this is a case of hunting with the hound and running with the hare. The investor community at large is comforting itself with a certain convenient falsehood masquerading as something true.

4. Small/Midcaps and any IPO stock listed in recent months are in a la-la land which we have seldom been to. Path to profitability or merely making profits is enough for these stocks to get any valuation that the protagonists attach.
5. No major stock market has their leading stocks trading at these valuations. Look at some large companies that shape the world.

Company	TTM PE(x)
NVIDIA Corp	54.4
Apple Inc	35.1
Microsoft Corp	34.7
Meta Platforms Inc	26.0
Taiwan Semiconductor Manufacturing Co	24.9
Alphabet Inc	21.9
Samsung Electronics Co	11.5
Toyota Motor Corp	8.1

Source: Bloomberg, Spark Fund Research. Data as on Nov 29, 2024.

Nvidia is the outlier but has seen 90% CAGR in EPS from 2021-2024 and growing fast despite higher base. So that cannot be held as an example. No Indian company can match this characteristic.

Surely, it cannot be that all these companies lack long-term moats which Indian companies are supposedly having in plenty.

If any data is presented, some counters that we have seen run something like this.

Sl.no.	Views	Our Opinion
1.	India is in a different growth orbit	Not factual. We are growing faster but not in any orbit. This is one of our concerns
2.	The Indian retail investor is doing the heavy lifting	We will see below the truth of the same
3.	There is too much liquidity	True. This is one of our concerns in this piece. Why conflate this with fundamentals whenever convenient

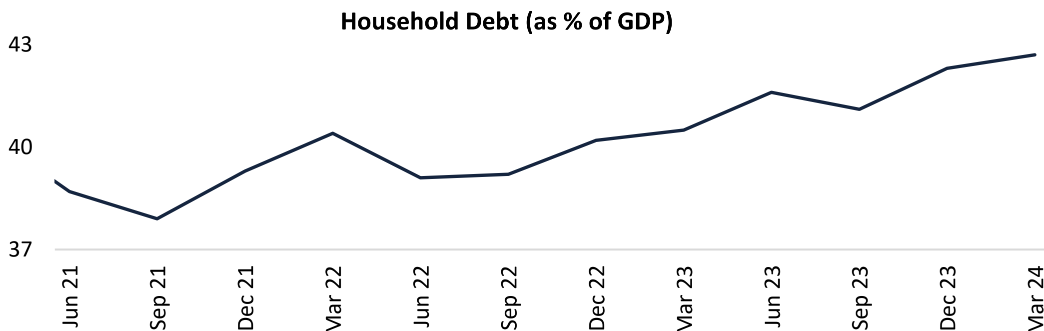
We are not advocating a bear market. We do not have any clairvoyance or metrics to do so. We believe we could see conditions ripening for a valuation re-set. This may not prove easy to handle. There are two points that concern us. Together, they are hard to ignore.

1. **Slowing growth**
2. **Adverse liquidity**

Slowing Growth

We do not expect growth to fall off the cliff and go away. However, the low-hanging fruits are gone. The post Covid productivity boost and growth impetus have run their course. We are in the midst of a powerful mid-cycle correction where we may have no option but to deal with the K-shaped recovery and other mid-cycle pangs.

1. Consumer demand is weak. There has been no income hit to any section of society in the last two years. There is therefore no proximate income effect. Leverage seems to be an issue for consumer households that from part of the weaker stroke in the K.



Source: Bank for International Settlements, Spark Fund Research.

2. Government spending on capex is slowing a tad. Obviously, the government cannot be expected to do the heavy lifting every quarter or half year.

3. Global growth impetus is weak. The new American administration can cause global trade to have several spasms before water finds its level. Geopolitics is hanging on a prayer and a limb. This could be binary. If the war in Ukraine gets resolved, that will be a positive. This is a wild card at this stage. That said, the mere act of avoiding a nuclear dogfight does not mean that growth would come back.

We foresee downgrades to this year's Indian GDP growth well below 6.5%. While FY26 could be better, there are no guarantees. It might be another year of 6-6.5% growth with a possible pick-up later in 2025. These numbers are not bad. However, our bulls believe that 7% plus is a given for India every year. This is because such growth may be deemed as a necessity for the markets to sustain the momentum from a high base. It is almost an occupational hazard to accept the possibility of lower or negative returns for the markets, even for a few quarters.

However, lower headline GDP growth is the other side of the same coin where lower revenue growth for companies is playing out. Prospects of revenue growth below nominal GDP growth are real for many companies. What is to be noted is that there is no need for aggregate growth in the economy to come down for this to happen as lower revenue growth in many sectors could also be the consequence of competition, consolidation and other structural changes. The issue is that the market positioning on many companies refuses to adjust for this scenario. While some (many) of these companies have delivered superior growth over the last 10-15 years, there has been a slowdown post Covid and all of these years, we have been told that markets are forward looking. Please look ahead and the disconnect begins to loom large.

Adverse liquidity

The problem now is that the above reality is coming face to face with negative foreign flows. The narrative of higher valuations amidst slowing growth or other problems is something global investors have seen in other markets (eg – Taiwan, Japan, Nasdaq). The end game was never pleasant. We have analysed three aspects of liquidity, and the picture is not very comforting.

Firstly, we looked at the nature of FII selling and DII buying post Covid. Here is the data.

Institutions	Period	Weighted Average Nifty	Quantum (Rs. Lakh Crores)
FII (Net Selling)	Jul 01, 2021 to Nov 29, 2024	20,452	7.0
DII (Net Buying)	Jul 01, 2021 to Nov 29, 2024	20,772	10.5

Source: Ace Equity, Spark Fund Research.

Here is the deception. The narrative seems to suggest that DIIs are so much in the money and FPIs have sold out early. Which looks true until you look at more data.

FPIs hold around Rs 71 lakh crore worth of Indian stock as of end October 2024. They have sold a small Rs. 7 lakh crores (net) in the last 3 ½ years. The market has doubled and therefore they are sitting on a lot of unrealised gains. The total Domestic MF ownership is around Rs. 42 lakh crores which at a gross level is of more recent vintage and is in the money to a lesser extent than the FPI funds. This analysis is no doubt simplistic. The notion that Domestic MF buying can stand up against Rs 71 lakh crore of FPI holding built over many years amidst sky-high valuations/large paper supply is even more naive.

Secondly, we have earlier highlighted that liquidity can be sucked out by IPOs. Look at recent large IPOs

Stock	Issue Size (Rs. Cr)	% Gain/Loss from IPO Price
Hyundai Motor India	27,856	-2.2
Vodafone Idea	18,000	-24.0
Swiggy	11,327	20.7
NTPC Green	10,000	15.6
Bajaj Housing Finance Ltd.	6,560	94.1

Note: Vodafone Idea is follow-on public offer. Gain/ Loss as on Nov 29, 2024.
Source: Ace Equity, Spark Fund Research.

These IPOs are not seriously in the money. Some are out of the money. Earnings/Revenue growth is falling (loss making companies don't have this problem of course). There are more issuances ready if there are buyers. This does not bode well for the argument that liquidity can keep doing wonders.

The third point on liquidity is the terrible volumes in small/midcaps. Without block activity, it is impossible to deal in large volumes of small/midcaps. For many, this may be par for the course. Up to a certain point, this may be true. Falling revenues/earnings, high valuations (premium to large caps invariably) and more supply make this an extremely dangerous situation. The table below captures the poor liquidity. Mutual funds are risky investments and open-end funds by mandate are supposed to offer immediate liquidity to the investor. Against this, the below data should cause alarm bells to ring. What makes it worse is that if there is no block activity, this liquidity picture itself does not hold good. Block activity by nature is a completely unreliable liquidity gauge. No one seems concerned. If we get any growth shocks in India (reasonable probability) or bad news from global markets, that can cause the markets to seize up.

Scheme Name	AUM (in Rs. Cr)		No. of days to liquidate 50% Portfolio	
	Oct-24	Feb-24	Oct-24	Feb-24
SBI Small Cap	33,105	25,534	56	60
Quant Small Cap	26,331	17,233	55	22
HDFC Small Cap	33,507	28,597	43	42
DSP Small Cap	16,148	13,703	43	32
Kotak Small Cap	17,597	14,189	37	33
Nippon India Small Cap	61,025	46,030	31	27
Tata Small Cap	9,467	6,274	27	35
Axis Small Cap	23,956	19,604	21	28

Note: Considered funds which takes more than 20 days to liquidate 50% of portfolio
Source: AMFI, Spark Fund Research.

The above factors have compelled us to call out the invisible risks which are mounting. Every crisis in financial markets have emanated from the build-up of risks accompanied by disdain towards data that screams out caution. This time around, FPI selling need not stop easily – which is what the data is telling us. They have lots more stock to sell than the domestic liquidity can absorb in short periods of time. Let us not be under this myth that they have no alternatives. Everyone has always had alternatives to expensive stocks. For instance, even a 2% probable return could be a good alternative to a 15% potential loss. On a separate note, let us also stress that even the domestic investors have alternatives which the cheerleaders brand as unexciting. When it comes to money, the most unexciting outcome is a nasty drawdown. It would be handy to be reminded of the same. While a corrective phase will invariably prove to be a good entry point, we wonder whether every correction needs to be viewed as a reason to jump in. Some corrections can have more legs than the optics give away.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

Disclaimer: The contents of this document are for general consumption only and are not to be construed as either a Research Report or a recommendation of any manner by Spark Capital Advisors (India) Private Limited or its affiliates ("Spark Group"). Spark Group shall not be responsible for any investment decisions made by the readers and recipients of this report.