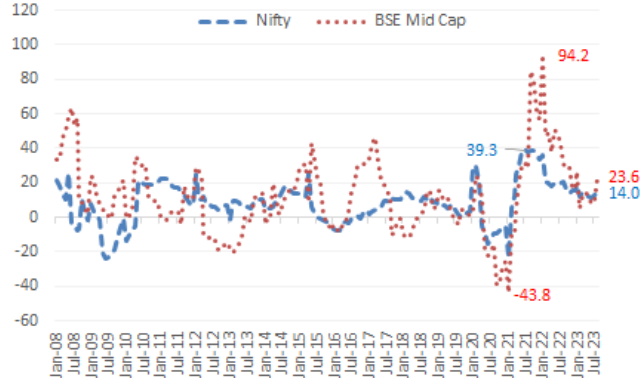


## SMID: Chinks in the growing consensus of overvaluation story

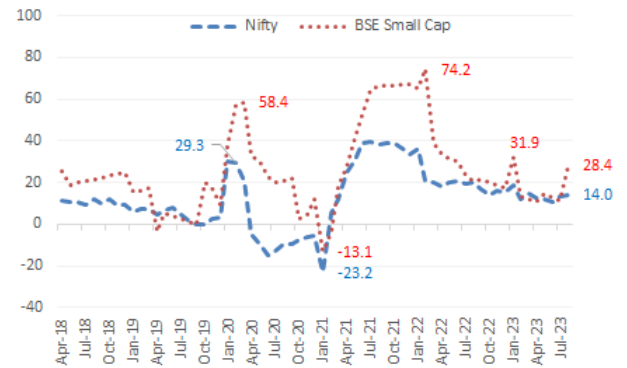
- 1) **The emerging consensus:** Too many people are cautious on the SMID space barring retail investors. When large part of the market is on one side, it's usually not a great side to be on. EPS multiples are not supporting the fear case.

Figure 1: EPS Growth – Midcaps comfortably ahead of large-caps



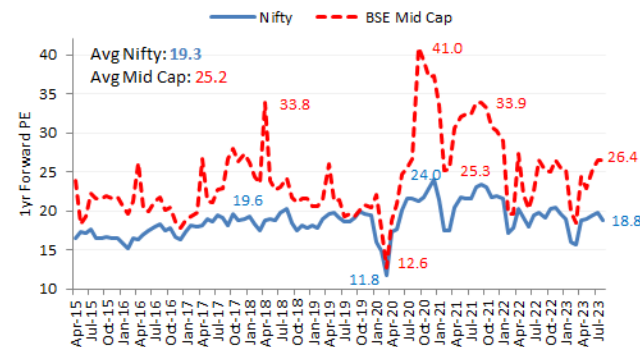
Source: Bloomberg, Refinitiv, ASKPW Research

Figure 2: The same is the case for smallcaps too



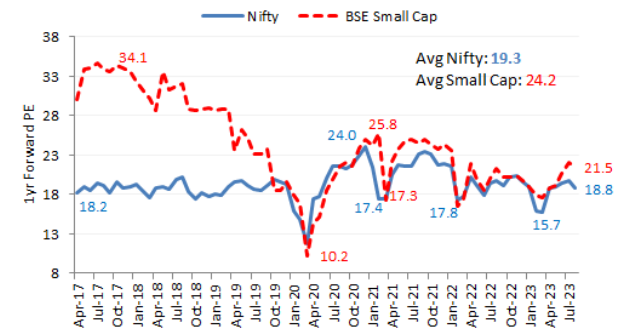
- 2) **Valuation:** Not much difference in stretch between largecap and SMID particularly with respect to their respective historical levels.

Figure 3: PE valuations are not anywhere closer to their historical high



Source: Bloomberg, Refinitiv, ASKPW Research

Figure 4: The same for small cap but here only recently valuations are ruling higher than largecap



Hence from an earnings-valuation perspective post-Covid index expansion is still lagging earnings for SMID compared to Large-caps.

Figure 5: Sharp growth in midcap earnings during post-Covid phase

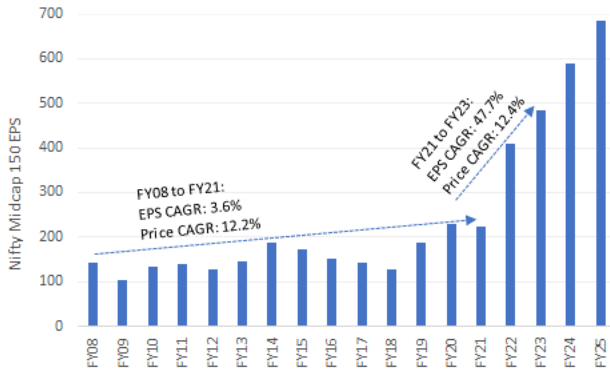
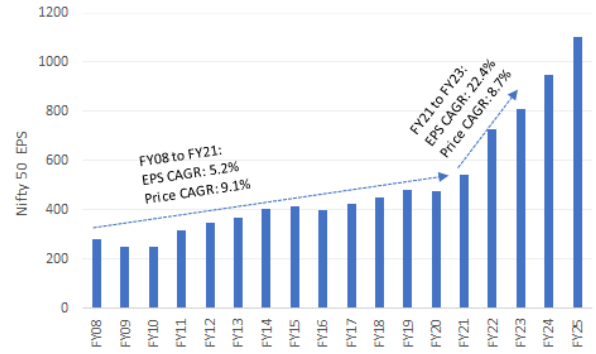


Figure 6: Large cap earnings growth too have returned but at a lower pace than midcap

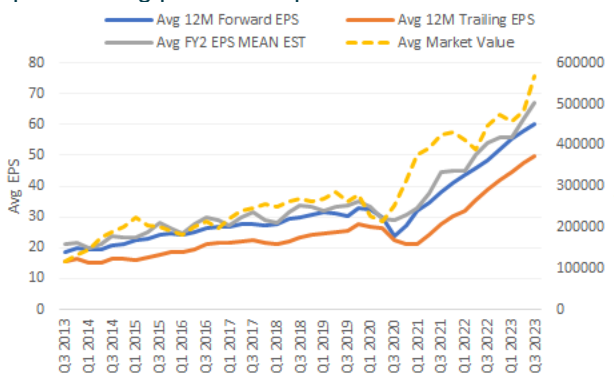


Source: Bloomberg, Refinitiv, ASKPW Research

- 3) **Volatility:** SMID indices are very volatile, so historical comparisons might be apples to custard apples. Hence, we took a more bottom-up approach.
  - a. Picked up top seven prime SMID funds in our universe (including within PMS and MF space).
  - b. Picked up the top 20 stocks from each fund, as of today constituting well over 50% of their portfolio, for a total universe of ~95 SMID portfolio stocks.
  - c. Ran valuation and earnings ratios on this portfolio – a more representative sample for SMID investible universe than indices.
  - d. Compared the same to a flagship large cap PMS industry scheme (as a representative sample of large cap, quality portfolios).

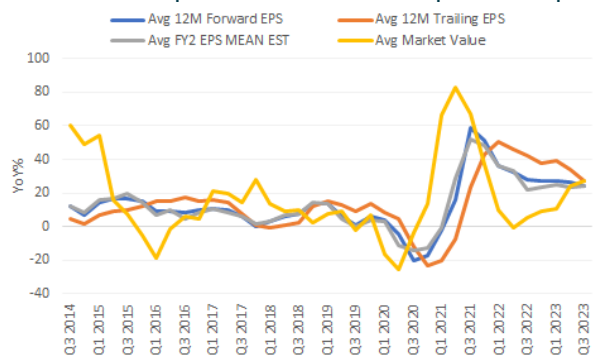
The results indicate that while there is some overshoot of market values to EPS growth it's not terribly high (yet). It's showing up in valuation multiples as well – the PE ratio of the universe is within tolerable limits of long period average.

Figure 7: Very sharp earnings momentum in the SMID space during post-Covid phase



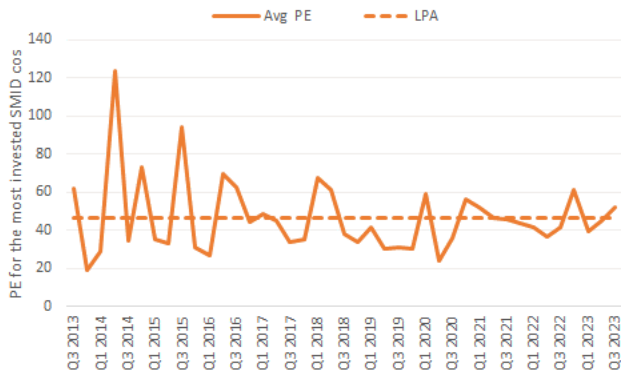
Source: Refinitiv, ASKPW Research

Figure 8: Prices would seem to have just caught up for the SMID space from their Covid period drop



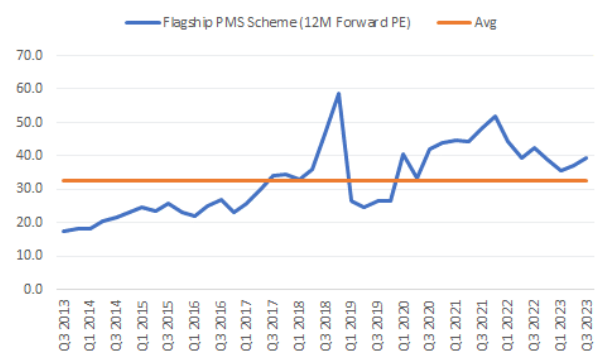
- 4) **Large cap:** Valuations stretch of this most invested SMID portfolio isn't very different from the flagship large cap PMS industry scheme – In other words, any valuation stretch is similar across large-cap and SMID.

Figure 9: Earnings spike have restrained the PE expansion for the SMID space



Source: Refinitiv, ASKPW Research

Figure 10: Concerns of valuation is similar for large cap space too



- 5) **Flows:** Flows are a potential issue for SMID, but here again numbers are (still) tolerable. As seen in the table below, SMID flows (MF only) have been super-strong, 3-6x previous year. But absorptive capacity (% of available SMID free float needed to absorb these flows) remain relatively intact, yet. In short, current flows need ~1-2% of available SMID FF M-cap, not counting fresh supplies, to be absorbed. FII flows have turned negative in recent weeks. This is, at the margin, net negative for Large caps and Large mid-caps. Ergo, it is not clear that the relative performance (Large cap will outperform SMID) can be thumped the table on with any level of empirical confidence.

Figure 11: Surge in flows in the SMID funds

Midcap MF Funds						
Apr-Jul	Net Inflow	Net AUM (Mar)	Net AUM (Jul)	AUM (Jul)- Mkt Adj	AUM growth (excl mkt effect)	YTD BSE Midcap (%)
YTD FY20	40,018	7,50,585	7,29,563	661548	68015	-11.9
YTD FY21	2,345	6,58,049	8,33,029	856596	-23568	30.2
YTD FY22	55,432	11,64,035	14,27,915	1331644	96271	14.4
YTD FY23	64,776	15,99,280	16,84,381	1595494	88886	-0.2
YTD FY24	63,585	18,32,555	22,98,790	2316414	-17624	26.4

Smallcap MF Funds						
Apr-Jul	Net Inflow	Net AUM (Mar)	Net AUM (Jul)	AUM (Jul)- Mkt Adj	AUM growth (excl mkt effect)	YTD BSE Smallcap (%)
YTD FY20	41,339	4,38,721	4,23,419	370546	52873	-15.5
YTD FY21	8,357	3,58,320	4,69,344	485586	-16243	35.5
YTD FY22	37,485	6,97,994	9,40,148	905448	34700	29.7
YTD FY23	68,811	10,68,573	11,33,321	1024670	108652	-4.1
YTD FY24	1,51,081	13,33,837	18,24,935	1731920	93015	29.8

Note: INR excluding % are in million.  
Source: Refinitiv, CMIE, ASKPW Research

Figure 12: Absorptive capacity isn't exhausted still

	2021	2022	2023
SMID Flows	92,916	1,33,587	2,14,666
SMID AUM (AUM Growth Excl Mkt Effect)	23,68,063	28,17,702	41,23,725
SMID Free Float Mkt Cap (Jul)	2,53,88,582	2,65,15,826	3,47,55,647
Stock (%)	9.33	10.63	11.86
Available Free Float	2,30,20,519	2,36,98,124	3,06,31,922
Absorptive Capacity	0.40	0.56	0.70

## Conclusion

1. Stay away from the herd – no need to exit SMID portfolios. The latter seems to have better growth profiles; similar valuation stretch and somewhat behind-the-curve price-catchup to valuations as Large-caps. No compelling “sell” case emerges. **Liquidity can be the biggest risk and any reversal in global risk environment would affect flows in equity including that coming to India. However, the timing of such events cannot be predicted.**
2. Larger macro risks – oil prices, interest rates – are egalitarian in impact across market segments. **US interest rate remaining higher for longer than expected may adversely impact the prospect of India in terms of flows.**
3. Several favoured larger companies are also quite richly valued.
4. Pockets of stretched SMID valuations could be there, as are pockets of liquidity running behind flows.
5. Evaluate strategies with more diversified, instead of concentrated, profiles to mitigate risks.
6. Be wary of SMID strategies beyond a certain AUM, prefer SMID portfolios with smaller AUMs. Alternatively, multi-cap strategies, as they will buffer volatility if a sharp downward trend comes.

## ENDS

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