Strategy

September 04, 2025

Passive = not active or inactive

In our view, (1) the rising share of passive funds in the overall shareholding of companies and (2) the increasing ‘passive’ behavior of shareholders in India may dilute the two main roles of capital markets—(1) allocation of capital and (2) pricing of capital. The trend may continue without active counter-measures, leading to bad outcomes for markets and participants.

Markets may not be doing their jobs well enough; it could become worse

We wonder if (1) stock markets can perform the twin roles of allocation of capital and pricing of capital efficiently and (2) the traditional benchmark-related investment industry can stay relevant due to (1) the likely rise of passive funds (ETFs and index funds) and (2) the increasing ‘passive’ behavior of the active domestic fund management industry. On the former, the higher share of passive funds in the shareholding of companies may democratize holding but dilute the role of capital markets. On the latter, ‘active’ investment strategies may be increasingly mimicking passive ones, which may accelerate the trend toward passive investment.

Passive shareholding may rise rapidly, diluting traditional capital market roles

We expect the share of passive funds to rise in most markets, including India. The entry of BlackRock-Jio into the asset management business will likely accelerate the trend in India. We note that the share of passive funds in the US has increased to (1) 54% of the total mutual fund assets (bonds and equities) as of CY2024 compared to 27% as of CY2014 and (2) 20% of the top-20 stocks by market capitalization as of 1HCY25 compared to 11% as of CY2014.

Passive investment mode of Indian households and institutional investors

We believe that (1) the price-agnostic investment behavior of retail investors and their constant purchase of stocks through domestic equity mutual funds and (2) the ‘forced’ purchases by domestic institutional investors may have induced an element of ‘passive’ investment among domestic institutional investors. In a way, funds are no longer controlling the timing of investment or even the nature of investment given (1) benchmarking imperatives and (2) restrictions of caps, sectors and themes in the case of ‘restricted’ funds, which have received a large share of new funds in the past two years.

Agnostic (asset, time) funds may be way to go

In our view, ‘agnostic’ funds may be a way (or perhaps the only way) to counter the growing threat to the active fund management industry in India. Such funds will allow institutional investors (funds) to take bolder calls with respect to (1) timing of investment and (2) nature of investment. Institutional investors will be able to discharge their fiduciary responsibility better by not being constrained by (1) the compulsions of having to be invested at all points in time irrespective of valuations or, even worse, having to invest when not being convinced about valuations and (2) the artifacts of benchmarks, caps and sectors/themes, which serve a limited purpose.

Key estimates summary

	2025	2026E	2027E
Nifty estimates			
Earnings growth (%)	6.4	8.9	17.9
Nifty EPS (Rs)	1,013	1,089	1,297
Nifty P/E (X)	24.4	22.7	19.1
Macro data			
Real GDP (%)	6.5	6.5	6.5
Avg CPI inflation (%)	4.6	2.6	4.8

Source: CEIC, Kotak Institutional Equities estimates

Quick Numbers

Share of passive funds in the US MF assets has increased to 54% in CY2024 compared to 27% in CY2014

MFs have seen equity inflows of Rs2.3 tn so far in CY2025

NFOs accounted for 23% share in fund mobilized over CY2021-25

Full sector coverage on KINSITE

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Table of Contents

1

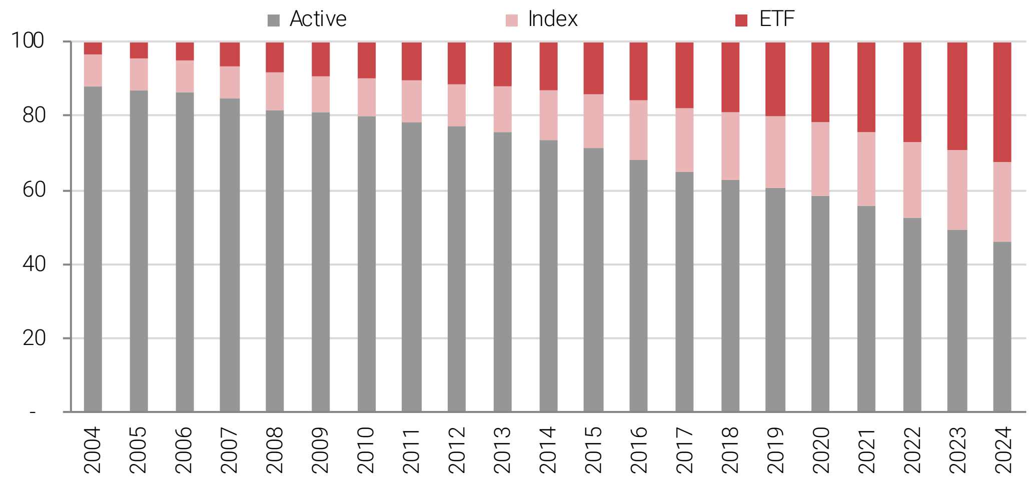
Overview: The ills and perils of being passive

We see two fallouts from (1) the rising share of passive funds and (2) increasing passive behavior of investors in India. The ills of passive funds of not allocating or pricing capital adequately have already been established by academic studies. The perils to the active fund management industry from the passive industry are also understood globally but are being ignored in India, given the misalignment of the incentives of market intermediaries with the imperatives of investors.

We expect the share of passive funds in overall funds to rise rapidly if the domestic asset management industry was to continue in its present form. We note that the increase in the share of passive funds in overall funds is a global phenomenon and the relentless rise of passive funds is most visible in the US (see Exhibit 1), which is the most vibrant capital market in the world. We expect the same trends for Indian fund management industry without a change in the incentives and structure of the industry.

Share of passive funds in US assets have increased from 27% in 2014 to 54% in 2024

Exhibit 1: AUM mix of MF assets across equity, debt and hybrid, calendar year-ends, 2004-24 (%)



Source: ICI, Kotak Institutional Equities

We doubt the Indian fund management industry can stay in its current form of quasi-active investment management. We use the term quasi-active management in the context of the self-imposed constraints by the domestic fund management industry. These constraints, in the form of (1) benchmarks, caps, sectors and themes that restrict the quantity and types of stocks in funds in general and (2) 'compulsory' investment that eliminates the timing of investment in the market and stocks, have resulted in parts of the active fund management industry resembling the passive fund management business.

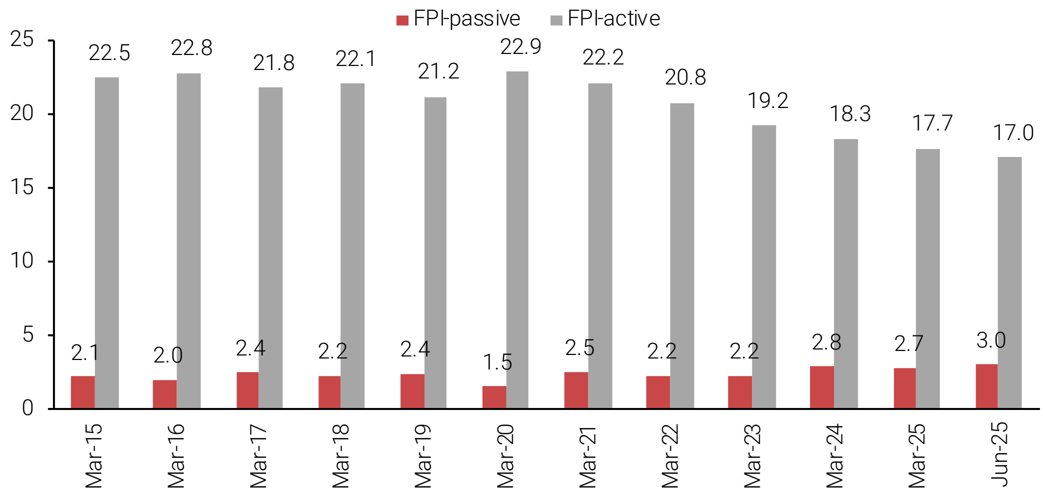
The industry has done a stellar job in (1) raising awareness of equities as an asset class, (2) developing a culture of investing (versus trading) for long-term wealth creation and (3) inculcating the importance of patience in investing among retail investors. However, it may be time for the industry to reinvent itself and transform itself into a more active one, unbound by the constraints of (1) benchmarks, caps, sectors and themes and (2) time.

The ills of the passive industry

We see potential risks of dilution to the key functions of capital markets from likely higher share of passive funds in the overall shareholding of companies in India over a period of time. India has largely stayed an active market (see Exhibits 2-3 for split of share of active and passive funds for foreign and domestic non-promoter shareholders over time) but it runs the risk of passive funds increasing their share in overall shareholding of companies and the market over time. The entry of Blackrock-Jio with its focus on passive funds may accelerate the process, as other asset management companies may be forced to launch more passive funds to counter the disruption.

Share of passive FPIs has increased marginally over the past few years

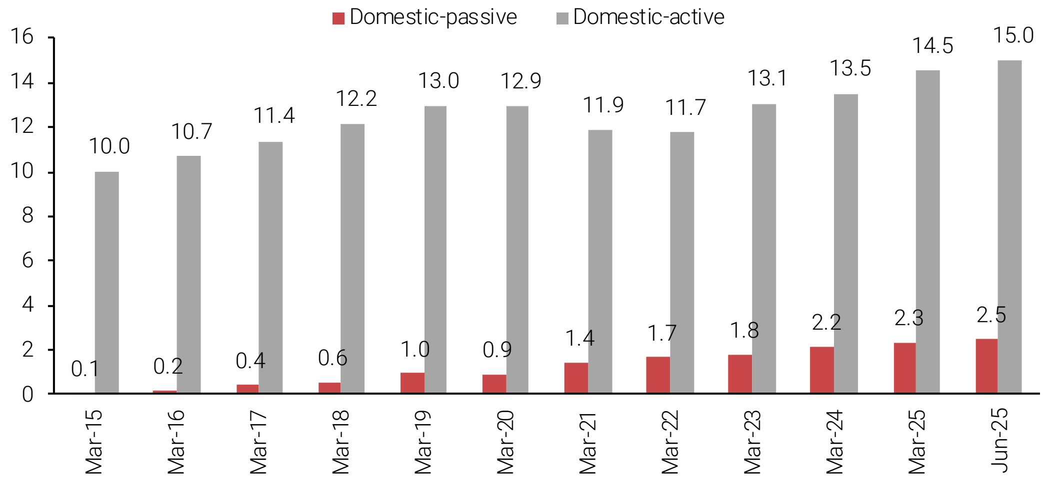
Exhibit 2: Share of foreign active and passive funds in the BSE-200 Index (%)



Source: EPFR, Prime Database, Kotak Institutional Equities

Share of passive domestic mutual funds has increased steadily over the past few years

Exhibit 3: Share of domestic active and passive funds in the BSE-200 Index (%)



Source: EPFR, Prime Database, Kotak Institutional Equities

It is obvious that the very nature of passive funds precludes them from any active role in allocation or pricing of capital, the twin objectives of capital markets.

- **Allocation of capital.** Passive funds or the unitholders of passive funds do not play an active role as shareholders of the underlying companies (stocks) in the passive fund. Passive funds can vote on resolutions of companies as shareholders but do not play the role of active shareholders for all practical purposes. They are unlikely to engage with companies actively on any major issue (capital allocation, governance, strategy) given the mandate and the nature of the passive funds. The unitholders of passive funds cannot play any role as shareholders of firms anyway since they are not even shareholders of the underlying firms in their passive funds.

An easy way to appreciate the problem of allocation of capital with passive funds would be think of extreme scenarios where (1) a company is entirely or largely owned by a majority shareholder and passive funds only or (2) a company is entirely or largely owned by passive funds. Such companies could indulge in poor governance including misallocation of capital given lack of any checks and balances from minority shareholders. Such companies may also struggle to raise new capital from the market even if they were practicing good governance. These are not inconceivable scenarios since we already have some companies in India in the former category and these scenarios could play out if the relentless march of the passive industry was to continue.

- **Pricing of capital.** Passive funds or the unitholders of passive funds may distort the price of equities during periods of extreme market sentiment (euphoria or depression) in the market. Retail shareholders may exaggerate the movement in stocks through purchase or sale of units of passive funds irrespective of prices and valuations of underlying stocks, as they are more likely to be swayed by the prevailing market sentiment.

  A passive fund does not decide on the stocks and quantity of stocks to buy or sell beyond the stocks in the fund and their weights in the fund linked to some index. We note that investment in underlying stocks in a passive fund is simply based on a formula (weight of the stock in the passive fund based on free-float market capitalization usually). A passive fund has to buy or sell stocks in the secondary market, as and when investors allocate more money to or withdraw money from the passive fund.

  A unitholder of a passive fund also does not decide on underlying stocks to buy, hold or sell. The unitholder is simply taking a top-down view that the unitholder will make an acceptable rate of return (expected rate of return) over a certain period of time when an investor is staying invested or investing in a passive fund or will not make an acceptable return over a period of time when an investor is selling from a passive fund. Such investment decisions to buy or sell units of a passive fund have very little to do with the underlying fundamentals and valuations of the stocks in the fund.

The perils to the active domestic industry

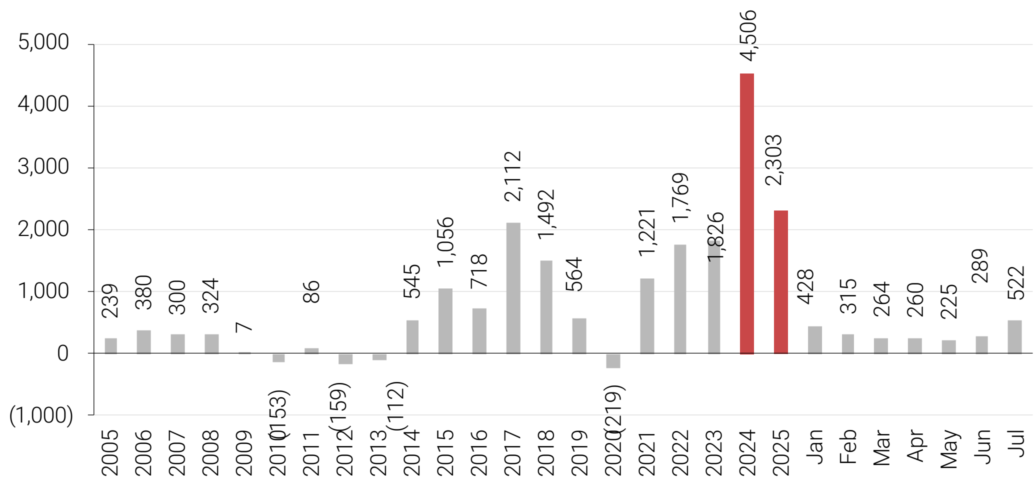
We note threats to the active domestic fund management industry from a rapid uptake of passive funds in the future, especially if the industry was to continue in its present quasi-active mode.

- **Active but passive investment style.** In our view, parts of the Indian active fund management industry may be starting to resemble passive funds given the structure of the market and design of the domestic fund management industry. The compulsory investment or divestment linked to retail sentiment blurs the difference between active and passive fund management with (1) timing of investment, a crucial element of investing, being removed from the equation and (2) sector and stock selection, the other key element of investing, being constrained by other factors of benchmarks (relative performance to benchmark), caps, competition (relative performance versus other competing schemes in the same category), etc.

  - **Price-agnostic investment behavior of retail investors.** We note that large investments or divestments by retail investors into and from domestic equity mutual funds reduce the flexibility of the active funds to deploy the funds according to their views on fundamentals and valuations of the market and stocks. The Indian market has seen continued large investments by retail investors in the past few years (see Exhibit 4) although the reverse phenomenon of large divestments has also been seen periodically during periods of panic due to domestic or global crises, which result in sharp and sudden loss of confidence in equities among retail investors.

MFs have seen equity inflows of Rs2.3 tn so far in CY2025

Exhibit 4: Net MF flows (Equity + 70% hybrid), calendar year-ends, 2005-25 (Rs bn)



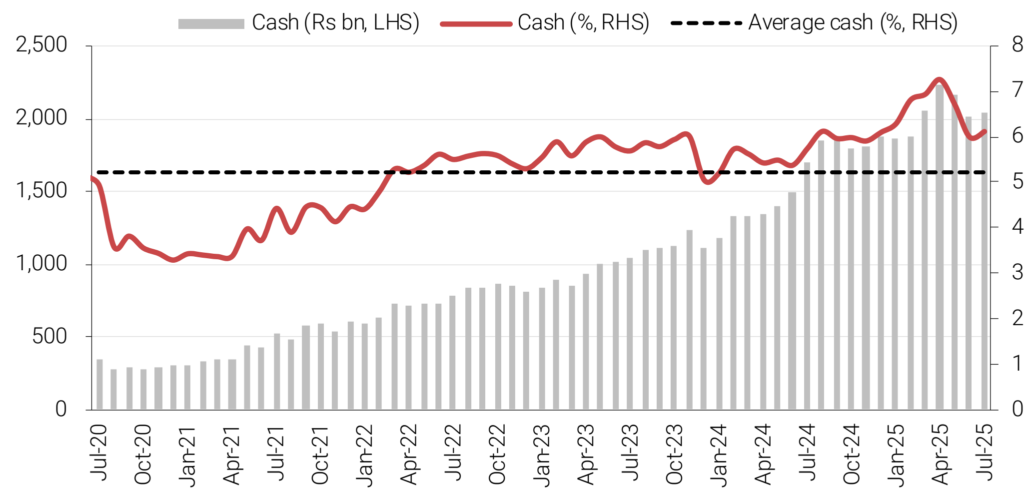
Source: AMFI, Kotak Institutional Equities

For all practical purposes, retail investors are dictating the timing of the investment in the market and not the active funds given the general mandate of funds to be broadly invested at all points in time. To be fair, the steady investment behavior of retail investors also suggests that they are investing for the long term, which is reassuring. Nonetheless, we believe investment returns can improve with additional flexibility to the funds on the timing of investment in the market, akin to the investment strategy of balanced funds.

- **Forced investment or divestment by institutional investors.** We highlight that most active domestic funds do not take 'cash' calls given the mandate of the funds, which leaves the decision of timing of investment to retail investors, as discussed above. This could be creating situations where an active fund is acting largely on the inflows into and outflows from the fund rather than on its own views on the fundamentals or valuations of the market and stocks. Exhibit 5 shows the cash position of the overall asset management industry (equity mutual funds only) over time. As can be seen, the proportion of cash of overall funds has remained broadly stable over time.

Cash position of mutual funds has remained broadly stable

Exhibit 5: Cash position of equity mutual funds, March fiscal year-ends, 2021-26



Source: Ace MF, Kotak Institutional Equities

- **Stock prices.** In our view, the quasi-passive nature of flows into and out of active equity funds may be creating distortions in stock prices. As discussed above, funds have little option but to act on the flows (inflows or outflows) of retail investors. This is particularly true in the current market environment and in the past few years where (1) retail investors have been investing aggressively in the stock market through equity mutual funds and (2) institutional investors have had to deploy the funds in the market irrespective of price (valuation) levels.

  The fact that retail investors have been pursuing price-agnostic investment in the market in general and SMID stocks and thematic funds in particular over the past 3-4 years (see Exhibit 6) would suggest that retail investors expect to (1) make 'high' returns on their investments at all price points and (2) make higher returns in SMID stocks and thematic stocks at all price points. Both these assumptions are obviously invalid but more pertinently, this may or may not be in sync with the view of the fund. We would note that valuations are/have been on the higher side for the broad market and for stocks in general (see Exhibits 7-16) relative to history.

Retail investors are pouring money into mid/small-cap. and thematic funds in India

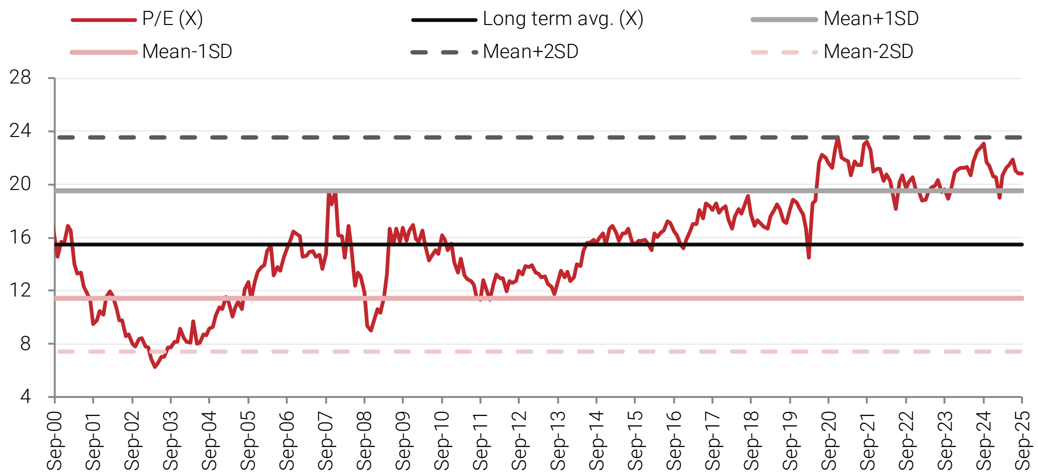
Exhibit 6: Net inflows to various categories of domestic mutual funds in India, calendar year-ends, 2020-25 (Rs bn)

	2020	2021	2022	2023	2024	Jan-25	Feb-25	Mar-25	Apr-25	May-25	Jun-25	Jul-25	2025
Flexi cap. fund	—	179	220	116	410	57	51	56	55	38	57	77	392
Large cap. fund	(24)	29	137	(30)	194	31	29	25	27	13	17	21	162
Large & mid Cap. fund	18	87	200	189	395	41	27	27	26	27	35	50	233
Mid cap. fund	5	106	205	229	343	51	34	34	33	28	38	52	271
Small cap. fund	14	38	198	410	342	57	37	41	40	32	40	65	313
Sectoral/thematic fund	83	255	209	308	1,557	90	57	2	20	21	5	94	289
Value/contra/focused	(3)	60	184	92	218	23	26	29	20	9	21	31	159
Dividend yield/ELSS/multi cap. fund	(3)	213	258	300	483	46	32	36	22	23	23	37	219
Total	**91**	**967**	**1,610**	**1,616**	**3,943**	**397**	**293**	**251**	**243**	**190**	**236**	**427**	**2,036**

Source: AMFI, Kotak Institutional Equities

Nifty-50 index trading at high multiples

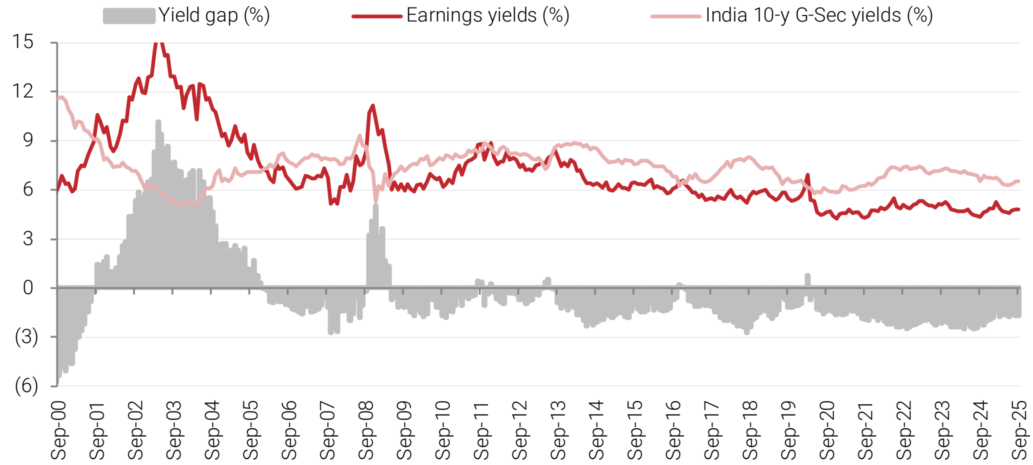
Exhibit 7: 12-m rolling forward PE of Nifty-50 Index, March fiscal year-ends, 2001-26 (X)



Source: Companies, Kotak Institutional Equities estimates

Yield gap (earnings yield less bond yield) has come off in recent months with the decline in bond yields

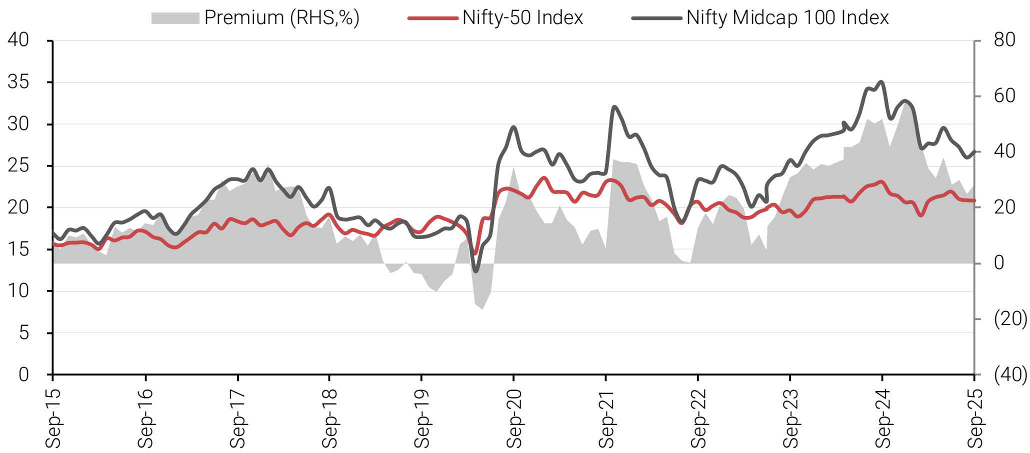
Exhibit 8: Nifty earnings yield (1-year forward estimated earnings) and bond yield, March fiscal year-ends, 2000-26 (%)



Source: CEIC, Kotak Institutional Equities estimates

Mid-cap. index is trading at a large premium to large-cap. index, despite recent derating

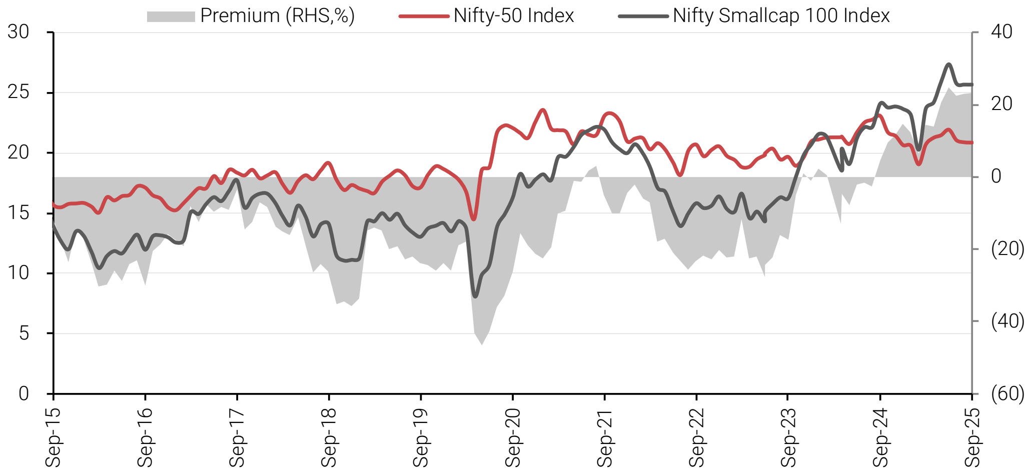
Exhibit 9: 1-year forward P/E multiple of Nifty-50 Index and Nifty Midcap 100 Index, March fiscal year-ends, 2015-26 (X)



Source: Bloomberg, Kotak Institutional Equities

Small-cap. index is trading at a large premium to large-cap. index

Exhibit 10: 1-year forward P/E multiple of Nifty-50 Index and Nifty Smallcap 100 Index, March fiscal year-ends, 2015-26 (X)



Source: Bloomberg, Kotak Institutional Equities

Most large-cap. consumption stocks are trading at expensive valuations

Exhibit 11: 12-m forward P/E multiple of large-cap. consumption stocks in KIE universe, March fiscal year-ends, 2011-27E

		12-m forward P/E multiple (X)															
Company	Sector	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22	Mar-23	Mar-24	Mar-25	Current
Bajaj Auto	Automobiles & Components	14	14	14	16	15	16	18	17	17	12	19	18	17	30	22	26
Eicher Motors	Automobiles & Components	15	14	16	24	38	33	33	29	21	17	29	25	23	25	29	33
Hero Motocorp	Automobiles & Components	14	15	14	16	16	17	17	18	13	10	16	14	13	20	15	21
Mahindra & Mahindra	Automobiles & Components	14	14	14	15	19	18	20	19	15	9	20	18	16	21	23	28
Maruti Suzuki	Automobiles & Components	14	16	13	17	21	18	22	26	23	18	28	30	23	28	22	28
Samvardhana Motherson	Automobiles & Components	17	13	14	19	28	21	25	25	19	11	25	22	15	20	20	23
TVS Motor	Automobiles & Components	11	7	7	15	22	23	28	30	23	19	32	24	27	40	35	45
Asian Paints	Commodity Chemicals	23	27	33	36	38	38	45	44	51	48	64	65	54	48	49	55
Berger Paints	Commodity Chemicals	17	17	25	27	36	35	45	44	49	58	81	61	49	52	47	47
Ambuja Cements	Construction Materials	18	18	14	24	23	29	34	29	26	16	25	20	26	38	31	33
Shree Cement	Construction Materials	NA	NA	14	22	46	34	36	31	37	34	44	32	41	34	57	49
UltraTech Cement	Construction Materials	18	18	16	24	23	28	34	31	32	20	32	26	30	31	37	36
Havells India	Consumer Durables & Apparel	13	16	16	20	31	32	42	36	46	32	56	49	49	59	52	54
Polycab	Consumer Durables & Apparel	NA	NA	NA	NA	NA	NA	NA	NA	NA	13	22	31	30	39	33	40
Britannia Industries	Consumer Staples	21	28	24	23	39	33	39	49	53	41	45	41	47	49	50	56
Colgate-Palmolive (India)	Consumer Staples	24	30	28	32	40	32	40	38	40	37	41	38	36	52	42	45
Dabur India	Consumer Staples	23	24	26	29	35	30	33	36	40	43	48	44	44	41	43	48
Godrej Consumer Products	Consumer Staples	20	22	30	31	31	35	37	43	38	29	39	36	45	52	49	51
Hindustan Unilever	Consumer Staples	26	29	28	33	40	39	41	47	50	56	58	47	52	46	47	55
Marico	Consumer Staples	24	26	27	25	35	37	41	42	39	31	40	43	40	39	46	49
Nestle India	Consumer Staples	35	37	34	35	44	41	47	50	51	63	65	62	63	72	62	67
Tata Consumer Products	Consumer Staples	14	18	17	18	19	16	18	26	23	31	50	53	46	61	56	58
Varun Beverages	Consumer Staples	NA	NA	NA	NA	NA	NA	32	36	42	28	36	39	45	67	52	47
United Spirits	Consumer Staples	22	16	37	59	90	57	53	58	43	33	41	53	48	57	58	53
Apollo Hospitals	Health Care Services	25	29	30	31	43	41	40	41	43	33	59	54	50	61	49	53
Avenue Supermarts	Retailing	NA	NA	NA	NA	NA	NA	54	77	73	78	90	100	71	86	75	90
Titan Company	Retailing	30	28	25	28	33	31	41	56	54	44	68	75	57	74	56	64
Trent	Retailing	NA	45	43	36	40	27	44	56	53	59	169	112	79	109	88	87
Pidilite Industries	Specialty Chemicals	21	22	27	26	42	34	37	43	54	49	64	74	62	69	60	61

Source: Companies, FactSet, Kotak Institutional Equities

Most mid-cap. consumption stocks are trading at expensive valuations

Exhibit 12: 12-m forward P/E multiple of mid-cap. consumption stocks in KIE universe, March fiscal year-ends, 2011-27E

		12-m forward P/E multiple (X)															
Company	Sector	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22	Mar-23	Mar-24	Mar-25	Current
Balkrishna Industries	Automobiles & Components	6	8	7	9	11	11	17	21	20	15	26	24	24	27	25	24
Exide Industries	Automobiles & Components	17	19	17	19	21	18	24	22	20	12	17	13	14	20	24	25
Schaeffler India	Automobiles & Components	11	14	12	17	31	27	31	29	30	25	35	37	42	41	45	46
SKF	Automobiles & Components	15	15	14	19	28	26	28	26	27	18	30	35	32	33	31	36
Timken	Automobiles & Components	NA	NA	NA	NA	40	24	31	34	29	23	39	44	41	49	42	42
Indigo Paints	Commodity Chemicals	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	93	47	32	33	28	34
Kansai Nerolac	Commodity Chemicals	20	19	26	24	31	36	38	43	41	32	47	37	30	27	26	27
Crompton Greaves Consumer	Consumer Durables & Apparel	NA	NA	NA	NA	NA	NA	39	36	31	24	40	33	29	29	33	32
Page Industries	Consumer Durables & Apparel	24	26	26	36	58	46	48	59	54	40	64	72	53	51	58	58
Voltas	Consumer Durables & Apparel	14	13	9	20	24	23	28	31	32	23	44	51	41	49	45	49
Whirlpool	Consumer Durables & Apparel	NA	15	14	21	34	28	41	43	38	35	46	42	44	45	29	33
United Breweries	Consumer Staples	47	54	58	68	63	51	51	51	52	35	51	55	56	64	67	66
Aster DM Healthcare	Health Care Services	NA	NA	NA	NA	NA	NA	NA	NA	22	10	16	16	17	31	54	62
Dr Lal Pathlabs	Health Care Services	NA	NA	NA	NA	NA	53	39	35	36	38	67	57	44	45	41	50
Max Healthcare	Health Care Services	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	35	34	34	51	58	56
Metropolis Healthcare	Health Care Services	NA	NA	NA	NA	NA	NA	NA	NA	NA	33	50	41	34	49	38	50
Narayana Hrudayalaya	Health Care Services	NA	NA	NA	NA	NA	136	47	44	37	34	39	39	26	31	38	36
Chalet Hotels	Hotels & Restaurants	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	146	29	45	37	37
Devyani International	Hotels & Restaurants	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	89	53	86	104	200
Indian Hotels	Hotels & Restaurants	26	23	39	48	66	67	47	51	54	28	100	70	40	51	53	49
Jubilant Foodworks	Hotels & Restaurants	36	48	41	40	54	52	54	58	48	45	75	58	51	69	102	97
Lemon Tree Hotels	Hotels & Restaurants	NA	NA	NA	NA	NA	NA	NA	NA	64	33	NA	173	39	36	36	43
Sapphire Foods	Hotels & Restaurants	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	106	54	88	103	152
Westlife Foodworld	Hotels & Restaurants	NA	NA	NA	119	264	139	120	107	69	49	113	94	67	91	135	152

Source: Companies, FactSet, Kotak Institutional Equities

Most investment stocks are trading at expensive valuations

Exhibit 13: 12-m forward P/E multiple of investment stocks in KIE universe, March fiscal year-ends, 2011-27E

		12-m forward P/E multiple (X)															
Company	Sector	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22	Mar-23	Mar-24	Mar-25	Current
ABB	Capital Goods	41	48	32	60	67	60	51	43	53	42	64	69	73	87	56	55
Bharat Electronics	Capital Goods	14	12	10	11	22	20	21	18	13	10	15	19	21	35	39	42
BHEL	Capital Goods	15	10	8	16	21	27	26	20	17	7	28	28	28	78	34	31
Carborundum Universal	Capital Goods	13	13	13	17	21	18	23	24	25	13	30	32	37	42	37	42
Cochin Shipyard	Capital Goods	NA	NA	NA	NA	NA	NA	NA	16	11	5	NA	6	14	37	44	48
Cummins India	Capital Goods	18	21	18	25	29	26	28	23	24	13	35	32	36	50	39	46
IRB Infrastructure	Capital Goods	13	12	7	7	13	12	11	8	6	4	8	26	17	32	19	24
Kalpataru Projects	Capital Goods	9	8	6	7	15	15	16	19	16	5	10	10	12	20	17	20
KEC International	Capital Goods	8	8	7	9	13	12	15	19	13	7	15	13	18	23	20	20
L&T	Capital Goods	21	16	15	22	28	21	23	23	19	11	19	21	22	31	26	25
Siemens	Capital Goods	28	28	29	53	75	50	50	37	37	30	52	52	59	76	58	58
Thermax	Capital Goods	16	15	18	24	33	28	36	35	27	23	43	48	43	65	49	44
Amber Enterprises	Electronic Manufacturing Services	NA	NA	NA	NA	NA	NA	NA	31	19	19	51	43	29	48	62	56
Avalon Technologies	Electronic Manufacturing Services	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	36	50	48
Cyient DLM	Electronic Manufacturing Services	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	49	32	30
Dixon Technologies	Electronic Manufacturing Services	NA	NA	NA	NA	NA	NA	NA	37	27	25	64	63	40	70	64	80
Kaynes Technology	Electronic Manufacturing Services	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	75	73	79
Syrma SGS Technology	Electronic Manufacturing Services	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	25	42	36	53

Source: Companies, FactSet, Kotak Institutional Equities

Most outsourcing stocks are trading at higher multiples, compared to their pre-Covid levels

Exhibit 14: 12-m forward P/E multiple of outsourcing stocks in KIE universe, March fiscal year-ends, 2011-27E

		12-m forward P/E multiple (X)															
Company	Sector	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22	Mar-23	Mar-24	Mar-25	Current
Coforge	IT Services	6	7	7	9	9	10	9	15	16	13	29	32	22	30	39	36
Cyient	IT Services	10	8	8	11	14	12	12	17	14	5	16	18	16	25	17	18
HCL Technologies	IT Services	16	13	14	15	18	13	14	14	14	10	18	21	18	24	23	21
Infosys	IT Services	22	17	16	15	19	18	15	16	18	15	26	30	21	23	22	21
KPIT Technologies	IT Services	NA	NA	NA	NA	NA	NA	NA	NA	NA	4	20	48	52	53	39	37
LTIMindtree	IT Services	NA	NA	NA	NA	NA	NA	12	18	17	15	32	38	27	27	25	28
L&T Technology Services	IT Services	NA	NA	NA	NA	NA	NA	16	23	21	14	31	46	28	38	31	30
Mphasis	IT Services	10	11	10	11	11	13	14	17	15	10	23	36	18	25	25	27
Persistent Systems	IT Services	11	8	10	13	17	18	13	14	12	11	27	42	29	43	49	43
Tata Elxsi	IT Services	NA	NA	10	21	30	28	22	23	18	14	39	88	44	51	35	43
Tata Technologies	IT Services	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	50	35	35
TCS	IT Services	23	18	20	19	20	18	17	19	22	20	30	31	24	28	24	21
Tech Mahindra	IT Services	11	10	11	13	15	13	12	16	14	11	16	21	16	23	23	23
Wipro	IT Services	18	15	14	15	16	14	14	15	15	11	20	24	15	21	20	19
Aurobindo Pharma	Pharmaceuticals	9	7	7	12	18	17	14	12	15	8	15	12	12	17	15	15
Cipla	Pharmaceuticals	21	18	18	19	30	20	24	20	22	18	24	25	20	27	23	25
Divis Laboratories	Pharmaceuticals	20	17	17	19	23	20	16	25	28	31	39	40	36	44	57	57
Dr Reddy's Laboratories	Pharmaceuticals	19	18	17	18	23	20	21	19	21	21	24	21	18	19	16	21
Emcure Pharmaceuticals	Pharmaceuticals	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	23	25
JB Chemicals & Pharma	Pharmaceuticals	NA	NA	NA	8	11	13	15	NA	13	13	22	24	28	36	31	31
Lupin	Pharmaceuticals	18	20	20	20	31	20	20	19	21	21	27	22	24	32	23	21
Mankind Pharma	Pharmaceuticals	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	41	43	45
Sun Pharmaceuticals	Pharmaceuticals	22	23	23	20	29	24	21	25	23	17	23	26	24	35	31	31
Torrent Pharmaceuticals	Pharmaceuticals	14	13	12	15	22	17	21	22	30	29	30	32	33	43	43	46
SRF	Specialty Chemicals	3	3	5	7	14	14	15	16	18	16	24	38	29	37	48	40

Source: Companies, FactSet, Kotak Institutional Equities

Tier-1 banks are fairly valued; a few tier-2 and tier-3 banks are trading at attractive valuations

Exhibit 15: 12 m forward P/B multiple of banks in KIE universe, March fiscal year-ends, 2011-27E

		12-m forward P/B multiple (X)															
Company	Sector	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22	Mar-23	Mar-24	Mar-25	Current
AU Small Finance Bank	Banks	NA	NA	NA	NA	NA	NA	NA	7.0	4.6	3.0	5.9	4.6	3.1	2.6	2.1	2.5
Axis Bank	Banks	2.6	1.8	1.7	1.6	2.6	1.8	2.1	1.9	2.7	1.1	1.9	1.9	1.8	1.9	1.7	1.5
Bandhan Bank	Banks	NA	NA	NA	NA	NA	NA	NA	5.2	4.9	1.7	2.7	2.6	1.4	1.2	0.9	0.9
Bank of Baroda	Banks	1.7	1.1	0.8	0.9	0.9	1.0	1.2	0.9	0.9	0.4	0.5	0.7	0.8	1.1	0.9	0.8
Canara Bank	Banks	1.3	0.9	0.7	0.5	0.6	0.5	0.9	0.9	1.3	0.2	0.6	0.6	0.7	1.2	0.8	0.9
City Union Bank	Banks	1.5	1.4	1.4	1.3	2.0	1.7	2.3	2.6	2.8	1.6	1.9	1.4	1.2	1.1	1.2	1.3
DCB Bank	Banks	1.3	1.3	1.0	1.2	1.9	1.2	2.2	1.8	2.0	0.8	0.9	0.6	0.7	0.7	0.6	0.7
Equitas Small Finance Bank	Banks	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	1.8	1.4	1.5	1.6	0.9	1.0
Federal Bank	Banks	1.3	1.2	1.2	1.1	1.3	0.9	1.7	1.4	1.4	0.5	NA	NA	NA	1.1	1.3	1.2
HDFC Bank	Banks	3.8	3.5	3.5	3.5	3.6	3.2	3.8	3.8	3.8	2.5	3.6	3.0	2.8	2.2	2.6	2.5
ICICI Bank	Banks	2.2	1.6	1.7	1.8	2.1	1.5	1.8	1.7	2.3	1.7	2.5	2.7	2.7	2.9	3.0	2.9
Indusind Bank	Banks	2.8	2.8	2.5	2.6	3.8	2.9	3.7	4.0	3.4	0.6	1.6	1.4	1.3	1.7	0.7	0.9
Karur Vysya Bank	Banks	1.7	1.3	1.4	1.1	1.5	1.1	1.4	1.3	1.0	0.3	0.7	0.5	0.9	1.3	1.3	1.4
Punjab National Bank	Banks	1.6	1.1	0.7	0.8	0.7	0.6	1.0	0.6	1.0	0.4	0.5	0.4	0.6	1.3	0.8	0.8
State Bank of India	Banks	1.9	1.7	1.4	1.3	1.6	1.2	1.5	1.2	1.4	0.8	1.3	1.5	1.3	1.7	1.5	1.4
Ujjivan Small Finance Bank	Banks	NA	NA	NA	NA	NA	NA	NA	NA	NA	1.4	1.6	0.9	1.0	1.4	1.0	1.2
Union Bank	Banks	1.4	0.9	0.8	0.5	0.6	0.6	0.7	0.5	0.6	0.3	0.5	0.4	0.6	1.1	0.8	0.8

Source: Companies, FactSet, Kotak Institutional Equities

NBFCs are trading at fair-to-full valuations

Exhibit 16: 12-m forward P/B multiple of financial stocks in KIE universe, March fiscal year-ends, 2011-27E

Company	Sector	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Mar-19	Mar-20	Mar-21	Mar-22	Mar-23	Mar-24	Mar-25	Current
12-m forward P/B multiple (X)																	
Aavas Financiers	Diversified Financials	NA	NA	NA	NA	NA	NA	NA	NA	4.7	3.9	7.0	6.4	3.4	2.4	3.3	2.3
Aadhar Housing Finance	Diversified Financials	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	2.5	2.7
Aptus Value Housing Finance	Diversified Financials	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	5.2	3.1	3.6	3.0	3.1
Bajaj Finance	Diversified Financials	1.6	1.4	1.5	1.9	3.5	4.2	5.7	5.3	7.3	3.4	7.1	8.4	5.2	5.0	5.0	4.8
Cholamandalam	Diversified Financials	1.6	1.6	1.8	1.6	2.6	2.8	3.2	3.8	3.2	1.3	4.1	4.5	3.9	4.3	4.5	4.0
Home First Finance	Diversified Financials	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	2.7	3.9	3.2	3.3	3.0	2.9
L&T Finance	Diversified Financials	NA	1.6	2.1	1.8	1.4	1.5	2.6	2.8	2.0	0.6	1.2	0.9	0.9	1.6	1.4	2.0
LIC Housing Finance	Diversified Financials	2.2	2.1	1.5	1.4	2.3	2.3	2.5	1.9	1.6	0.6	1.0	0.8	0.7	1.0	0.8	0.7
Mahindra & Mahindra Financial	Diversified Financials	2.7	2.0	2.2	2.5	2.3	2.2	2.7	3.1	2.3	0.8	1.6	1.2	1.6	1.7	1.6	1.5
Muthoot Finance	Diversified Financials	NA	1.1	1.3	1.4	1.5	1.2	2.1	1.9	2.4	1.7	2.7	2.5	1.6	2.1	2.9	3.1
Shriram Finance	Diversified Financials	3.0	1.9	1.8	1.8	2.4	2.0	2.0	2.3	1.7	0.7	1.6	1.1	1.0	1.6	2.0	1.7
12-m forward P/E multiple (X)																	
360 One	Capital Markets	NA	NA	NA	NA	NA	NA	NA	NA	NA	22.5	26.4	23	20	27	31	31
ABSL AMC	Capital Markets	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	22	13	18	19	21
CAMS	Capital Markets	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	37.4	34	29	35	36	36
CRISIL	Capital Markets	19.8	27.4	22.3	30.6	40.9	37.3	33.3	36.2	25.4	21.8	33.6	45	40	50	38	43
HDFC AMC	Capital Markets	NA	NA	NA	NA	NA	NA	NA	NA	34.0	30.9	40.6	29	23	38	31	39
ICRA	Capital Markets	16.1	18.0	15.8	24.1	41.1	39.2	44.9	33.7	22.4	19.9	35.5	32	27	31	27	29
Kfin Technologies	Capital Markets	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	25	36	44	44
Nippon AMC	Capital Markets	NA	NA	NA	NA	NA	NA	NA	24.7	24.3	24.1	33.8	26	17	27	25	33
UTI AMC	Capital Markets	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	18.9	20	14	15	16	19

Source: Companies, FactSet, Kotak Institutional Equities

- **Herd mentality and groupthink.** In our view, the nature of the fund management industry may be resulting in a fair degree of herd mentality among funds. A number of 'innovations' in the asset management industry were probably devised with good intentions to act as guides and/or guardrails for the industry but most have lived their utility given the disruption from the passive industry. If anything, these guardrails are making the active fund management industry mimic the passive management industry.

  - **Benchmarks.** We believe that the prolific use of benchmarks creates anchoring effect (anchoring bias) in the minds of investors in terms of stocks and weights. In the best-case scenario, the stocks and weights in a benchmark act as a starting template for portfolio construction. In the worst-case scenario, the benchmark can result in indexation and passive investment. Most funds would probably be somewhere in between but the fact remains that benchmarks reduce risk-taking and increase conformation (herd mentality) among investors.

  - **Caps.** We believe that the breakdown of stocks into caps and the related restriction on stocks based on market capitalization in funds may reduce the flexibility of the funds to deliver optimal performance for retail investors. Active funds are bound by market caps of companies and restricted to a certain set of companies based on the market capitalization mandate of the fund. We see herd mentality a natural corollary of such a restriction, especially as all funds in a category will only have a certain limited number of stocks as their investible universe.

    This phenomenon is most acutely seen in the case of large-cap. stocks as defined as the top-100 stocks by market capitalization and mid-cap. stocks as defined as the next 150 stocks by market capitalization in India. In our view, it may be better to have a cut-off linked to market capitalization rather than go by the number of stocks in a market capitalization category. As can be seen in Exhibit 17, the market caps of stocks in the large-cap. and mid-cap. stocks have increased dramatically over the past few years while the definition has artificially constrained the number of stocks to 100 and 150 in the large-cap. and mid-cap. categories. The 101st stock by market capitalization in India has a market capitalization of US\$11 bn and the 250th stock has a market capitalization of US\$3.6 bn, which compares with US\$6.1 bn and US\$1.9 bn at the end of CY2022.

Market caps of mid-cap. and small-cap. stocks have increased dramatically

Exhibit 17: Market cap. of stocks in the large-cap. and mid-cap. at AMFI cut-offs (Rs bn)

Market cap. (Rs bn)	Dec-22	Dec-23	Dec-24	Jun-25
Large-cap. (100th stock)	489	670	1,001	916
Mid-cap. (250th stock)	168	220	332	308

Source: AMFI, Kotak Institutional Equities

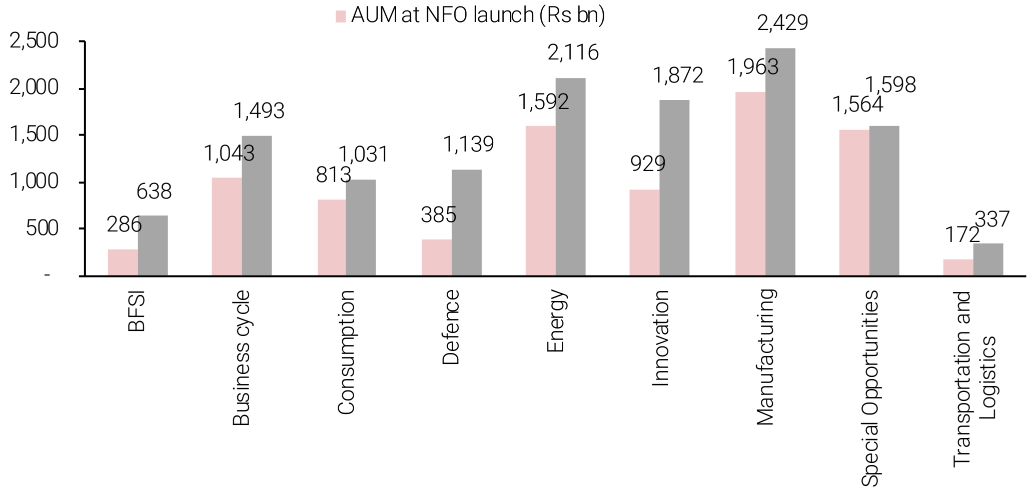
- **Sectors and themes.** In our view, the division of funds by sectors and themes may be further reducing the opportunity set for retail investors and more pertinently, (1) inflating the prices (valuations) of stocks above the fair value levels (fair valuations) during periods of extreme optimism around a sector or a theme or (2) deflating the prices of stocks (valuations) of stocks below the fair value levels during periods of extreme pessimism around a sector or a theme.

  We note that (1) the extreme price movements in stocks linked to a sector or a theme and (2) the compulsions of relative performance (to benchmark or peers) may also be resulting in the investment community starting to believe in or disregard a theme based on the price movements of stocks linked to the sector or theme rather than fundamentals of the sector and stocks. This not only results in herd mentality but also, leads to endowment effect among investors (once they have bought into a theme).

  We have seen this in the case of several sectors based on narratives in those sectors in 2023-24. The sectors and thematic funds saw large inflows, which created pockets of over-valuation in those sectors given the limited number of stocks in the sectors or stocks relevant for the theme. The stocks gave up a large portion of the gains once the narratives fizzled out, as they inevitably did in many sectors. Exhibit 18 shows the AUM of certain specific sectors and themes over 2023-25 and we cover the performance of such sectoral and thematic funds in the last section of the report. There is clear evidence of circularity between flows and performance. We note that most narratives have not played out according to market expectations. In fact, the outcome of most narratives has been quite different from market expectations (see Exhibit 19), which would imply that retail investors may have been saddled with 'narrative' stocks at high valuations.

Select thematic funds saw large inflows over 2023-25

Exhibit 18: Launch and July 2025 AUM comparison of certain select sectoral and thematic active and passive funds launched since January 2023 (Rs bn)



Source: Ace MF, Kotak Institutional Equities

Easy come, easy go!

Exhibit 19: List of major narratives that dominated Indian equity markets in the past few quarters

Sector	Narrative	Period of narrative	Comment/outcome
Government reforms			
Public sector	Privatization	2024	No progress despite a lot of hope before and after 2024 general elections
Public sector	Market prices of retail automobile fuels	Periodic	No progress
General elections			
Economy	100-day agenda	2024	No announcement after general elections
Judiciary	Judicial reforms	2024	Limited progress
Investment/Manufacturing/China + 1			
Manufacturing	Shift in manufacturing to India due to China	2021-25	EMS is the only noteworthy success; limited progress in autos, capital goods, chemicals, etc. so far
Manufacturing	Exports hub for listed MNCs	2021-25	Limited progress
Economy	India to relatively benefit from US reciprocal tariffs and will get favorable trade deal	Apr-25	Reciprocal import tariffs at 25% for Indian exports to the US are higher than those of competing countries
Economy	Private sector capex to recover	2021-25	Private sector GFCF/GDP broadly flat over the past few years (around 11% over FY2020-24)
Market			
Markets	Earnings recovery	2024-25	Steady cut in EPS for the past 5-6 quarters
Sectors			
Automobiles	Automobiles-electrification	2021-25	Pace of electrification has been weak
Capital goods	Elevated EBITDA margins of capital goods to sustain	2024-25	Profitability peaked in FY2024; margins down significantly since then
Capital goods-defence	Strong order inflow, indigenization in defense sector	2023-25	Steady progress in indigenization; disappointment in IAC-2 order
Construction materials	Cement companies will see improved profitability from consolidation	Ongoing	Companies have struggled to maintain profitability
Commodity chemicals	Competition unlikely to disrupt the moat of paints companies	2022-25	Loss of market share, deterioration in margins of incumbents
Consumer durables	Sharp increase in durables demand due to hot summer	2025	Summer saw weak demand due to unseasonal rains; broad volume weakness
Consumer staples	Green-shoots of recovery in demand for consumer staples	2023-25	Continued disappointment, despite positive commentary by select companies after every quarter
Electric utilities	Electricity deficit on strong electricity demand	2023-25	3% increase in electricity demand in FY2025 (5.4% CAGR over FY2023-25); 1% yoy increase in 1QFY26
IT services	IT sector demand recovery	2024-25	Demand slowdown has continued for the 4-5 quarters
QSR	QSR to see strong growth with no impact from food delivery	2023-current	SSSG has been quite weak
Telecom	Relief on AGR dues	2024	No progress despite periodic excitement/expectation in market

Source: Media reports, Kotak Institutional Equities

We also note that many of the ‘narrative’ stocks are now significantly owned by passive funds (see Exhibit 20), which would suggest that sectoral or thematic passive funds that got launched later bought the stocks from the market to simply comply with the higher weight of such stocks in the benchmarks and not on the basis of the fundamentals of the companies. In other words, active funds divested the shares to passive funds.

Several 'narrative' stocks have high passive holding

Exhibit 20: Active and passive MF holdings in 'narrative' stocks, June 2025 (%)

Company	Active	Passive
Bharat Dynamics	3.9	0.9
BHEL	7.2	0.2
Cochin Shipyard	1.7	0.8
Fertilizers & Chemicals Travancore	—	0.0
Garden Reach Shipbuilders & Engineers	0.7	0.7
Hindustan Aeronautics	3.6	0.8
Hindustan Copper	2.2	0.2
HUDCO	2.0	0.1
IRFC	0.0	0.2
Ircon International	—	0.2
IREDA	0.4	0.1
ITI	—	0.0
KIOCL	—	0.0
Mazagon Dock	0.7	0.8
NBCC	5.1	0.3
NHPC	3.8	0.2
NLC India	9.8	0.1
Rail Vikas Nigam	0.0	0.2
Railtel	0.1	0.2
SJVN	1.3	0.1

Source: Ace MF, ACE Equity, Kotak Institutional Equities

A holistic asset management approach versus segmented mandates

We believe the investment objectives of households can be better served by the asset management industry (1) adopting a more holistic approach to the management of household financial assets and savings versus the current narrow approach of managing debt and equity separately and (2) encouraging the growth of flexi/multi-cap. funds and balanced/hybrid (both bonds and equities) versus narrow sector and thematic funds.

- **Asset allocation with asset managers and not with households.** In our view, a more holistic asset management framework would better serve the primary requirement of the customers (households) of the asset management industry—earn decent risk-adjusted returns over time. In the current investment framework, households are primarily responsible for allocation of financial savings/assets and they decide on the proportion of financial savings/assets to be allocated to debt or equity. This asset allocation may be beyond the financial capabilities of most households and may be resulting in sub-optimal financial outcomes for households.

- **Asset management over equity management.** In our view, a more integrated investment approach to all assets from the domestic asset management industry would help meet the primary objective of the asset management industry—provide decent risk-adjusted returns to households on the entire assets of households rather than on equity alone. This would also result in secondary benefits of (1) more active management of assets by asset managers through more active calls on both macro (interest rates, valuations) and micro (sector, company) factors and (2) more realistic pricing of assets, one of the two primary objectives of capital markets.

2

Rapid increase in passive investing

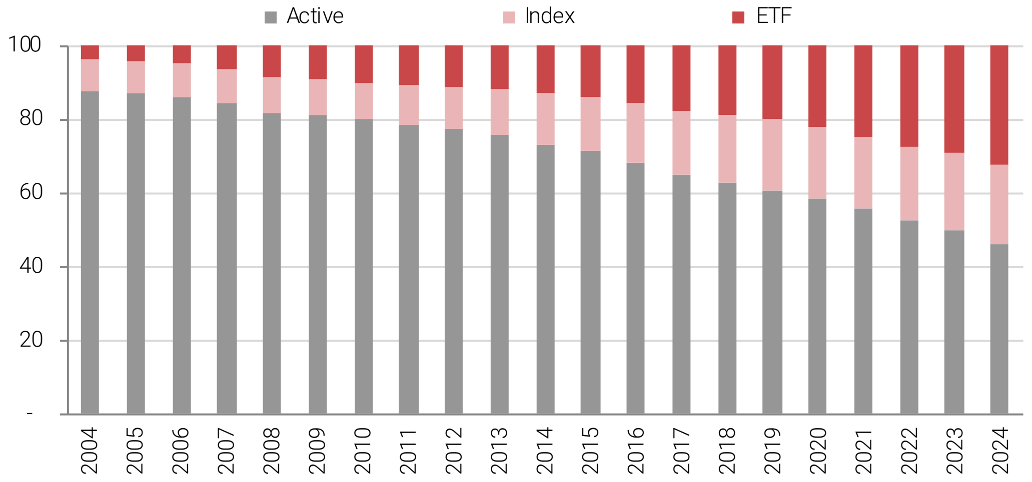
We expect the share of passive funds to rise in most markets including India. The share of passive funds in the US has increased to (1) 54% of the total mutual fund assets (bonds and equities) as of CY2024 compared to 27% as of CY2014 and (2) 20% of the top-20 stocks by market capitalization as of 1HCY25 compared to 11% as of CY2014. We expect the same to play out in India as well, given (1) the democratization of distribution and (2) entry of larger players, who are focused on passive offerings.

Sharp increase in passive ownership in US

The global fund management industry has witnessed a rapid transformation over the past decade, marked by the relentless rise of passive funds. The steady shift from active to passive funds is visible across most DMs, including US, EU and Japan. The US has been at the forefront of the passive investing boom. We note that the shares of index funds and ETFs in AUM of US mutual funds have sharply increased from 27% in 2014 to 54% in 2024 (see Exhibit 21).

Share of passive funds in US assets have increased from 27% in 2014 to 54% in 2024

Exhibit 21: AUM mix of MF assets across equity, debt and hybrid, calendar year-ends, 2004-24 (%)



Source: ICI, Kotak Institutional Equities

As a result, the share of ownership of passive funds in top US stocks has seen a sharp increase over this period (see Exhibit 22). We note that ownership of passive funds in top-20 US stocks by market cap. has increased from 11% in 2014 to 20% in 2024. Meanwhile, the ownership of active funds in the same set of stocks has declined from 15% in 2014 to 12% in 2024.

Ownership of passive funds in top-20 US stocks has increased from 11% in 2014 to 20% in 1HCY25

Exhibit 22: Active and passive funds ownership of the largest market cap. companies in the US (%)

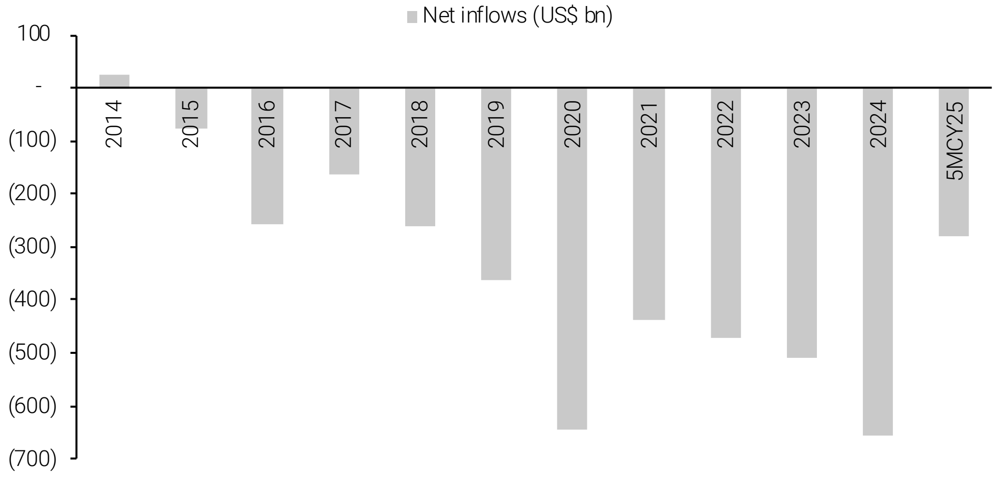
	Dec-14		Current		Difference	
	Passive	Active	Passive	Active	Passive	Active
Nvidia Corp.	15	24	21	11	6	(13)
Microsoft Corp.	12	19	21	13	9	(5)
Apple Inc.	12	11	21	8	9	(3)
Amazon.Com	9	25	18	12	8	(13)
Alphabet Inc.-Class A	12	26	20	14	9	(12)
Meta Platforms Inc.-Class A	11	17	20	18	9	1
Broadcom Inc.	15	40	23	18	8	(22)
Berkshire Hathaway Inc.-Class B	15	4	24	4	9	0
Tesla Inc.	6	20	18	6	13	(14)
JP Morgan Chase & Co.	11	20	20	11	9	(9)
Walmart Inc.	6	4	11	4	4	(0)
Eli Lilly & Co.	11	18	17	15	7	(2)
Visa Inc.-Class A	12	24	21	16	10	(8)
Oracle Corp.	8	15	12	7	4	(8)
Netflix Inc.	12	27	23	18	11	(9)
Mastercard Inc. - A	10	23	19	17	10	(5)
Exxon Mobil Corp.	12	6	22	10	10	4
Costco Wholesale Corp.	12	21	23	6	11	(14)
Johnson & Johnson	12	13	22	10	10	(3)
Procter & Gamble Co.	11	11	21	9	9	(2)

Source: Bloomberg, Kotak Institutional Equities

The steady shift in allocation of US households from active to passive funds has resulted in dampening of inflows into active mutual funds in the US. We note that US equity mutual funds (active plus passive) have witnessed US$4 tn of outflows over 2014-25, while their AUM has been broadly stable over 2021-25, supported by the strong performance of US equities (see Exhibits 23-24). The same can also be seen in the steady decline in number of US funds being launched over time, while the number of merged/liquidated funds witnessed a steady increase (see Exhibit 25).

US equity mutual funds witnessed US$4 tn of outflows over 2014-25

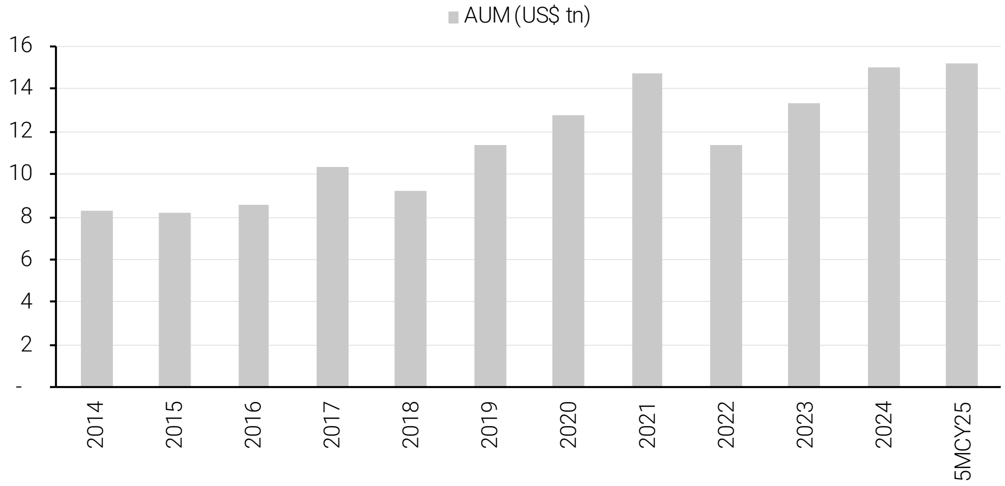
Exhibit 23: Net inflows into/outflows from US equity mutual funds, calendar year-ends, 2014-25 (US$ bn)



Source: CEIC, ICI, Kotak Institutional Equities

AUM of US equity mutual funds has been around US$15 tn over 2021-25

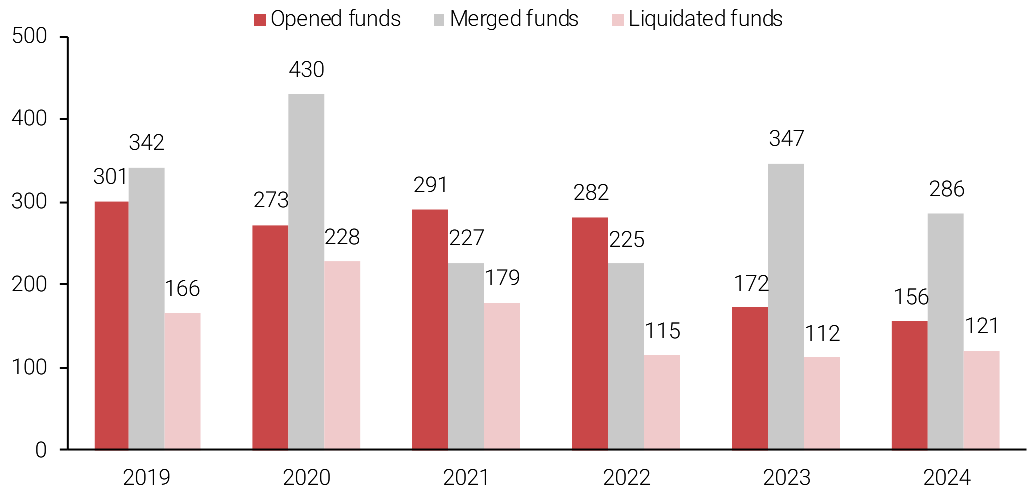
Exhibit 24: AUM of US equity mutual funds, calendar year-ends, 2014-25 (US$ tn)



Source: CEIC, ICI, Kotak Institutional Equities

Steady decline in new mutual funds launched in US but steady increase in merged and liquidated funds

Exhibit 25: Number of mutual funds (includes bonds) opened, merged and liquidated, calendar year-ends, 2019-24 (#)

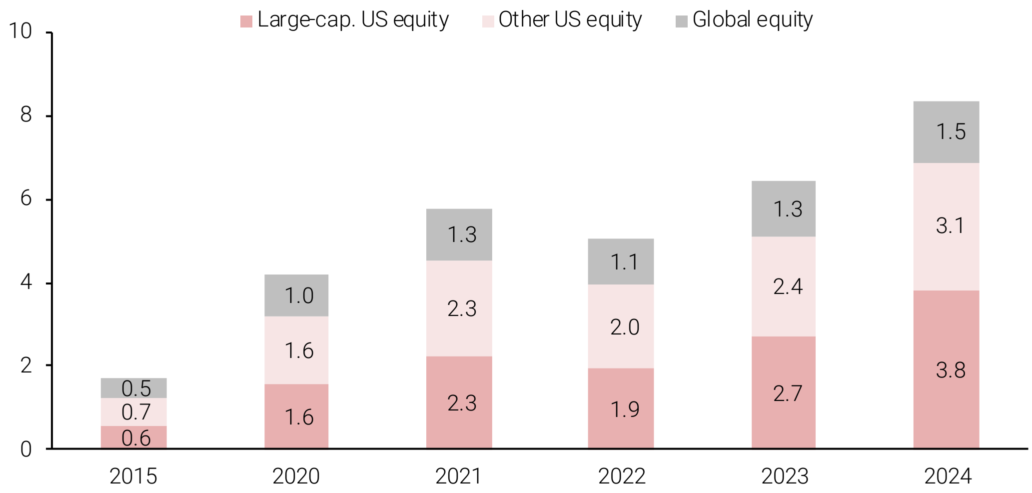


Source: ICI, Kotak Institutional Equities

Over the same 2015-24 period, US-based index equity mutual funds and ETFs received US$2.9 tn in net new cash and reinvested dividends. Furthermore in 2024, 37% of fund complexes saw positive flows to their long-term mutual funds, while 85% of ETF sponsors had positive net share issuance. Exhibit 26 shows the trend in AUMs of equity-oriented US ETFs.

AUM of US based equity ETFs have increased US$1.8 tn in 2015 to US$8.4 tn in 2024

Exhibit 26: Net assets of equity ETFs based out of US, calendar year-ends, 2015-24 (US$ tn)



Source: ICI, Kotak Institutional Equities

Cost versus outperformance, a key driver of shift toward passive funds

The rising share of passive funds in both AUM and flows reflects the weak performance of active funds in the past decade. Most US active funds have failed to beat their respective benchmarks over the past two decades, with only a small minority of active US funds beating the benchmark over the last decade (see Exhibit 27). The degree of underperformance has been expectedly higher for large-cap. funds versus their smaller peers. Over a 10-year period, only 6% of active large-cap funds, 11% of mid-cap funds and 19% of small-cap. funds have beaten their benchmarks in the US.

Only a select minority of mutual funds have consistently outperformed passive funds in the US

Exhibit 27: Success rate of US active mutual funds by category, calendar year-end, 2024 (%)

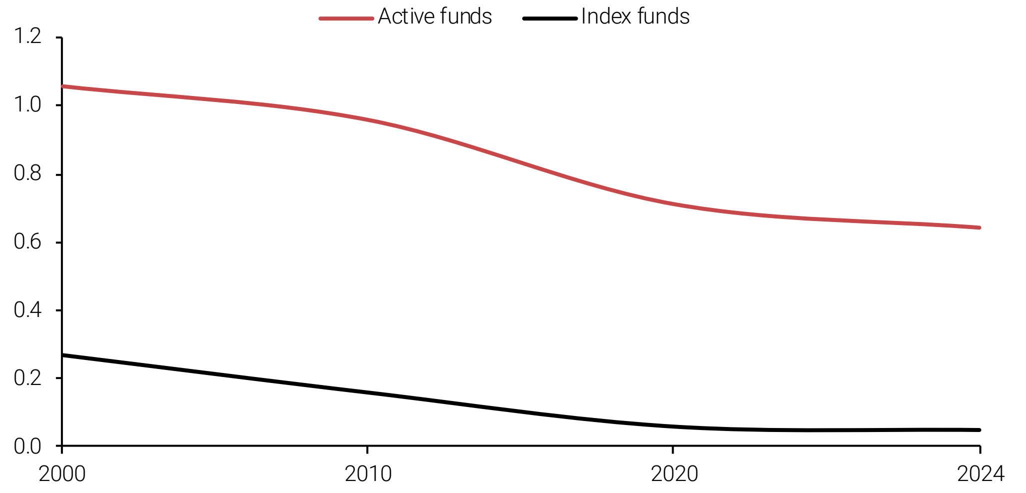
Category	1-y	3-y	5-y	10-y	15-y	20-y
Large-cap. blended	29	26	20	6	4	8
Large-cap. growth	44	41	35	14	8	9
Large-cap. value	40	18	8	3	1	1
Mid-cap. blended	39	51	35	11	13	8
Mid-cap. growth	41	48	48	25	15	31
Mid-cap. value	34	20	29	26	13	19
Small-cap. blended	40	52	47	19	14	11
Small-cap. growth	48	46	42	22	18	25
Small-cap. value	42	34	49	35	26	22

Source: Morningstar, Kotak Institutional Equities

US active funds have higher expense ratios versus the passive funds despite the likelihood of underperformance of active funds. We note that the expense ratios in US active funds have seen a steady decline over the past decade (see Exhibit 28), partly led by competitive market dynamics as well as regulatory changes.

Decline in expense ratios of both active and index funds in the US; active funds are still more expensive

Exhibit 28: Average expense ratios of active equity funds versus index funds in US, calendar year-ends, 2000-24 (%)



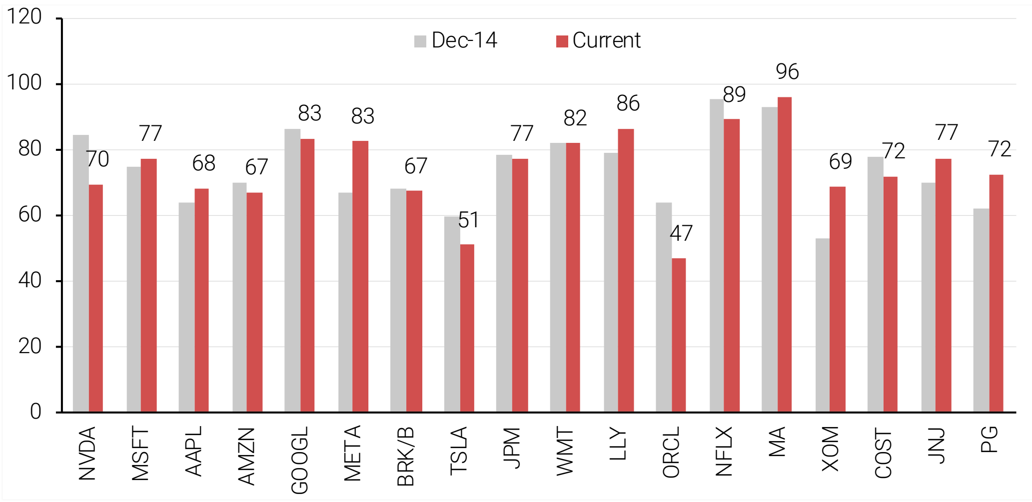
Source: ICI, Kotak Institutional Equities

High institutional ownership in DMs

The high share of ownership of stocks by institutions (funds) in DMs rules out outperformance of a significant portion of funds. It is obvious that only a certain number of funds will outperform the market over any period when the bulk of the shareholding is by institutions (funds). The share of institutional ownership in DMs over the last decade has been broadly steady at high levels. A number of heavy-weights in S&P-500 Index have seen a meaningful decline in their institutional ownership but that has been offset by a decent increase in others, resulting in broadly stable trend in institutional ownership of mega-caps (see Exhibit 29).

High institutional ownership in DMs

Exhibit 29: Institutional ownership of the largest companies in the US (by market cap.) (%)

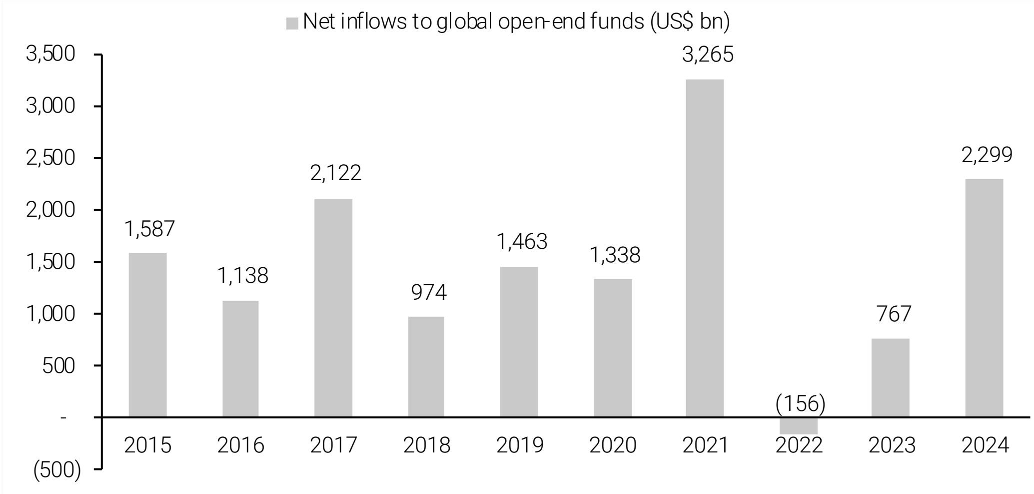


Source: Bloomberg, Kotak Institutional Equities

Global net sales of regulated open-ended long-term funds saw a sharp increase in CY2024, after witnessing moderation over CY2022-23 (see Exhibit 30). The bulk of the flows were captured by bond funds, with equity funds garnering 40% of the net inflows (see Exhibit 31). We note that the US accounted for 42% of flows into global long-term regulated funds, while Asia-Pacific was sizeable with 29% share in CY2024 (see Exhibit 32). It is important to highlight that US households have significantly higher share of their wealth in regulated funds versus European Union and Japan, who continue to have the larger share in bank products (see Exhibit 33).

Global demand for regulated open-ended funds recovered in 2024 after weakness over 2022-23

Exhibit 30: Net global sales of regulated open-end long-term funds (bonds and equities), calendar year-ends, 2015-24 (US$ bn)



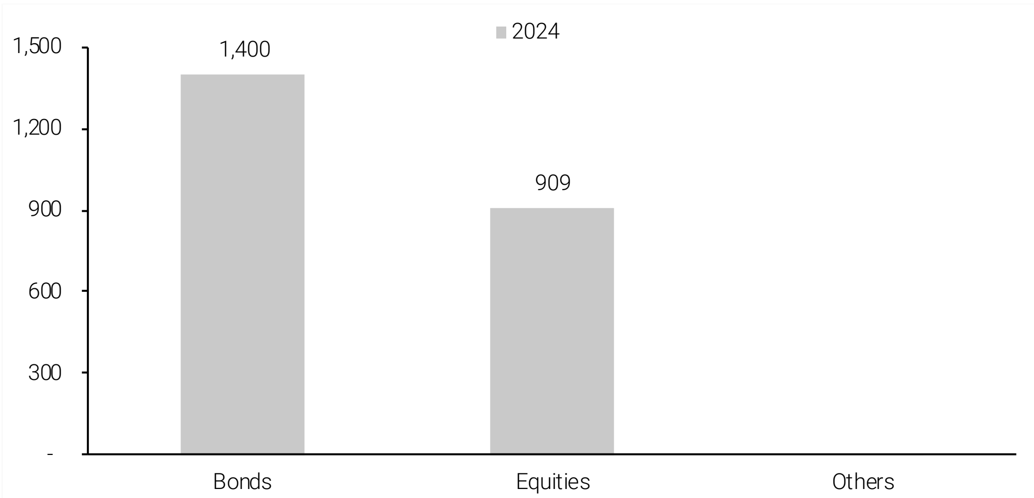
Notes:

(a) Regulated funds include mutual funds, ETFs and institutional funds.

Source: ICI, Kotak Institutional Equities

Equities accounted for 40% of net inflows into regulated open-end long-term funds globally

Exhibit 31: Net sales of regulated open-end long-term funds in bonds and equities globally, calendar year-end, 2024 (US$ bn)



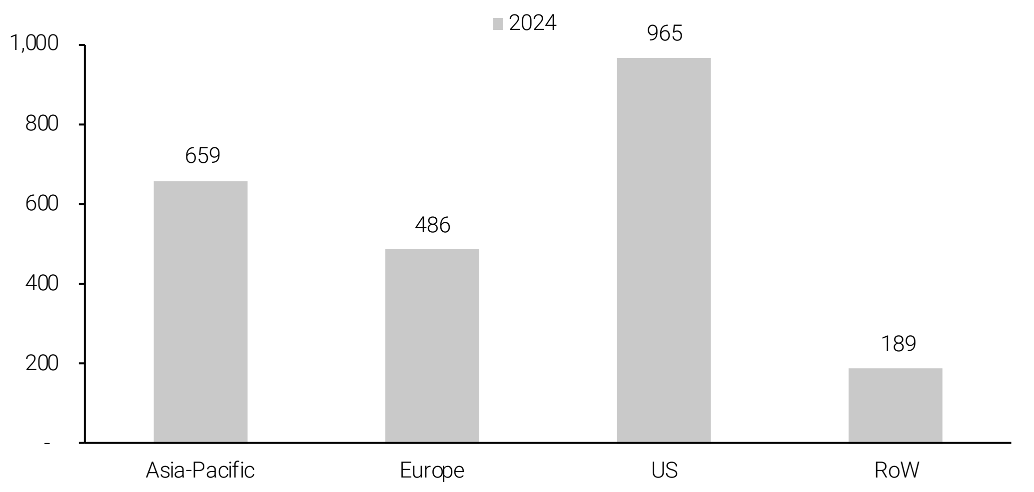
Notes:

(a) Regulated funds include mutual funds, ETFs and institutional funds.

Source: ICI, Kotak Institutional Equities

US accounted for 42% of flows into regulated open-end long-term funds

Exhibit 32: Geography-wise net sales of regulated open-end long-term funds, calendar year-end, 2024 (US$ bn)



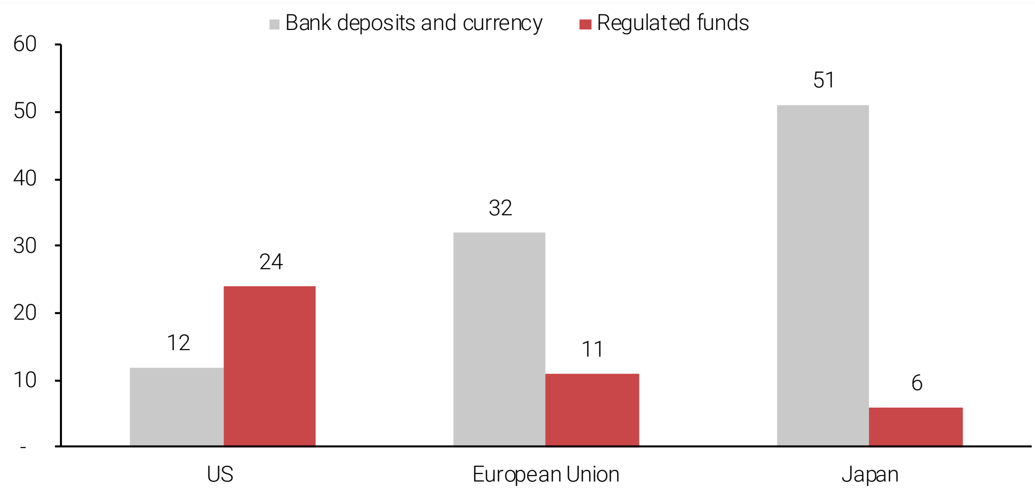
Notes:

(a) Regulated funds include mutual funds, ETFs and institutional funds.

Source: ICI, Kotak Institutional Equities

US households have significantly higher share of their wealth in regulated funds

Exhibit 33: Share of household financial wealth in bank products and regulated funds, calendar year-ends, 2015-24 (US$ bn)



Notes:

(a) Regulated funds include mutual funds, ETFs and institutional funds.

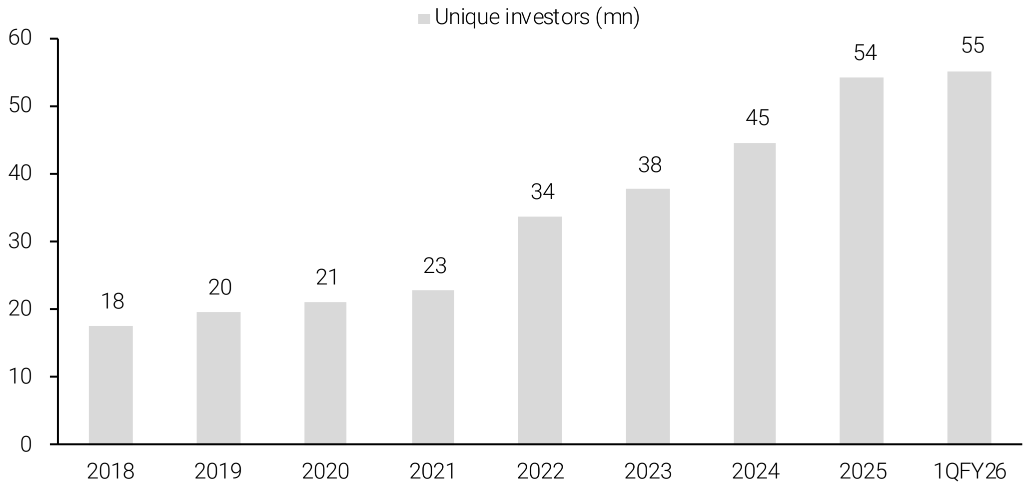
Source: ICI, Kotak Institutional Equities

Steady rise of passive funds in India

Indian equity mutual funds have also seen a steady increase in adoption of passive funds, led by (1) favorable regulatory support, (2) rapid adoption of technology, (3) allocation of EPFO AUM to ETFs and (4) entry of new players. Strong regulatory support and technological improvement have enabled democratization of distribution as well as rollout of new products. Furthermore, the sharp influx of new investors over the past five years (see Exhibit 34) has resulted in intense competition among players, with a segment of newer and marginal players opting for passive products to gain market share.

More than 50% of current investors in domestic mutual funds have come in the past five years

Exhibit 34: Unique domestic mutual fund investors in India, March fiscal year-ends, 2018-26 (mn)

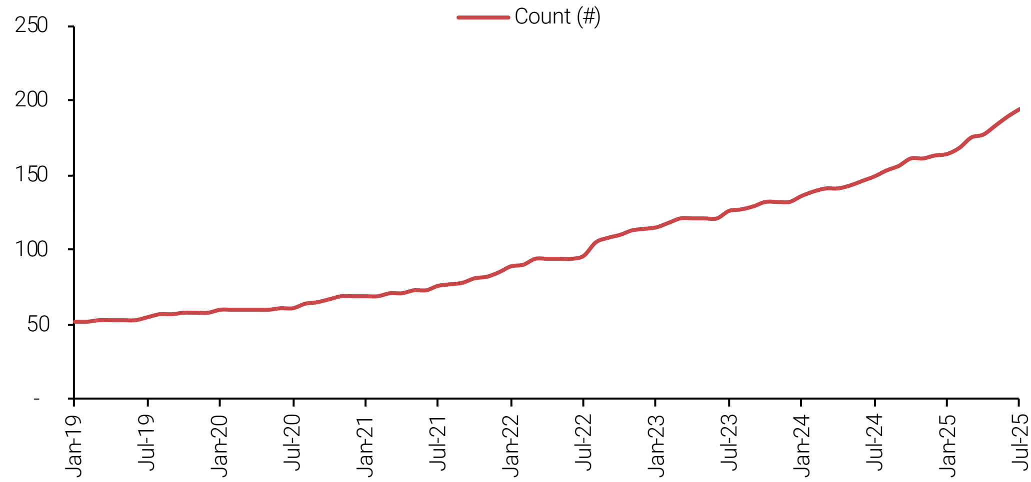


Source: Industry, SEBI, NSE, AMFI, Kotak Institutional Equities

India has seen a sharp increase in the number of ETFs as well as passive AUM over 2019-25, with AUM increasing from Rs0.9 tn in January 2019 to Rs6.6 tn in July 2025. Exhibits 35-37 show steady increase in the number of passive funds and the AUM managed by passive funds in India. In our view, the entry of Jio-Blackrock may further hasten the transformation of the Indian mutual fund industry.

Steady increase in the number of equity ETFs in India

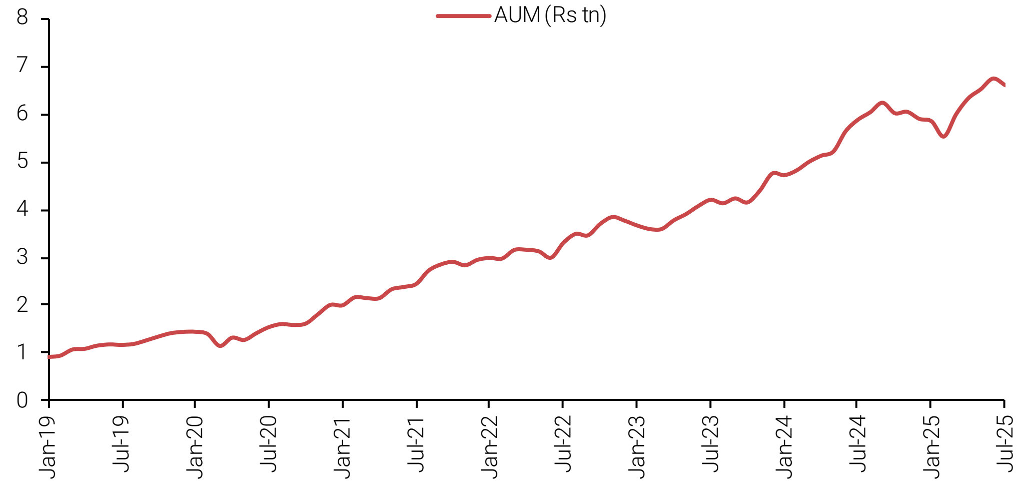
Exhibit 35: Count of equity ETFs in India, calendar year-ends, 2019-25 (#)



Source: Ace MF, Kotak Institutional Equities

AUM of equity ETFs in India has increased from Rs0.9 tn in 2019 to Rs6.6 tn in July 2025

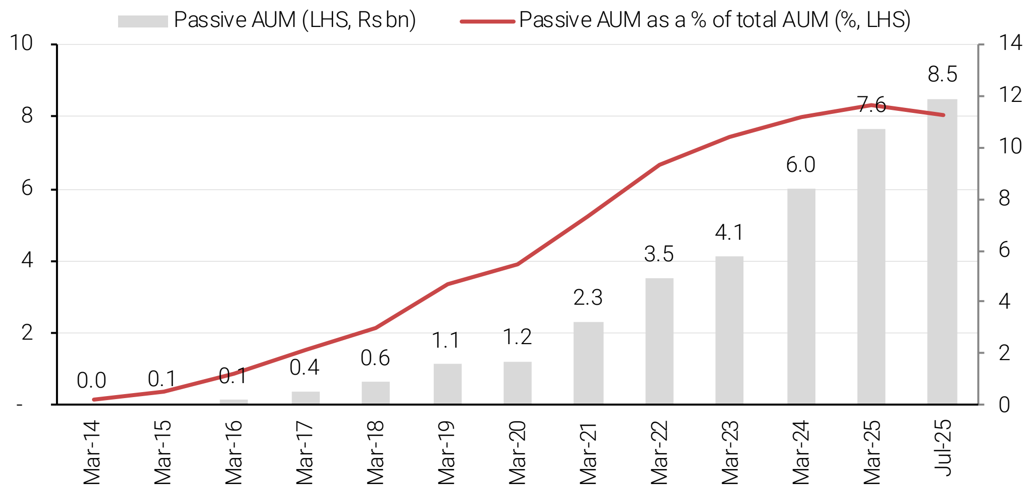
Exhibit 36: AUM of equity ETFs in India, calendar year-ends, 2019-25 (Rs tn)



Source: Ace MF, Kotak Institutional Equities

Passive AUM has increased exponentially in India

Exhibit 37: Trend of passive (ETFs + Index funds) equity AUM in India, March fiscal year-ends, 2014-26



Source: Ace MF, Kotak Institutional Equities

3

Increasing passive style of DIIs

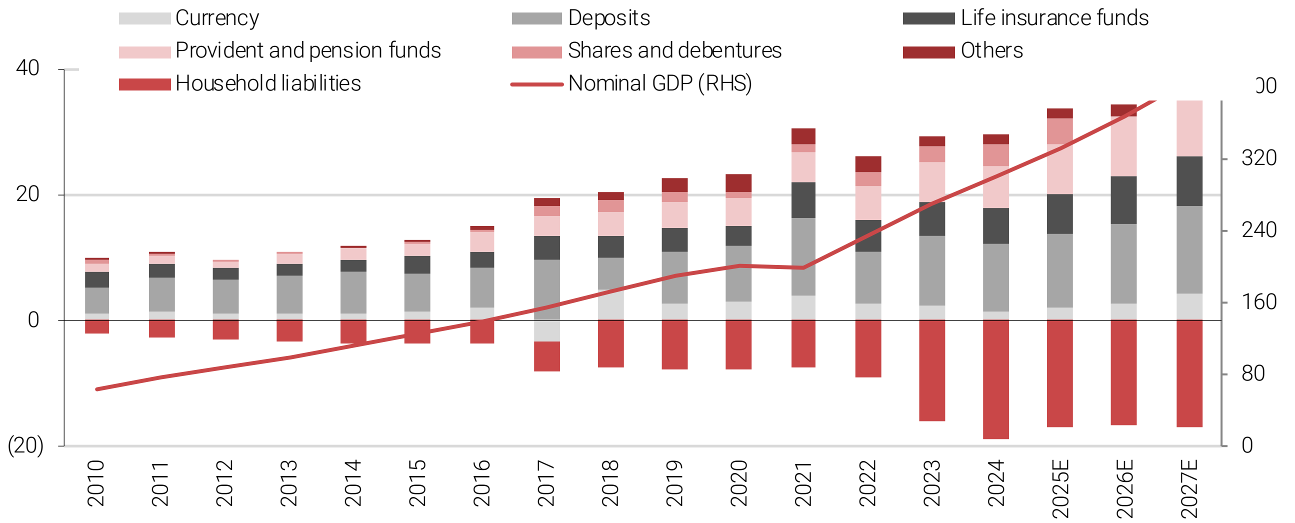
India's active equity fund management industry appears to be increasingly following a passive style of investing, given the structure of the market and design of the domestic fund management industry. Investment mandates and styles appear to be linked disproportionately to the prevailing retail sentiment, thereby resulting in a low discretion to fund managers with respect to (1) timing of investment and (2) selection of sectors and stocks.

Sharp increase in allocation toward equities among Indian households

We note that (1) the strong returns from equity markets from the Covid-19 pandemic lows and (2) the disproportionate increase in household financial savings in FY2021, resulted in a greater preference for equity in overall financial savings among Indian households over the past few years (see Exhibits 38-39). India's active fund management industry has tapped into the change in financial savings behavior of Indian households, which resulted in 138% increase in unique mutual fund investors in India over FY2021-25 (see Exhibit 40). Also, smaller cities (beyond metros) have led the deepening of equity penetration over this period (see Exhibits 41-42).

Stable gross household financial savings over FY2021-24 after a sharp jump in FY2021

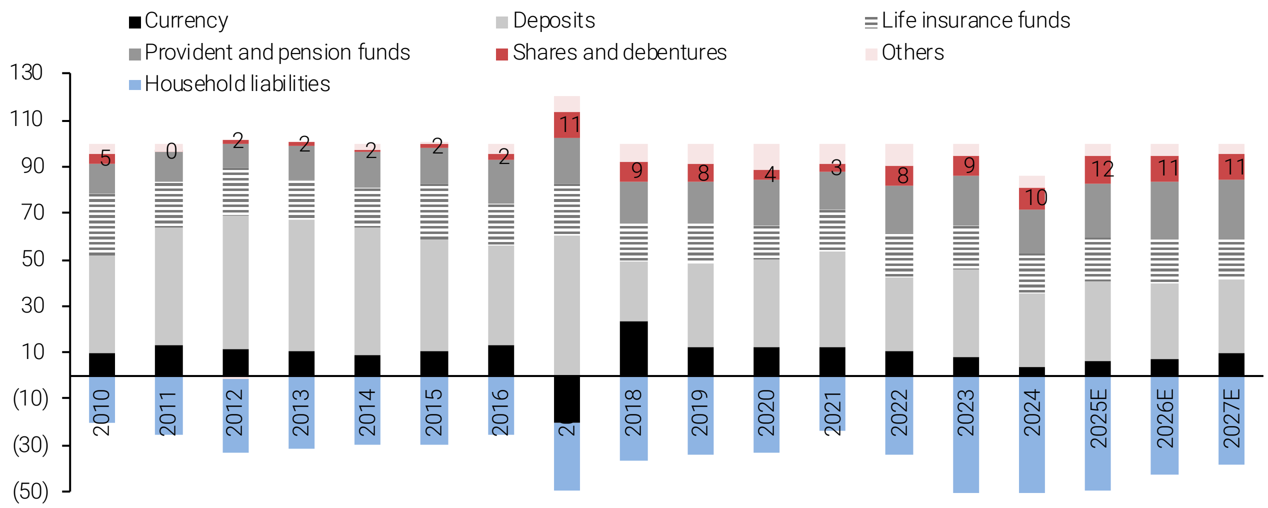
Exhibit 38: Saving inflows across products, March fiscal year-ends, 2010-27E (Rs tn)



Source: RBI, Kotak Institutional Equities estimates

Shares and debentures account for around 10% of gross household financial savings, higher than FY2020-21 levels

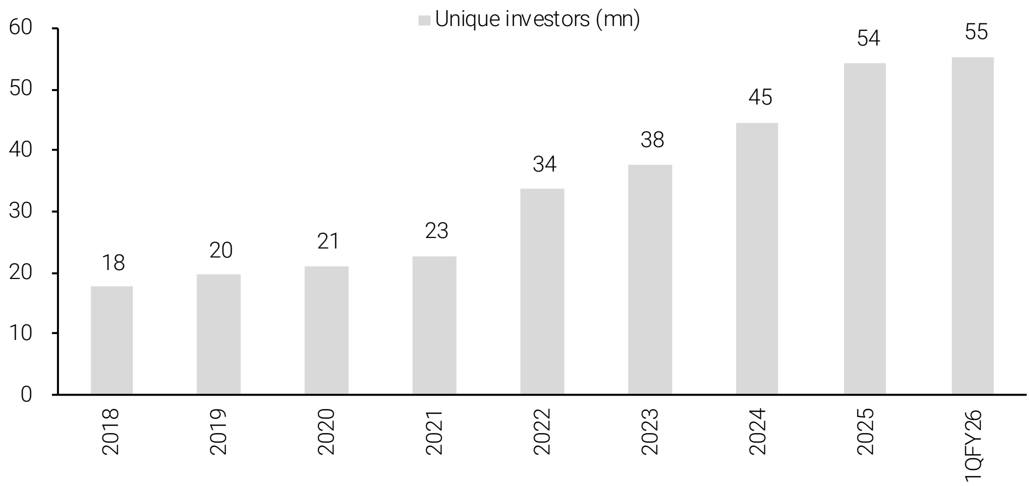
Exhibit 39: Share of various financial assets as a proportion of gross household financial savings, March fiscal year-ends, 2010-27E (%)



Source: RBI, Kotak Institutional Equities estimates

More than 50% of the current investors in domestic mutual funds have come in the past five years

Exhibit 40: Unique domestic mutual fund investors in India, March fiscal year-ends, 2018-26 (mn)



Source: Industry, SEBI, NSE, AMFI, Kotak Institutional Equities

Sharp increase in fund mobilization from smaller cities over FY2022-24

Exhibit 41: Net inflows to domestic mutual funds from major cities in India, March fiscal year-ends, 2015-24 (Rs bn)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Mumbai	550	347	1,518	624	262	320	1,718	620	(333)	1,292
Pune	36	55	176	95	98	47	68	(8)	13	206
Chennai	(83)	37	87	127	(18)	78	(37)	51	32	158
Bangalore	22	80	217	137	109	7	6	304	11	151
Kolkata	(31)	72	153	143	8	66	18	65	6	106
Delhi	91	258	403	378	(61)	20	97	310	42	102
Hyderabad	38	25	55	87	6	(33)	32	55	92	91
Vadodara	9	15	26	37	18	9	(4)	37	24	38
Surat	10	11	23	26	20	10	4	13	21	37
Jaipur	13	12	18	24	19	5	11	36	18	33
Lucknow	6	13	16	31	18	10	6	26	20	24
Kanpur	4	8	15	18	7	(3)	1	17	10	16
Chandigarh	1	8	18	26	5	1	(6)	8	5	11
Panaji	(3)	5	21	10	2	(2)	0	1	3	3
Ahmedabad	147	67	75	128	80	16	110	103	(82)	(30)
Other cities	223	329	608	827	525	321	124	830	881	1,307
Total	**1,033**	**1,342**	**3,430**	**2,718**	**1,097**	**873**	**2,148**	**2,467**	**762**	**3,547**
Share of other cities (%)	**22**	**25**	**18**	**30**	**48**	**37**	**6**	**34**	**116**	**37**

Source: SEBI, Kotak Institutional Equities

Share of smaller cities in AUM at 35% in FY2024 versus 14% in 2015 and 24% in FY2020

Exhibit 42: AUM of domestic mutual funds by major cities in India, March fiscal year-ends, 2015-24 (Rs bn)

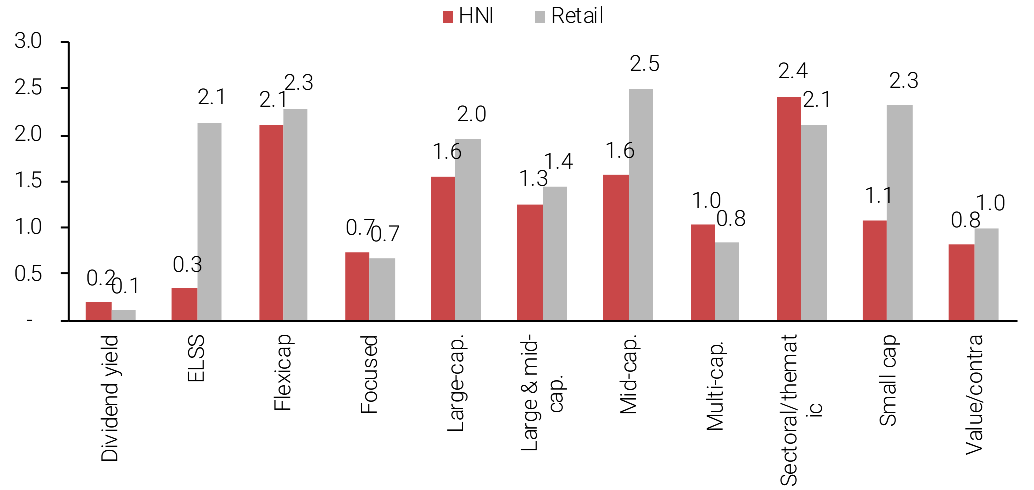
	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Mumbai	4,567	5,153	7,472	8,285	7,677	7,450	9,811	11,295	11,005	14,308
Delhi	1,565	1,706	2,258	2,894	3,472	3,281	4,114	4,889	5,247	6,712
Bangalore	659	746	1,015	1,237	1,518	1,385	1,772	2,233	2,174	2,932
Pune	417	470	675	821	1,062	1,047	1,400	1,541	1,593	2,198
Kolkata	504	570	802	961	1,025	955	1,216	1,404	1,455	1,945
Chennai	496	575	813	1,157	772	792	912	1,060	1,181	1,621
Ahmedabad	385	444	520	696	772	747	1,048	1,249	1,228	1,471
Hyderabad	208	235	349	425	483	400	568	708	764	1,068
Vadodara	79	89	132	166	197	173	240	314	339	484
Jaipur	88	93	126	165	171	146	220	291	311	446
Surat	66	68	104	132	157	138	204	252	270	407
Lucknow	60	69	96	124	146	130	192	244	266	376
Kanpur	64	69	98	121	129	107	152	189	199	278
Chandigarh	56	66	95	111	98	86	133	163	138	193
Panaji	58	58	79	66	51	44	58	66	63	85
Other cities	1,559	1,917	2,913	4,000	6,065	5,382	9,387	11,669	13,188	18,879
Total	**10,828**	**12,328**	**17,546**	**21,360**	**23,796**	**22,262**	**31,428**	**37,567**	**39,420**	**53,402**
Share of other cities (%)	**14**	**16**	**17**	**19**	**25**	**24**	**30**	**31**	**33**	**35**

Source: SEBI, Kotak Institutional Equities

The Indian mutual fund industry has also benefited from the increased risk appetite of Indian households within equities. It has launched products to match the changing investment pattern of households. We note that retail investors have displayed disproportionate risk-taking behavior, given their inclination to invest more in equity products with higher risk (and presumably higher expected return among retail investors). Retail investors invested disproportionately in SMID stocks and thematic funds over CY2022-25 in the hope of garnering superlative returns. Exhibits 43-45 show the investment pattern of HNI and retail investors in open-ended equity-oriented funds. Both HNI and retail investors have roughly 40% of their AUM in mid-cap, small-cap. and thematic funds. We also note that retail investors have remained broadly invested over the last one year, despite large volatility and decent time correction in the markets.

Both HNI and retail investors exhibit high risk-taking behavior

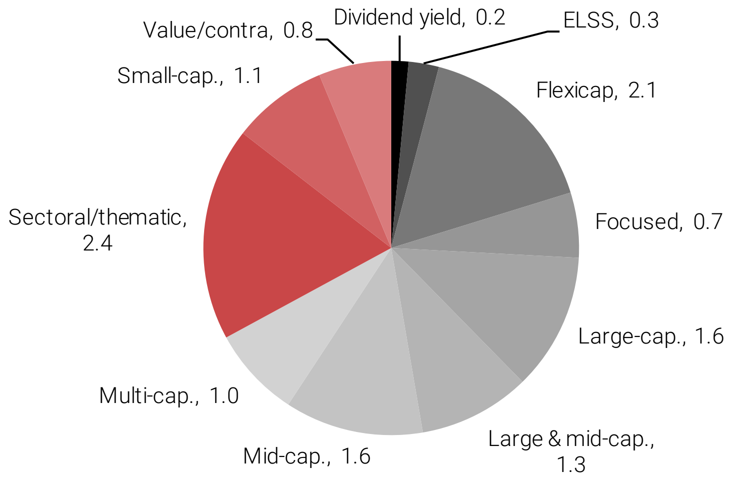
Exhibit 43: AUM of HNI and retail investors in various equity-oriented open-end schemes, June 2025 (Rs tn)



Source: AMFI, Kotak Institutional Equities

Mid-cap., small-cap. and thematic funds account for 39% of HNI AUM

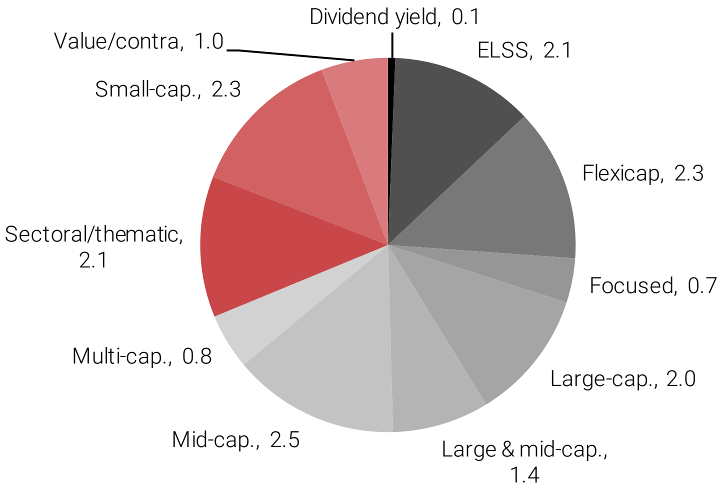
Exhibit 44: AUM of HNI investors in various equity-oriented open-end schemes, June 2025 (Rs tn)



Source: AMFI, Kotak Institutional Equities

Mid-cap., small-cap. and thematic funds account for 40% of HNI AUM

Exhibit 45: AUM of retail investors in various equity-oriented open-end schemes, June 2025 (Rs tn)



Source: AMFI, Kotak Institutional Equities

MFs focused on mobilization and maintaining market share

Mutual funds have focused on (1) capturing a portion of the inflows into equity mutual funds from households and (2) increasing their market shares. We note that major fund houses have seen a steady increase in their equity AUM in line with retail flows, that has helped them broadly maintain their market share over this period. Exhibit 46 shows the trend in equity AUM and market shares of major MFs over the past few years.

Most AMCs have maintained their market share over FY2021-26

Exhibit 46: Actively-managed equity oriented market share (MAAUM basis), March fiscal year-ends, 2017-26 (%)

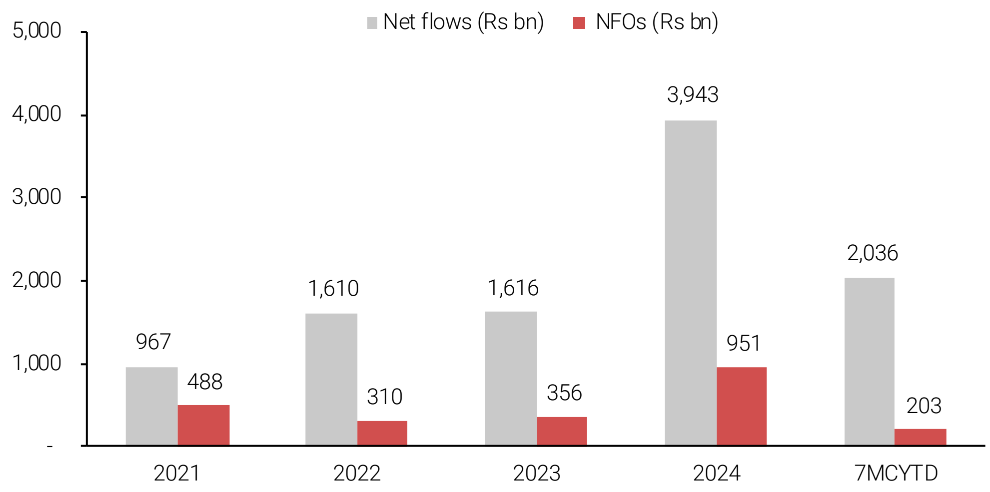
	2017	2018	2019	2020	2021	2022	2023	2024	2025	1QFY26
Aditya Birla Sun Life	8.7	9.2	8.8	7.7	7.2	6.4	5.5	4.8	4.2	4.2
Axis AMC	3.3	3.6	4.6	6.8	8.0	8.4	7.1	5.6	4.9	4.7
Bandhan AMC	2.2	2.1	2.2	2.6	2.0	1.6	1.5	1.6	1.7	1.8
DSP Mutual Fund	4.4	4.4	3.9	3.9	4.1	3.8	3.4	3.1	3.1	3.1
Franklin Templeton	7.5	5.6	5.2	4.3	3.7	2.8	2.6	2.5	2.3	2.3
HDFC AMC	15.8	16.2	15.6	14.4	13.0	11.4	12.2	12.9	12.8	12.8
ICICI Prudential AMC	15.2	15.0	14.3	13.5	12.5	12.4	13.0	13.2	13.6	13.5
Kotak AMC	3.7	4.7	5.1	6.4	6.7	7.0	7.0	7.2	7.3	7.4
Mirae AMC	1.2	1.5	2.2	3.5	4.7	4.9	4.9	4.4	3.8	3.7
Nippon Life India AMC	9.7	9.2	8.9	7.4	6.9	6.3	6.4	6.8	6.9	7.1
SBI AMC	8.0	7.9	8.9	9.7	10.2	12.0	12.6	12.8	12.7	12.4
Tata AMC	2.1	1.7	2.3	2.3	2.5	2.9	2.8	2.8	2.8	2.7
UTI AMC	6.3	4.8	4.7	4.4	4.8	4.8	4.5	3.9	3.7	3.6
Total of above players	**88.2**	**86.1**	**86.5**	**86.9**	**86.3**	**84.7**	**83.5**	**81.6**	**86.7**	**86.3**
Top-10 players	**82.7**	**80.7**	**79.9**	**78.5**	**78.0**	**77.4**	**76.6**	**74.7**	**77.0**	**77.0**

Source: AMFI, Kotak Institutional Equities

Many have launched more/new products and ensured low gaps in their offerings versus competition to retain market shares. Exhibit 47 shows the trend in NFOs over the past three years. We note that NFOs accounted for 23% share in fund mobilized over CY2021-25.

NFOs accounted for 23% share in fund mobilized over CY2021-7MCY25

Exhibit 47: Net inflows and fund mobilized through new fund offerings in equity-oriented schemes, calendar year-ends, 2021-25 (Rs bn)



Source: Ace MF, Kotak Institutional Equities

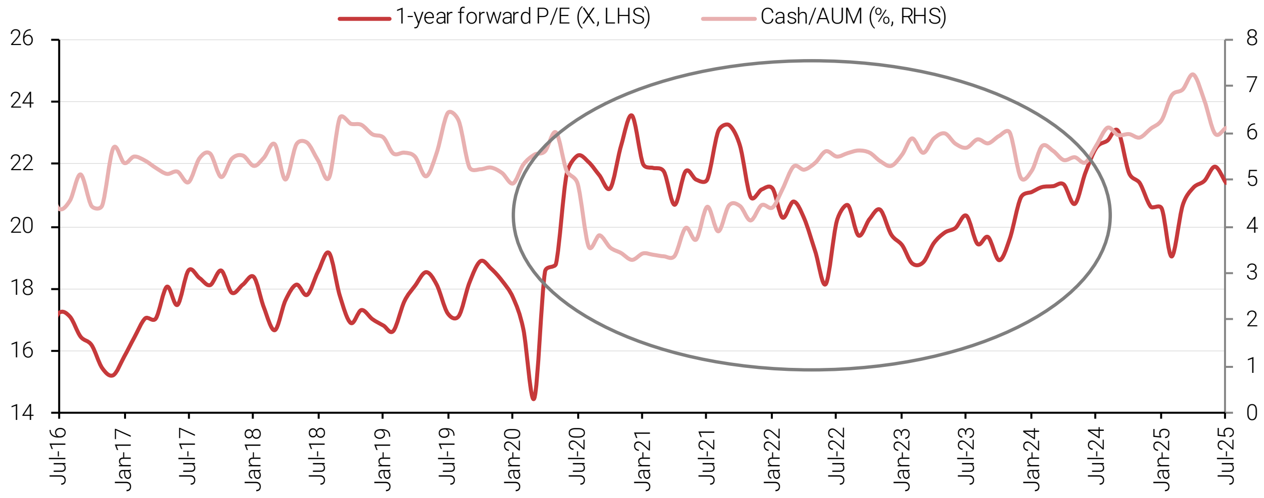
Declining component of active decision-making

It is possible that active decision-making may have been compromised in the quest for market share in a hyper-competitive industry. We note (1) stable cash/AUM ratios of the industry, (2) low tracking error among most of the 'active' MF industry, (3) large overlap of stocks among competing funds and (3) declining share of 'active' (flexible, hybrid, multi-cap.) active funds.

- **Stable cash/AUM in the industry.** A key investment tenet of the domestic mutual fund industry appears to be being invested at all times, irrespective of market valuations. This can be seen from the fact that the cash levels as a proportion of MF AUM have been in a narrow band of 4-6% over the majority of the past decade, irrespective of market valuations (see Exhibit 48). In fact, cash levels of mutual funds, on an aggregate, have been inversely proportional to market valuations post the Covid-19 pandemic, even within the narrow band, suggesting mutual funds were at their peak investment levels during peak valuation periods and lowest investment levels during trough valuation periods. We note that SEBI allows up to 20% allocation in non-equity products for large-cap. equity funds.

Cash levels of Indian mutual funds have been between 4% and 6%, irrespective of market valuations

Exhibit 48: 1-year forward P/E of Nifty-50 Index versus cash levels as a proportion of AUM of equity MFs, March fiscal year-ends, 2017-26 (X)



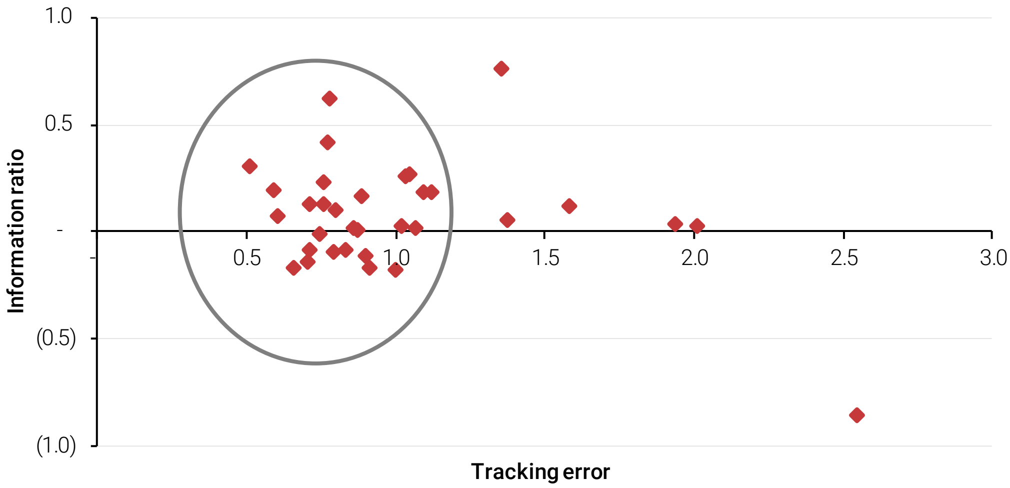
Source: AMFI, Kotak Institutional Equities estimates

The stable cash levels for equity MFs have resulted in funds (1) possibly failing to realize large 'MTMs' during periods of 'rich' valuations and (2) facing risks of fund liquidations during periods of panic, instead of having 'excess' cash for deployment. We note that only a handful number of funds have used 'cash' calls aggressively.

- **Low tracking error among majority of funds.** Our analysis suggests that the bulk of the domestic mutual funds have very low tracking error versus their respective benchmarks. Exhibits 49-51 show the scatter plot of tracking error versus information ratio of large-cap., mid-cap. and small-cap. funds in India. This would suggest that the bulk of the industry is running broadly similar portfolios compared to their respective benchmarks, with most large-cap. and mid-cap. funds having low tracking error as well as information ratio, suggesting high degree of passivity in portfolio construction. A part of this may be by design, given that the universe of large- and mid-caps are effectively decided by AMFI classification for large-cap, mid-cap. and small-cap. stocks.

Most large-cap. funds in India have had low tracking error over the past three years

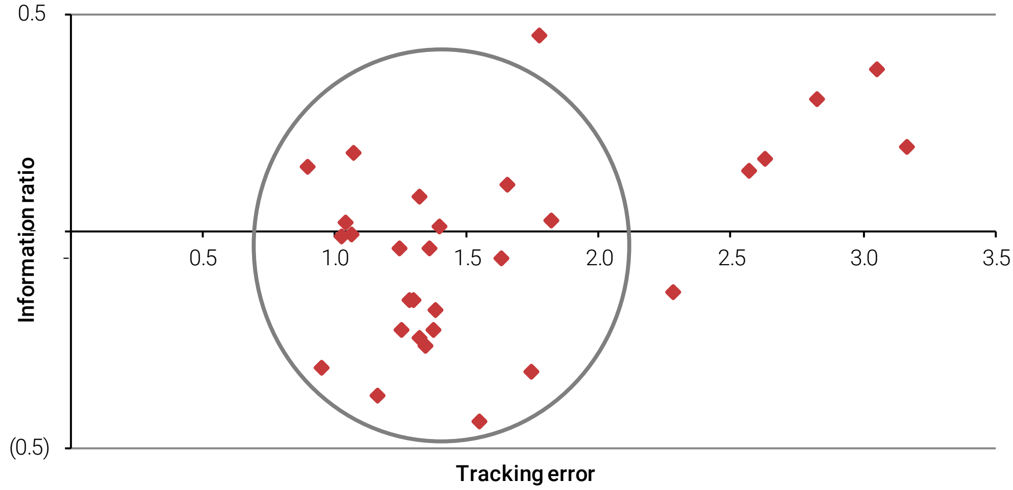
Exhibit 49: Information ratio versus tracking error of large-cap. equity mutual funds in India, August 2022-25 (%)



Source: Ace MF, Kotak Institutional Equities

Most mid-cap funds in India exhibited large degree of passive behavior over the past three years

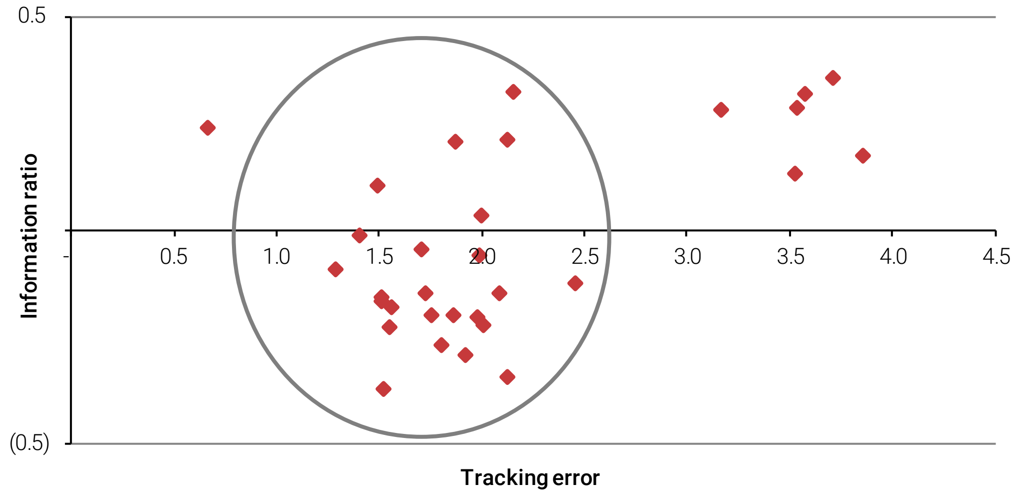
Exhibit 50: Information ratio versus tracking error of mid-cap. equity mutual funds in India, August 2022-25 (%)



Source: Ace MF, Kotak Institutional Equities

Small-cap. funds have been relatively more active in nature

Exhibit 51: Information ratio versus tracking error of small-cap. equity mutual funds in India, August 2022-25 (%)



Source: Ace MF, Kotak Institutional Equities

- **Large overlap of stocks among active mutual funds.** We note that most active funds have a fairly large quantum of overlap among each other. Exhibit 52 shows the weight of the most common 15 large-cap. stocks among the active large-cap. funds. 27 out of 31 large-cap. active funds have a cumulative weight of more than 40% in the 15 most-common large-cap. stocks. Similarly, we note decent overlap among active mid-cap. mutual funds, with the degree of overlap being somewhat lower compared to large-cap. funds (see Exhibit 53).

The 15 common large-cap. stocks account for 50-55% of portfolio of most large-cap. funds

Exhibit 52: Weight of most common 15 large-cap. stocks in the portfolio of active large-cap. funds, July 2025 (%)

	Active large-cap. fund																														
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30	31
HDFC Bank	8	10	8	10	9	8	10	10	7	7	10	10	10	10	9	9	9	8	10	10	10	10	9	10	—	4	10	9	10	9	10
ICICI Bank	8	9	6	8	5	8	9	8	8	9	10	10	10	9	7	5	6	8	7	9	8	7	6	10	—	1	8	9	5	7	8
Bharti Airtel	4	5	—	3	1	4	4	—	3	—	4	6	4	4	4	3	5	4	4	4	4	4	-	5	—	(0)	3	6	2	4	4
Reliance Industries	5	6	6	7	4	6	5	-	7	4	4	5	5	7	4	6	4	7	6	7	5	7	6	8	6	2	8	4	6	4	7
Kotak Mahindra Bank	3	2	4	—	—	4	2	4	2	4	3	4	3	—	3	3	2	2	3	1	2	2	0	1	—	3	3	3	5	—	2
NTPC	2	1	—	3	3	2	2	4	2	—	2	4	3	2	—	2	1	2	—	—	1	2	2	2	—	—	—	2	2	—	3
Infosys	5	5	4	4	2	3	4	4	2	5	(3)	3	5	3	6	3	3	4	4	6	6	4	2	2	2	—	4	5	4	2	4
Axis Bank	3	—	—	3	—	1	2	5	3	4	2	3	3	4	2	3	3	3	2	4	3	2	4	2	—	—	3	3	4	3	3
Sun Pharmaceutical Industries	2	1	3	3	1	1	2	—	2	2	2	3	2	3	—	1	—	3	2	0	1	1	—	3	4	—	—	3	1	2	2
ITC	2	1	—	2	3	2	2	5	3	—	—	3	2	1	—	2	—	3	3	2	4	2	3	1	—	—	2	—	—	8	3
Eternal	2	4	3	3	2	2	3	—	—	5	1	2	4	—	3	—	—	2	—	—	2	2	2	3	—	1	2	—	—	—	1
Larsen & Toubro	4	4	5	2	1	4	4	—	4	2	6	2	1	6	—	3	4	4	4	4	3	3	4	4	8	—	5	3	4	1	4
Interglobe Aviation	2	3	—	2	1	—	2	—	—	3	—	2	—	2	2	1	3	2	—	1	1	2	2	3	—	4	—	3	—	—	1
State Bank Of India	3	3	7	2	5	2	3	3	2	3	3	1	4	—	—	4	2	3	3	3	2	3	4	—	—	—	3	3	2	5	3
Ultratech Cement	1	3	5	—	—	2	3	—	2	1	1	1	2	4	—	1	2	2	1	—	—	—	2	2	—	—	—	2	—	—	1
Total	**55**	**57**	**49**	**52**	**37**	**49**	**56**	**43**	**45**	**49**	**43**	**58**	**57**	**56**	**39**	**47**	**42**	**55**	**49**	**50**	**52**	**50**	**46**	**55**	**20**	**15**	**51**	**55**	**45**	**45**	**55**

Source: Ace MF, Kotak Institutional Equities

Decent overlap among active mid-cap. mutual funds

Exhibit 53: Weight of the most common mid-cap. stocks in the portfolio of active mid-cap. funds, July 2025 (%)

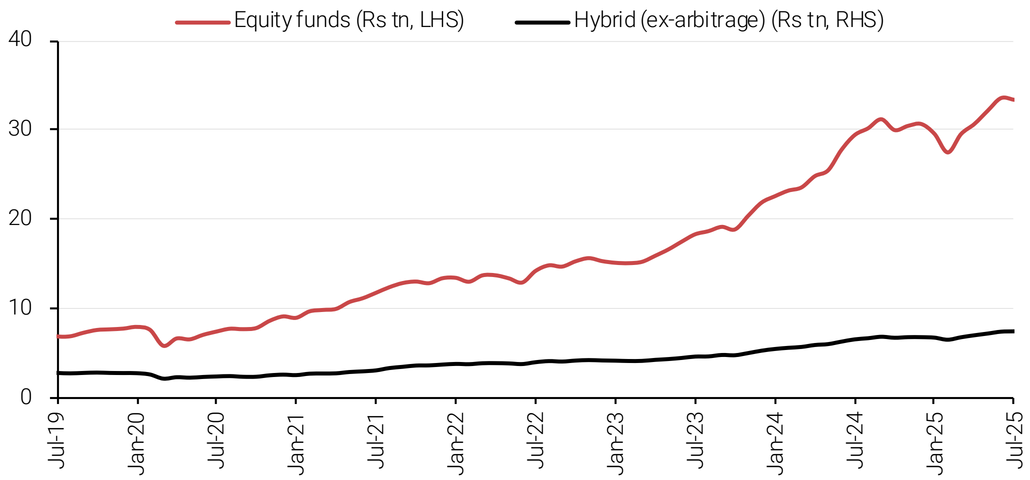
	Active mid-cap. fund																													
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30
Max Healthcare Institute	—	1	2	2	3	—	3	2	—	—	5	—	4	3	2	1	—	3	—	4	2	4	—	2	2	2	—	2	2	1
Persistent Systems	1	2	3	2	3	—	3	1	2	—	2	—	—	2	—	2	2	1	—	8	2	2	—	—	2	1	1	2	2	3
Coforge	—	1	2	—	1	4	3	2	3	—	3	—	1	2	2	—	—	2	—	9	—	—	—	—	2	—	3	2	2	3
PB Fintech	—	2	3	3	2	—	3	2	2	2	2	3	—	2	—	—	—	—	2	0	—	1	2	—	2	—	—	1	2	3
Dixon Technologies (India)	2	2	3	—	3	2	2	1	1	—	5	—	3	—	2	3	1	—	—	11	2	2	—	—	1	—	—	2	2	1
Fortis Healthcare	4	4	2	2	—	2	2	—	3	3	—	—	—	2	2	4	2	1	1	—	3	—	—	—	3	—	—	2	—	2
Indian Bank	—	1	1	2	2	—	2	—	3	—	0	—	—	2	1	1	—	3	1	—	1	—	—	—	2	2	—	2	2	1
Page Industries	1	1	—	1	-	2	2	1	—	—	—	—	—	1	—	—	2	1	—	—	1	2	—	2	—	1	—	—	1	0
UNO Minda	0	2	2	—	3	1	2	1	—	2	—	0	1	—	—	1	3	2	—	—	—	2	—	—	1	2	—	2	—	—
HDFC Asset Management Company	1	1	—	—	3	—	2	—	—	2	1	0	3	2	2	—	—	—	1	—	1	3	—	1	—	—	2	1	—	—
The Federal Bank	2	2	2	2	2	2	2	3	3	—	1	—	4	2	1	1	3	2	2	—	2	—	—	2	2	2	3	3	1	3
BSE	—	1	1	—	2	—	2	—	—	—	3	4	5	1	2	1	1	—	0	—	3	—	—	—	2	—	—	—	1	—
Vishal Mega Mart	1	1	1	—	1	2	2	1	2	3	—	—	2	1	—	3	—	—	—	—	1	3	—	—	—	—	—	1	—	—
APL Apollo Tubes	3	—	1	—	—	1	2	2	—	2	—	3	—	—	1	1	2	2	—	—	1	1	—	—	1	—	—	1	2	—
JK Cement	2	3	2	—	3	2	2	2	—	—	1	0	4	1	3	3	—	2	—	—	1	3	—	2	2	2	—	2	2	—
Max Financial Services	3	-	1	1	2	2	2	2	5	1	3	—	4	—	—	1	—	—	2	—	2	3	—	2	1	3	—	3	2	4
Cummins India	—	1	2	1	2	—	2	2	2	—	0	2	—	2	2	—	—	—	2	—	1	1	—	—	4	3	—	2	—	2
KEI Industries	2	0	1	—	1	1	1	—	—	—	2	2	—	—	—	2	1	1	—	4	—	1	—	—	—	—	2	2	—	2
SRF	—	0	1	—	—	—	1	1	—	—	—	2	—	2	—	2	2	—	1	—	—	2	—	—	—	—	—	2	1	—
Jubilant FoodWorks	—	1	2	—	1	1	1	1	—	—	4	—	—	—	3	—	1	—	—	—	1	1	—	2	2	2	—	2	1	—
Trent	—	1	3	—	2	—	1	1	—	—	1	—	3	1	—	—	2	—	—	8	1	1	—	—	0	-	—	0	—	1
Bharti Hexacom	—	2	2	1	1	—	1	2	0	2	2	4	2	2	—	2	—	2	—	4	—	3	—	—	1	2	—	2	1	4
Mphasis	2	1	1	—	—	2	1	2	1	—	0	0	—	—	—	3	1	1	3	—	1	—	—	—	—	2	—	1	1	—
The Phoenix Mills	1	1	—	2	2	2	1	1	—	2	—	—	2	—	—	—	—	—	—	—	—	1	—	1	2	1	—	2	2	1
Hindustan Petroleum Corporation	—	1	—	2	—	2	1	1	3	2	—	—	—	—	3	2	—	1	1	—	1	—	3	1	2	2	3	2	1	1
Bharat Forge	1	1	1	1	—	3	1	—	1	—	0	2	1	1	1	1	2	—	2	—	2	—	3	2	—	1	—	—	1	—
Torrent Power	2	1	1	—	2	—	1	—	—	—	0	0	—	—	—	—	1	1	—	—	1	1	—	3	1	1	—	—	1	—
Schaeffler India	1	2	1	2	1	2	1	—	—	2	-	2	—	1	1	2	2	2	1	—	1	1	—	3	1	—	2	1	2	—
GE Vernova T&D India	—	2	3	3	2	—	0	—	—	—	4	0	—	2	1	4	—	—	1	—	1	1	—	—	3	—	—	2	1	1
HDB Financial Services	1	1	0	1	—	1	0	1	—	—	1	1	1	1	1	—	2	—	1	—	1	—	—	2	-	—	—	—	1	—
Prestige Estates Projects	2	1	3	—	2	—	—	2	—	—	0	3	4	1	2	—	2	—	2	2	2	2	—	—	1	—	—	1	—	—
Supreme Industries	2	1	1	—	1	3	—	—	1	—	0	2	—	1	—	—	—	—	2	2	1	1	—	—	1	—	—	2	1	1
Tri-Party Repo (TREPS)	—	—	1	—	2	6	—	—	7	7	2	2	0	—	—	1	3	2	3	—	1	—	12	3	4	—	—	3	—	—
Voltas	1	1	1	—	1	2	—	—	—	—	0	1	—	—	—	1	2	2	3	—	2	1	—	1	0	1	2	1	1	—
Coromandel International	2	3	2	2	—	3	—	2	1	—	—	0	—	—	—	3	2	—	—	—	1	2	—	—	4	—	—	2	1	2
Swiggy	1	1	2	—	2	—	—	—	—	2	0	—	5	1	2	3	—	—	2	—	0	—	—	—	—	—	1	1	1	—
KPIT Technologies	2	0	1	1	2	2	—	—	—	1	0	—	—	—	2	-	1	—	2	2	—	1	—	—	—	—	—	0	1	0
ICICI Lombard General Insurance Company	—	1	1	2	—	—	—	1	0	1	—	—	1	1	—	1	—	—	—	—	1	2	—	0	—	2	—	—	1	1
Total	**41**	**49**	**55**	**32**	**54**	**51**	**47**	**37**	**40**	**36**	**40**	**34**	**50**	**37**	**34**	**51**	**40**	**32**	**34**	**53**	**43**	**45**	**19**	**31**	**45**	**33**	**20**	**54**	**40**	**35**

Source: Ace MF, Kotak Institutional Equities

- **Declining share of 'active' active funds.** Our analysis shows that hybrid funds (ex-arbitrage) have seen a steady decline in the overall AUM of equity-oriented funds (see Exhibit 54). At the same time, the share of flexi-cap. and multi-cap. funds has also seen a steady decline in the overall AUM of equity-oriented funds (see Exhibit 55). In our view, these funds provide greater flexibility to a fund manager to take active decisions. On the other hand, the rising share of sectoral funds (see Exhibit 56) in the overall equity MF AUM would suggest that sectoral allocation is increasingly outsourced to the retail investor on an overall portfolio basis.

Sharp increase in AUM of equity funds versus AUM of hybrid (ex-arbitrage) funds

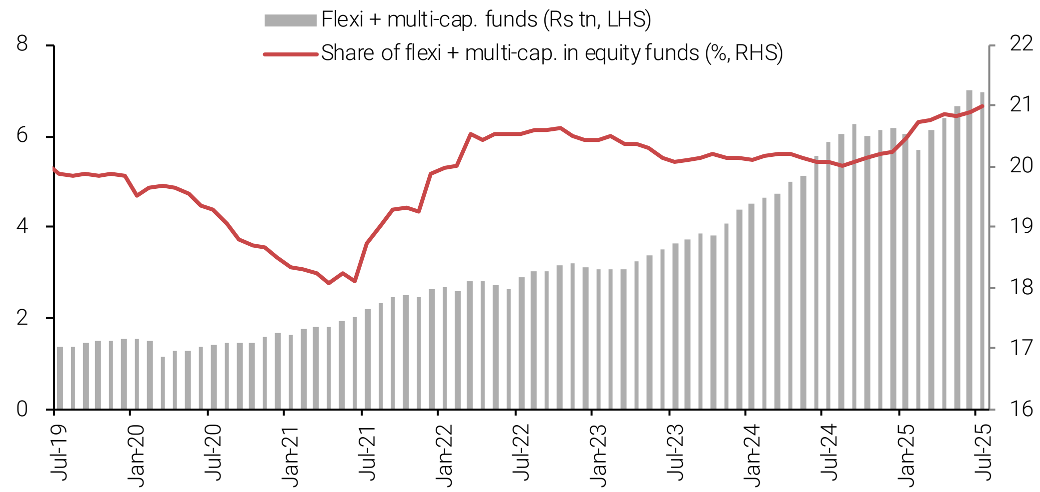
Exhibit 54: Net AUM of equity funds versus hybrid funds (ex-arbitrage), March fiscal year-ends, 2020-26 (Rs tn)



Source: AMFI, CEIC, Kotak Institutional Equities

Share of flexi+multi-cap. funds has been around 20% in equity MF AUM

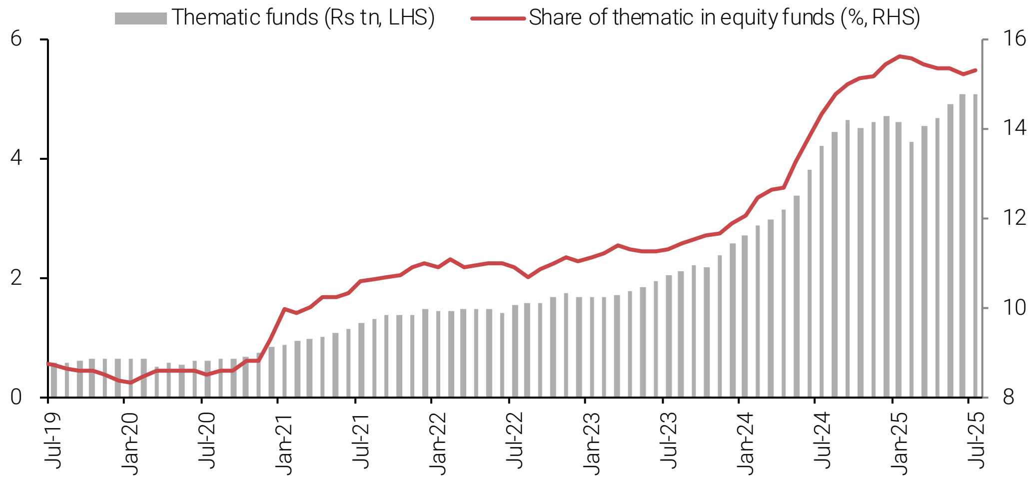
Exhibit 55: Net AUM of flexi-cap. and multi-cap. funds in India, March fiscal year-ends, 2020-26



Source: AMFI, CEIC, Kotak Institutional Equities

Steady increase in share of thematic mutual fund AUM in overall equity AUM in India

Exhibit 56: Net AUM of thematic funds in India, March fiscal year-ends, 2020-26



Source: AMFI, CEIC, Kotak Institutional Equities

Circularity of groupthink resulting in high valuations in pockets and disappointments later

In our view, the steady shift toward 'passivity' of the domestic mutual fund industry may be increasingly affecting the price discovery of stocks with stocks being increasingly disconnected from fundamentals. We note a steady increase in broad market valuations, irrespective of fundamentals, with extremely optimistic narratives driving expectations across sectors and stocks. However, a large proportion of companies have disappointed versus implicit market assumptions in the past few years. Lastly, we note that various guardrails, such as (1) benchmarks, (2) market-cap.-based categorization and (3) sectoral/thematic categorization, create further distortions in stock prices, during phases of market exuberance.

- **Large proclivity to using benchmarks for portfolio construction.** We note that the domestic mutual fund industry may have constrained itself excessively by focusing on benchmarks. In our view, the goal of the industry should be to deliver acceptable risk-adjusted returns on a consistent basis. However, the industry has been consistently using benchmarks to explain fund performance relative to benchmarks and peers. As a result, funds may be often choosing stocks with high momentum in the hope of beating benchmarks in the short term, even when fundamental valuation principles would highlight the risk-reward balance to be unfavorable. Furthermore, the frequent churn in benchmarks, arising from short-term tailwinds to certain sectors and stocks from select narratives may have resulted in many funds focusing on potential entrants in a bid to outperform.

  Exhibits 57-58 show the list of top-20 most-owned stocks by mutual funds, currently in the mid-cap. and small-cap. indices, their fundamental performance over the past three years and current ownership of MFs. We note that only 10/20 highly-owned mid-cap. stocks and 6/20 highly-owned small-cap. stocks have delivered strong returns over the past three years.

50% of highly owned mid-cap. stocks have delivered strong returns over the past three years

Exhibit 57: Financial and price performance of the top-20 mid-cap. stocks with highest mutual fund ownership in June 2025

	FY2025		3Y CAGR (%)			MF ownership
	P/S (X)	P/E (X)	Sales	PAT	Price perf	(%)
Max Financial	1.2	167	14	9	26	39
Coforge	4.8	69	23	8	36	38
Federal Bank	1.7	11	25	28	17	35
Gland Pharma	5.5	44	8	(17)	(10)	31
Ipca Labs.	3.9	40	15	(0)	15	30
Sona BLW Precision	7.8	45	19	21	(5)	28
Jubilant Foodworks	5.1	181	23	(19)	2	27
Fortis Health.	8.8	81	11	41	47	26
Vishal Mega Mart	6.5	110	NA	NA	NA	26
Mphasis	3.7	31	6	6	12	24
KEI Industries	3.7	52	19	23	40	24
GE Vernova T&D	16.6	117	12	NM	174	24
Persistent Systems	7.0	59	28	27	47	22
Emami	6.6	31	6	(2)	7	22
Bharat Forge	3.5	51	13	1	14	21
Blue Star	3.2	67	25	51	53	21
Dixon Technolog.	2.6	137	54	57	62	21
J K Cements	4.5	68	14	5	37	21
Syngene Intl.	6.9	53	12	4	2	21
AU Small Finance	3.3	25	39	23	3	21

Source: Capitaline, FactSet, Kotak Institutional Equities

Only a small number of highly-owned small-cap stocks have delivered strong returns over the past three years

Exhibit 58: Financial and price performance of the top-20 small-cap. stocks with highest mutual fund ownership in June 2025

	FY2025		3Y CAGR (%)			MF ownership
	P/S (X)	P/E (X)	Sales	PAT	Price perf	(%)
Crompton Greaves Consumer	2.7	38	13	(2)	(5)	49
Kalpataru Projects	1.0	36	15	13	45	40
MCX	33.8	67	45	52	82	36
Sapphire Foods	3.7	348	19	(13)	6	32
PVR Inox	1.9	NM	63	NM	(16)	32
Karur Vysya Bank	2.1	11	20	42	54	31
Metropolis Health	8.5	78	3	(11)	16	30
Cyient	1.8	21	18	6	13	29
RBL Bank	1.1	22	18	(263)	30	29
City Union Bank	2.5	13	12	14	4	29
IEX	23.2	29	8	12	(4)	28
Carborundum Universal	3.6	48	14	3	3	27
Delhivery	3.9	209	9	NM	(6)	27
PNB Housing	2.6	10	7	32	36	27
Whirlpool India	2.1	47	9	7	(9)	26
Balrampur Chini	2.0	25	4	(2)	16	26
PNC Infratech	1.2	10	(2)	12	2	25
KIMS	9.6	77	23	4	43	25
Sonata Software	1.0	23	22	4	10	25
GSPL	0.9	15	(1)	(12)	8	25

Source: Capitaline, FactSet, Kotak Institutional Equities

- **Rule-based market cap. categorization may be accentuating distortion.** We believe that current market cap. categorizations of ranking the top-100 stocks as large cap., 101-250th stocks as mid-cap. and rest of the stocks as small-cap. may be reducing flexibility of fund managers and consequently creating more distortions in the market. In our view, such artificial distinctions serve limited purpose, especially as the market caps of stocks will likely increase over time.

  Nonetheless, fund managers have decent leeway in managing risk, given the current construct of various funds. Exhibit 59 shows the broader criteria on mutual funds, based on market caps. In our observation, only a few funds may be appropriately using the reasonable flexibility available within the categorization criteria for various types of funds.

Decent flexibility to manage risks under the current framework for various types of equity funds

Exhibit 59: Key restrictions on minimum investment in equity and market cap. for various types of equity mutual funds

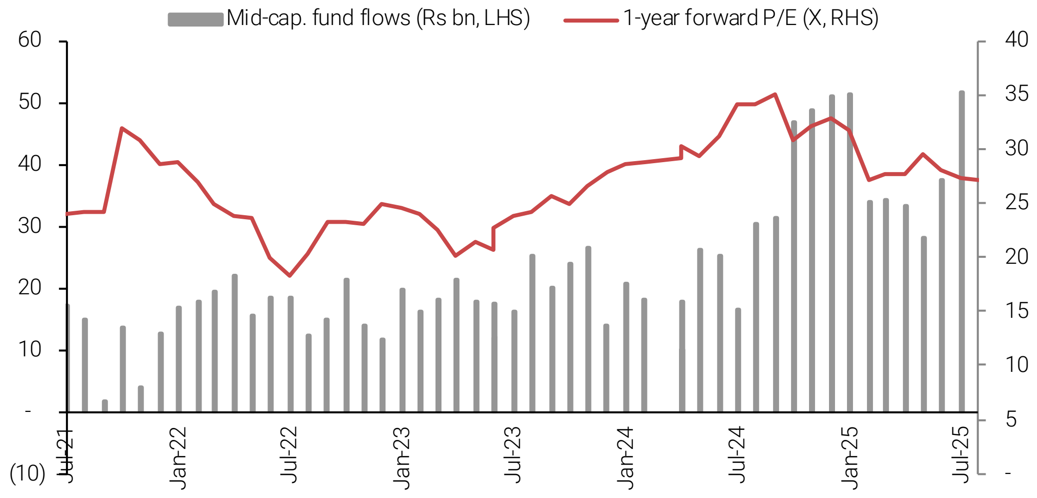
Fund type	Restriction
Contra	Contrarian strategy with at least 65% investment in stocks
Flexi-cap.	At least 65% investment in equity & equity-related instruments
Focused	Maximum 30 stocks with at least 65% investment in equity & equity-related instruments
Large & mid-cap.	At least 35% investment in large-cap. and at least 35% investment in mid-cap. stocks
Large-cap.	At least 80% investment in large-cap. stocks
Mid-cap.	At least 65% investment in mid-cap. stocks
Multi-cap.	At least 75% investment in equity & equity-related instruments
Sectoral/thematic	At least 80% investment in stocks of a particular theme
Small-cap.	At least 65% investment in small-cap. stocks
Value	Value investment strategy, with at least 65% investment in stocks

Source: AMFI, Kotak Institutional Equities

In our view, the constraints imposed by the artificial categorization of stocks into various capitalization buckets become more visible during periods of exuberance, given (1) optimistic expectations among investors about SMID stocks delivering stronger earnings and performance than large-cap. stocks, (2) disproportionate quantum of mobilized funds going into SMID funds and (3) lower liquidity of SMIDs versus large-caps. Exhibits 60-61 show the circularity in valuations of SMIDs versus flows into mid-and-small cap. active funds in India.

Mid-cap. funds see sharp increase in net inflows after periods of strong performance of mid-cap. stocks

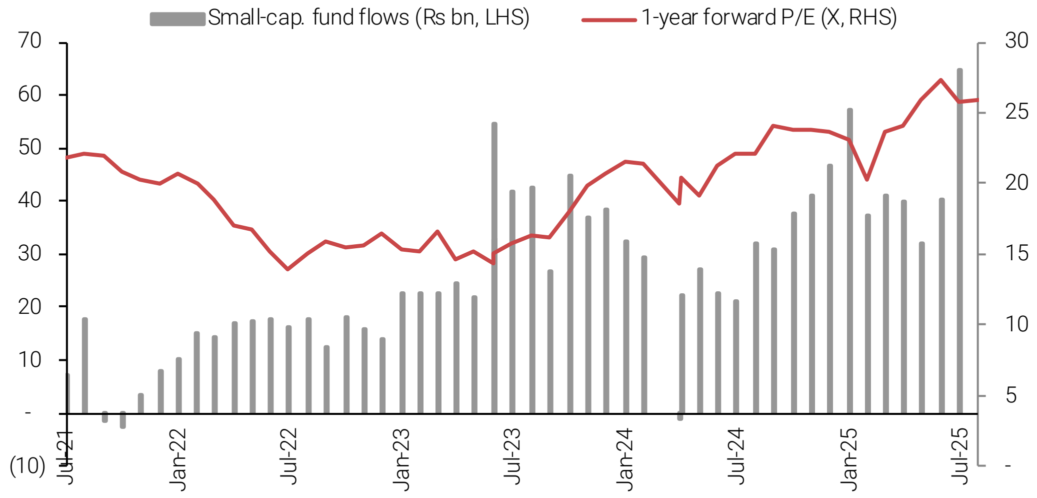
Exhibit 60: Net inflows into active mid-cap. funds versus valuation, March fiscal year-ends, 2022-26 (Rs bn, X)



Source: Bloomberg, AMFI, Kotak Institutional Equities

Small cap. funds see sharp increase in net inflows after periods of strong performance of small-cap. stocks

Exhibit 61: Net inflows into active small-cap. funds versus valuation, March fiscal year-ends, 2022-26 (Rs bn, X)



Source: Bloomberg, AMFI, Kotak Institutional Equities

- **Optimistic narrative-driven flows to thematic/sectoral funds accentuate distortions.** We believe that the creation of a large number of theme-based indices may be accentuating distortions in equity markets even more, given some degree of overlap of stocks in the thematic indices versus other indices. Exhibit 62 shows the top-10 stocks by market cap. in the major thematic benchmarks.

Stocks in thematic indices tend to be subset of broader indices and thereby have some degree of overlap with each other too

Exhibit 62: Top-10 stocks in major thematic benchmarks and their weights, August 29, 2025 (%)

Nifty India Consumption		Nifty India Defence		Nifty Energy		Nifty India Manufacturing	
Stock	Weight (%)	Stock	Weight (%)	Stock	Weight (%)	Stock	Weight (%)
ITC	9.6	Bharat Electronics	21.3	Reliance Industries	9.8	Maruti Suzuki	5.4
Bharti Airtel	9.4	Hindustan Aeronautics	21.2	ONGC	9.8	Mahindra & Mahindra	5.0
Mahindra & Mahindra	8.5	Solar Industries	14.9	Coal India	9.2	Sun Pharmaceuticals Industries	4.8
Hindustan Unilever	7.1	Mazagon Dock Shipbuilders	8.8	NTPC	6.9	Reliance Industries	4.7
Eternal	6.6	Cochin Shipyard	6.0	Suzlon Energy	6.0	Tata Motors	3.9
Maruti Suzuki	5.8	Bharat Dynamics	5.9	Power Grid	5.6	Bharat Electronics	3.5
Titan	4.5	Astra Microwave Products	3.8	GAIL (India)	5.0	Tata Steel	3.5
Trent	3.5	BEML	3.3	CG Power & Industrial Solutions	3.9	Hindalco Industries	2.8
Asian Paints	3.4	Data Patterns	3.2	GE Vernova T&D	3.1	JSW Steel	2.7
InterGlobe Aviation	3.3	Garden Reach Shipbuilders	3.1	Tata Power	2.8	Bajaj Auto	2.6

Notes:
(a) Business cycle funds and innovation funds are benchmarked versus the Nifty-500 Index by most funds.

Source: Ace MF, NSE, Kotak Institutional Equities

Furthermore, we note that most major thematic funds were launched on the back of strong trailing returns of the respective benchmarks (see Exhibit 63). However, subsequent returns of most of these funds have been poor reflecting the disappointment in the themes versus unrealistic expectations around the themes in the market. Exhibit 64 shows the trend in aggregate NAV of thematic funds over the past two years. As can be seen, the weighted-average NAV of these funds are currently around December 2023 levels, suggesting large time-correction for this cohort.

NFO launches were on the back of strong trailing returns of their respective benchmarks

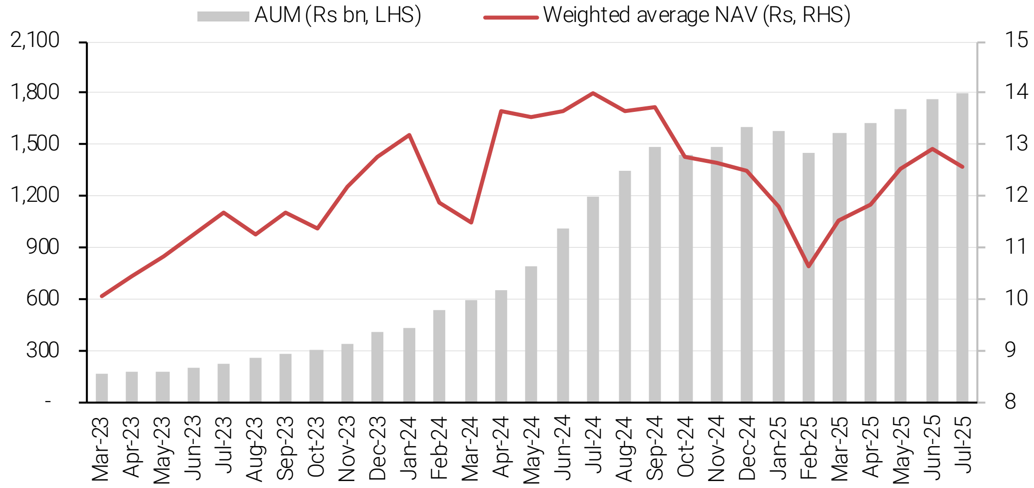
Exhibit 63: 3m and 6m trailing return to the NFO open date of select sectoral/thematic funds over 2022-25 (%)

		Benchmark Trailing return (%)	
Thematic funds	Benchmark Index	3M	6M
Fund A	Nifty India Manufacturing - TRI	17	36
Fund B	NIFTY ENERGY - TRI	50	79
Fund C	NIFTY 500 - TRI	12	19
Fund D	NIFTY ENERGY - TRI	40	47
Fund E	NIFTY AUTO - TRI	14	38
Fund F	Nifty India Consumption - TRI	12	21
Fund G	NIFTY 500 - TRI	23	33
Fund H	Nifty India Manufacturing - TRI	6	19

Source: Ace MF, Kotak Institutional Equities

Weighted-average NAV of sectoral/thematic funds are similar to December 2023 levels

Exhibit 64: Total AUM and weighted-average NAV of sectoral/thematic funds launched since 2023



Source: Ace MF, Kotak Institutional Equities

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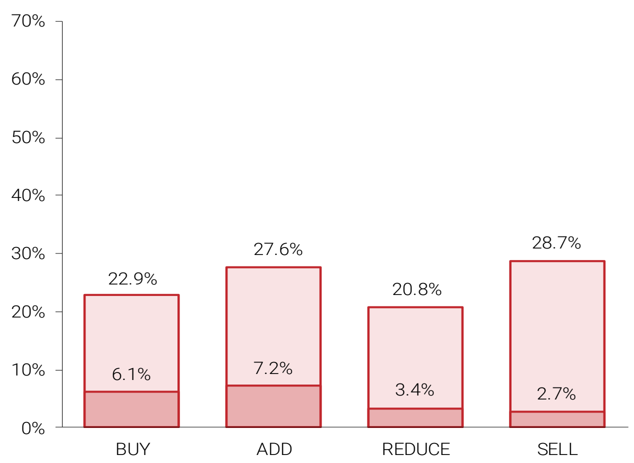

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Source: Kotak Institutional Equities

As of June 30, 2025

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