NETRA

Early Signals Through Charts

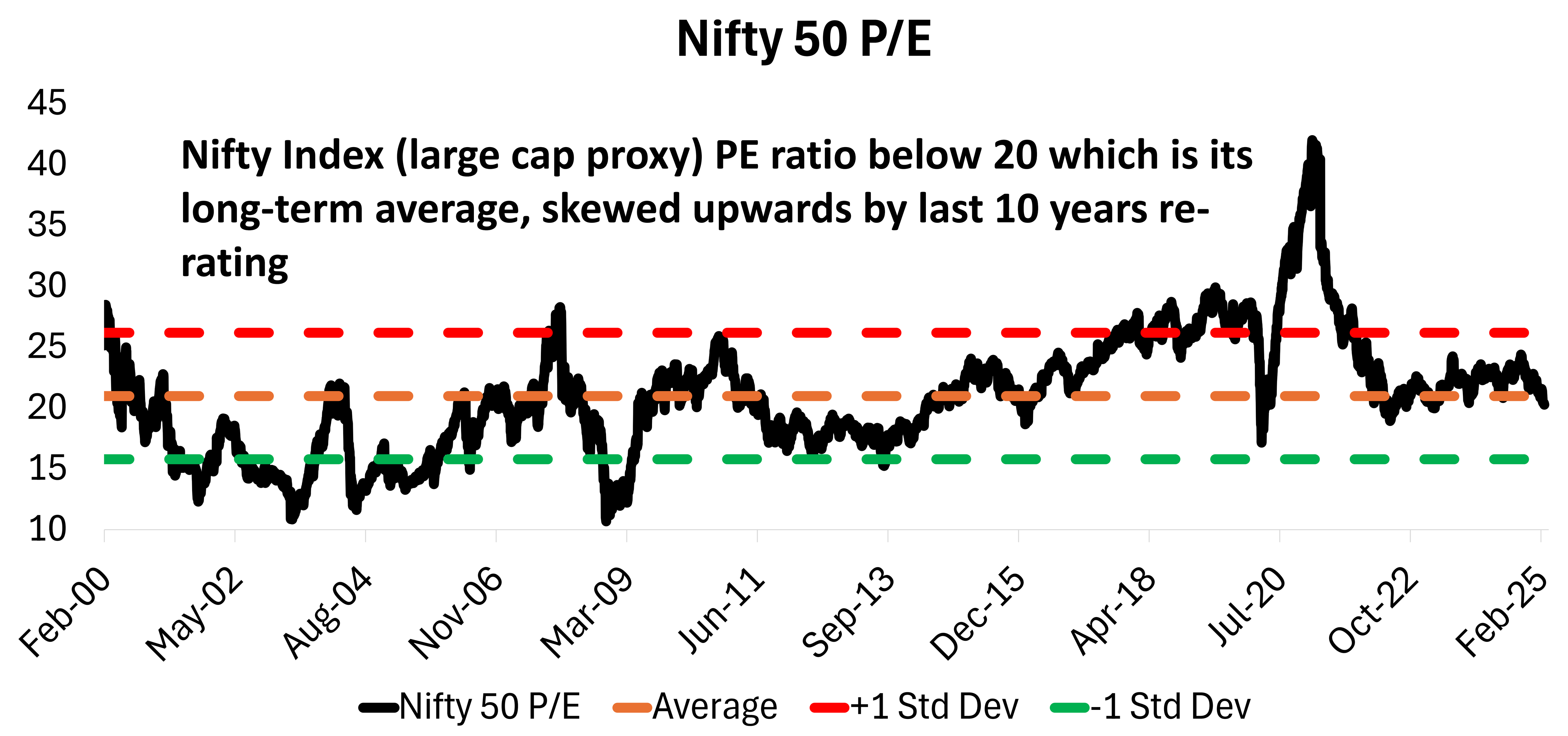
March 2025

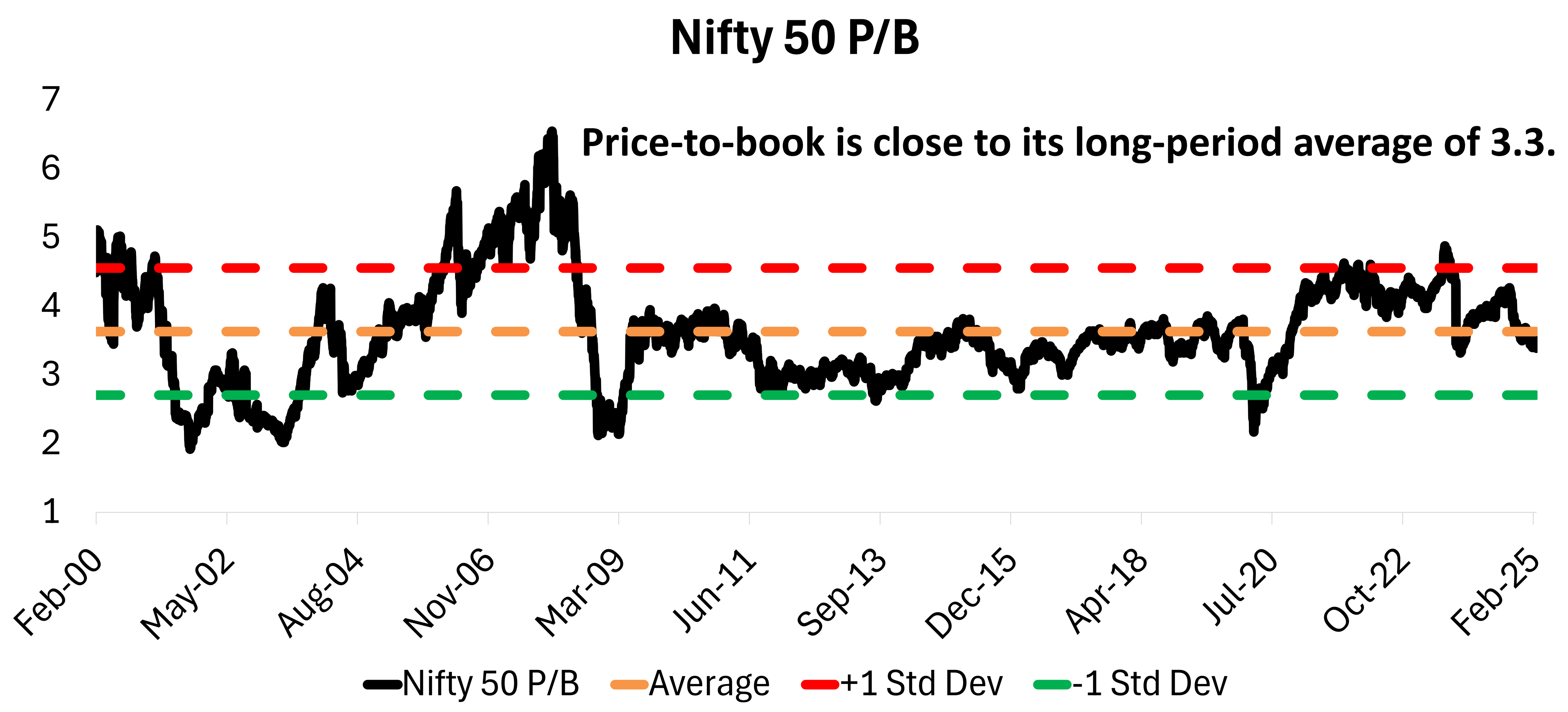
Released on 05th March 2025

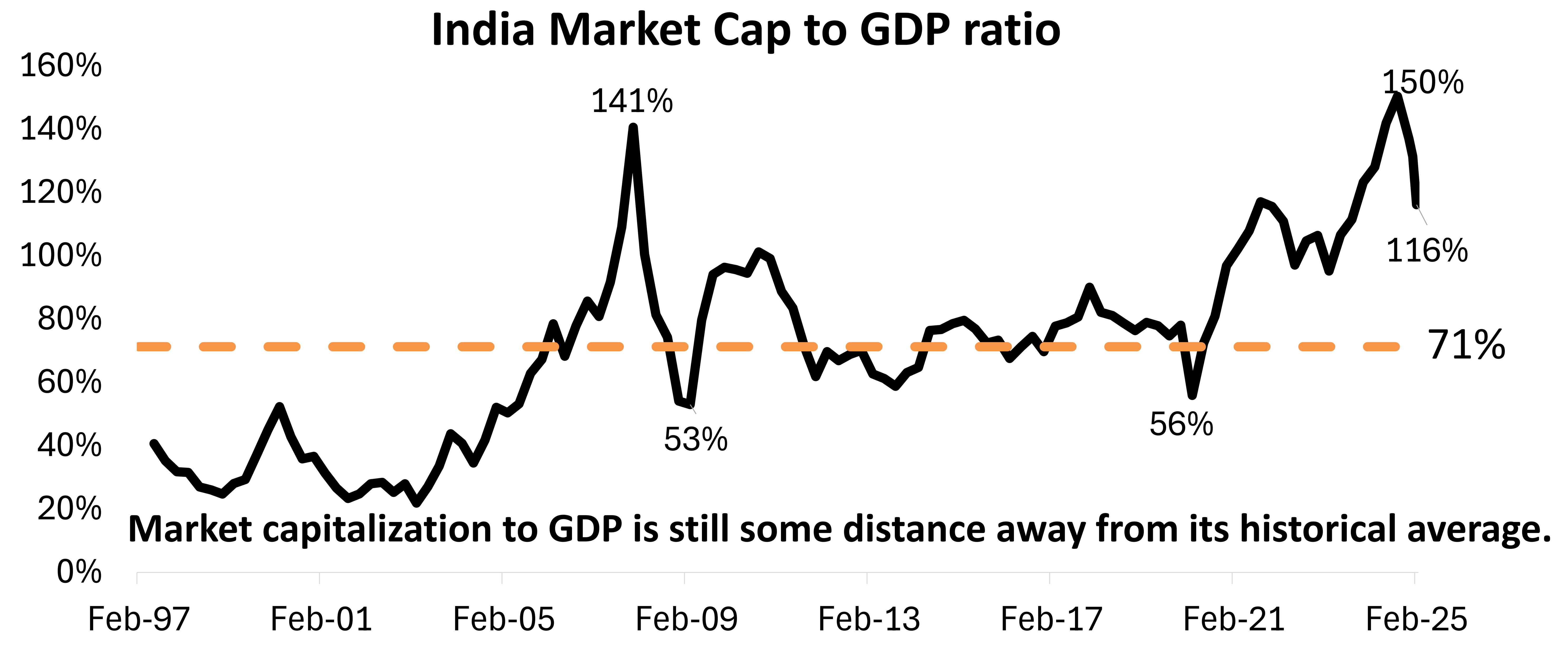
Thoughts On Indian Equity Valuations

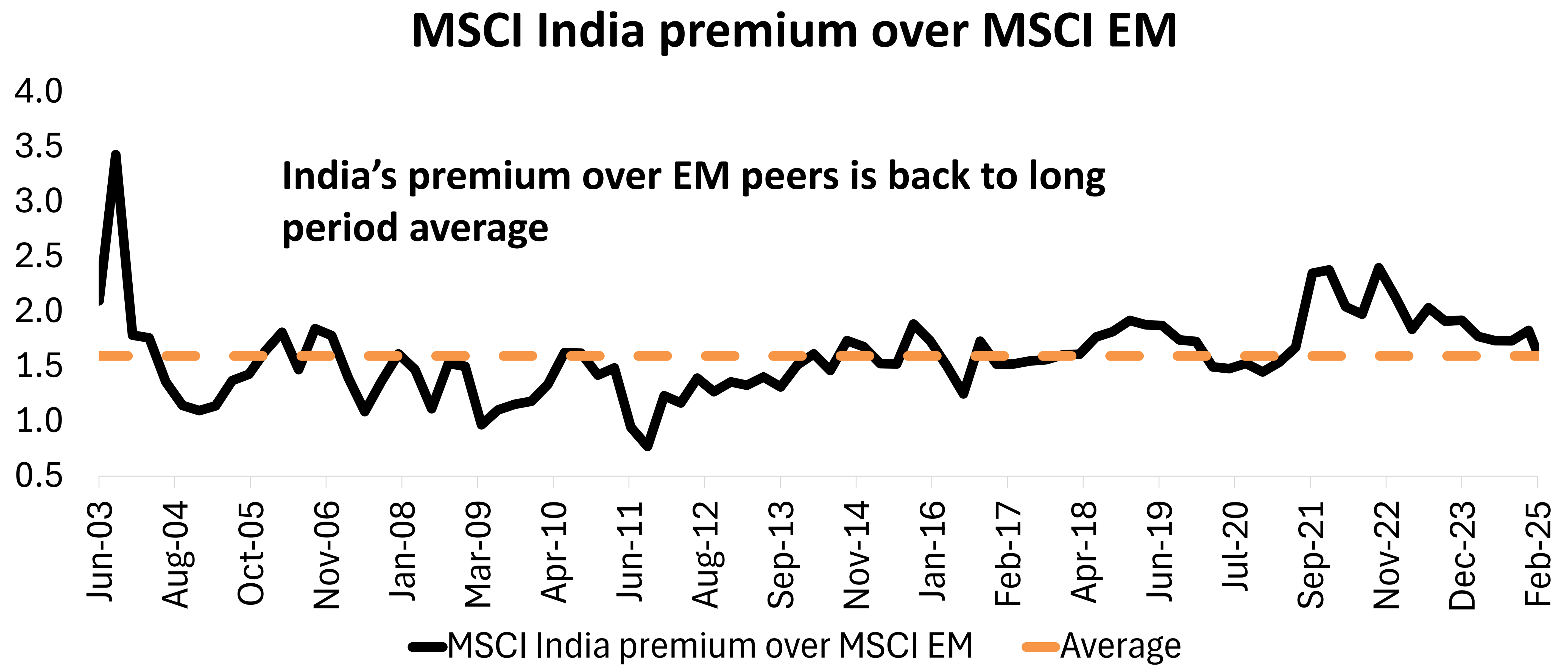
DSP

Has Large Cap Valuation Froth Been Washed Off?









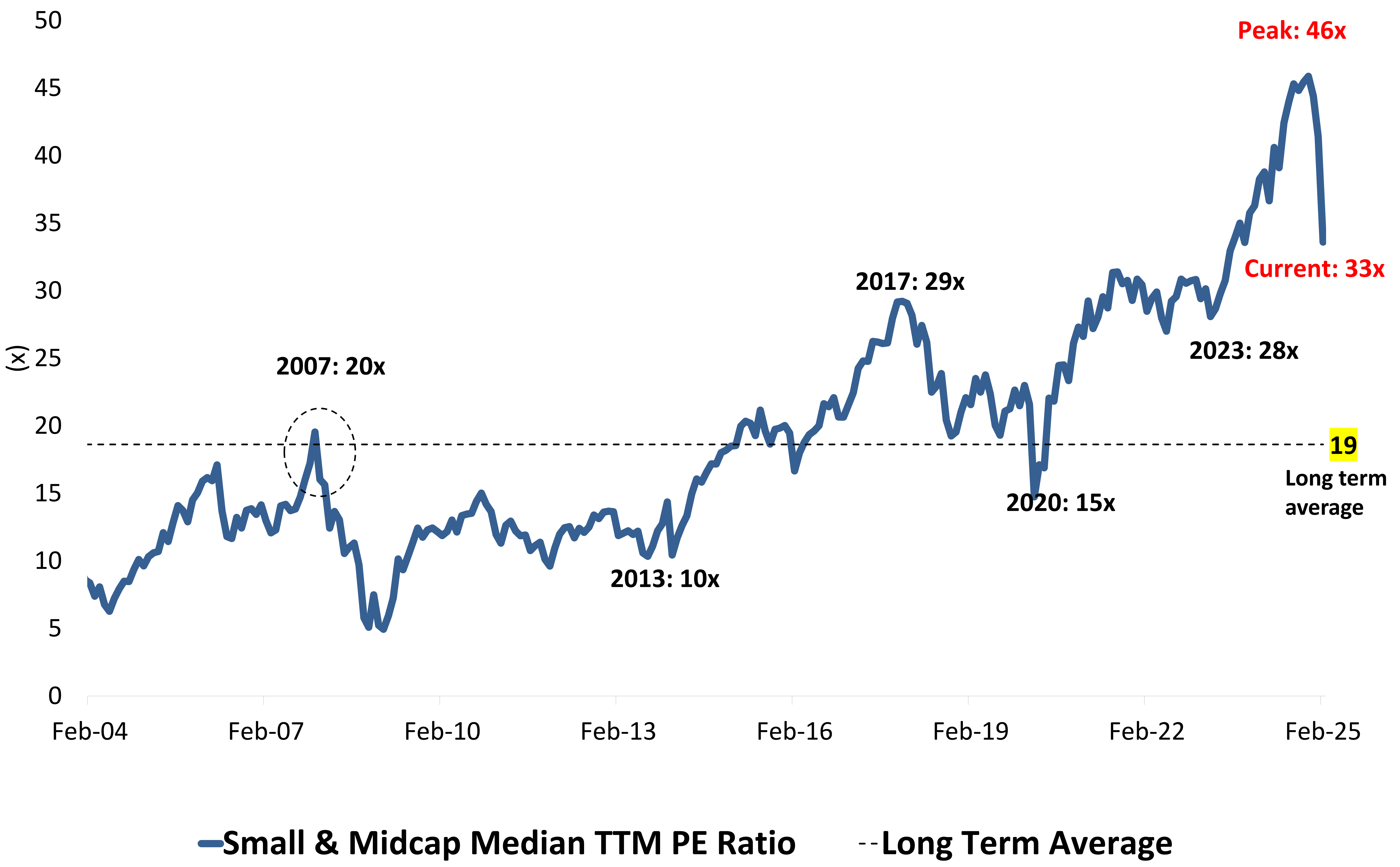
DSP

Source: NSE, CMIE, DSP. Data as of Feb 2025. For Feb 2025 we have considered March estimate GDP.

Small & Midcap Valuation Multiples Are Beginning To Soften

SMID profits, after outperforming large caps for most of FY25, have now started to lag for the second consecutive quarter. This underperformance could be a result of a domestic slowdown, to which SMIDs earnings are sensitive. Excluding BFSI, SMID profit growth has sharply declined and has been contracting year-over-year for the second consecutive quarter, underperforming large caps. The only exception is BFSI, where SMID banks continue to deliver stronger profit growth.

The decline in profit growth is a problem. When valuations are at an all time high and SMID universe ROE's are at ~14%, a slowdown in earnings can be brutal for stock prices. This is the scenario which was visible in numbers but took time for markets to deliver. Markets have their own memory and mechanisms beyond pure logic and data. Markets fluctuate. They are now fluctuating towards better prices. But for SMIDs, there is still some distance to cover.



DSP

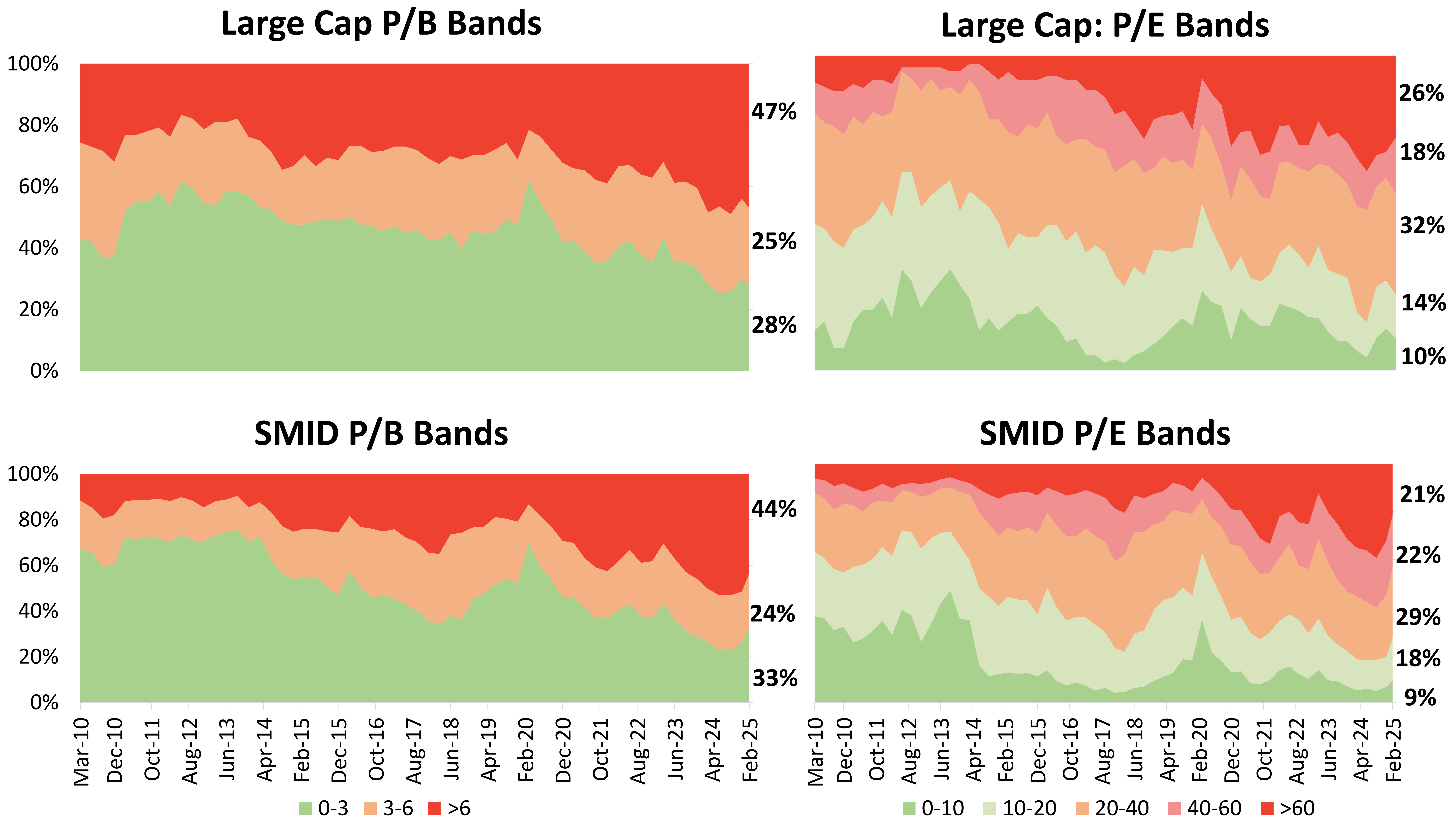
Source: Nuvama Research, DSP, Data As of Feb 2025

The Valuations Breadth Timelapse – From Conservatism To A Moderate View

With 15% to 20% fall in indices, depending on which broad index you select, valuations have begun to normalize.

At the extreme, back in Sep’24 (easily identifiable in hindsight now) less than 1 in 4 stocks were trading below 3x price to book within the Nifty MidSmall 400 Index universe, a rare occurrence in Indian equity markets.

This number has now increased to about 33%, or 1 in 3 stocks now have a price to book of below 3x. A healthy condition is to have a universe with at least half the stocks below 3x price to book when the aggregate ROEs are close to 15%. We are still some distance from it. A combination of softer prices and rising earnings may help align valuations to the long-term history.



DSP

Source: DSP. Data as of Feb 2025. Negative earnings (P/E) and book value (P/B) companies are excluded.

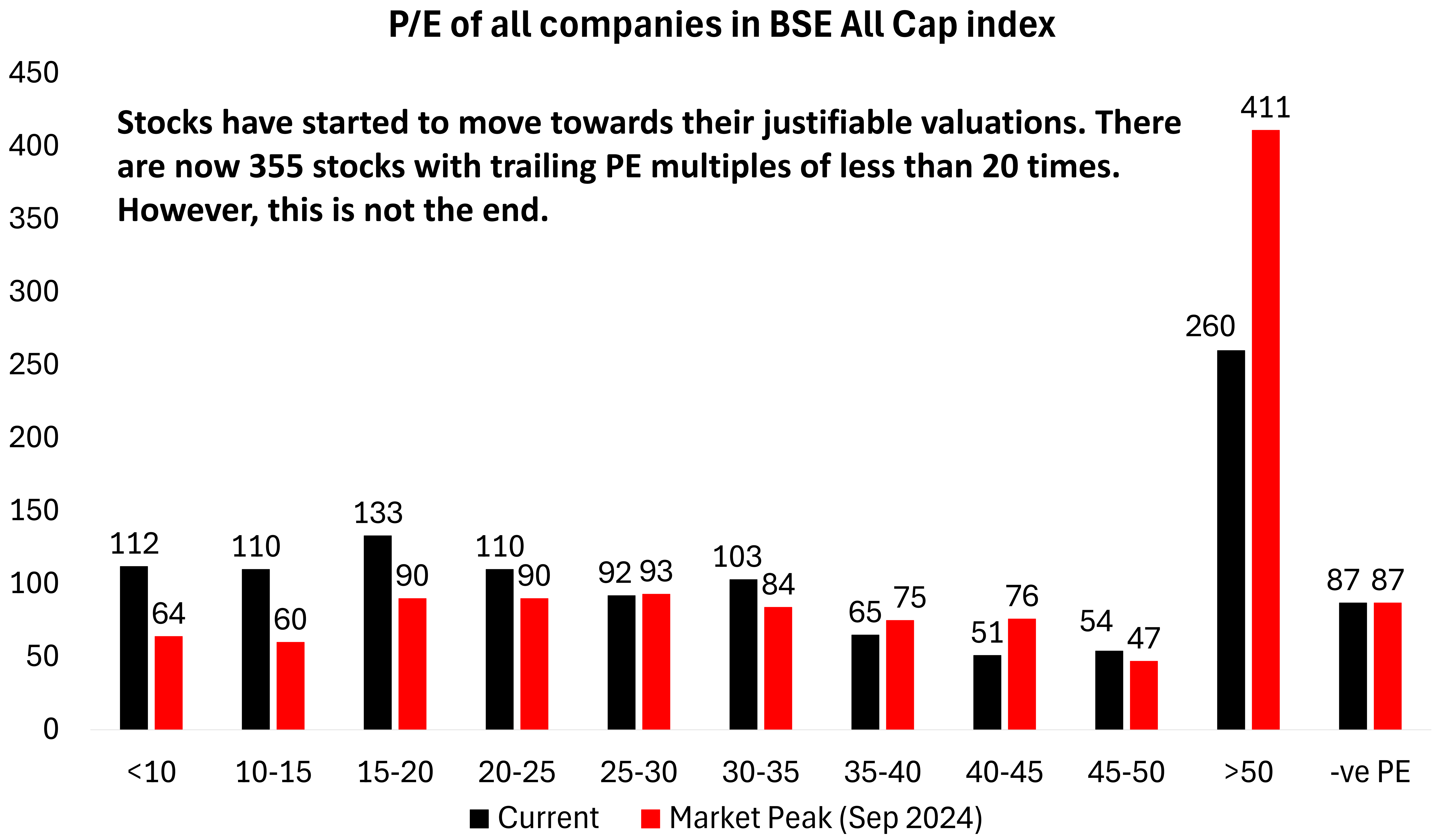
Downshift In Valuations Across The Broader Universe Augurs Well For Long-Term Investors

Across market capitalizations, price earnings multiples are trending lower. This shift is driven by a combination of slowing earnings growth and the ever-changing temperament of Mr. Market.

Ben Graham's timeless allegory remains relevant:

"Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you."

As the market swings into a manic-depressive phase, opportunities will emerge. Those with both capital and conviction will be best positioned to seize them. Courage will come in handy as well.



Source: Bloomberg, DSP. Data as of Feb 2025.

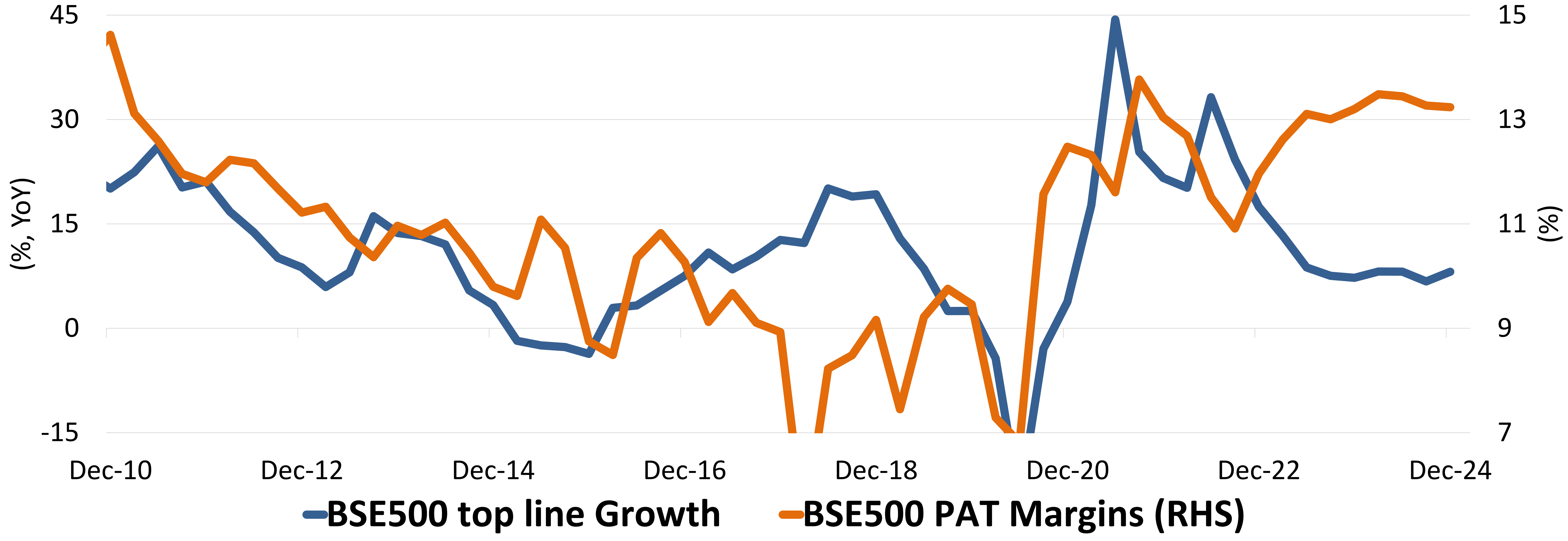
Earnings Growth Has Slowed, Margins Compression Ahead?

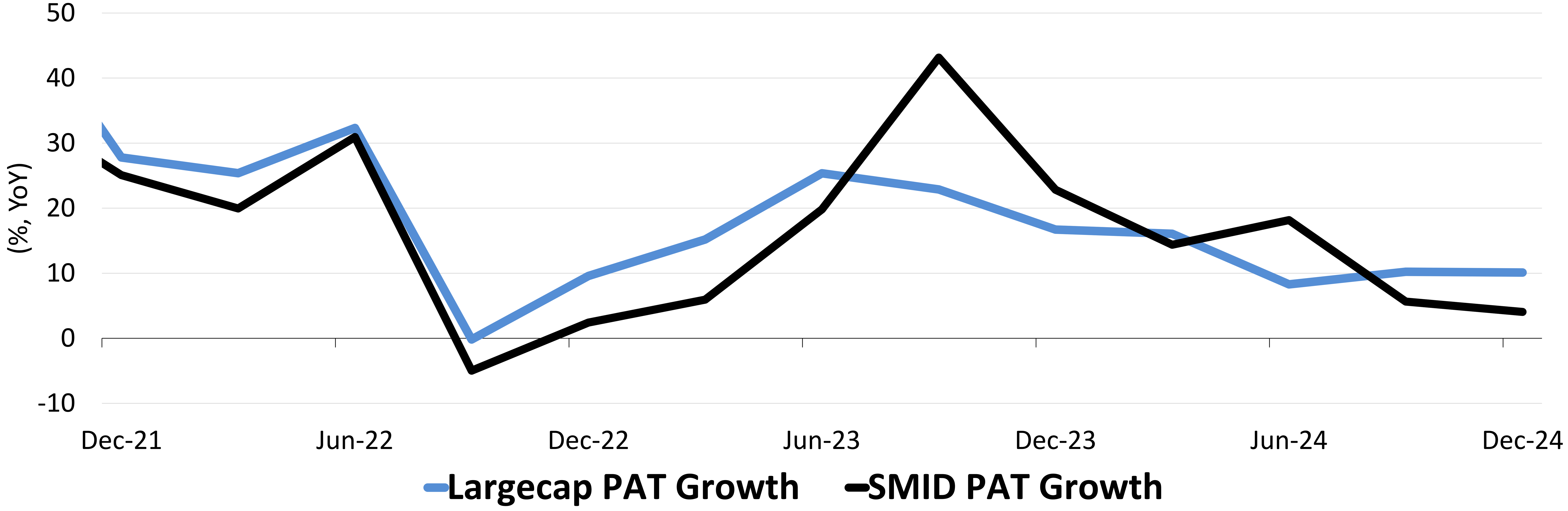
Indian equities were riding high on earnings growth. The post-pandemic earnings recovery cycle lasted a while and significantly boosted market sentiment. This was reflected in rising earnings multiples of the PE ratio.

One driver of earnings was a sharp profitability rebound due to declining raw material and other costs. This boosted profit margins, as shown by the orange line in the first chart. Margins for the BSE 500 are near their all-time high.

The other contributor was sales growth. The topline growth for the BSE 500 stayed above 20% for a considerable period.

Both these levers have now reversed. This is the biggest short-term "worry" for the markets. If earnings growth mutes to 10–12%, valuation multiples must contract—and they are contracting now. Also, note how sharply earnings for the Small & Midcap (SMID) universe have shrunk. That's one reason we highlighted the complete absence of a margin of safety in SMIDs. SMID valuations are now mean-reverting, and earnings growth bottoming out will determine where they stabilize.





DSP

Source: Nuvama Research, DSP. Data as of Feb 2025

Large Cap Valuations Approaching Average, Broader Market Still Away

Nifty Index price to earnings ratio is now close to its long period average. But the price to earnings ratio, or one way of valuing the aggregate numbers has been rising steadily for the last many years. Nifty Index TTM PE Ratio averaged 17x from 2003 to 2013 and since then, from 2014 to now, it has averaged 22x. A 5 points re-rating upwards. One way to judge a fair multiple for the Index is to consider the Return on Equity (ROE) at an aggregate level in context of earnings growth. It is not the most pristine way, but an indication of current market placement.

From Sep 2024 peak, Nifty Index PE has declined by 5pp or 20%, while for Nifty 500 the decline is sharper. At an ROE of 15%, and earnings growth of 14.5%, the PE for Nifty 500 Index still looks rich. Earnings growth for the broader market is slowing as indicated in the last slide. If earnings grow at 10% to 12% range, considering an ROE of 15%, market would be fairly valued when it trades close to 17x to 17.5x PE multiple. Nifty Index is approaching that territory fast while Nifty 500 Index is a bit of a distance away. Once there, the ability of valuations to influence equity allocation, at aggregate level will decline. Large cap indices are approaching a point which warrants moderate equity allocation, diluting the conservative stance that valuations suggested for a long while. Another 8% to 10% price correction or a sequential rise in earnings EPS or a combination will get large caps there. For broader market, the valuations comfort is still missing but is on its way.

In the CY25, Nifty Index EPS is likely to touch Rs. 1150, when is unknown. At 17x to 17.5x trailing earnings (or say 19500 to 20,200 Index levels) there wouldn't be much to gauge from these numbers for allocation decisions. Hence, equity allocation to large-caps in a moderate manner should be considered in this valuation range. There is no perfect method.

Nifty 500 Index	Sep-24	Feb-25	Change
Index Level	24,500	20,000	-18.4%
PE Ratio	28	22	-21.4%
ROE %	15.5	15.3	-0.2
TTM EPS Growth yoy%	22%	14.5%	-7.5%

Nifty Index	Sep-24	Feb-25	Change
Index Level	26,200	22,200	-15.3%
PE Ratio	24.8	20	-19.4%
ROE %	15.9	15.9	0.0
TTM EPS Growth yoy%	15%	11.0%	-4.0%

Note: Numbers for EPS Growth of Index and not Aggregate PAT growth of constituents. EPS numbers are higher due to weights & OMC/Fertilizer industry one-offs

DSP

Source: DSP, Capitaline, Data As of Feb 2025

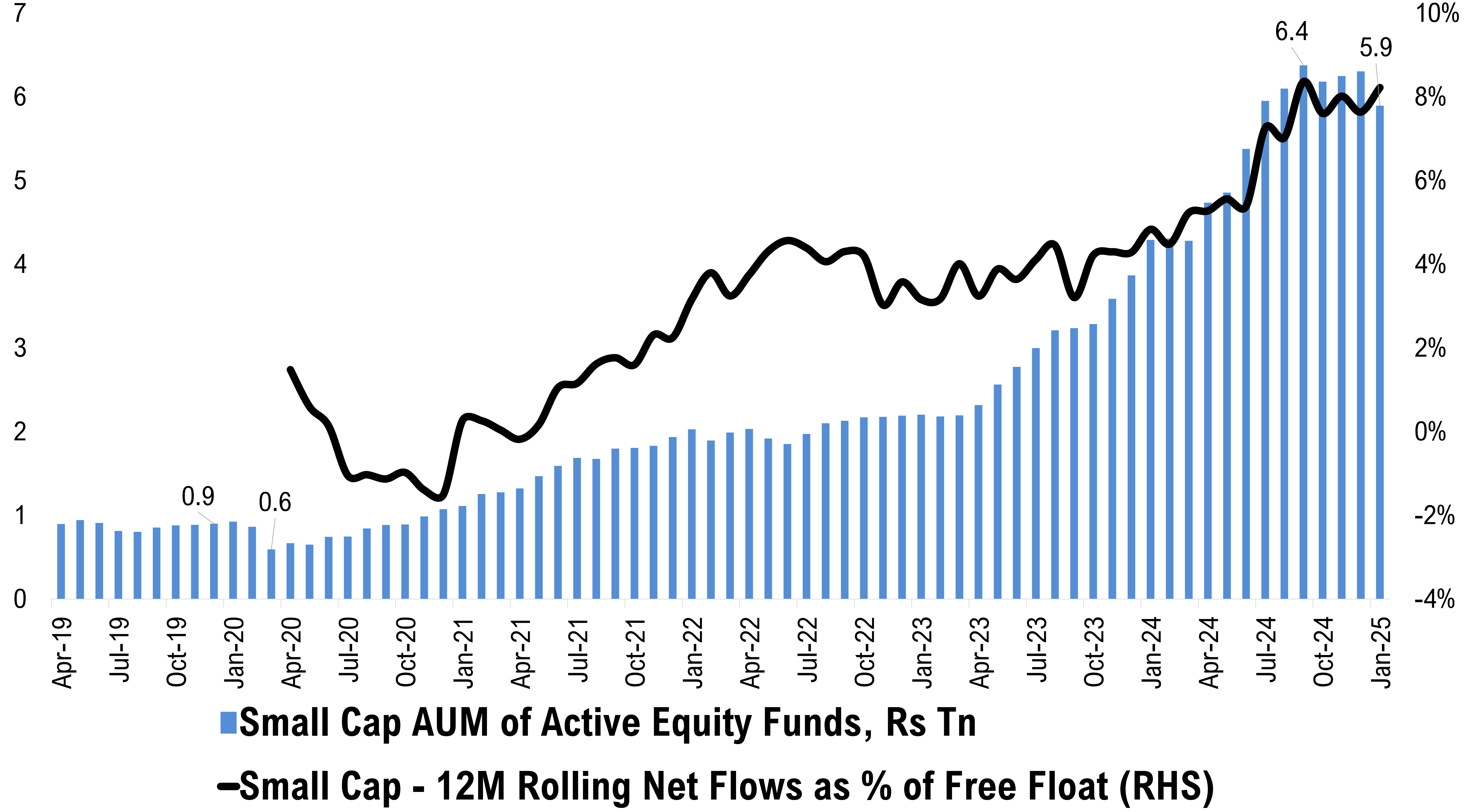
An Aberration That Mr. Market Can Correct: Flows Into Small Caps

In previous DSP Netra editions, we noted: "Flows chase returns, not cause them." Here, we define the Smallcap universe as stocks ranked 251–500 by market capitalization, including data from all active equity fund categories not just Smallcap funds.

The pace of flows into the Smallcap universe has been exceptional. Fueled by strong performance, investors have flocked to this category in recent years. Over the past 12 months, mutual fund flows into the Smallcap universe reached 8.2% of its free float—an unprecedented level. Further, the small cap assets held by active equity funds rose 10x since Mar-20 (versus 6.6x growth in free float). In the same period, large cap assets of active equity funds increased by 4x (versus 3x growth in free float). Individual investors and domestic mutual funds hold ~40% of India's free float market cap. Assuming a similar ratio for Small caps, 8.2% of flows targeted this universe in the last year. This may have caused a short-term anomaly in the Smallcap and broader SMID segments.

As returns soften, incremental flows to Small caps are likely to decline, reducing excess valuation froth.

Small Cap assets of active equity funds rose ~10x from Mar 2020
Last 12M rolling Small Cap net flows are 8.2% of the average free float of the period



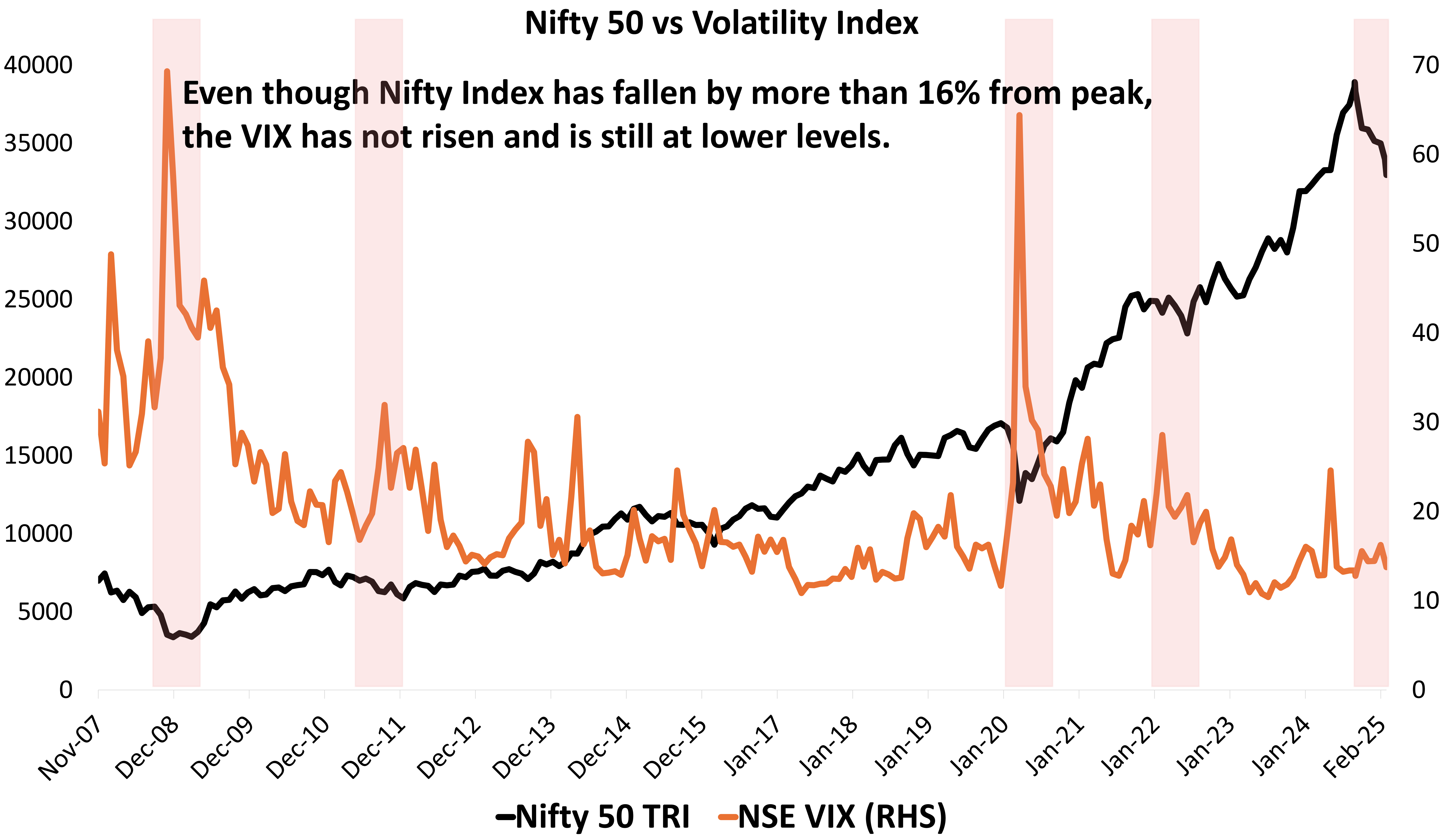
DSP

Source: MFIE, Bloomberg, DSP. Data as of 31 Jan 2025. All Active Equity MF categories are considered. Market Cap grouping is based on AMFI categorization used by MFIE. Net flows are estimated using change in monthly AUM adjusted for Index mark to market movement. Average free float of Nifty Smallcap 250 & Nifty 100 during the evaluation period is considered to arrive at % data.

Volatility Readings Yet To Indicate Capitulation, Don't Be In A Hurry

The VIX is a market options pricing based forward-looking indicator. It is a combination of values derived from puts and calls, and it does not attempt to predict what direction markets are expected to head - only how bouncy the path will be over the next month. It rises sharply when market participants are ready to pay a premium for capturing large moves in the market. This means VIX rises sharply when market moves wildly. Most bear markets experience elevated VIX readings when they decline sharply, typically above 20 VIX.

Bear markets are characterized by RUST: Randomness, Uncertainty, Stressors, Turbulence. This makes navigating them challenging. As investors we need to be optimistic about falling equity valuations and prices, especially in sectors and firms where quality of the businesses is intact. However, bear markets usually make price bottoms when participants are ready to pay a steep premium for protection (buying puts) or for high volatility. This means an elevated VIX readings beyond 20, would be a good sign of capitulation



DSP

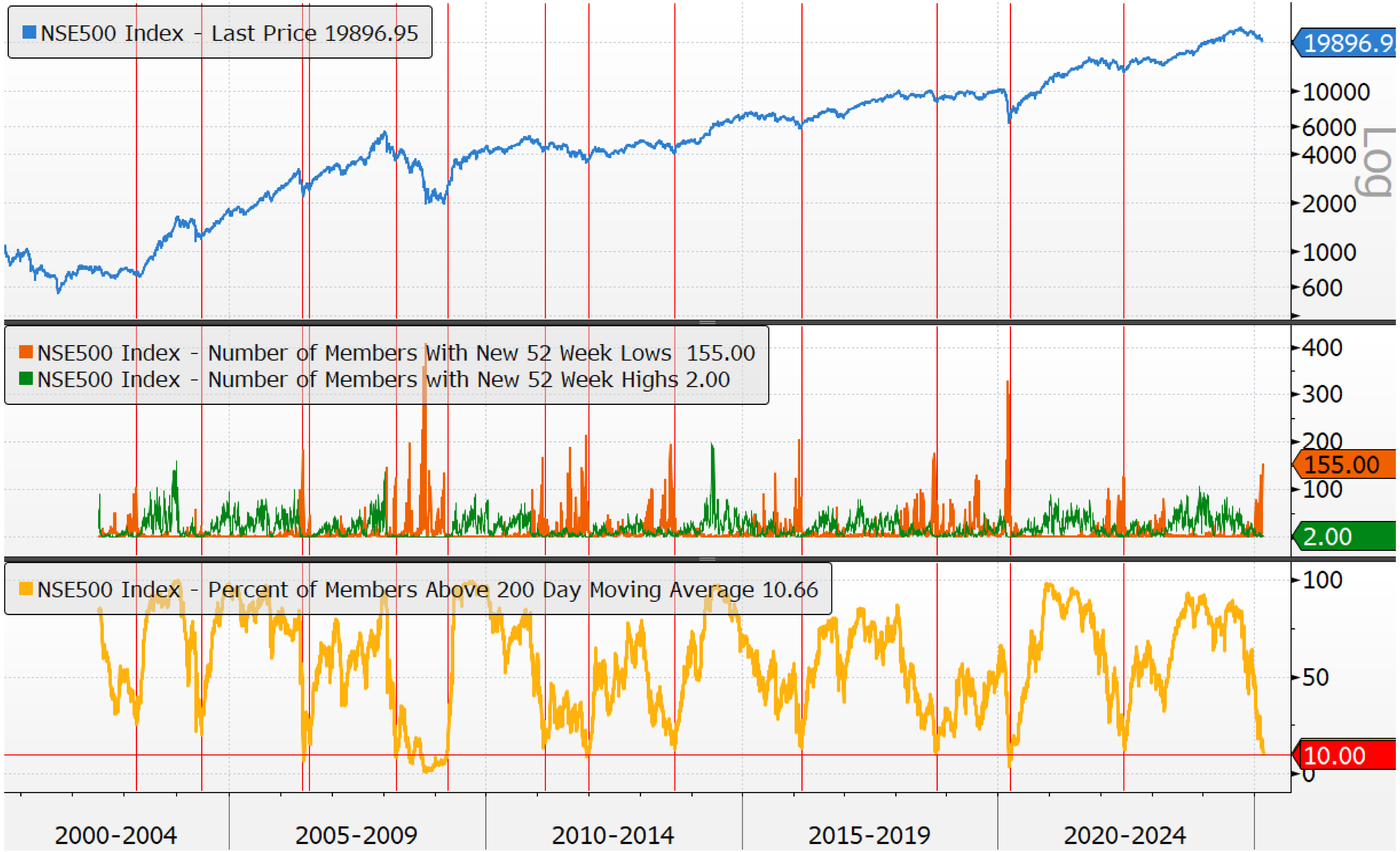
Source: NSE, DSP. Data as of Feb 2025

Market Breadth Has Deteriorated To Bear Market Levels

The number of stocks trading above the 200DMA has fallen to about 10% of the Nifty500 Index constituents. This is consistent with how dramatically the market breadth deteriorates during bear markets.

Note that the number of stocks making a new 52-week low stands at 155 (as of 3rd March 2025 close). In the past, this number has risen to a much higher level. This means that nearly 200 or more stocks must hit their 52-week low simultaneously before the index sees a slowdown in downward momentum.

There are other indicators which signal market breadth and price deterioration characteristics. For instance, after a prolonged bull market of more than 3 years, most stocks give up more than 50% of the gains registered from the start to end of the bull market. These readings are approaching but are some distance away.



DSP

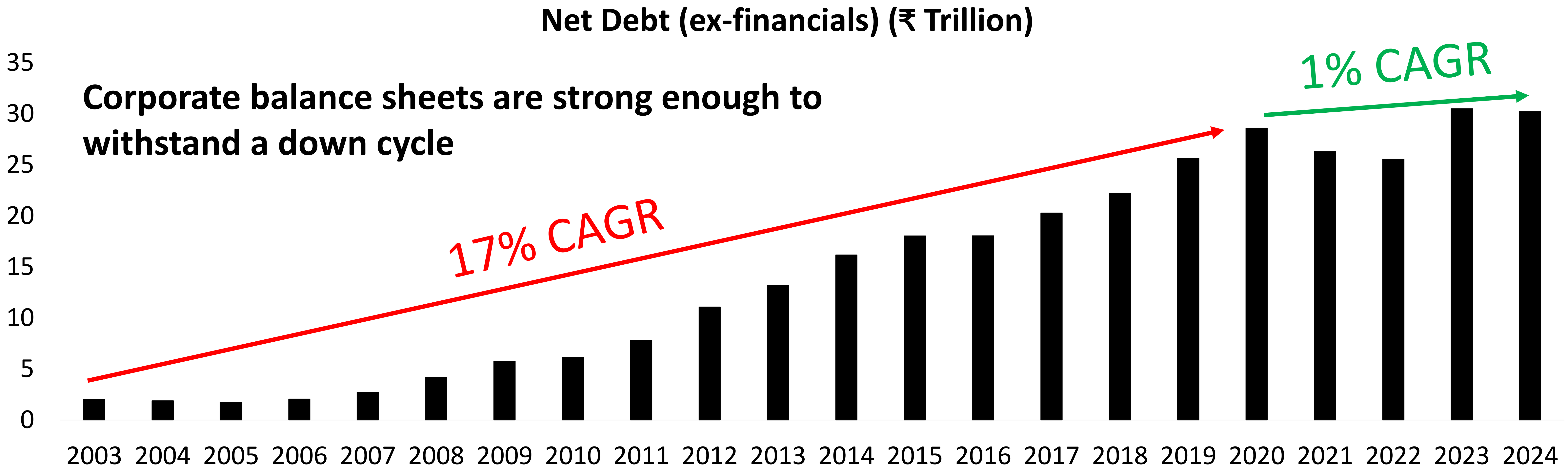
Source: Bloomberg, DSP. Data as of 3rd March 2025.

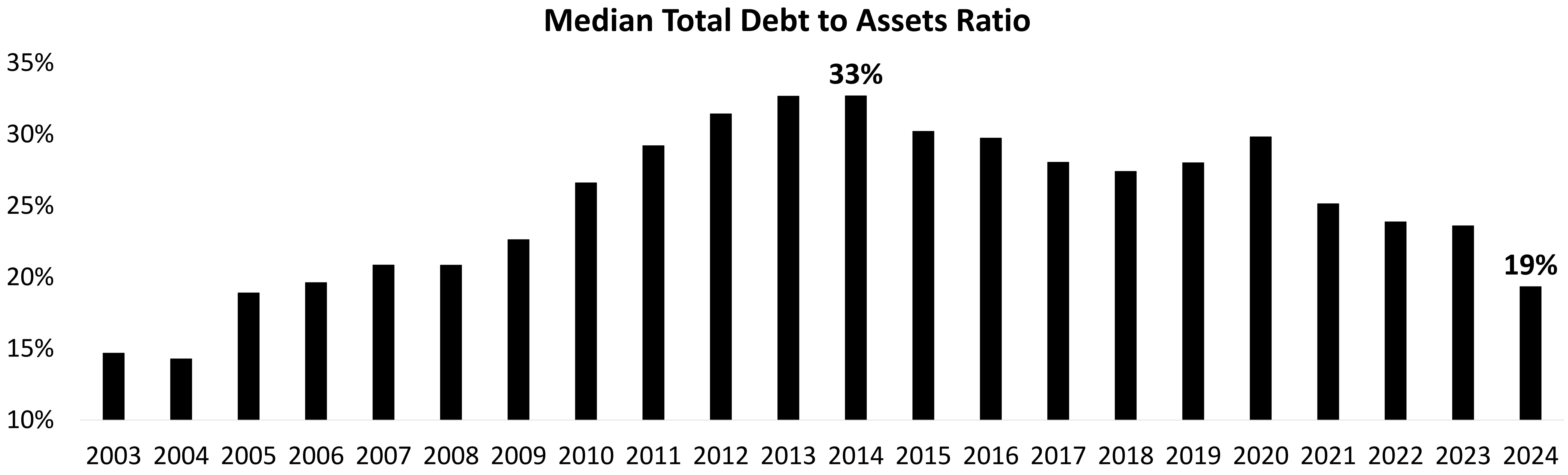
Corporate Balance Sheet Strength To Set The Base For Recovery

Historically, in every market cycle, companies have leveraged their balance sheets to unsustainable levels—far beyond what their growth prospects could justify. This excessive leverage often strained financial stability, pushing balance sheets to a breaking point.

However, post-COVID, many businesses experienced higher growth for the first time in years. This resurgence, driven by expansion efforts, played a crucial role in pushing stock prices higher. As a result, market sentiment shifted, leading investors to believe that any valuation could be justified as long as a company demonstrated some level of growth potential.

In the current cycle, however, balance sheet leverage has remained relatively controlled, with net debt levels not rising significantly unlike previous cycles. A key indicator of this shift is the Median Total Debt to Total Assets ratio (which means % of assets funded by debt), which has been declining. This suggests that companies are increasingly funding their expansion through internal reserves and profits rather than relying on debt, reflecting a more sustainable approach to growth.





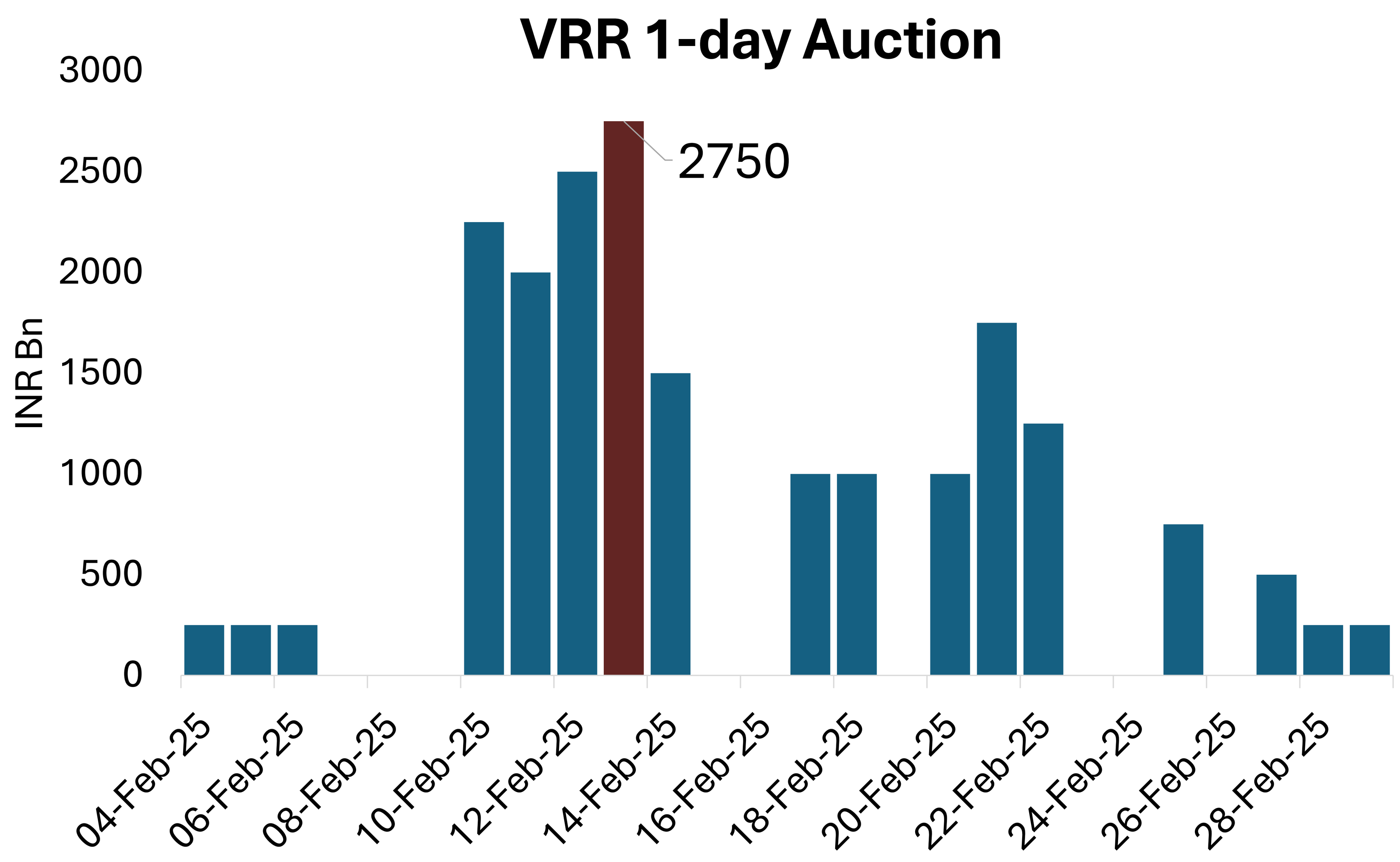
DSP

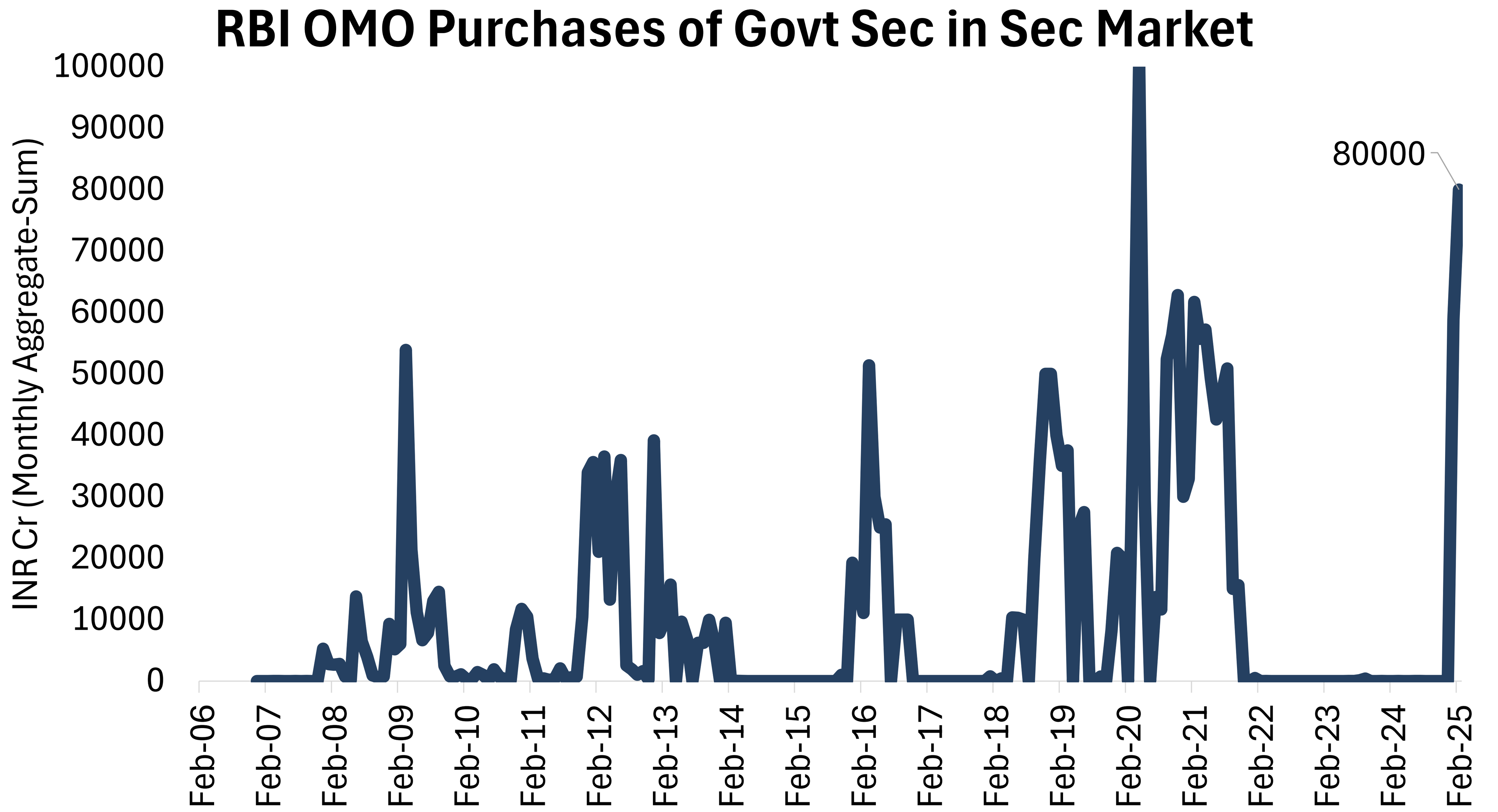
Source: Capitaline, DSP. Data as of Feb 2025. Data using current constituents of BSE Allcap Index.

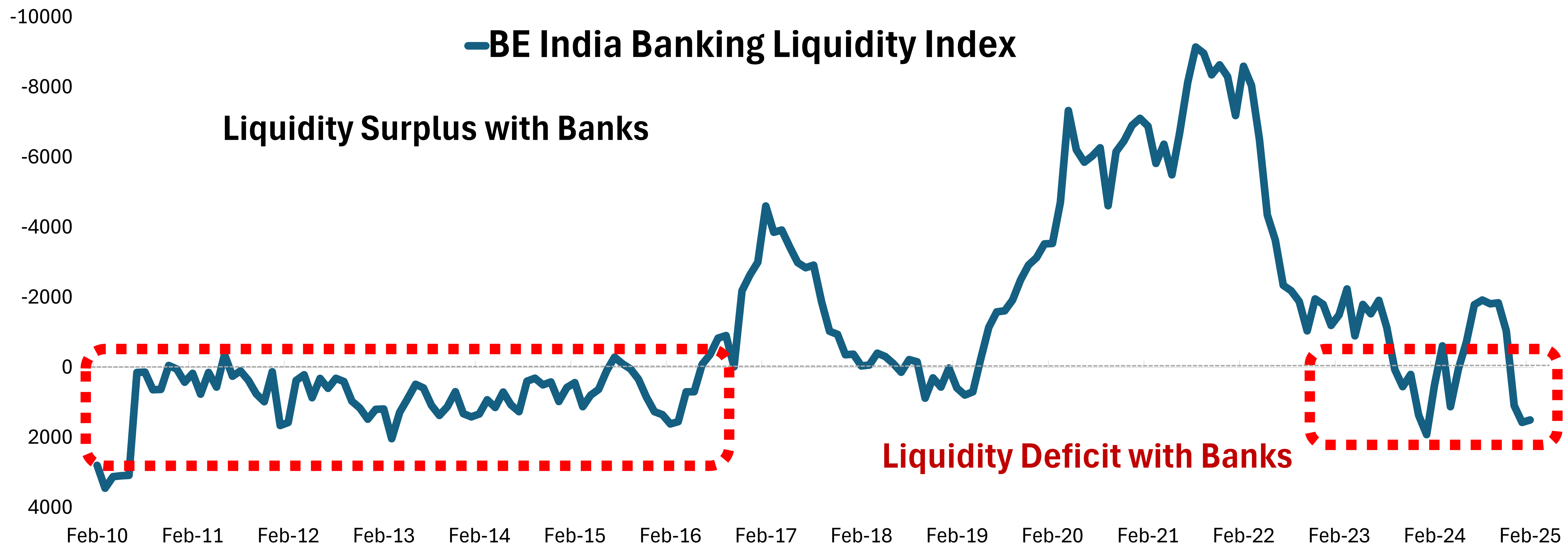
Efforts to Improve Liquidity Haven't Succeeded Yet but Should Prove Beneficial Eventually

The RBI is addressing a rising liquidity deficit—now nearing levels seen during past foreign outflow crises—through aggressive short-term interventions. February saw frequent 1-day VRR auctions, including a massive ₹2,750 billion overnight auction on February 13, equal to 1.2% of total bank deposits and 5.8% of the FY25 government expenditure. However, these auctions only redistribute liquidity rather than injecting fresh funds, leading to volatility in short-term rates.

To counter this, the RBI announced a ₹600 billion OMO injection, covering just 20% of the ₹2.9 trillion deficit. Additional measures include reinstating risk weights on bank exposures to NBFCs and a CRR cut. Despite these interventions, the core liquidity deficit persists, highlighting the RBI's intent to actively manage liquidity while maintaining caution in a potential rate-cut cycle. This shift suggests monetary policy is now assuming a stabilizing role traditionally handled by fiscal policy. Notably, these liquidity measures were absent from the February MPC statement, indicating a deliberate low-profile approach. While policy transmission may take time, these actions reinforce the RBI's commitment to supporting growth without making an overt change in tone.







DSP

Source: RBI, Bloomberg, DSP, Data As of Feb 2025

What Should Investors Do?

A. Shift from a conservative to a moderate stance. The time for aggression will come, but not yet.

B. Raise equity exposure one notch by

1. Fresh deployment through use of hybrids like Dynamic Asset Allocation or Multi Asset Allocation strategies as they raise equity weights on lower valuations.
2. Top up SIPs
3. Focus on large-caps, for staggered purchases and equity allocation
4. BFSI, especially Private Banks, can be considered for addition

C. Do not become aggressive in allocating to SMIDs, yet.

Source: DSP, as of March 2025

Mixing of Assets

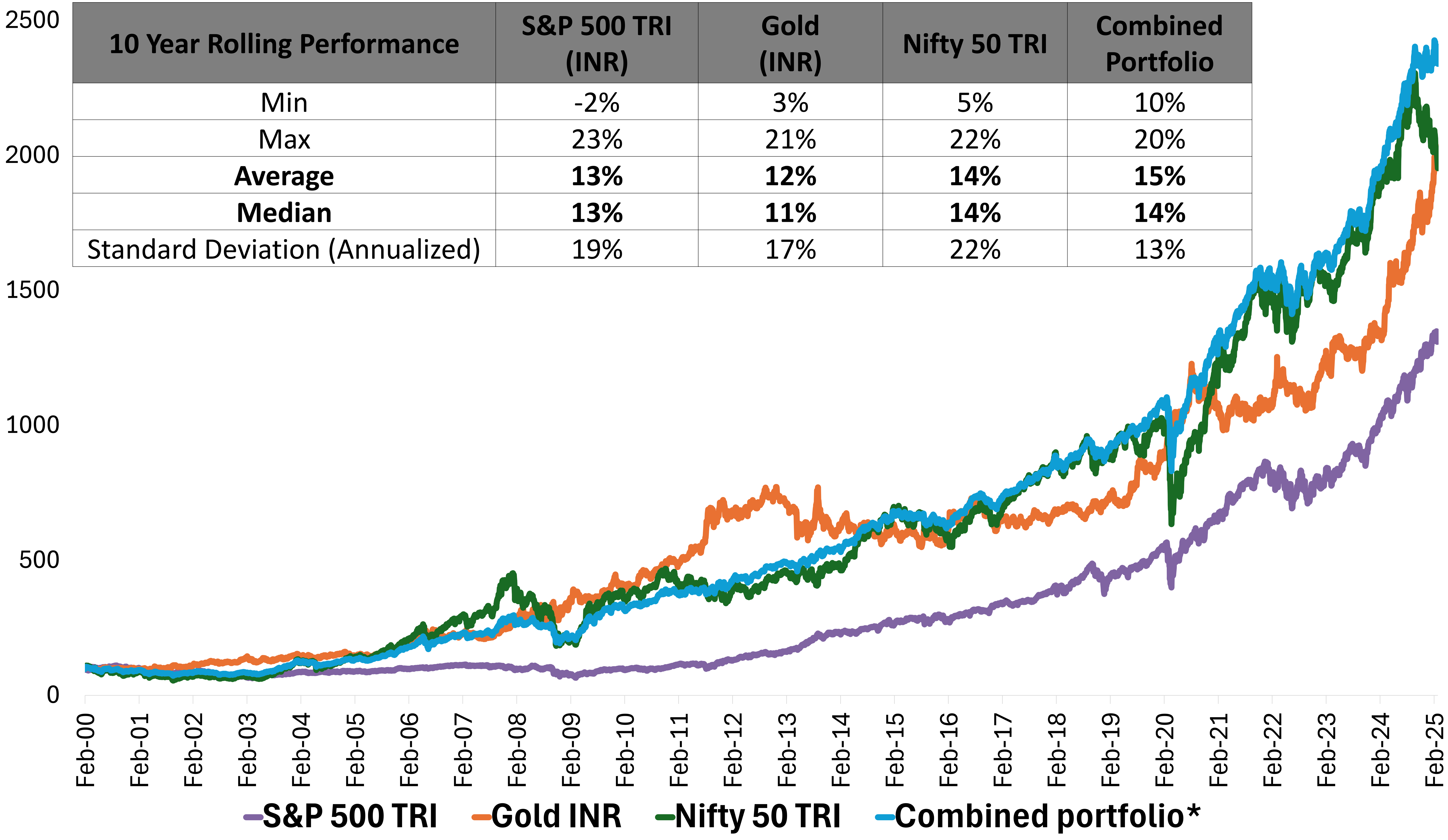
All Asset Classes Are Cyclical, The Mix Less So

Investors who find it hard to stomach stock market declines are served better by mixing various assets together. Note how each of the following assets: Domestic equities, global equities and Gold are volatile on their own. Their volatility differs, but a single asset class can give a large drawdown.

Investors who can remain steadfast during large drawdowns will have great outcomes, even in a single asset portfolio. But it is easier said than done. It is very hard to remain disciplined when portfolio value deteriorates sharply.

Here comes the case for multi-asset allocation strategies. When you mix assets, the uncorrelated or random behavior of assets allows you to have slightly different path with possibly less fluctuations. This helps avoid behavioral mistakes and impulsive decisions allowing you to stay invested for a long time and let your capital compound.

10 Year Rolling Performance	S&P 500 TRI (INR)	Gold (INR)	Nifty 50 TRI	Combined Portfolio
Min	-2%	3%	5%	10%
Max	23%	21%	22%	20%
Average	**13%**	**12%**	**14%**	**15%**
Median	**13%**	**11%**	**14%**	**14%**
Standard Deviation (Annualized)	19%	17%	22%	13%



DSP

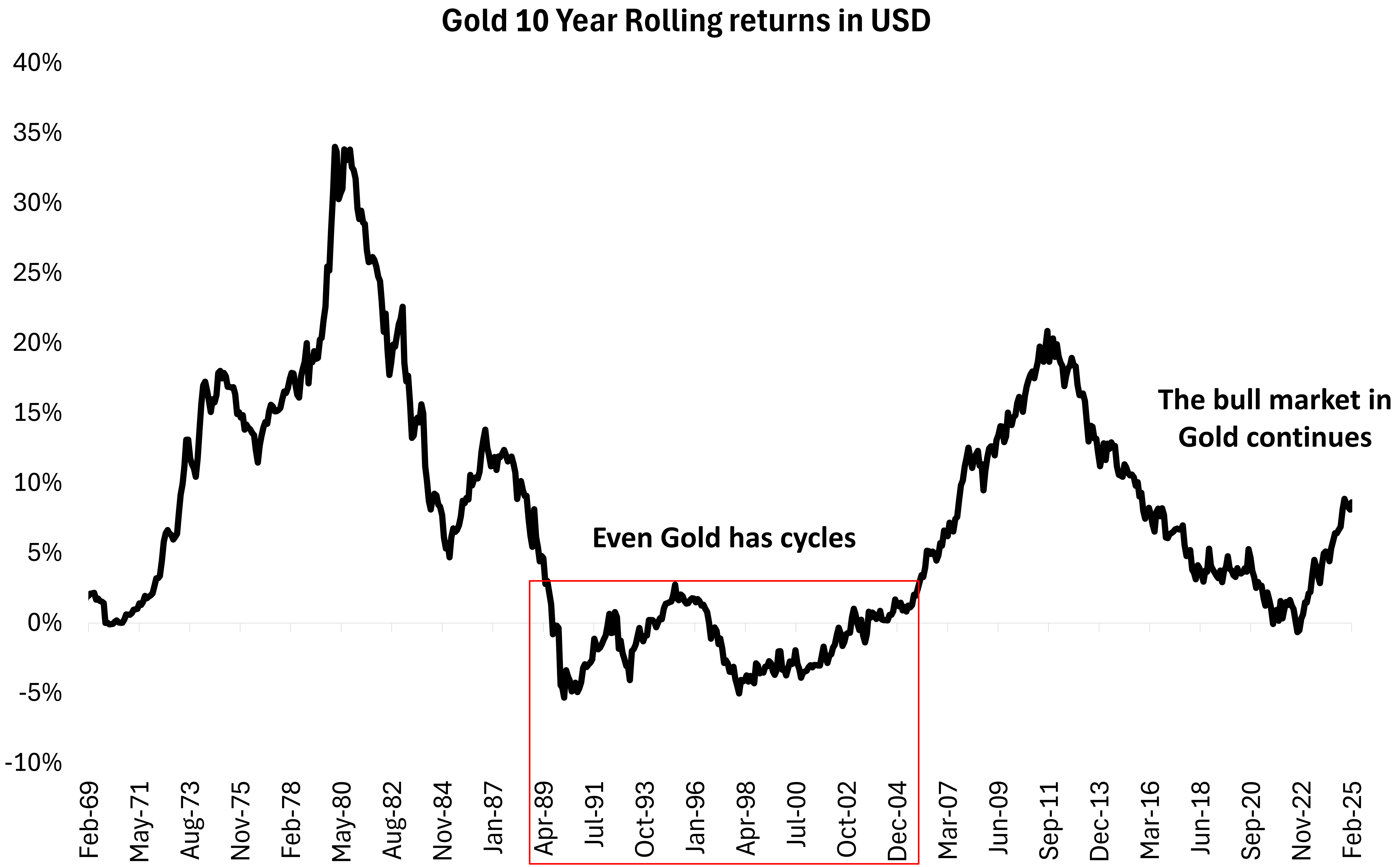
Source: NSE, Bloomberg, DSP. Data as of Feb 2025. All indices rebased to 100. *Combined Portfolio allocation is 50% Nifty 50 TRI and 25% each Gold (INR) and S&P 500 TRI (INR), rebalanced annually. All indices are in INR.

Remember, Even The Mighty Gold Is Cyclical

All assets are cyclical. Gold, a proven store of value and strong performer, is a valuable portfolio addition. As we've shown in past editions, Gold has outperformed most equity markets in the 21st century in local currency terms. However, even top-performing assets experience cycles. Consider Gold's 10-year rolling returns in USD—there have been extended periods of underperformance and phases of exceptional gains. Recently, Gold's 10-year returns were weak, but post-COVID government borrowing created a high margin of safety for Gold bulls, which played out well.

Still, Gold will have periods of drawdowns. Asset allocation should focus on assets offering high margins of safety, not a choice of one over another, but a balance of multiple assets.

It's not Equity or Gold, It's not equity or bonds, It's not India or global. It's AND,...Equity AND....other assets. Multi-asset.

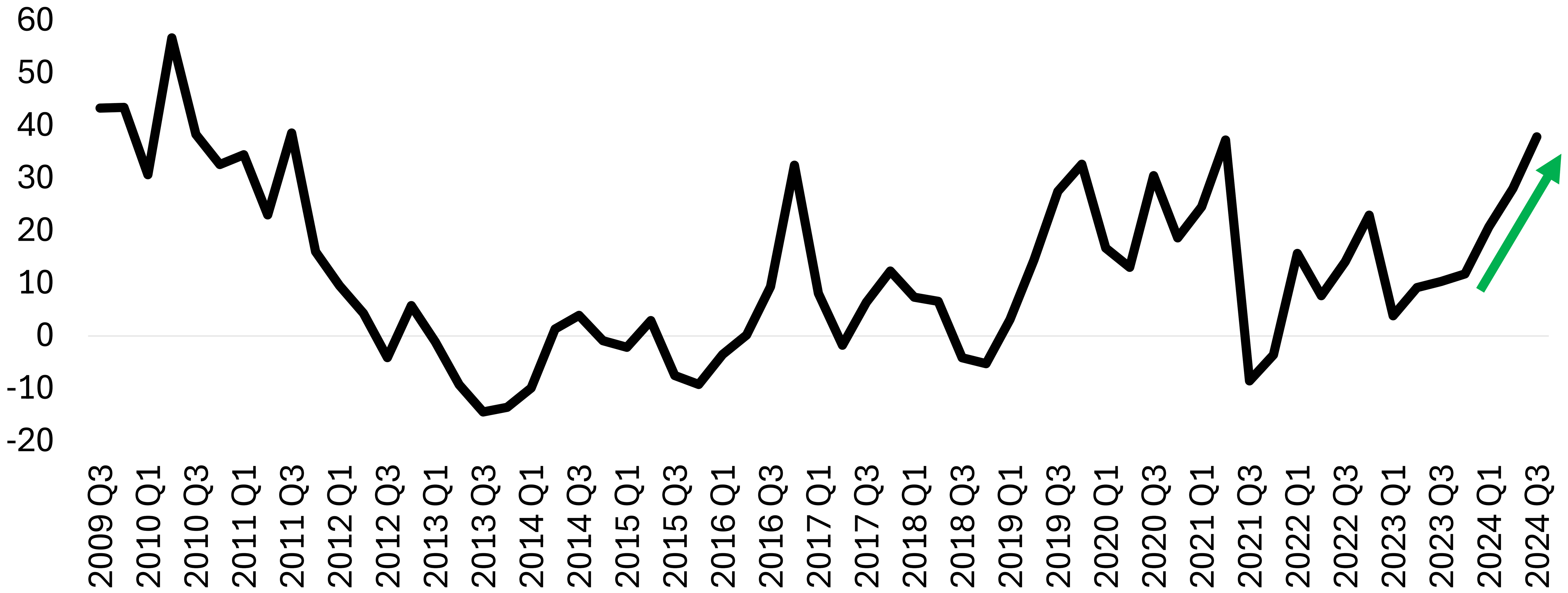


DSP

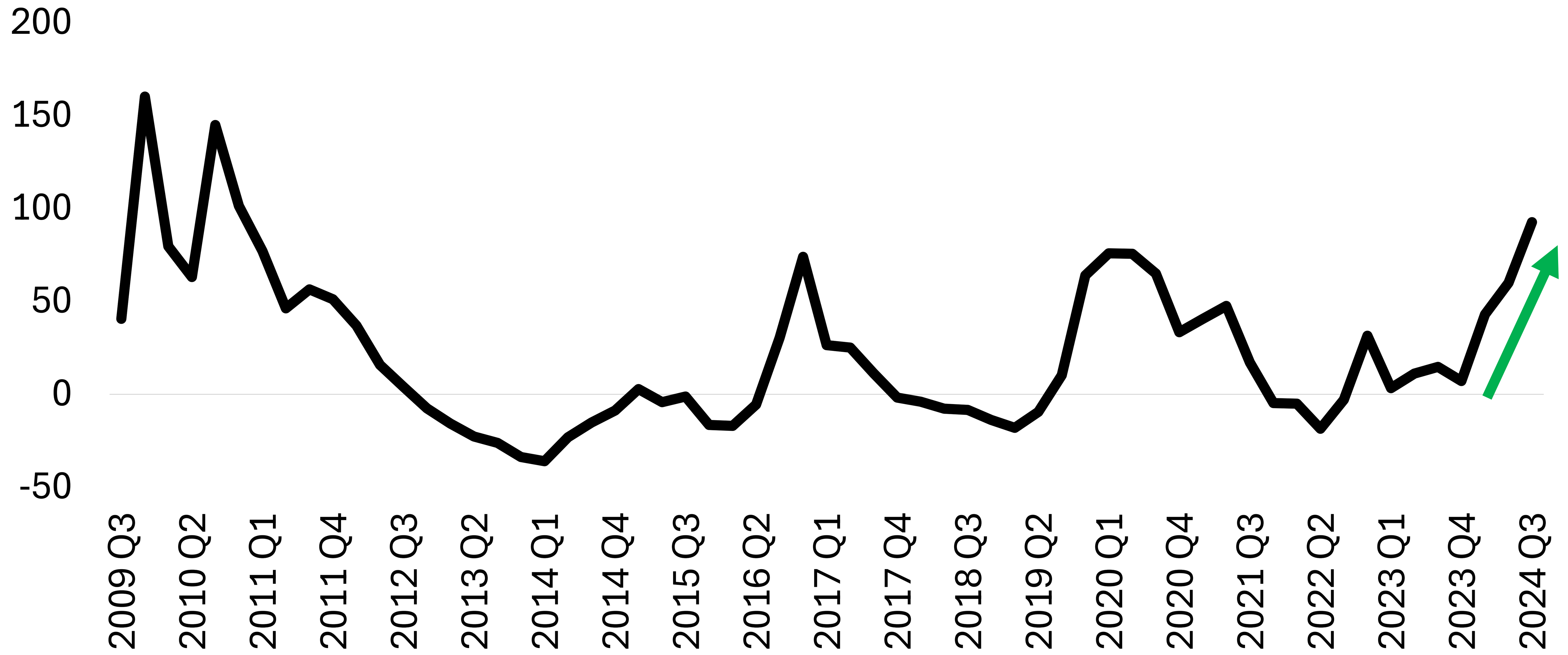
Source: Bloomberg, DSP. Data as of Feb 2025

Gold Rally Has Begun To Show Up In Gold Miners P&L

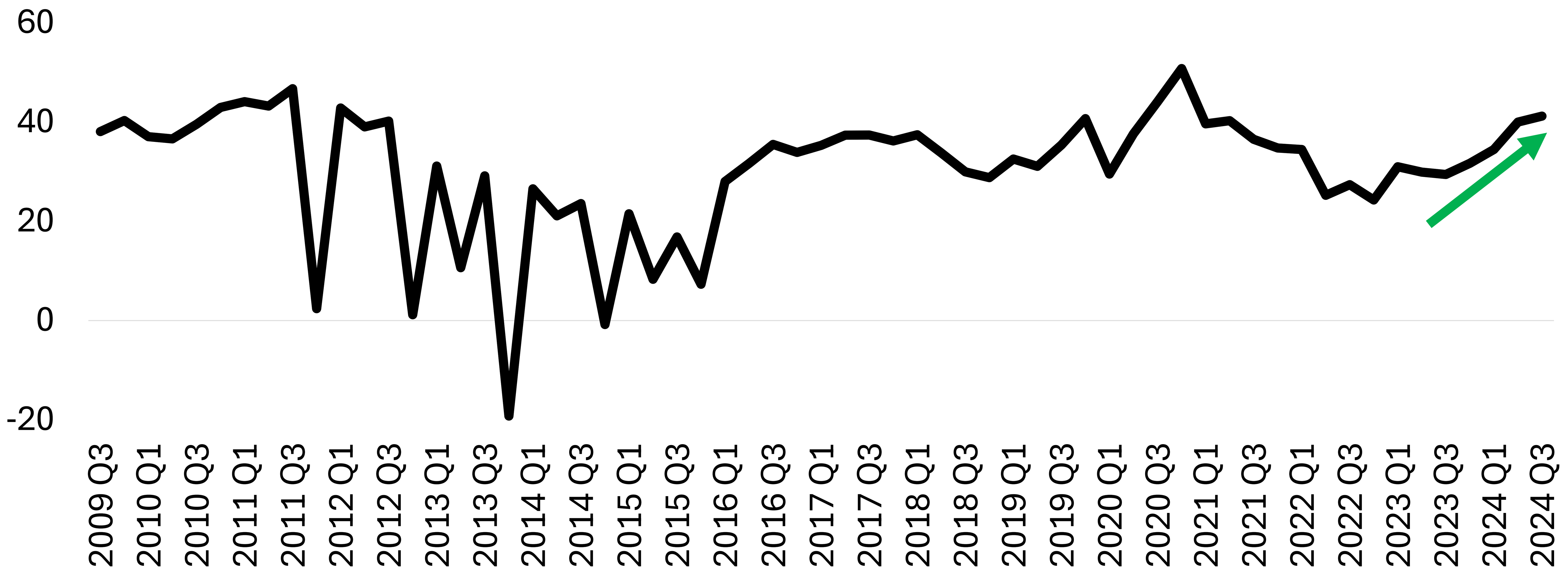
Sales Growth (YoY%)



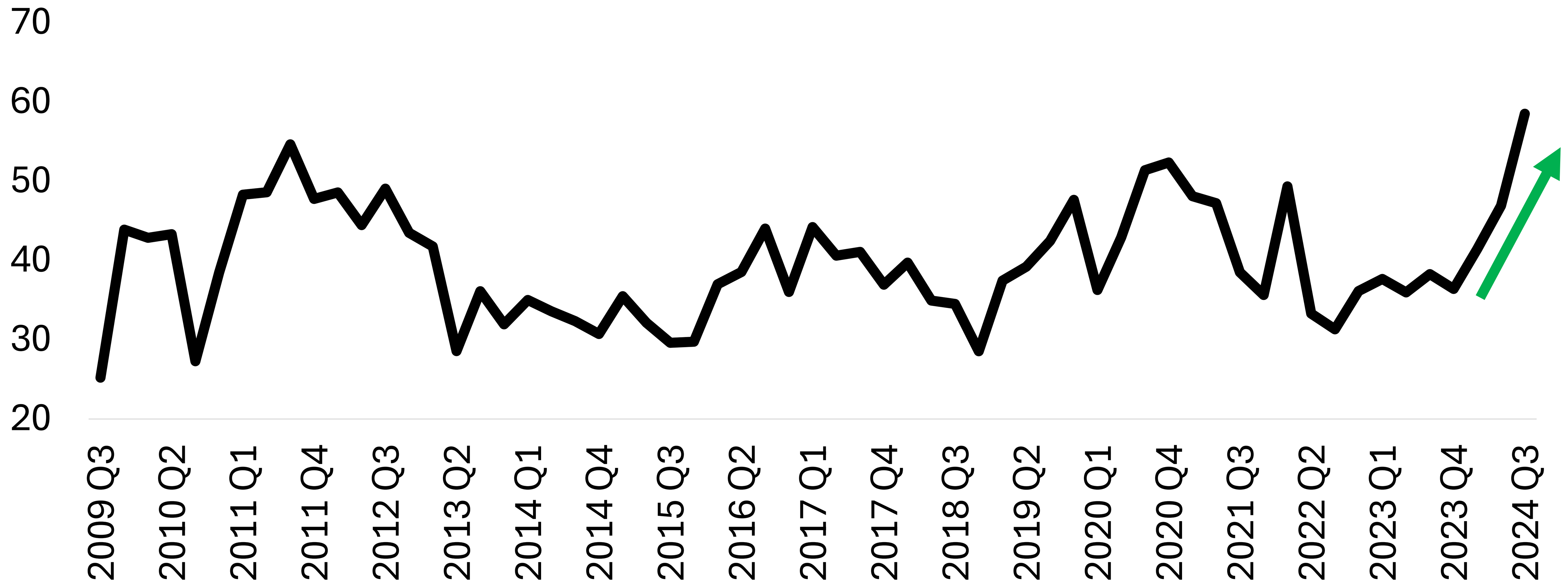
EBITDA Growth (YoY%)



Gross Margin



EBITDA Margin



DSP

Source: Bloomberg, DSP. Data as of Feb 2025. Data taken is of Senior Gold Mining companies which are Agnico Eagle Mines Ltd, Barrick Gold Corp, Cia de Minas Buenaventura SAA, Kinross Gold Corp, Newmont Corp, Zijin Mining Group Co Ltd.

Silver's Demand–Supply Mismatch

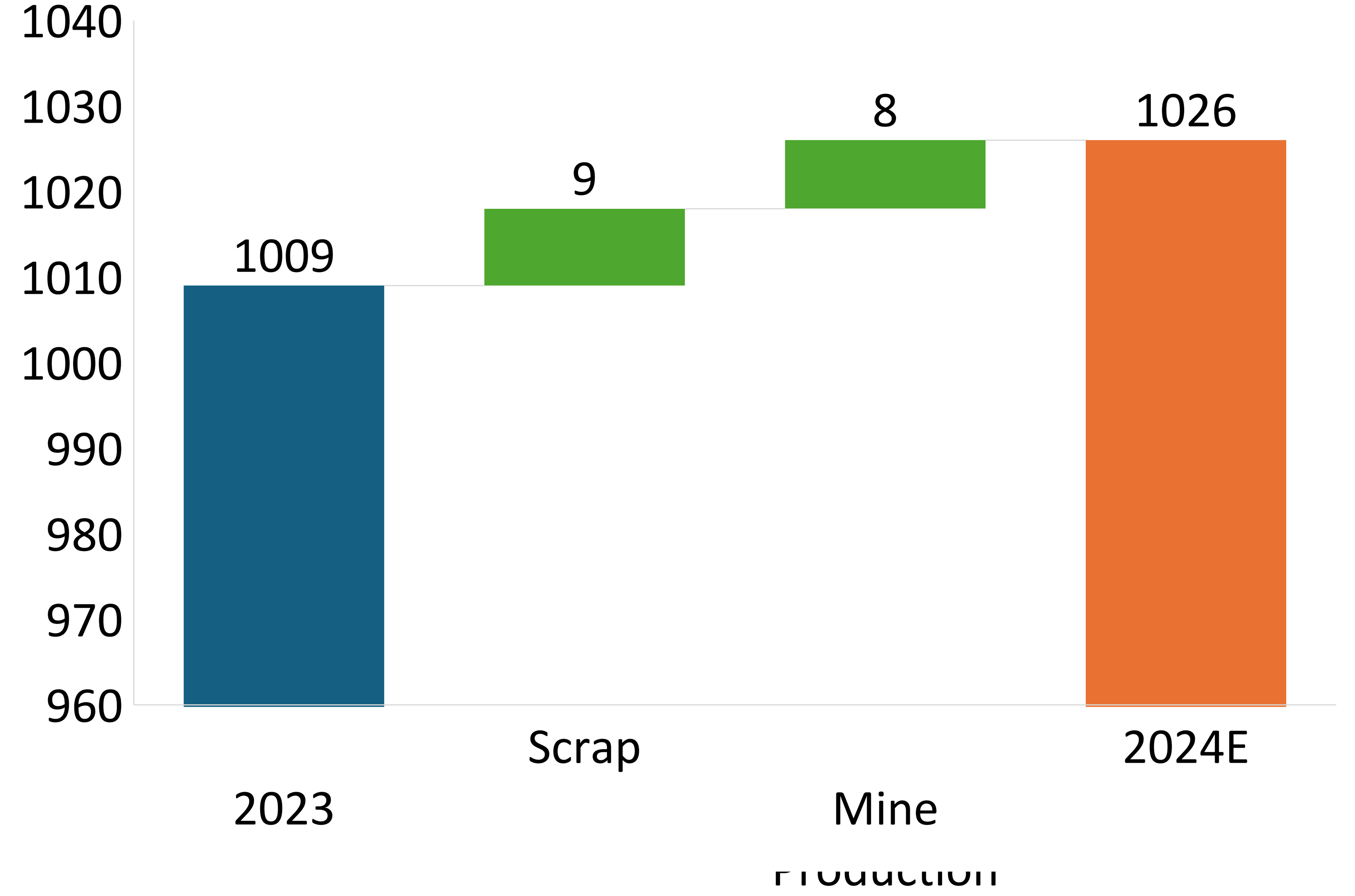
Demand for Silver has outstripped supply for fourth year running. Silver is also undervalued with respect to Gold prices. The Gold to Silver ratio is close to 88:1 versus its long period average of 65:1.

The movement of Gold across UK and US trade routes also indicate some changes in supply chains for Gold. Silver, for the longest time, has been used as a quasi store of value. It can have a rub-off because of changes in Gold's demand and supply chain.

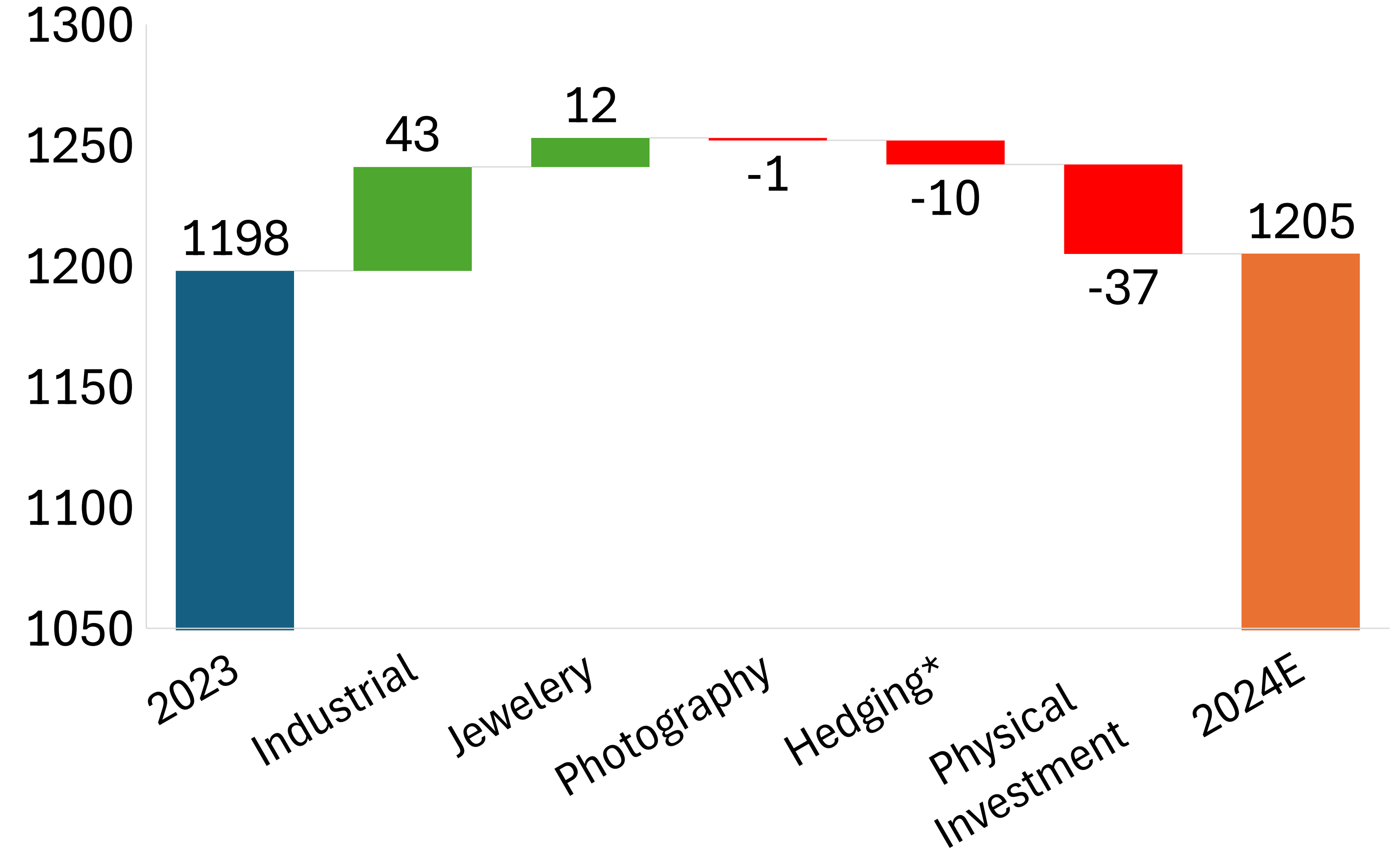
We have been early and wrong about silver for now. It hasn't rallied over the last few months even when Gold prices rallied to new lifetime highs.

But the bulk of evidence still suggests that Silver appears attractive for an extended up move and could be part of portfolio allocations from here on.

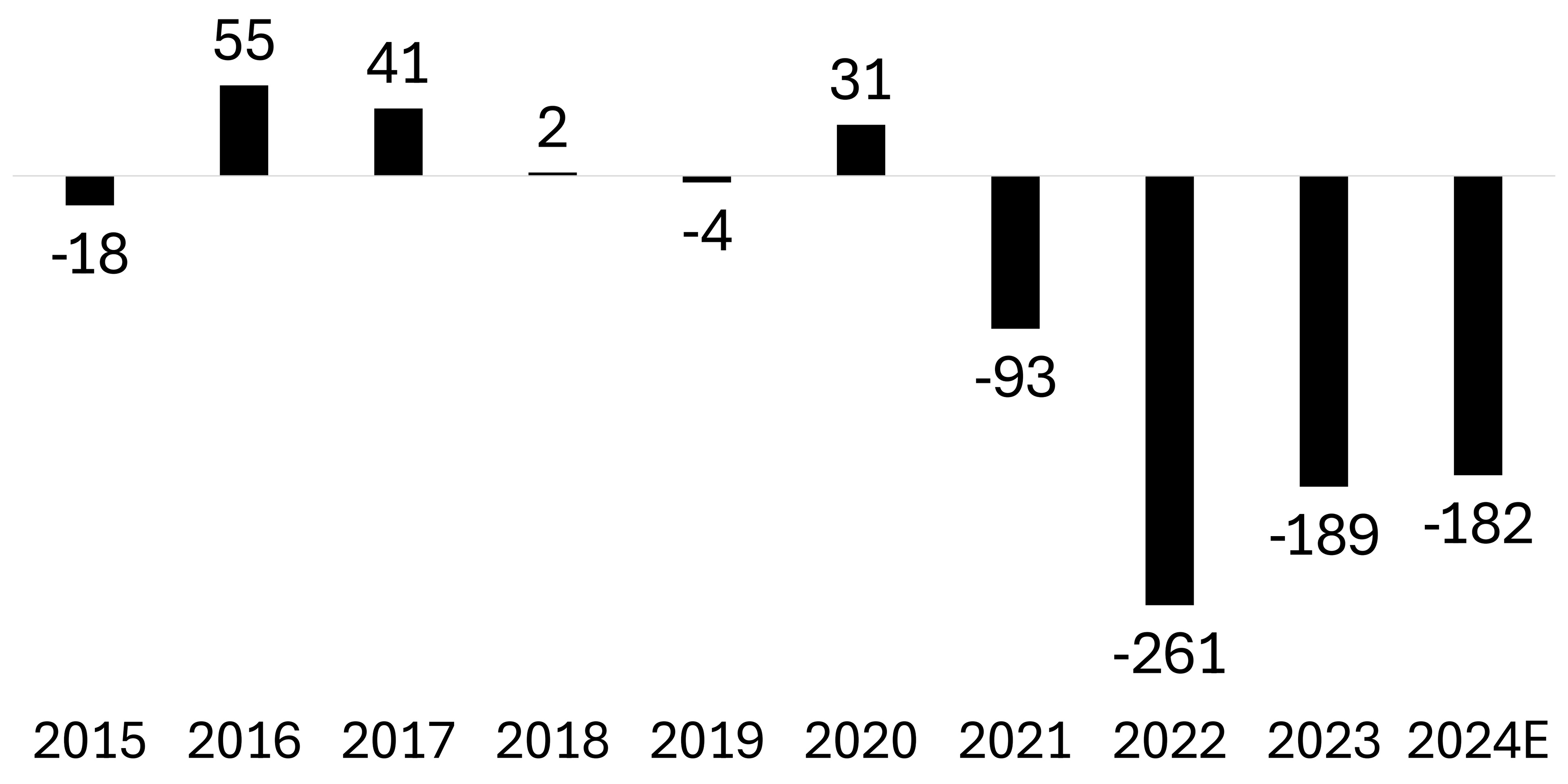
Global Supply: 2024 recovers by 2% to 8-year high



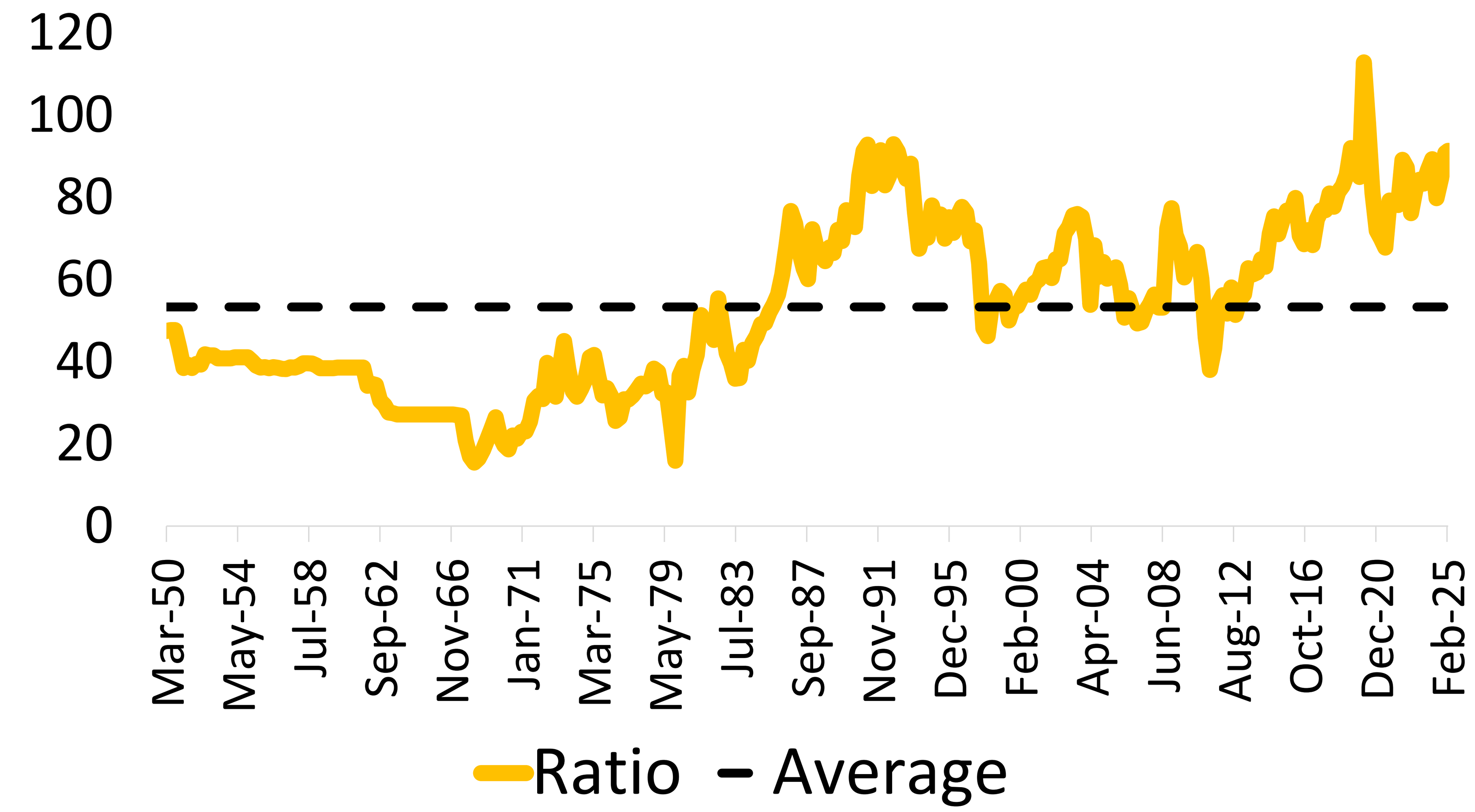
Global Demand: 2024 edged up by 1%, not far off 2022's record high



Silver Market Balance: Demand Minus Supply (Mn Oz)

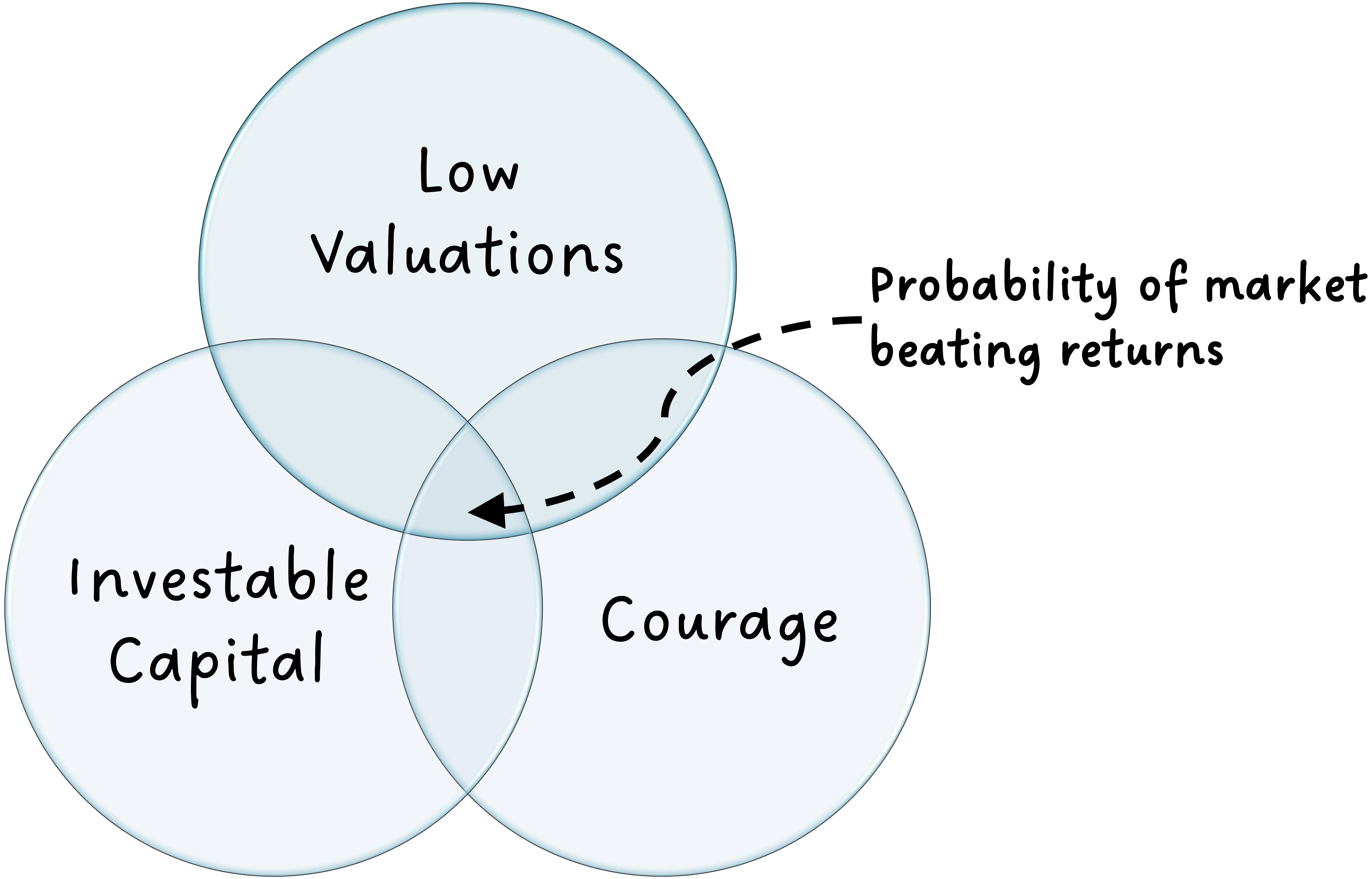


Gold - Silver Ratio



Source: Silver Institute Interim report, DSP. Data as on Feb 2025. *Hedging done by the mining companies.

Three Ingredients For Great Investing Outcome



DSP

DSP ASSET MANAGERS

INVEST FOR GOOD

Disclaimer