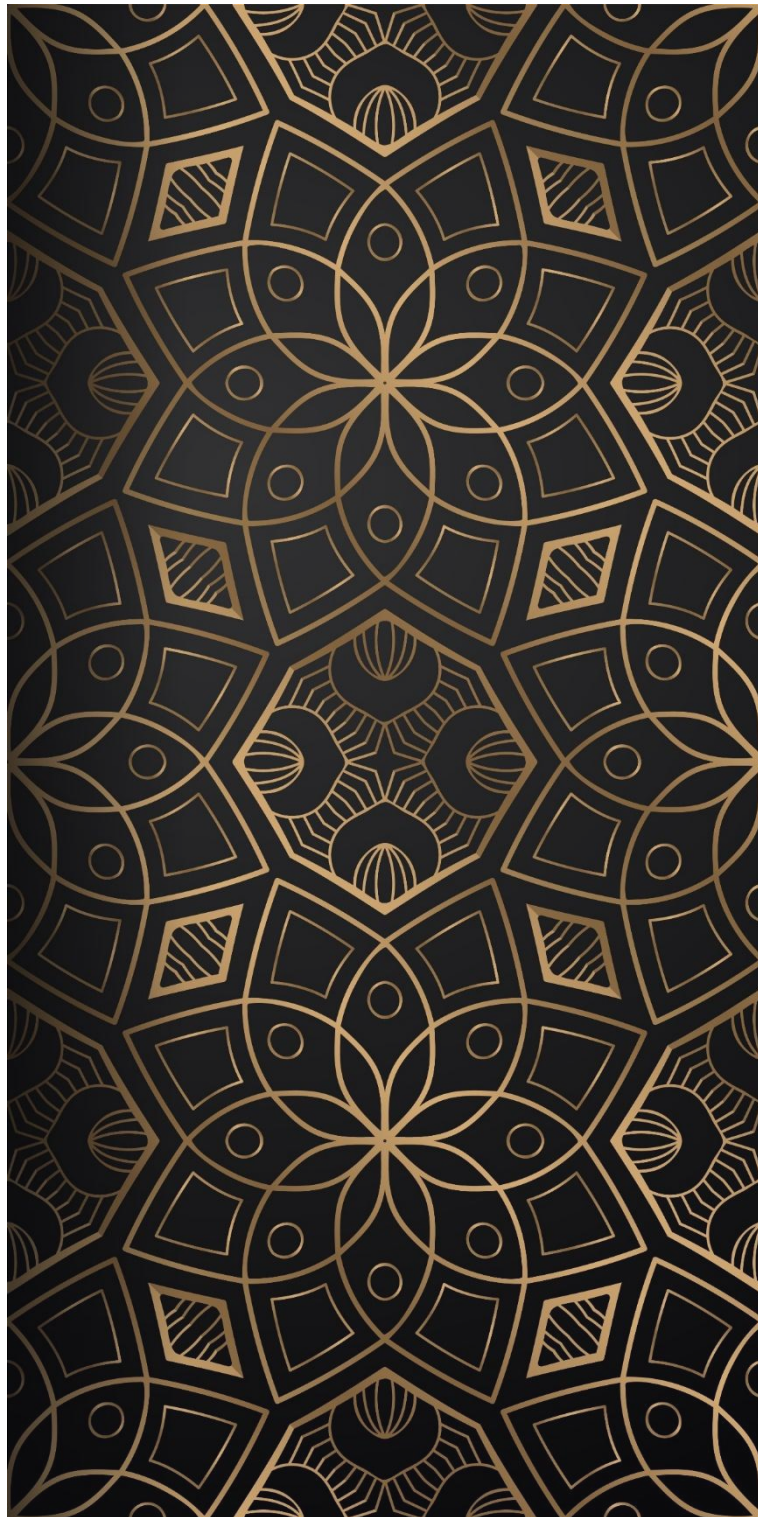




**BURMAN**  
CAPITAL MANAGEMENT



## The relentless small cap rally

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## Summary

“Mid, smallcaps reach for the sky despite analysts sounding caution” was the headline of a Business Standard article dated Aug 1, 2023. Since that day, the BSE Smallcap index has delivered more than 60% returns to date! In Mar 2024, SEBI (Securities and Exchange Board of India), directed small cap mutual funds to do a stress test to check if they are prepared for a significant pull-out of liquidity from the market. During the period, several small-cap mutual funds temporarily closed subscriptions and increased cash levels. Since then, BSE Smallcap index has delivered close to 40% returns.

Investors with a value orientation have been perplexed by the strong performance small-caps have delivered since COVID-19. Analysts, fund managers, media and investors who have stayed out have been waiting (read: praying) for a crash for some time now, but the same has remained elusive.

In this newsletter, we discuss why the current small-caps bull market has been this resilient and what are the key risks that may potentially lead to its reversal. Hope you enjoy reading!

## Portfolio performance update

During the Jul-Sep 2024 quarter our portfolio delivered returns of 15.6% vs 7.6% for our benchmark S&P BSE 500 TRI. All indices delivered strong returns during the period despite intermittent volatility in (1.) Aug-24 driven by a weak US Jobs report that led to fears of a hard landing for the US economy and (2.) late September with the escalation of the ongoing middle east conflict.

The Indian economy has slowed down recently largely due to a lack of government spending during the election season. Economic growth trajectory hereon will be a key determinant of the near-term market trajectory.

Since inception i.e., Mar 23, 2021, our portfolio has delivered annualized returns of 39.1% vs. S&P BSE 500 TRI returns of 22.4%, delivering outperformance of more than 1,600 bps annualized. Over the last three years, our returns have been 34.5% annualized vs 18.4% for our benchmark, an outperformance of more than 1,500 bps.

## Performance Snapshot

	1 Month		3 Month		6 Month		1 Year		2 Year		3 Year		Since Inception
Burman Capital Management	3.1		15.6		33.7		30.8		31.3		34.5		39.1
S&P BSE 500 TRI	2.1		7.6		20.2		41.1		28.7		18.4		22.4
Monthly performance (Absolute returns %)	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	
2021	NA	NA	0.67	6.5	5.7	(0.5)	7.5	4.1	4.3	4.0	7.3	9.6	
2022	0.2	(7.0)	11.7	(2.5)	(5.7)	(2.8)	9.3	8.7	4.5	4.1	(3.5)	0.1	
2023	(1.3)	1.0	(0.5)	9.0	7.1	3.6	1.7	6.8	0.8	-	8.7	0.6	
2024	1.4	(3.5)	(8.6)	10.5	(5.1)	10.3	4.9	6.9	3.1				

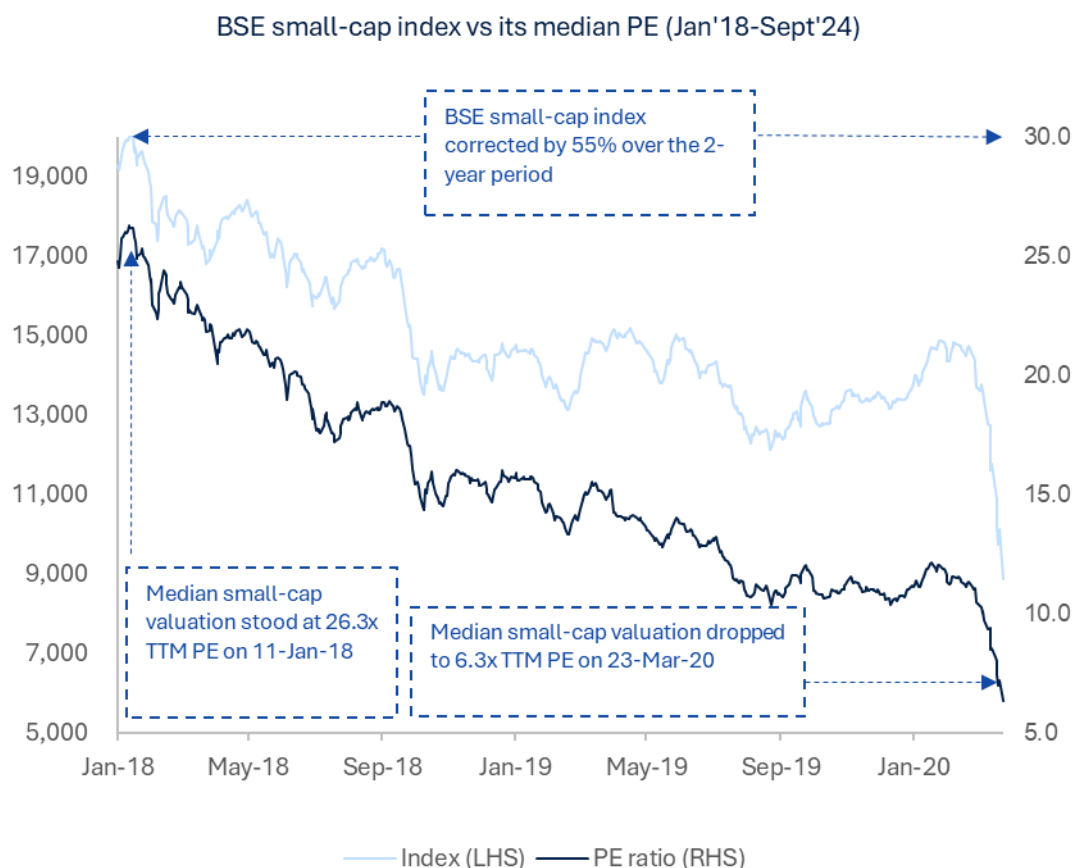
Note: All returns are net of fees and expenses (TWRR). Since inception, two-year and three-year returns are annualized; other time period returns are absolute. Benchmark changed effective from 1st April 2023 to S&P BSE 500 TRI from S&P BSE Small Cap Index, according to SEBI circular dated December 16, 2022.

## The record small-cap rally

On Mar 23rd, 2020, a day before Prime Minister Mr. Narendra Modi announced the first 21-day country-wide lockdown to stop the spread of COVID-19, the BSE Small cap closed at a low of Rs8,873. At the time of writing this newsletter, the index closed at Rs57,224 on Oct 15, 2024, a more than 6X increase! In our view, this relentless rally has four key drivers – (1.) dirt-cheap entry valuations on Mar 23, 2020, following a two-year period of turmoil, (2.) strong macro environment, (3.) exceptional micro-environment and (4.) exceptionally strong domestic liquidity.

### Dirt-cheap entry valuations

After hitting a peak on Jan 15<sup>th</sup>, 2018, the BSE Small cap index corrected by close to 55% over the following two years to reach a low on Mar 23, 2020. This was driven by a myriad of fundamental issues including corporate frauds, SEBI small-cap reclassification, liquidity crunch driven by the IL&FS crisis, a steep economic slowdown in 2019 and finally the onset of COVID-19. The small cap space by then was avoided by the investment community at large. The median small cap traded at a meagre 6.3X TTM P/E which was the lowest median level since the global financial crisis.



### Strong macro-environment

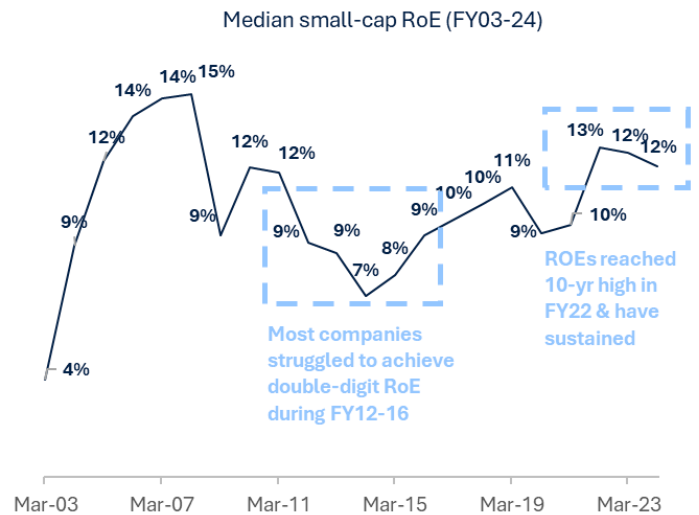
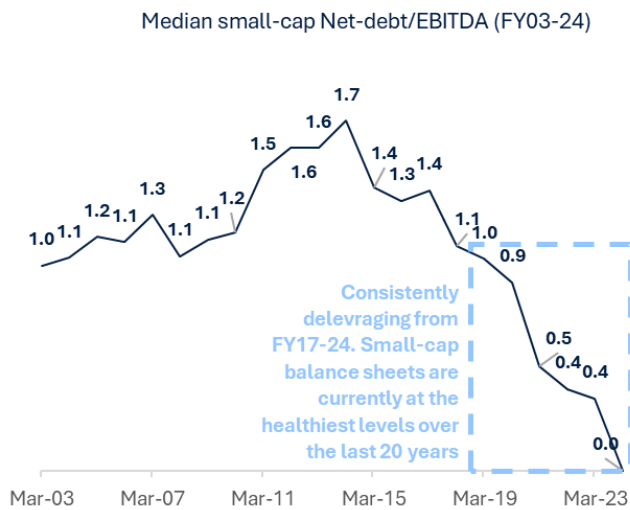
India's macro environment is currently in one of its best shape in the last couple of decades

- GDP growth trended up in FY2024, with real GDP growth at 8.2% highest since 2017 on the back of 7.2% in FY2023
- Fiscal deficit has come down from 9.2% in FY2021 to 5.9% in FY2024
- Government debt has come down from 88% in FY2021 to 82.5% in FY2024
- Unlike most developed economies inflation and interest rates have been in a narrow band

- Forex reserves have grown to US\$700 bn+ and the INR has been one of the most stable emerging markets currencies

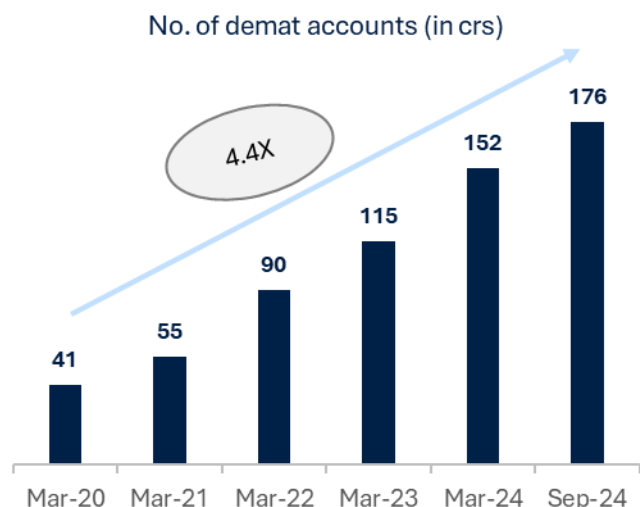
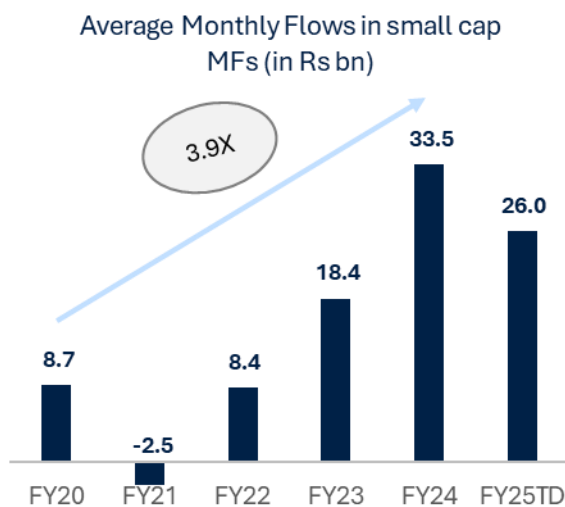
### Exceptional macro-environment

Over the last four years, small cap companies have delivered exceptional fundamental performance with record low leverage, 10-year high RoE, and strong earnings growth (16-18% annual growth over the last two fiscal years). Please see charts below for Leverage and RoE trends.



### Exceptionally strong domestic liquidity

The last four years have been characterized by a revolution in retail and domestic institutional participation in Indian equity markets. Average monthly small-cap mutual fund flows which used to be around Rs8.7 bn pre-COVID are currently at Rs26 bn. The total number of demat accounts have gone up from 41 mn to 176 mn.

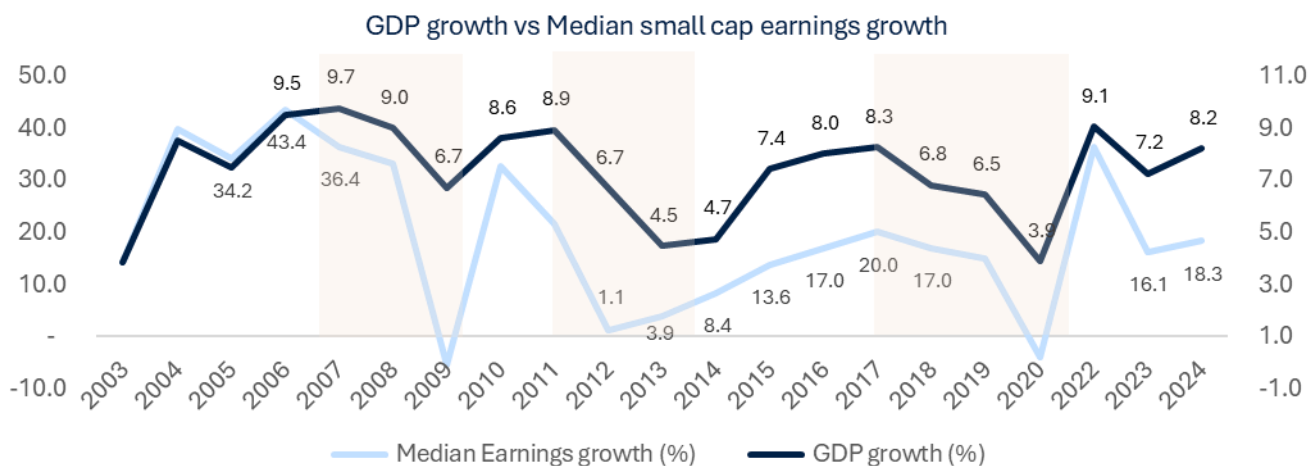


## How small-cap rallies have ended in the past

There have been seven instances in the small cap index's history where it has corrected by more than 30%. The last five of the seven have been associated with a sharp economic slowdown and a resultant change in flows and sentiment. Details below.

S. No.	Correction start date	Correction end date	Index level pre-correction	Index level post-correction	Quantum of Correction (%)	Days of Correction	Reason for correction
1	07-Jan-08	06-Mar-09	13,975	2,912	79	424	Global Financial Crisis
2	10-Nov-10	20-Dec-11	11,244	5,466	51	405	Eurozone debt crisis and double-dip recession in the US
3	07-Jan-13	06-Aug-13	7,657	5,101	33	211	Quantitative easing by US Fed and weak local macros
4	15-Jan-18	22-Aug-19	20,047	12,119	40	584	IL&FS crisis and economic slowdown
5	27-Jan-20	23-Mar-20	14,850	8,873	40	56	Lockdowns driven by COVID-19

Small-cap earnings have remarkably high correlation (76%) with GDP growth. Whenever GDP growth has changed by more than 200bps over a short period, median small cap earnings growth has taken a beating. These are also periods where we have seen some of the sharpest drawdowns in small-caps. Please see data below.



GDP data however comes with a lag, high-frequency indicators such as power demand can potentially point to issues in growth. Power demand has a high 74% correlation with GDP growth.

## Current scenario

Currently, we are witnessing a slowdown in GDP growth which may be temporary, as it has been impacted by election-driven pause in government spending and relatively tight monetary conditions. While macroeconomists expect this to reverse during the current festive season, risks can emerge if the current slowdown persists. Given where valuations are today, we remain cautious and nudge investors to (1.) lower their return expectations in the medium-term and (2.) expect volatility. Predicting market movements is impossible, but it may make sense to adjust one's stance (defensive vs aggressive) basis market conditions. Our stance is one of caution currently. If you would like to know more about our investing approach, please feel free to write to us at [agupta@burmancapital.com](mailto:agupta@burmancapital.com).

## About Burman Capital Management

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Burman Capital Management is a part of Burman Family Holdings, the strategic investment platform of the Burman Family, which over the last twenty years has invested over US \$500 million in various businesses primarily in India and have partnered and joint ventured with many of the leading Fortune 100 companies from around the world. The Burman family are the control shareholders of the Dabur Group. Dabur was founded in 1884 by Dr. S.K. Burman and is today one of the largest Indian Fast Moving Consumer Good Company in India with over US\$1 billion in revenue and a market capitalization of over US\$14 billion.

At Burman Capital Management, we are long-term investors with deep passion for identifying and investing in exceptional businesses early. We are fundamentals-driven bottom-up investors and run concentrated portfolios focusing on small to mid-size companies. We are a SEBI-registered Portfolio Manager with registration number INP100007091.

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