



## YOUR MONEY

### SMALLCAP STOCKS

# Use current valuations to enter stocks with robust fundamentals

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A recent study by Abakkus Mutual Fund found that nearly 50 per cent of smallcap stocks were currently trading around 40 per cent below their all-time highs. The fund house says such market resets create a window for retail investors to accumulate high-potential businesses at sustainable valuations.

#### Valuations have normalised

Valuations are no longer euphoric. "Much of the froth visible in 2023 and early 2024 has been absorbed," says Gaurav Bhandari, chief executive officer (CEO), Monarch Network Capital.

At the index level, valuations still look expensive compared to the five-year average, but the picture differs at the individual stock level. "Several quality smallcaps are now available at sub-20 valuation multiples on a forward price-to-earnings (P/E) basis," says Prabhakar Kudva, director and principal officer, portfolio management ser-

vice (PMS), Samvitti Capital.

#### Positive drivers

After the downgrade cycle of 2024-25, earnings have picked up. "Domestic tax reforms, higher government and private spending, and easing global trade uncertainties could support a strengthening of this trend," says Vinod Nair, head of research, Geojit Investments.

"If tariff and geopolitical noise settle and global risk appetite returns, small caps could benefit disproportionately," says Kudva.

Manufacturing, defence, and capital goods drove previous rallies. "A new theme or sector with demonstrably high earnings growth will need to emerge to drive

portfolio allocations back into this segment," says Kudva.

Stable interest rates and liquidity, along with a return of risk appetite among domestic retail and high-net-worth individuals, would also create conducive conditions.

#### Key impediments

Several developments could prevent a turnaround. "Delayed rate cuts and liquidity tightening are key risks," says Bhandari. Many smallcap companies are exporters, so a global slowdown would weigh upon them.

Global factors could also extend the risk-off environment, keeping foreign inflows and risk appetite subdued. Such an environment would slow down domestic earnings growth. "It would take away the fundamental support small caps need to re-rate," says Kudva.

#### Enter cautiously

Conditions do not support indiscriminate buying. "Focus on companies with quality balance sheets and earnings visibility," says Bhandari. Nair says selective opportunities exist in domestic-focused private banks, infrastructure, real estate, capital goods, and auto.

#### Be wary of volatility

The smallcap segment is volatile. "Over the past 10-15 years, the segment has witnessed corrections of 20-30 per cent roughly once every

two years. Enter only at prices that make sense from an intrinsic value perspective," says Joseph Thomas, head of research, Emkay Wealth Management.

Due to low liquidity in many small caps, even modest selling can trigger sharp drawdowns.

Many businesses remain unproven. "They are dependent on limited products and customers, which increases business risk. Corporate governance issues and earnings unpredictability are common," says Harsh Vira, founder, FinPro Wealth.

#### Do the due diligence

Only enter stocks having considerable liquidity. "A meaningful promoter stake signals alignment of interest and long-term commitment," says Thomas. The company should not have compliance issues.

Assess key financial parameters. "Evaluate earnings growth and consistency, debt levels, cash flows, and return ratios like return on equity and return on capital employed over multiple years," says Vira.

#### Precautions to exercise

Take limited exposure to this segment. "Except for extremely conservative investors, others can consider allocating 10-20 per cent of their portfolio to small caps," says Thomas. Diversify across stocks.

Existing investors should track sector prospects and earnings trends. "Hold if fundamentals, earnings trajectory, and growth outlook remain intact. Exit if earnings deteriorate or governance concerns arise," says Vira.

The writer is a Mumbai-based independent journalist

### Index P/E at premium to 5-year averages

	Current	Average	
		5-year	10-year
Nifty Smallcap 100	23.5	19.9	17.1
Blended forward 12-month P/E	30.0	27.5	32.4
12-month trailing P/E			

P/E: Price-to-earnings

Source: Bloomberg