

CHARGING AHEAD

IN THE ONGOING FINANCIAL YEAR, SECOND-RUNG STOCKS HAVE SIGNIFICANTLY OUTPACED LARGE-CAP STOCKS. GOING FORWARD, INVESTORS WILL HAVE TO DIG DEEPER TO IDENTIFY THE NEXT WINNERS

BY RIDDHIMA BHATNAGAR

► **MID- AND SMALL-CAP** indices have bounced back from a 20%-rout since September-end till February, when several key companies experienced sizeable declines in share price and market value. In last few years, mid- and small-cap stocks had risen sharply, leading to valuations perceived as excessive compared to earnings growth.

Now, with valuations appearing more appealing next to large-caps, an earnings recovery, enhanced sentiment in both global and domestic markets, and steady inflows from foreign and domestic investors have sparked the rebound, says Vipul Bhowar, Senior Director and Head of Equities, Waterfield Advisors.

The divergence underscores a growing investor shift toward high-growth opportunities in the broader market, despite global headwinds.

If you look at mutual fund inflows into mid- and small-caps, there has been an uptick there too. Nifty midcap 150 gained 24% and Nifty small cap 250 gained 29%.

May alone saw inflows ₹3,214 crore in small-cap funds and ₹4,003 crore in mid-caps out of total equity inflows of ₹19,013 crore.

Lalit Kumar, Senior Fund Manager at ICICI Prudential Mutual Fund, says another reason for the mid-cap rally is that the mid-cap index has a higher allocation to domestic-facing sectors, which have benefited from the strong

fundamentals of the Indian economy. Also, the large-cap index has greater exposure to oil & gas, fast-moving consumer goods, banking, and information technology sectors that have not performed very well recently. Mid-caps have a higher exposure to the manufacturing theme, which has been buoyed by government initiatives.

The NSE Nifty is constrained by large companies in sectors like financials, IT and consumer that have limited headroom for a rally, whereas mid-caps in similar sectors have been doing better. Take financials, for instance. The recent pockets of outperformance like NBFCs and capital market plays largely fall into the mid-cap rung. The India-Pakistan conflict also gave a sudden



VALUATIONS AND RETURNS OF INDICES

leg-up to defence stocks, which also largely fall in the mid-cap space and enhanced overall performance, says Chandrachoodamani NV, Senior Equity Analyst, Primeinvestor.in.

G. Chokkalingam, Founder and CIO at Equinomics Research, explains: "The mid- and small-cap space has been rich with new themes and growth opportunities that are missing from the Sensex or Nifty stocks. This explains why BSE SmallCap and MidCap indices now command a high premium over large-caps."

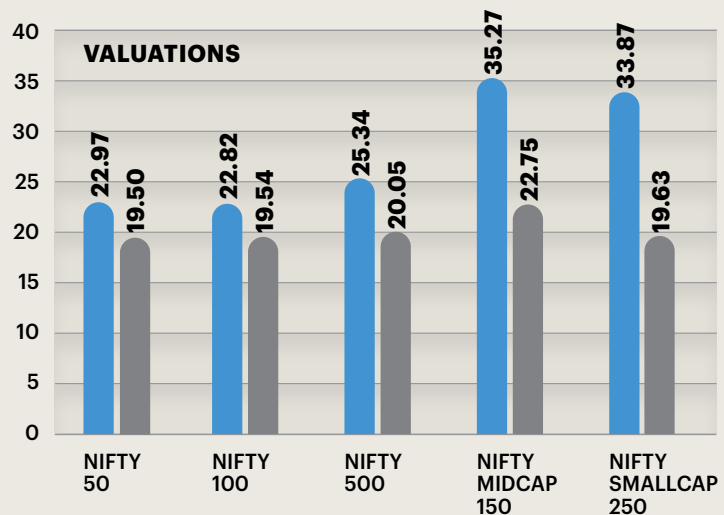
Akshay Tiwari, Associate Vice President and Research Analyst at Asit C. Mehta Financial Services, says that midcaps in the banking sector like L&T Finance are performing because of their strong asset quality, loan portfolio and superior technology.

DOES THE RALLY HAVE LEGS LEFT?

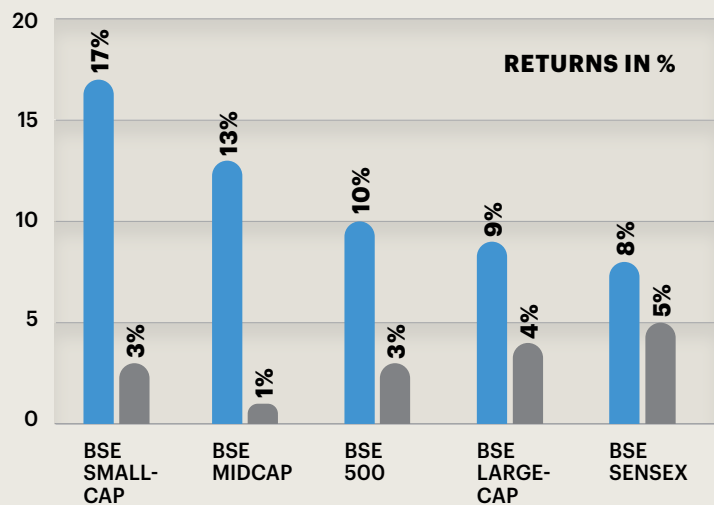
Despite the euphoria of the rally in the broader markets, several industry experts strike a cautionary note.

Chandraprakash Padiyar, Senior Fund Manager, Tata Mutual Fund, notes that though profit-to-gross domestic product has climbed from 1.7% in FY19 to 5.3% in FY25, future earnings divergence is inevitable.

Padiyar says, "We believe the profit-to-GDP ratio is likely to cross the previous peak of 6.8%, which means that Indian corporates in the listed space have a reasonable runway to continue to deliver earnings growth over the next few years." Though he believes that earnings have more room to grow, the pace of growth will move closer to nominal GDP growth with larger divergences. However, he does expect divergences in earnings delivery on an incremental basis, which means that stock selection will be increasingly very important. "Not all firms will be able to grow earnings over



● PRICE-TO-EARNINGS RATIO (P/E) AS OF 30 JUNE 2025 ● P/E RATIO AS OF 30 JUNE 2022 **SOURCE** ACE EQUITY, DATA AS ON JUNE 30, 2025



● RETURN SINCE MARCH END 2025 ● 1 YEAR RETURN **SOURCE** ACE EQUITY, DATA AS ON JUNE 30, 2025



20% CAGR while valuations are on the higher side, typically a recipe for either a longer time correction or selectively price correction as well.”

Padiyar also advises investors to look at diversified funds rather than sectoral, thematic or market cap ones.

Siddharth Bharmre, Research Head of Asit C Mehta, says mid-cap valuations are elevated while returns have been strong, but investors need to be highly selective. “Now there are some mid-caps that would probably justify higher valuation because people will say the growth rate is also high. But you will have to pick and choose. You cannot paint the entire basket in same stroke.”

Yet, the market isn't expecting a crash. Since large-caps are not highly overvalued and are resilient, the floor for broader market corrections remains strong unless large-cap heavyweights begin to falter, which is unlikely in the short term, adds Bharmre.

The latest data confirms the trend. Current valuations in the mid and small cap space stands at 35.27 and 33.87, which is overvalued compared to 22.75 and 19.63, respectively, in 2022. Similarly, large-caps too are bit overvalued with a price-to-earnings ratio of 22.82 compared to 19.54 in 2022.

At this time, across the board, institutional voices are preaching selective optimism. BFSI (banking, financial services & insurance) is a favourite among multiple fund managers, including George Thomas, Equity Fund Manager, Quantum MF.

“Though private banks could see margin pressures in the near term, markets have factored the changed environment, and companies have initiated steps to restore margins,” says Thomas. Consumer



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discretionary is another space with tailwinds from potential rate cuts and higher disposable incomes, thanks to income tax rebates and cooling inflation, he adds.

The latest data from ACE Equity bears this out. When we talk about the returns of BSE Small caps in the past 3 years, it stands at 122% and for mid-caps at 114%, whereas BSE large-caps delivered a 61% return.

Chokkalingam of Equinomics Research is positive on the small- and mid-cap segment. He says, “The segment would continue to do well in FY26 and is likely to outperform Sensex and Nifty by a significant margin. A vast universe of this segment offers huge opportunities in terms of growth, deep values and acquisitions or consolidation possibilities.”

Retail investors should, however, keep an eye on quality of management and balance sheets, durability of business models and valuation comfort before investing in SMC stocks.

Experts foresee the rally continuing but with a divergence, so they recommend bottom-up stock selection. They also advise investors to watch Q1FY26 guidance, which could signal whether mid-caps can maintain their earnings momentum. Apart from this, investors should monitor geopolitical tensions and the monsoon's progress.

Experts say India's mid and small-cap rally is real, earnings-backed, and reflective of changing market dynamics. However, the days of blind indexing are likely over.

With valuations stretched and growth divergence expected, investors will need to dig deeper to identify the next winners. **BT**

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