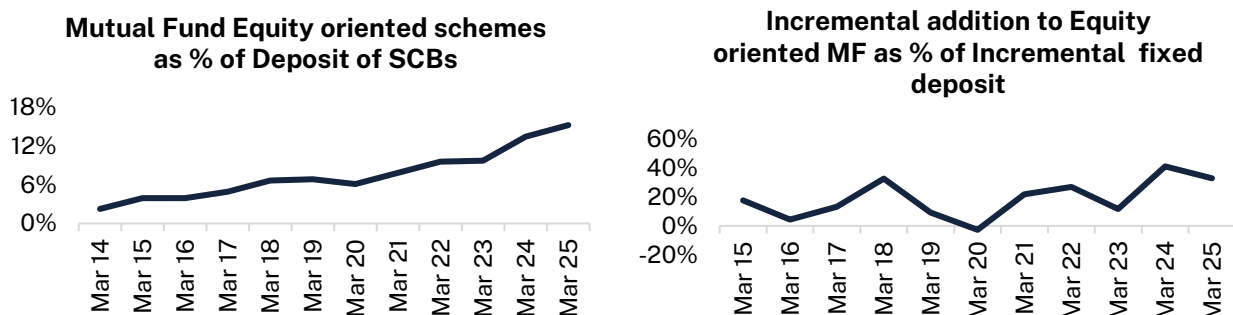


**EQUITY OVERLOAD**

The share of equity in the capital structure of Indian companies and in the asset allocation mix of investors has been on the ascendant. Apart from hogging mindshare and TRPs, this trend is beginning to create new pressure points. We take a closer look.

Let us differentiate this from an equity bubble which is all about over-valuation getting out of control. The debate about equity bubble has come up time and again. For now, this remains inconclusive as there has been no large-scale wealth destruction caused by a bubble bursting in recent years. If it does not implode, it is no bubble and so goes the argument. Be that as it may.

Equity overload is a situation where there is too much of equity in the capital structure of companies and in the asset allocation mix of investors. The two balance sheets are chalk and cheese. That said, it is the underlying dynamics that makes this twin overload explosive. For those who decide on the balance sheet structure in companies, equities have come to be a seemingly cheap source of capital in relation to debt and one that is available whatever be the size and on tap. For investors, the skew towards equity allocation is egged on by a rationale that other asset classes cannot off-set inflation on a post-tax basis. TINA & FOMO add fuel to this. The performance of equity markets in recent years seem to suggest that there can be volatility but no losses. The equity risk premium has been distorted and gamed. There is a feeling of peace and well-being all over. This is precisely the set-up for some cracks to go unnoticed and widen.



Source: AMFI, Spark Fund Research

The optimists will no doubt say these numbers are nowhere near a point of alarm. While that is optically true, let us remember that deposits are held by all Indians with access to a bank account and this includes transactional savings. The MF holdings are held by far fewer people, and we have only reckoned the equity MFs. Consider the rise in the last decade as well.

Look at the second graph showing the delta. While the addition may look small, we are afraid that if we drill down to certain income categories, the trend may get to be concerning. The fact is that there are no precedents or bankable metrics here as this is a first time for India. That should cause consternation. It is not and that makes it even more troubling. While investment into bank deposits and equities are well understood in terms of relative merits, there are points that need to be underscored.

Bank Deposits	Equity
RBI has never allowed a scheduled bank to default on its deposits	SEBI is not mandated to backstop investor returns. Free market principles are supposed to be at work. There is convenient complacency here on the investor side
Pricing is free but there is tight regulation. There are implicit boundaries set by SLR, CRR, risk limits, CAR et al.	Pricing is free and based on disclosures. So, Caveat Emptor. No holds barred other than supply and demand. Unlisted market is unregulated and is completely out of control now
Sources of supply and demand are fully domestic. Hence the pricing is based on Indian fundamentals	Significant presence of foreign capital in both supply and demand in the primary and secondary markets. The distortions are all too evident but have been glossed over for a long time.
There is no tax incentive to distort investor decisions	There is preferential taxation (through MFs and in rates) that started off as an incentive for long term capital



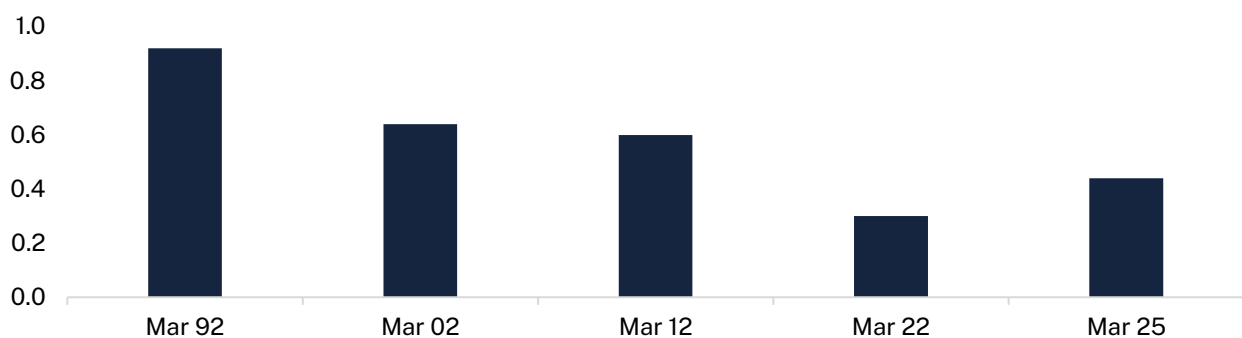
formation. It has now become a holy cow. Policy is now riding on a tiger it helped create and that too in the rich pockets of this poor country.

Conclusion – Risk is rising. Of course, we stress and acknowledge that it can keep rising harmlessly for a lot more time. No one knows how long. However, as they say, the principle here seems to be to keep dancing as long as the music is on.

Distortions in capital structure

Let us look at some solid data on a company which has come to epitomise the success story of Indian free market capitalism and the fabled success of the equity cult.

Reliance Industries Debt-Equity(x)



Source: Ace Equity, Spark Fund Research

Everyone agrees that Reliance has been a great allocator of capital. This is not a graph that suggests that the capital structure of Reliance is off-balance. It is data from a long period and such data is not even easily available on company websites. What we wish to highlight is that this is part of a wider trend. While India suffered from lack of access to equity in earlier years, the pendulum may have swung to the other side now. We are not suggesting that all of corporate India has too much of equity in its balance sheet. However, there is a growing feeling that equity has very little cost and this is based on some wrong implied assumptions on infallibility of equity markets.

The narrative around capital structuring has been tilting in favour of equities for some time now. It goes like this. The equity risk premium for India is supposedly at 6-7% which looks like it is consistent with an emerging market. All looks kosher as this is higher than for the developed world. This rests on the valuation of an index. The valuation does not adjust for cyclicity amongst its constituents. Capital raising at individual company level happens at valuations which are very different.

Capital raising (pre-IPO deals, IPO pricing) is done at valuations where there is practically no risk premium or negative risk premium for the stock in question. If earnings yield is 2-2.5% (40-50 PE seems to be common) or worse still zero (as there are losses), there is ZERO risk being attached to growth. Growth is being taken for granted. To make it worse, so-called experts use sophistry to convince investors that the reported losses are due to conventional accounting principles which do not adjust for the new economy. Customer acquisition and scale-building costs are supposedly written off fully while they are actually “investments in future”. Nothing on evidence suggests that many of these companies have moats to transition to scale up with normal profitable levels. Merely transitioning to EBITDA levels of 2-3 % or PAT levels of a few tens of crores is being celebrated as a victory for the India story and much more. In some instances, even if there are sustained profits in the future, the valuations cannot normalise at all for years. No one cares for the various unknowns ahead and about known risks of potential disruption. Investors have been given a free visa to la-la land and they have chosen to settle down there.

There have been comparisons with the West where equity financing has been seen as an inspirational game changer. The per capita income of the USA is USD 85,800, and we are not even at USD 2,700. There is not a single company in Nifty 50 which is IP-driven. Our companies are execution machines who have benefited from the top-line surge from low hanging fruits or labour cost arbitrage. Some of these companies have in the past no doubt demonstrated exemplary capital discipline when equity capital was



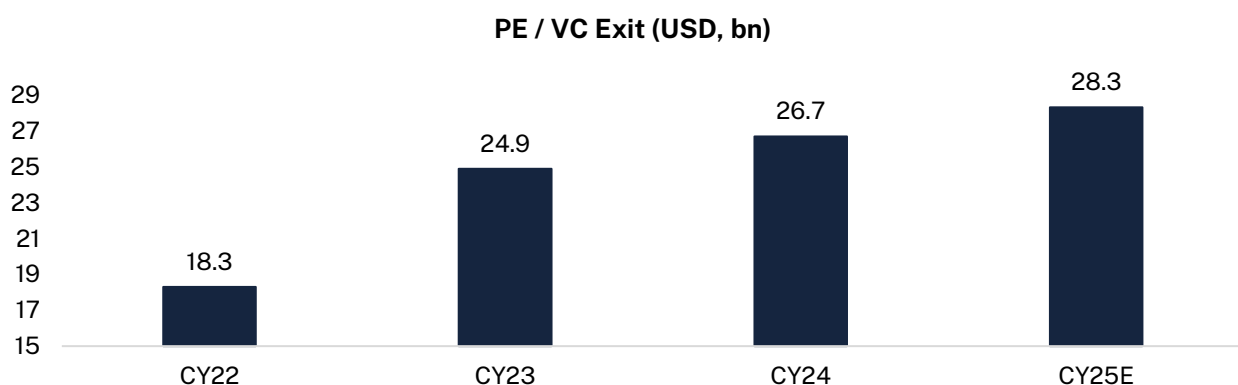
very difficult to come by and debt was expensive. They were good at what they did. Everyone has been milking the goodwill.

In the 1990s, bank lending rates were at 15-20%. Shadow bank sources (ICDs for e.g.) were costing 20-30%. Informal financing was at even higher levels. Equity was not necessarily more expensive but was not available. There was equity draught as against the overload we see at present.

The economy, which was smaller in size, had accidents. Market survived many crises. Unit 64, the most famous example of equity risk disguised as an instrument which was seen as having no-risk and variable upside, had to be bailed out at a great cost to the exchequer. It was possible because the size of the problem was manageable then. With equity oriented MFs standing at 15% of bank deposits as on March 31, 2025, the situation is not the same now.

Bits & Pieces; Do we want to smell the coffee

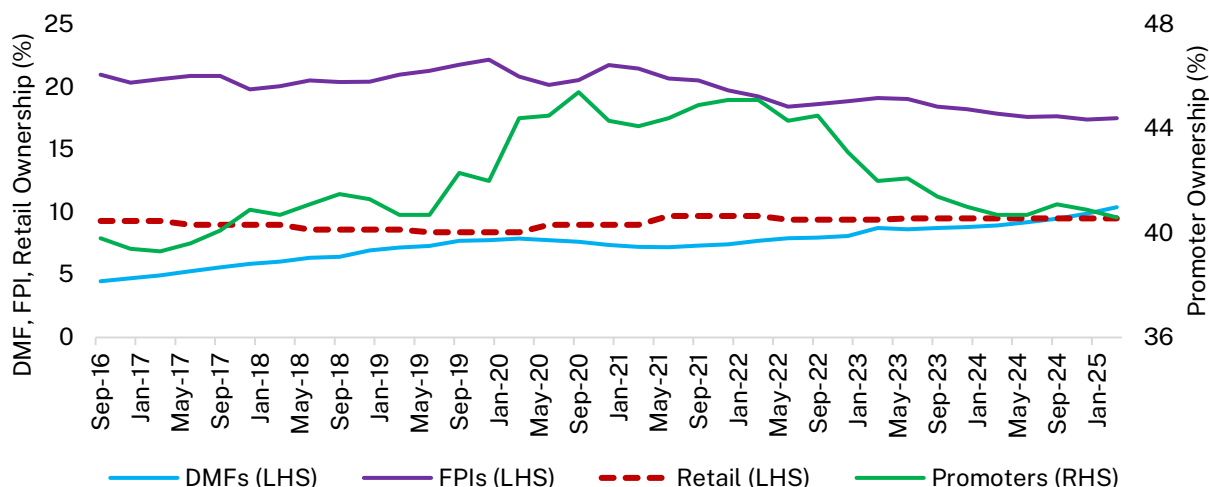
1. We came across a piece extolling the growing equity cult in a poor Indian state. There is little evidence suggesting that investors in one state are less knowledgeable. However, consider this. There is scant history of joint stock companies of substantial size following the tenets of free market capitalism using poor states as their base. This can be seen from the representation amongst BSE-500 companies. We are constrained to draw a parallel here. There was a certain post office outfit in Finland and a police institution in Britain that participated in mortgage-backed securities in the run-up to 2008. The same was seen as a celebration of the democratisation of capitalism. Rest is history. There is reason to worry.
2. Look at the recent action by SEBI on the issue of profits made from the F&O market by a big foreign investor. In an earlier report, SEBI had pointed out that a predominant majority of retail investors are losing money in F&O. In a free market, any post-mortem will reveal that someone lost money. However, the assertions that Indian retail investors are showing lot of maturity in an expensive and volatile market appear far-fetched.
3. We are not sure what is driving market performance. Absolute level of earnings is definitely not a key driver. Some may argue that delivery of earnings versus expectations is. But if there is a beat on earnings based on low-balled expectations, how long can the show go on? The latest quarterly profit in some sectors is at low to mid-single digits. This comes after at least two years of equally tepid growth. Mind you the growth (in some instances, it is negative) is decidedly below nominal GDP growth. Yet many analyst reports claim that these are beats and the outlook is very bright. The market wants to cheer this. This is also supposedly consistent with the most promising large economy in the world. There is no ethical or legal remedy to collective rigging of expectations by the entire capital market echo-system of service providers who are beneficiaries of drumming up the feel-good.
4. Who are the sellers in Indian equities? Private equity and promoters are the categories that stand out. These categories can be called highly informed investors vis-à-vis the minority investors. They may also be insiders in many cases.



Source: Avendus Spark, Spark Fund Research



Ownership Trend in NSE Listed Universe



Source: ICICI Securities, Spark Fund Research

The PE investors have the benefit of lack of regulation in the price discovery process in the pre-IPO life of a company. Valuations of most companies doing IPOs have been marked up prior to the IPO with very little change in financials or fundamentals. As outlook by definition is a matter of opinion, this is sugar-coated to achieve the desired ends. This is a disaster waiting to blow up.

Why are we saying what we are saying

We are managers of listed equity and have an undeniable vested interest in the healthy performance of listed equities. Why are we calling this out?

Here are two reasons and one final thought.

1. If we close our eyes, the world will not become dark. Someone is going to call a spade a spade. It makes sense to keep our eyes open and interpret what we see in a candid manner.
2. If the party goes on with the same drumbeat, our ability to add value will get constrained anyway. No one can add much value to analysis if a stock with a PE ratio of 60 goes up even more because investors and their cheerleaders who control liquidity decide without basis that next year will be better than current year – and keep repeating the same. Or where a PE of 100+ is countenanced because PE is a bad measure when it is inconveniently high. Or where an EV/EBITDA of 30 or 40 is considered reliable with no path to paybacks or no precedent anywhere of this sustaining. Or because all valuations in the world and all assessments of worth are supposedly on relative merit in cases where other methodologies do not work.

Finally, we wish to be in Fund Management business the day after The Day of Reckoning arrives for Indians. We admit we cannot predict when some of these issues will come to a head and force a reset which will most probably be painful. That is no good reason to look the other way when the writing on the wall is clear enough.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

Disclaimer: The contents of this document are for general consumption only and are not to be construed as either a Research Report or a recommendation of any manner by Spark Capital Advisors (India) Private Limited or its affiliates ("Spark Group"). Spark Group shall not be responsible for any investment decisions made by the readers and recipients of this report.