K3 Domestic AIF: Newsletter for Dec 2025

Over the past 18 months, Indian equity markets have been among the biggest underperformers globally. This was on account of elevated starting valuations and slowdown in Nominal GDP and corporate earnings.

Adding to the challenges in last couple of quarters has been the ongoing delay in U.S. trade tariffs deal which has negatively impacted export outlook and the Indian rupee. The weaker FX environment has further discouraged foreign portfolio inflows, amplifying market pressure. Consequently, Indian markets continue to witness net FII outflow. That, India is not positioned to benefit from the "AI-trade" is another big reason for its underperformance.

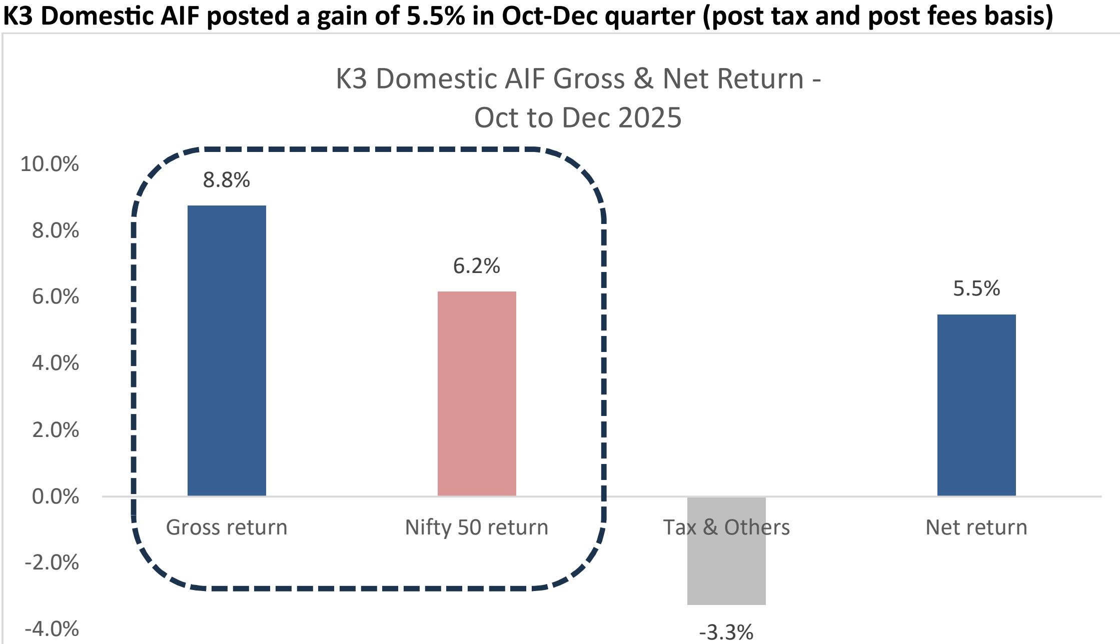
However, markets staged a comeback during the October-December period. This was largely driven by improvement in corporate earnings growth. Ongoing strong regulatory support and continued pouring in of retail money have provided support as well.

We believe (covered in our outlook segment later) that not much has changed from last year and hence it will not be appropriate at this time to expect a big recovery in the Indian markets. Based on how things are as of now, it will be a better year than 2025 but mostly back ended.

We remain steadfast in our investment philosophy — guided by fundamentals, disciplined in execution, and focused on achieving our long-term return objectives.

After a subdued performance in July-Sept qtr, K3 Funds has outperformed the benchmark Nifty in the Oct-Dec period on pre-tax basis with a net gain of 5.5% for the quarter.

K3 Domestic AIF posted a gain of 5.5% in Oct-Dec quarter (post tax and post fees basis)



Return Comparison since inception

Month	K3 AIF - Pre Fees Pre Tax Return	Nifty 50
May	3.1%	1.7%
June	5.2%	3.1%
July	-1.4%	-2.9%
Aug	-3.0%	-1.4%
Sept	-1.1%	0.8%
Oct	2.6%	4.5%
Nov	2.4%	1.9%
Dec	3.6%	-0.3%
Total	**11.5%**	**7.4%**

Note: This performance is excluding the initial couple of months where the fund was in deployment phase

Performance Review - K3 Domestic Alternate Investment Fund

As of Dec end, we were at 164% gross and 77% net exposure for the fund while the average exposure for the quarter was **142%** gross and **68%** net. Our exposure has tilted slightly towards large caps during the quarter.

K3 Domestic AIF: Portfolio Breakup – quarter end (based on market cap)

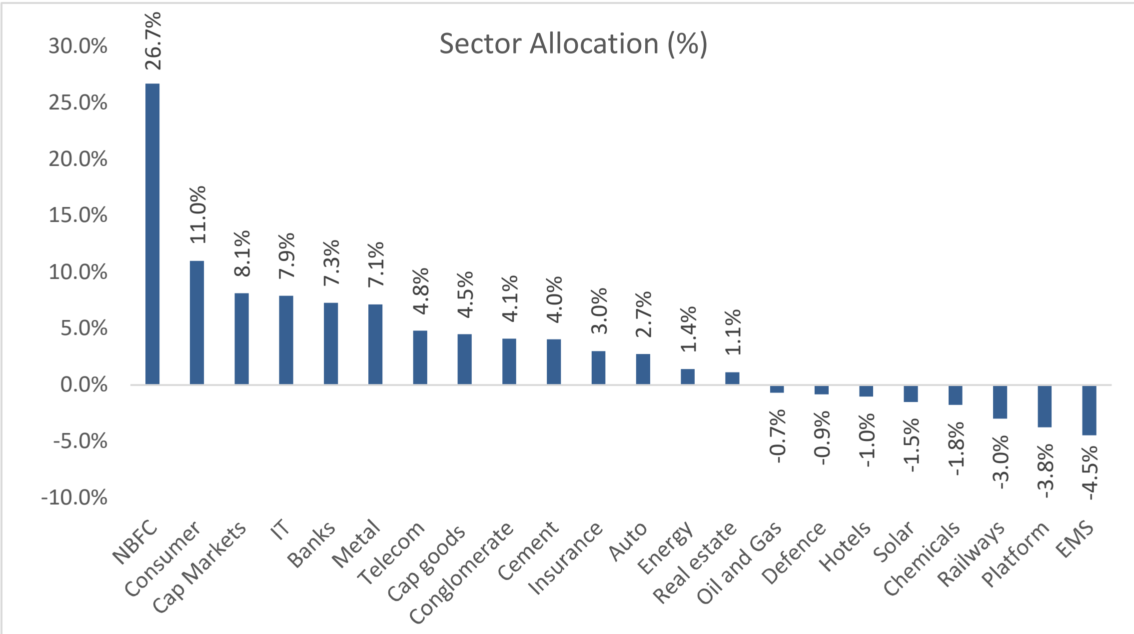
Category	Long	Short	Gross	Net
Large	65.6%	22.0%	87.6%	43.6%
Mid & Small	54.6%	21.7%	76.3%	32.8%
Total	**120.1%**	**43.7%**	**163.8%**	**76.5%**

K3 Domestic AIF: Longs vs Shorts

P/E and Growth, F2027e

Particulars	Wtd. Avg. EPS Growth %	Wtd. Avg. PE
Long portfolio	23.0%	25.0
Short portfolio	21.8%	30.2

K3 Domestic AIF: Sector Allocation (net positions in each sector based on actual positions as of Dec end)



During the quarter, sectors where we had higher net exposure such as NBFCs, Banks, Metals and Mining worked as per our expectations. We remain constructive on these segments given higher expected revenue / earnings CAGR over next two years. We remain net short on Indian platform and EMS sector given regulatory headwinds, expensive valuations amid slowing growth. We believe the new labour laws could have sizeable impact on these sectors which is not properly understood. We remain constructive on consumer and cement sectors in general and expect earnings pickup in the coming quarters.

K3 Funds - 2026 Outlook

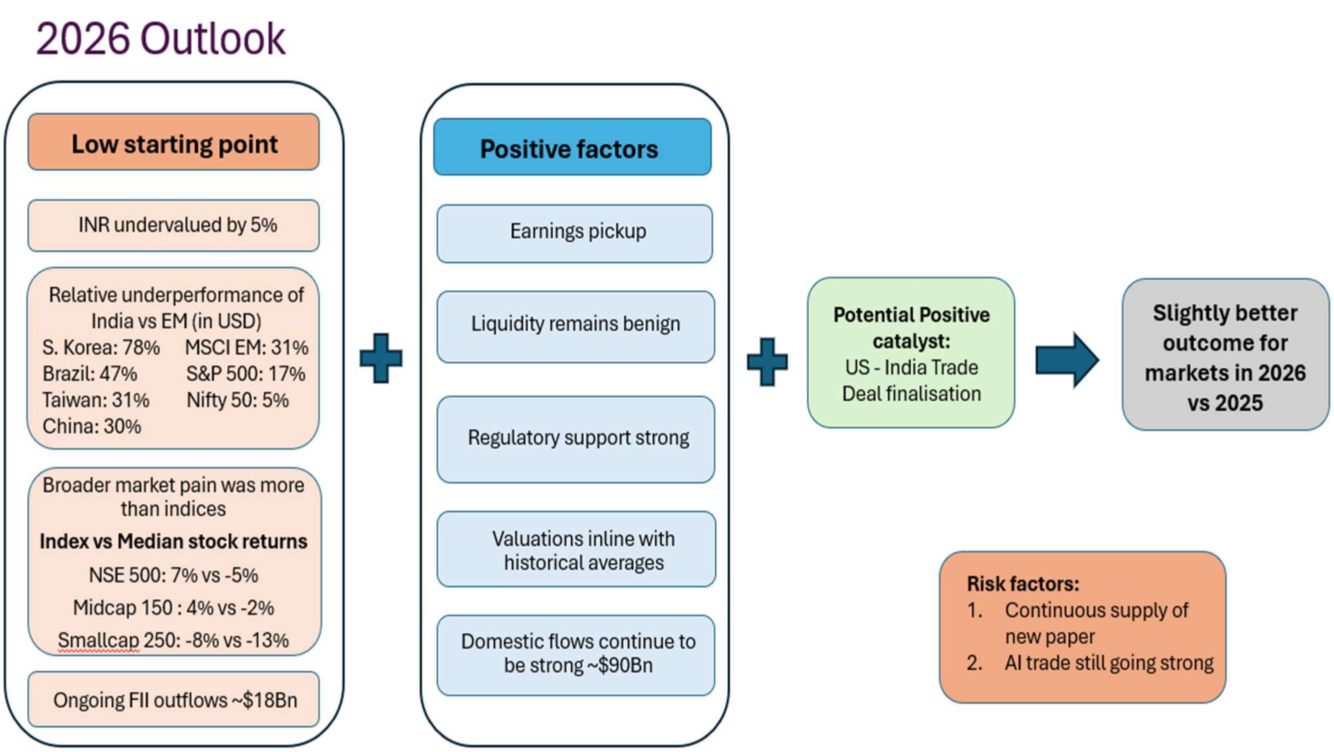
2025 was a tough year for Indian equity markets. On paper, a 10% NIFTY return does not look too bad; however, the journey to that outcome was far from comfortable. The path was volatile and exhausting, India underperformed most global markets, and even beating the headline NIFTY return proved difficult for most participants.

As we regroup and frame our thoughts for 2026, our initial stance was one of hope—understandable after a tiring 2025. However, as we worked through the investment thesis, it became clear that while the setup has improved, the broader environment remains largely unchanged hence still warranting caution to some extent.

There are positives - starting valuations are more reasonable which matters significantly in our business, and the fundamental building blocks appear broadly intact. That said, the key challenges persist and uncertainty on tariffs etc. remain as it is.

As a result, our view is that 2026 is likely to be another grinding year. Outcomes may be better than 2025, but any meaningful upside is more likely to be back ended, with the second half of the year offering better prospects than the first.

We have tried to show our views in the chart form below.

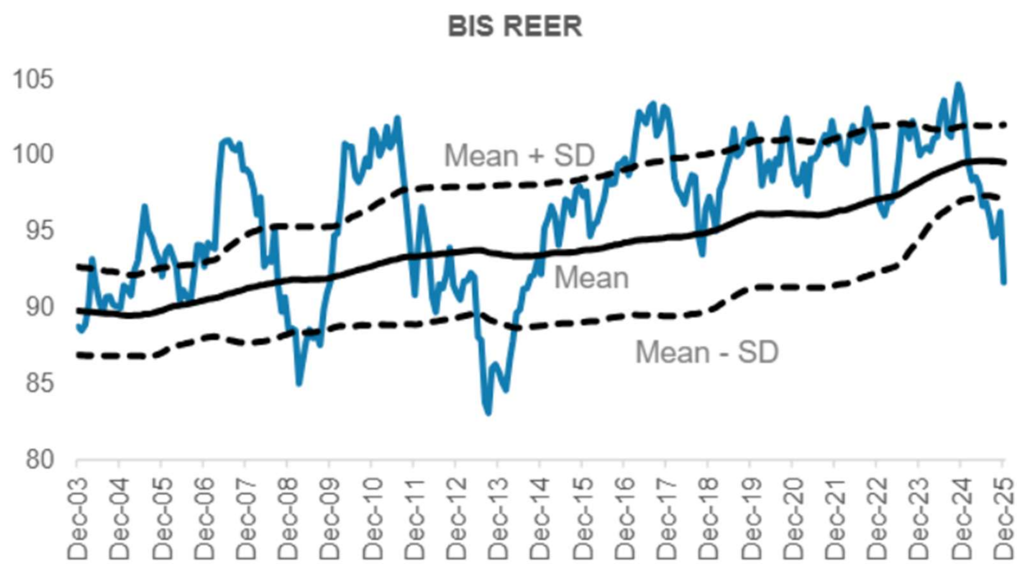


Low Starting Point

a) INR Depreciation – INR has depreciated by 5% in 2025 on the back of strong FII sell flows due to lack of confidence in domestic demand growth outlook, negative news flow regarding delay in US-India trade deal. Ongoing rally in precious metals has led to increase in imports and widened trade deficit and further putting pressure on the currency.

As per a recent Jefferies report, Rupee is deeply undervalued. Jefferies said the rupee has weakened about 5% against the dollar in 2025 even as the dollar index has fallen around 9% over the same period. The rupee is also down 9% versus the yuan, 16% against the euro and 11% against the pound. On this basis, Jefferies estimates the rupee is roughly 5% undervalued, making it the most undervalued in the past 12 years.

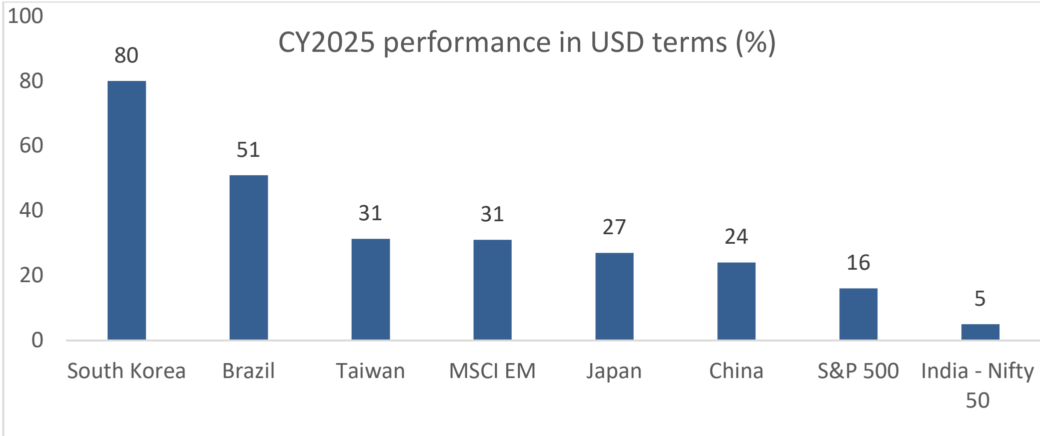
INR Real Effective Interest Rate is at lowest levels since 2013/14



Source: Morgan Stanley

b) Relative underperformance of India vs EM peers – Nifty has seen sharp underperformance on a relative basis vs other EM peer. In USD terms, Nifty was up just 5% for 2025 as compared to South Korea +80%, Brazil +51%, Taiwan +31%. At the beginning of the year, a lot of EMs were at substantial discount to India and were also the beneficiary of AI trade and flows coming into those stocks.

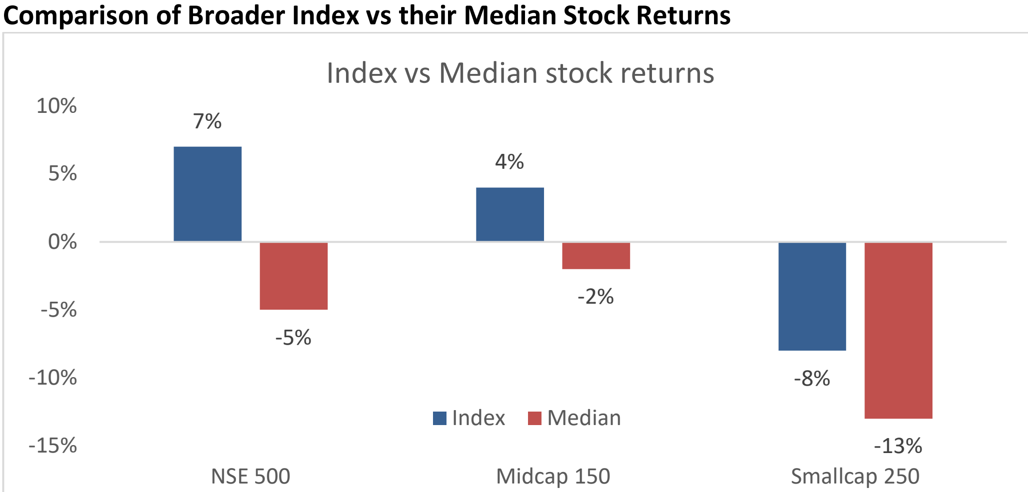
India underperformance vs EM peers



Source: Bloomberg Data, K3 Funds

c) **Broader Market Pain –** While on an index basis, Nifty was up 10% for 2025, however the real pain is in the broader market stocks as the rally has been carried on by a handful of stocks. Even if one looks at Midcap-150 and Smallcap-250 indices, 52% and 72% ended in negative territory for the year. Median stock returns are also negative.

Comparison of Broader Index vs their Median Stock Returns



Source: Bloomberg Data, K3 Funds

d) **FII Outflows putting pressure** – 2025 marked one of the biggest sell-offs by FIIs with sell flows of $18 Bn (bulk of this ~$14Bn came in the months of Jan & Feb on account of weaker earnings, stretched valuations and other EM markets trading at substantial discount to India. Foreign investors are very skeptical on India, citing a lack of confidence in the growth outlook and rupee weakness weighing on dollar returns. As pointed in our earlier newsletter India is Anti-AI trade and hence as of now not much in demand in portfolio allocations.

FII Outflows counterbalanced by Retail money inflow

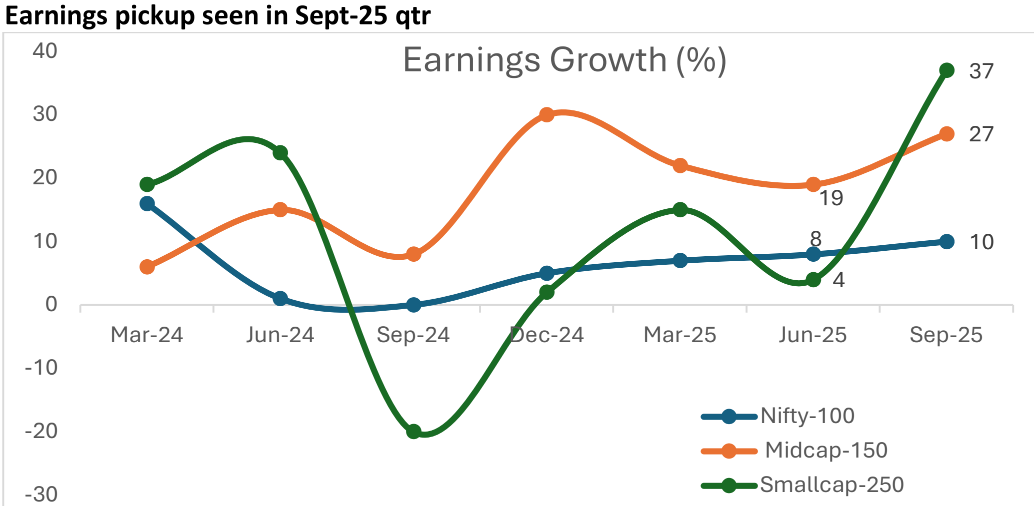
US$ Bn	FII	DII
Jan-25	-8.4	10.0
Feb-25	-5.4	7.4
Mar-25	0.2	4.3
Apr-25	1.3	3.3
May-25	1.7	7.9
Jun-25	2.4	8.5
Jul-25	-2.9	7.1
Aug-25	-4.3	10.8
Sept-25	-2.1	7.4
Oct-25	1.3	5.8
Nov-25	0.0	8.7
Dec-25	-2.6	8.9
YTD	**-18.8**	**90.1**

Source: Bloomberg Data, K3 Funds

Positive factors

a) **Earnings pick up** – Earnings for broader market which remained stable or were in declining trend during end 2024 and first half of 2025 showed initial signs of pickup with yoy growth rising across the board during Sept qtr. Broad market corporate revenue, excluding energy and financials, had slowed to an 8-quarter low of 7% YoY growth for the Jun-25 quarter before recovering to 9% YoY in the Sep-25 quarter (Nominal GDP grew 8.7% in Sept qtr). As per sell side consensus, Nifty 50 earnings are expected to rise by 13-15% in FY27 as compared to just 7-9% in FY26.

Earnings pickup seen in Sept-25 qtr

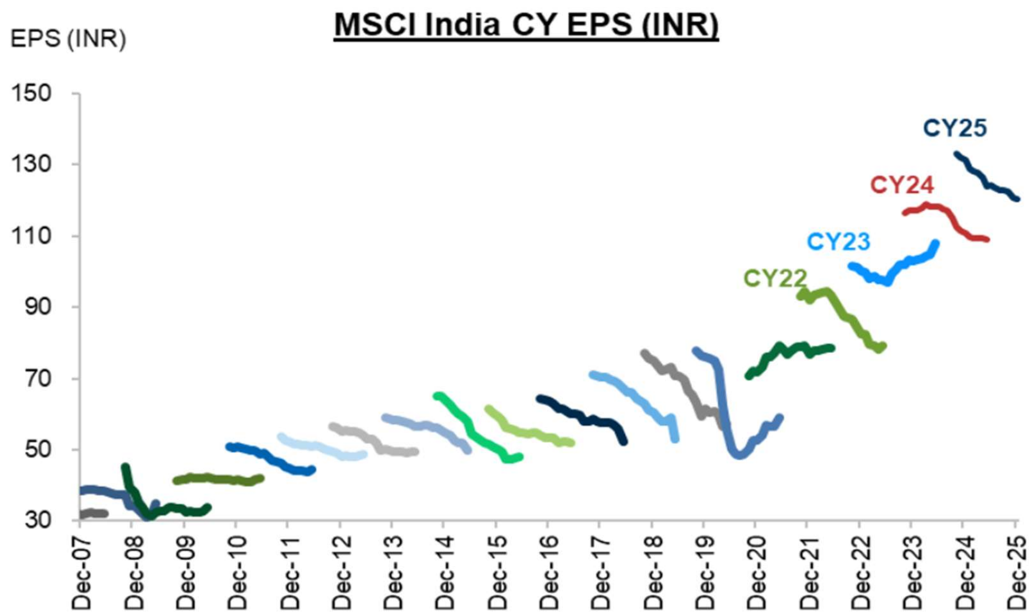


Source: Bloomberg Data, K3 Funds. Earnings growth is on unadjusted basis and hence big swings on account of oil marketing companies, etc.

ONE BIG CAVEAT though is that earnings revisions matter more than earnings growth for the stocks! – and it seems while earnings may grow in F2027, it may struggle to have any positive revisions in a meaningful way given current expectations are still high.

From the chart below, we see that there have been very sharp cuts in earnings estimates from mid CY24 and CY25 which explains the recent performance of the Indian market. On the contrary CY21 and CY23 had seen strong earnings growth (and upgrades) and explain the strong market performance in those years. (CY22 saw a global downgrade cycle post covid, India did relatively better).

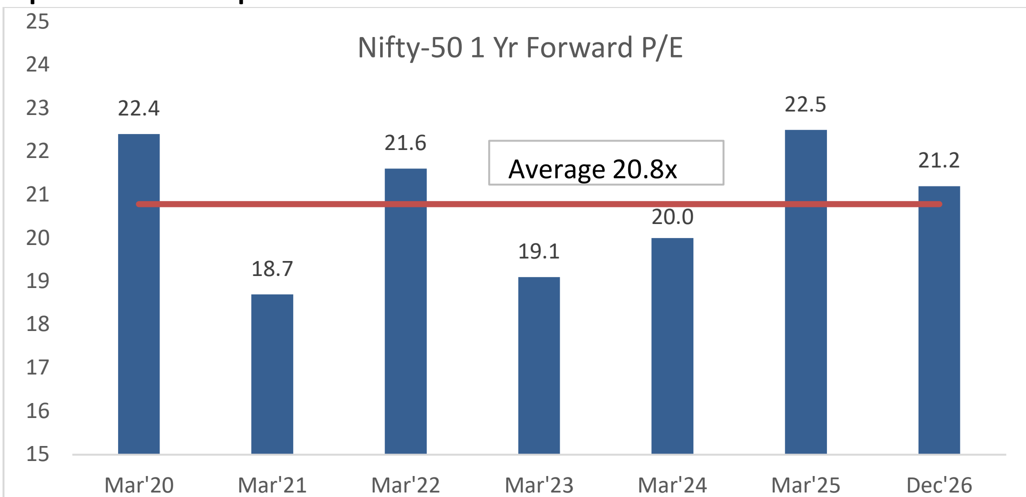
Start of the year EPS expectation vs actual outcome

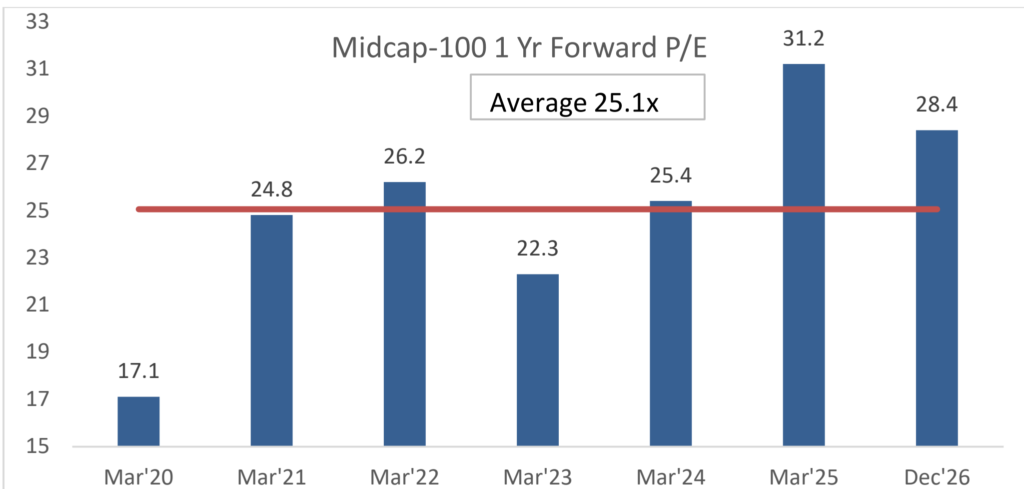


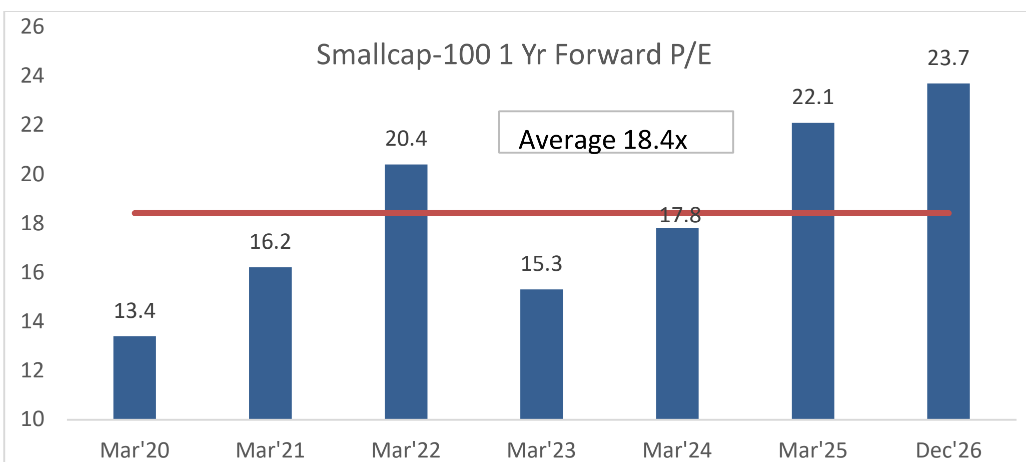
Source: Refinitiv Eikon, Goldman Sachs

b) **Valuations – time correction helpful** – 2025 started with elevated starting valuations and decline in nominal GDP growth and corporate earnings which led to valuations of large cap stocks cooling off. Nifty 1 yr forward PE now stands at 21x whereas Mid and small cap index still trade at a premium to their long-term average PE.

Nifty-50 1 Year Forward Valuations nearing long term averages while Mid and Small caps still trade at a premium







Source: Bloomberg Data, K3 Funds

c) **Regulatory support continues to be strong** – 2025 saw a lot of fiscal and monetary actions taken by Govt and regulatory agencies which was kicked off by income tax cuts, GST cuts, then a continued repo rate cut of 125bps and regulatory easing by RBI for both banks and NBFCs – leading to a decline in supply-side inflation which should drive stronger consumer spending. This has been visible in the last quarter of 2025 which saw strong growth in auto sales and consumer loan growth and should play out further into this year.

d) **Retail Money still pouring in** - Higher sell flows from FIIs was successfully countered by strong domestic flows and provided a strong floor with DIIs raking up purchases of $90 Bn during the year and could continue with strong retail SIP money flowing through into 2026.

Potential Positive Catalyst

US-India trade deal: This remains as one of the key catalysts going into 2026. Escalation in US trade tariffs during the year on Indian goods to 50% vs other Asian peers at 19-20% has negatively impacted export outlook and the Indian rupee. The weaker FX environment has further discouraged foreign portfolio inflows, amplifying market pressure.

Risk Factors

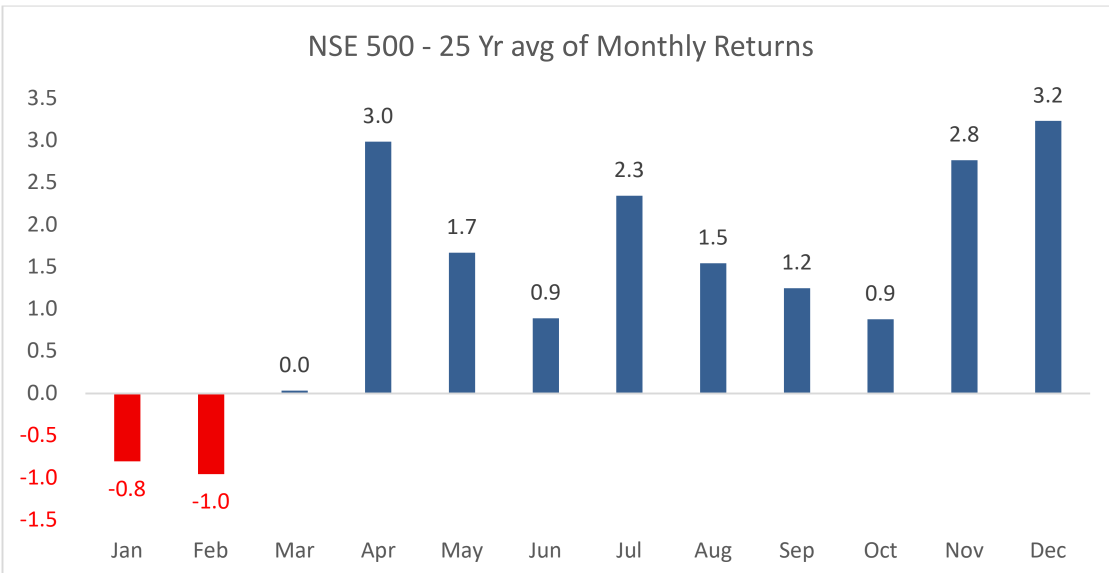
Continuous supply of new paper (issuances and sell downs) – 2025 was marked by large IPO fundraising which stood at ~$20 Bn within which OFS was roughly $12.5bn and fresh issuances being $7.5bn. Apart from this, companies have raised more than $26Bn through QIP route in last 2 years either for capex, growth or deleveraging.

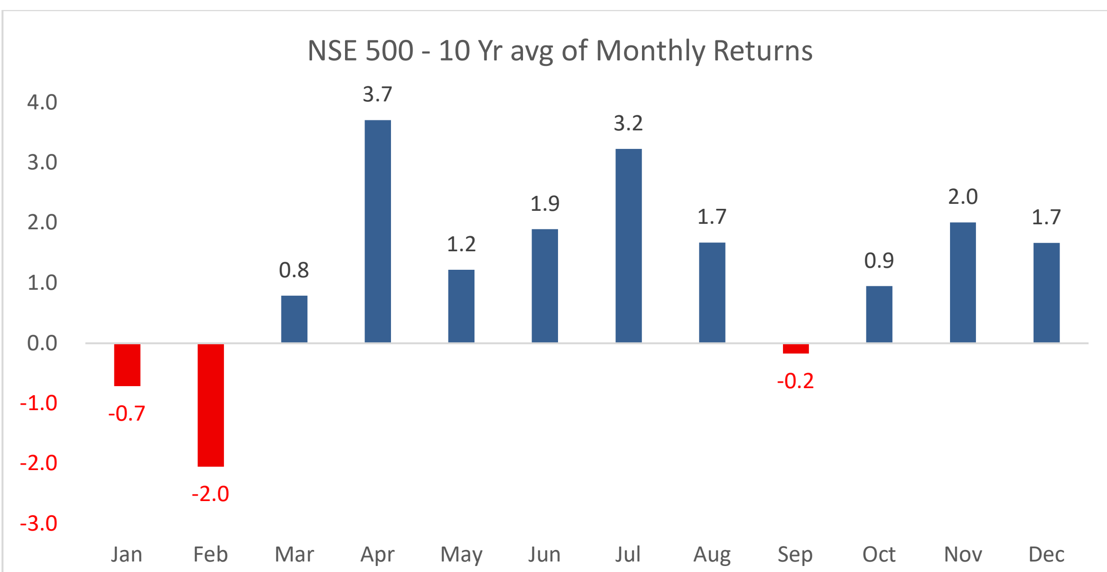
AI trade still going strong - On the AI front, India remains underrepresented in the global supply chain. In fact, the country may be structurally "short" the theme. The Indian IT services industry — a massive employer and export contributor — has long positioned itself as an executor rather than an innovator. As AI-driven automation advances, this model faces pressure.

Mind the seasonality

One must be mindful of seasonality in Indian markets. The chart below shows that caution and selectivity during the first quarter of the year have historically paid off.

Markets historically underperformed in Jan-Mar Quarter





Source: Bloomberg Data, K3 Funds

Financials – updating our view

Financials especially NBFCs have been flavor of the season with RBI doing rate cuts thereby easing borrowing costs, Govt of India bringing in GST 2.0 and other regulatory easing leading to strong loan growth as evidenced through preliminary Q3FY26 numbers. We continue to remain bullish on the sector especially on the mid and the small financials wherein earnings continue to normalize and compound in FY27 & FY28 and valuations remain comfortable.

India Financials – Comparative Table

Scrip	Price	F2026 - EPS	F2027 - EPS	F2028 - EPS	EPS CAGR F26-28	F2028 - PE	PEG Ratio
IDFC First Bk	83	2.5	5.3	7.8	112%	10.6	0.09
Poonawala	461	5.8	15.1	24.5	160%	18.8	0.12
RBL	306	17.5	28.0	42.3	60%	7.2	0.12
Bandhan	143	16.4	22.8	27.5	39%	5.2	0.13
Manappuram	308	15.6	25.7	30.4	64%	10.1	0.16
IIFL Fin	638	35.6	54.9	67.4	54%	9.5	0.17
Piramal Fin	1854	58.8	92.4	169.6	57%	10.9	0.19
PNB	125	15.2	18.0	19.6	18%	6.4	0.34
Federal Bk	249	16.1	20.3	25.0	26%	10.0	0.38
PNB Hsg	970	85.6	103.1	123.9	20%	7.8	0.38
MMFS	363	21.0	27.0	32.5	29%	11.2	0.39
Tata Cap	351	12.1	17.1	21.6	41%	16.3	0.39
LTF	288	12.3	16.5	21.4	34%	13.5	0.39
AB Cap	351	15.2	20.2	25.8	33%	13.6	0.41
Shriram Fin	979	49.2	63.2	82.4	28%	11.9	0.42
Axis Bk	1262	80.4	99.1	118.8	23%	10.6	0.46
AU SFB	972	34.4	45.1	59.1	31%	16.4	0.53
SBI Cards	858	23.6	32.9	40.4	39%	21.2	0.54
Chola	1701	62.5	80.2	97.3	28%	17.5	0.62
Kotak Bk	2133	101.0	122.0	145.0	21%	14.7	0.71
BAF	949	33.3	41.3	51.5	24%	18.4	0.77
HDFC Bk	937	49.0	56.1	67.4	14%	13.9	0.96
Muthoot	3926	198.6	229.3	259.8	15%	15.1	0.98
BoB	302	38.5	40.5	44.9	5%	6.7	1.29
ICICI Bk	1437	72.4	77.3	86.3	7%	16.7	2.46
SBIN	1028	85.8	89.4	99.1	4%	10.4	2.47

Source: Bloomberg, K3 estimates; Price data is as of 13th Jan

Thank you for being a part of K3 Funds

K3 team