Identifying Valuable Mid-Cap Listed Companies

Subrata Ray
ICRA Ltd.

Shamsher Dewan
ICRA Ltd.

Siddharth Shah
ICRA Ltd.

Introduction

While the definition of 'Midcap' stock continues to evolve with maturity, depth and growth in the underlying market, in today's context stocks with market capitalization ranging between Rs. 10-100 billion can be classified as 'Midcap. The midcap stocks generally fit into higher risks-return framework as compared to large cap stocks. Other things being same, midcap companies generally have a smaller scale of operation and enjoy lower valuation multiples as compared to its large cap peers. The CNX 500 Index, one of the most broad-based index in the market, currently includes ~275 companies in the midcap segment, accounting for ~15% of the total market capitalization. The large cap companies also account for significant proportion of the traded volume in the stock market – for example the 50 stocks (all large caps) which are part of Nifty accounts for ~50% of the trading volume in the market.

As organization grow larger, their market position and bargaining powers generally improve across all segments, including suppliers, lenders, creditors and employees, leading to greater stability in business, and giving a sense of lower risk perception to investors. However, as companies grow, their organic growth rate tends to moderate due to higher base effect, sometimes accentuated by saturation in the industry itself. Also, while scale offers definite advantages, it also tends to limits organization's speed of response to changing business environments. On the other hand, the mid-cap companies offer prospects of better growth rates due to factors like lower base effect, offerings of niche products or services catering to an underpenetrated market space. However, since the risks involved are higher, a deeper understanding of business model and thorough analysis in selecting companies in mid-cap space have the potential to become multi-baggers and turn large-caps in future.

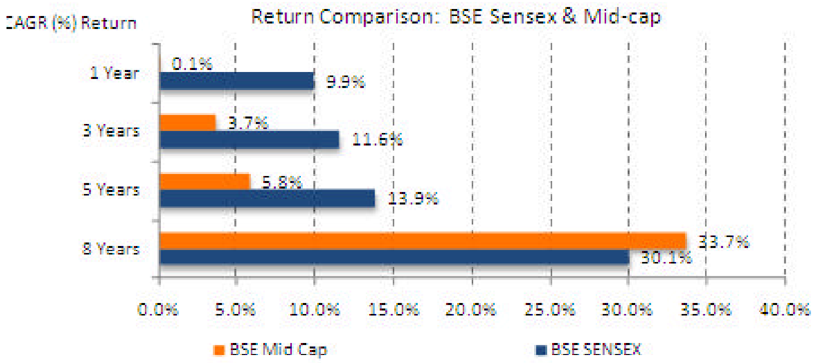
During weak market conditions, as investors flock to the safety of large cap stocks, the valuation difference widens between large cap and small cap stocks. However, the valuation cycle tends to favour the midcap during the bull market as with reduced risk aversion, typically the valuation discount for midcap reduces. However, some midcaps, with stronger growth potential, can enjoy a valuation premium for extended period.

Ability to attract institutional investors constrained..

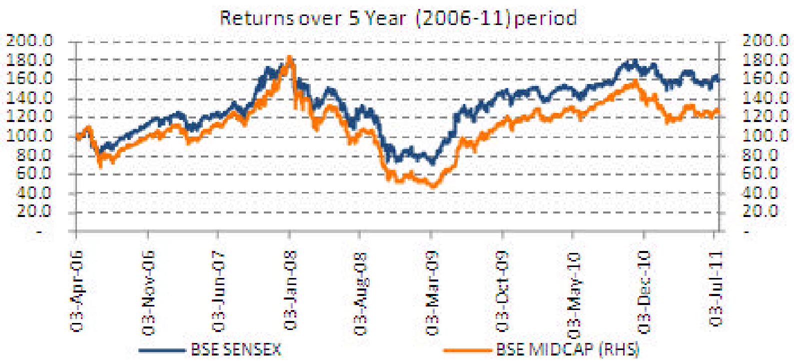
Domestic and foreign institutional investors are key players in the stock market accounting for a large proportion of investible funds. A large number of institutional investors are constrained by their investment charter to invest only in liquid and large-cap stocks. This apart, disclosure levels, research coverage and liquidity of investee companies are key criteria applied for 'short listing' potential investment targets by most institutional investors. The large cap companies are typically better equipped in terms of resources to service the institutional investors through sophisticated disclosure standards and investor relation set-up. In contrast, many midcap companies suffer from weak disclosure standards, limiting appetite of institutional investors. All these circumstances contribute to the environment where the research infrastructure of brokerages and media houses are geared more to deal with large cap companies. In contrast mid and small companies typically suffer from weak coverage from both research and media houses, leading to a situation where informed decision making on this category can be a challenge.

Broad index level returns are volatile in midcap segment - stock selection is key

The BSE Mid-cap index, representing a wide gamut of 280 stocks across diverse sectors has outperformed the SENSEX; by delivering 33.7% return over the past eight years compared 30.1% return posted by SENSEX. However, the scenario changes significantly for shorter periods of investments - the mid-cap index has consistently underperformed the broader indices. For instance, in the past three years, the mid-cap index has generated a meager 3.7% CAGR return, while the SENSEX has posted a return of 11.6% p.a.



Source: BSE, ICRA Online Estimates



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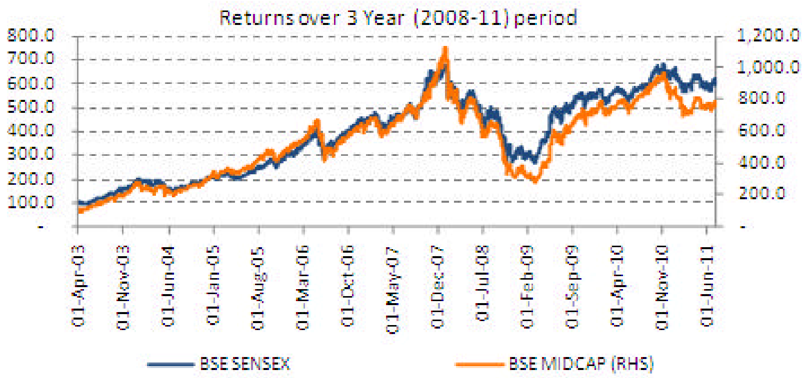
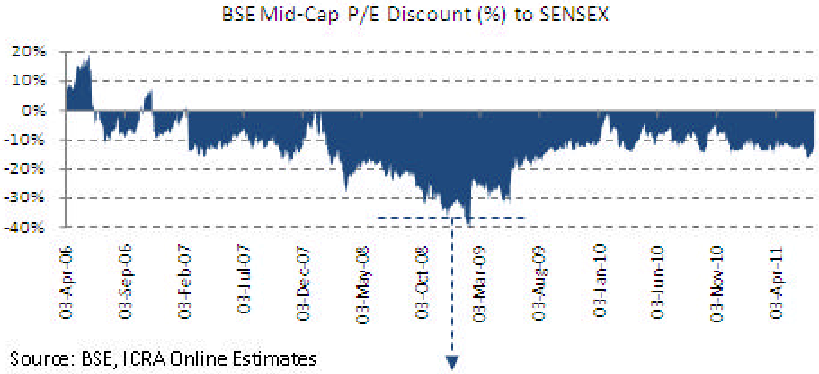


Source: BSE, ICRA Online Estimates

The strong underperformance by mid-cap companies as a whole over the past three years primarily reflects the general risk aversion by investors across the board since the global liquidity crisis in 2008. The flight to safety during the period of crisis impacted the midcap segment much more severely as compared to the large cap space. The market recovery since then has also been relatively muted in the midcap segment as the overall sentiment across the world remains cautious.

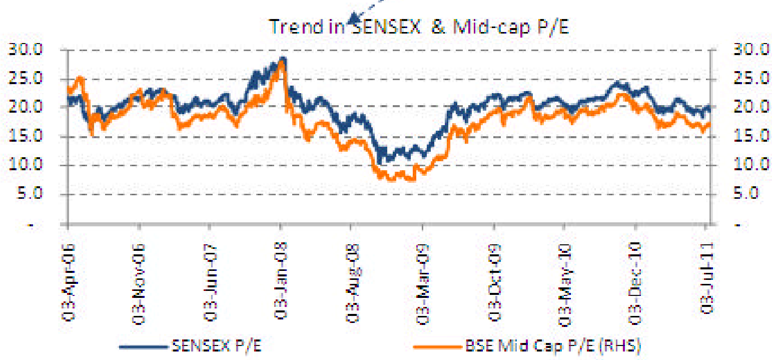
Bottom-up approach key to selecting stocks in mid-cap segment

Barring a small period between April-June 2006, midcap stocks have traditionally traded at a discount to the larger indices such as SENSEX notwithstanding the fact the midcaps offer higher growth prospects. The extent of discount to large-cap stocks is a function overall economic scenario, liquidity in the market and level of risk aversion among investors.



Discount to large-cap stocks peaked during economic meltdown in 2008-09

Mid-caps commanded a premium to large-caps during periods of irrational exuberance & abundant liquidity



Although there are sharp variations in discount levels, the mid-cap stocks have traded at a discount of ~20% to large caps in the Indian context. However there have been periods of economic slowdown followed by heightened risk aversion such as the meltdown witnessed in 2008-09, when the extent of valuation discount between mid-caps and large-caps had risen to as high as 35-40%. While the broader basket of stocks reflects such a trend, there are numerous companies within the mid-cap radar, which have consistently traded at premium to large-cap stocks and even witnessed improvement in their valuation over a period of time.

Large number of midcap companies can be found in sunrise industries – as the industry itself is at the evolving stage, smaller companies with new approach to services or products are often able establish itself quickly in these businesses. The higher growth in sunrise industry tends to accommodate new entrants relatively easily. The IT services industry, during 1990s and early 200s could be an example. As the industry was is a high growth phase a large number of small and midsized companies could participate in the same and some of them have now evolved into large cap companies. However, with industry now consolidating around large sized players having advantages of scale, the opportunities for smaller players however has diminished to an extent.

Strong growth prospects, robust financial performance, leading/strong market position in their sectors, pricing power and relatively less vulnerability to external factors are some of the reasons, which can help companies outperform large-cap indices and maintain premium valuations over its peers. In the Indian context, structural shifts in sectors, strong domestic consumption driven demand and inorganic opportunities have also helped companies maintain strong profitable track record to command premium valuations. At the same time, companies in sectors, which are impacted by external factors such as sharp rise in crude oil prices (i.e. airlines), commodity prices (i.e.

auto component manufacturers - tyres, batteries etc.) and vulnerability to higher interest rates (i.e. real estate) also witnessed sharp fluctuation in their valuations.

Often companies in the midcap sectors owing to low-base and favourable growth prospects (i.e. organized retail, healthcare services) remain in investment phase, which could largely be debt-funded. As a result of high capital requirements, companies with better financial discipline tend to stand out and command higher valuation vis-à-vis its peers. Frequent equity dilution to support expansion plans also impacts valuations to an extent

Several companies in the mid-cap space are leaders in their segment

Interestingly many of the companies in the midcap sector are either market leaders or among the leading players in their sectors. Ability to achieve and sustain market leading position is largely a function of long-standing in the business, strengths in technology, product profile and even marketing & distribution reach. Most players in the mid-cap sector exhibit few/most of these traits. A fraction of companies in mid-cap sectors have also been "Industry first", leading their sectors both in terms of growth as well innovation. Being part of established foreign parent or part of conglomerate, deriving synergies from parent have also helped some mid-cap companies in establishing sound market position.

Besides market position, strong product profile, pricing power, ability to negotiate with suppliers, strong financial performance and relatively low capital requirements allows companies to sustain through business cycles and enjoy premium valuations. While most of the successful midcap players have strong positioning in the domestic market, some of the players have also attempted to create meaningful presence in international markets through in-organic investments/acquisitions. Broadly, the impact of these acquisitions has had a mixed impact on valuation of these companies as in some cases; the consolidated performance has been impacted due to low profitability of acquired entities and in other due to mature market conditions in their respective economies. Some acquisitions with the intent of gaining technological/client access have also benefitted some of the companies

Table: An indicative list of companies with strong market position

Companies	Market Positioning
Amara Raja Batteries	Second largest player in the lead-acid batteries
Greaves Cotton	Leading manufacturer of engines for 3Ws and SCVs
TTK Prestige	Leading kitchen appliances company with presence in pressure cookers
Blue Dart Express	Market leader in the organised air cargo segment
Havells India	Enjoys strong market position across segments in electrical equipment
Voltas	Dominant player in HVAC systems; also 2^{nd} largest in air conditioning
Pantaloon Retail	Largest retail company in India
Fortis Healthcare	Leading player in organised healthcare & diagnosis space
Thermax	Dominant player in the BTG segment of power equipment space

Source: ICRA estimates

Conclusion

The inherent limitations of midcap companies – like inadequate research coverage and higher risk perceptions – are some of the key reasons why there is a greater opportunity of identifying an under-valued business in the midcap segment. In contrast, continuous media and research house coverage limits the scope of finding significant under valuations in large cap stocks to an extent. For institutional investors, cherry picked midcap stocks can provide the much sought after 'alpha' push to its investment portfolio. For individual investors and HNIs with higher risk appetite, the midcap space offers opportunities for higher returns, provided stock selection is backed by adequate homework.

Overall, while the midcap segment offers significant opportunities for stock selection, the low returns in midcap index stocks highlight the importance of selective approach to stock selection backed by solid research in this segment.