Value of Independent Equity Research (IER)

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What is independent equity research[1] ?
Independent Equity Research (IER) is a service designed to provide unbiased and independent opinion on the listed companies from fundamental as well as valuations perspective. The need for independent equity research becomes even more pronounced for companies with limited coverage, especially in mid and small cap domain.

Independent Equity Research provides easy-to-grasp and periodically updated reports to help market participants with independent, unbiased and dependable opinions on equity quality. Investors in particular can use the assessment to choose from among the options available in the equity market and design their portfolios suitably. Besides, the independent assessment can potentially help issuer companies – even the lesser researched ones –broaden market participation for their stock. Besides, a positive assessment should also enable a company showcase its strength to potential investors and other stakeholders. Moreover, the independent equity assessment captures both the relative valuation and the fundamental earning quality of the companies graded, replaces name recognition with objective judgement, thereby contributing to the cause of market transparency and minimizing information asymmetry.

Independent equity research Schemes prevalent in other countries
Regulators and Stock exchanges in various countries have initiated Independent Equity Research Schemes for listed companies with the aim of providing unbiased research reports, to encourage informed decision making by investors. The details of IER schemes launched in other countries are as follows:

Singapore: SGX Equity Research Insights (SERI) is administered by SGX and each participating listed company is covered by independent agencies for two years. The reports are available free of charge to all investors. The listed companies pay an annual fee to SGX based on their market capitalization, which is in-turn used to fund the research.

Malaysia: Listed companies pay a total fee of RM 16,800 for which they receive research coverage for two years. All companies listed on Bursa Malaysia are eligible to participate.

Indonesia: Reference share price target reports are prepared by credit rating agency, PT Pefindo's Equity research division twice a year and are available freely on the IDX website.

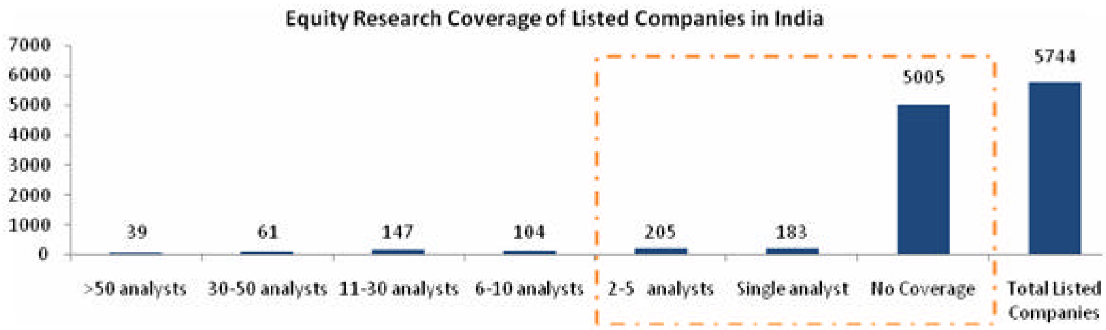
Australia: ASX will provide $1 Million to fund the 12 months trail equity research scheme in FY13. It is designed to provide high-quality research on all listed entities with less than $1 billion market capitalization *('Fact sheets' for companies below $50 Million Mcap, 'Standard Retail Research Reports' for companies between $50 Million to $200 Million Mcap and 'Standard Institutional Research Reports' for companies between $200 million to $1 billion Mcap).*

Nasdaq: Nasdaq serves as an intermediary – listed companies pay Nasdaq a fee for independent coverage, Nasdaq in turn pays *'Morningstar'* (one of the largest independent research firms in the world) for detailed Institutional Research Reports on the company. Listed companies many not review the contents or ratings prior to publication.

Limited analyst coverage beyond large cap names in India
The mid-cap / small cap stocks are generally perceived to have higher risks and yield higher returns than large cap stocks. Empirical analysis suggests that the risks for failure decreases as small start-up firms attain higher scale and diversification. As they grow large, they enjoy better market positioning and risk mitigation infrastructure, besides having better bargaining power with customers, suppliers and creditors. However, as the companies grow to large caps, their organic growth rates moderates due to higher base effect, sometimes accentuated by saturation in the

industry itself. On the other hand, the mid-cap / small caps companies offer better growth rates due to lower base, further aided by presence in niche or underpenetrated segment.

Since the risks involved are higher, one needs deeper understanding and thorough analysis in selecting the mid-caps /small-caps that have the potential to be multi-baggers and turn large-caps in future. However, as shown in the graph below, from ~5700 companies listed on Indian stock exchanges, ~700 companies are actively covered by the brokerage industry – leaving a large underserved market needing the services of Independent Equity Research Services.



Source: Bloomberg, ICRA Equity Research

Benefits of Independent Equity Research

- While Independent equity grading could boost investor confidence and ease equity funding plans, the relevant fees are substantially lower than the merchant banking fees paid at the time of raising equity capital
- It could improve shareholding risk/returns profile by improving liquidity and reducing volatility in share prices.
- It could help improve transparency, widely decimate relevant information and reduce burden on the investor relations department.
- It could help build confidence among employees / suppliers / dealers / franchisees / clients by effectively showcasing performance improvements and strategic vision of the company.
- A positive independent assessment could improve brand image and bargaining power with potential institutional investors, Private Equity investors (@lower IRRs), financial institutions (@share pledging) and merchant bankers (@lower fees).

Comparison with Brokerage Research

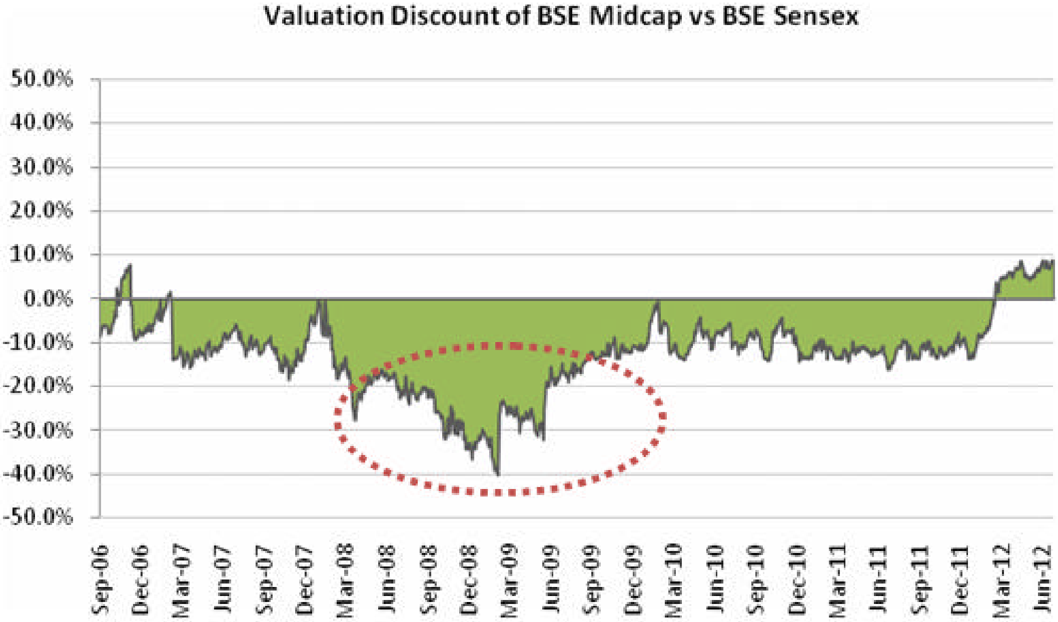
Independent Equity Research	Brokerage Research
▶ Unbiased views irrespective of subsequent stock price performance; concern over use of research reports to facilitate entry/exits of key institutional clients does not exist	▶ Conflict of interest might arise as brokerage income is derived from stock recommendations
▶ Specialized & independent agencies with, long-standing reputation, large talent pool, proven research across multiple sectors, and rigorous analytical processes	▶ Limited track records of most brokerage houses due to high mortality rates in the industry
▶ Leverages expertise gained after rating large number of companies across sectors	▶ Understanding / Coverage limited to few large and widely covered sectors
▶ Primary Research due to direct access to the top-management	▶ Mostly Secondary research based on publicly available information

Several mid-cap companies have outperformed large-caps in the long run

Several mid-cap companies are either market leaders or among the leading players in their sectors – mainly due to first mover advantage, long-standing experience in the business, patented technology, innovative product profile or even marketing & distribution reach. 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 strong market position, pricing power, ability to negotiate with suppliers, strong financial performance and relatively low capital requirements allows companies to sustain through business cycles and outperform large-caps over an extended period of time.

Mid-caps require more comprehensive research due to their high risk – return profile

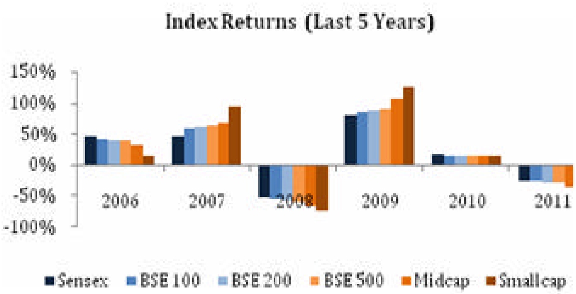
While it is difficult to establish a clear trend due to significant volatility faced by the global financial markets and considerable M&A activity exhibited by Indian corporate over the last five years, the broad financial analysis shown below reinforces the assumption that large cap companies report relatively higher resilience during an economic downturns. While these risks are normally factored in lower valuation multiples enjoyed by the mid-cap companies, the valuation discounts are exaggerated at times (as shown in the graph below).

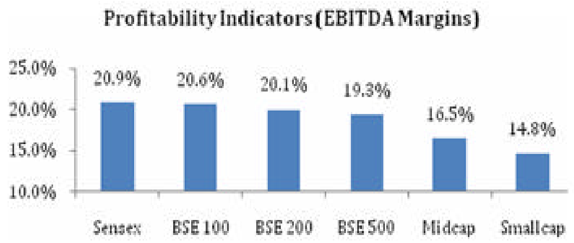


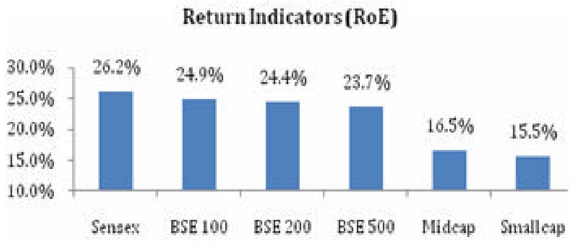
Source: BSE, ICRA Equity Research

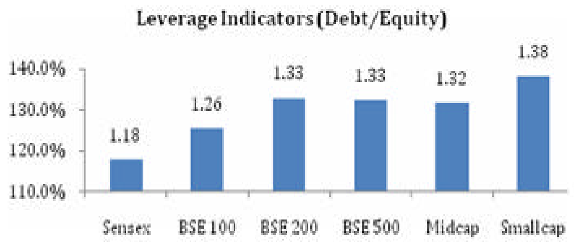
The inherent higher risks in mid-cap stocks can be further established by the lower profitability and return ratios, higher leverage levels and weaker coverage indicators of BSE Mid-cap and BSE Small-cap indices (as shown in the graphs below). However, inadequate research coverage, limited access to information 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, we think that focussed and independent mid-cap research could help identify undervalued companies that can considerably outperform large caps through a combination of stronger earnings growth and expansion of valuation multiples.

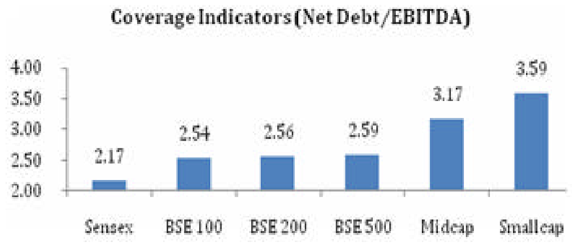
Large Cap Vs Mid Caps: Relative Financial Performance

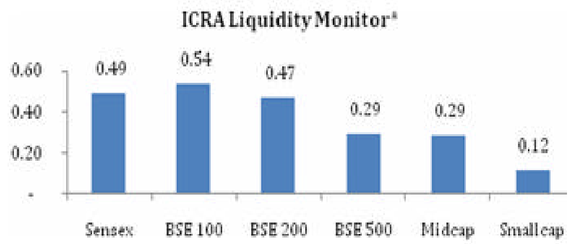


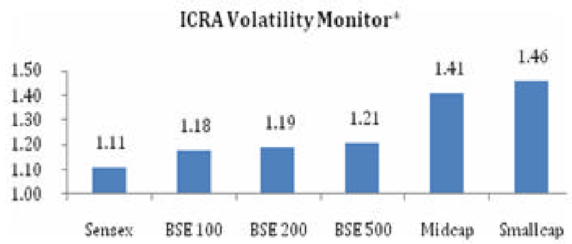


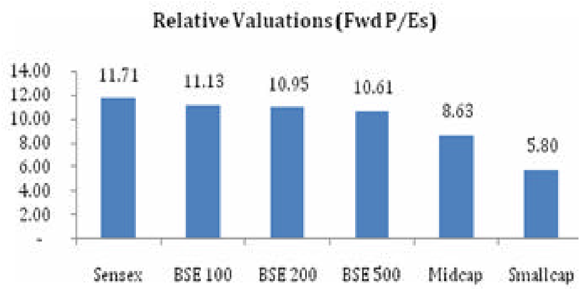


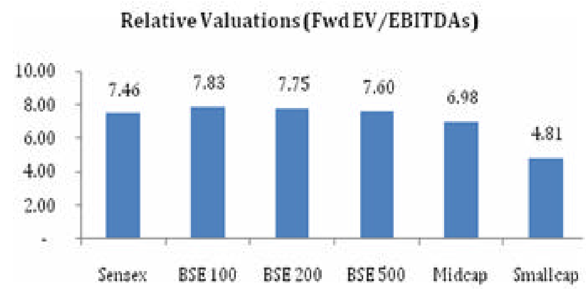












Source: Bloomberg, ICRA Equity Research

** ICRA Volatility Monitor: Beta calculated with MSCI World Index for last 5 years using monthly returns*
 # ICRA Liquidity Monitor: Average six month trading volume / total market capitalization

[1] ICRA Limited also offers independent equity research – ICRA Equity Research is a mandate-driven, paid service.