Investing in Midcap Companies: fraught with risks but can generate healthy returns in the long-run

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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 BSE Midcap Index, one of the most broad-based index in the market, currently includes 233 companies in the midcap segment, accounting for ~14% of the total market capitalization. The midcap universe in India has a wide sector base with banking and financial services companies dominating the space with almost ~23% contribution to market capitalization. In comparison to large cap companies, the midcap also has much wider sector coverage as companies from some of the sectors such as textile, retail and shipping do not have companies with large capitalization. As a result, it offers a wider investment basket inclusive of sectors that are currently in high-growth phase.

Exhibit 1 Midcap universe accounts for 14% of total market cap

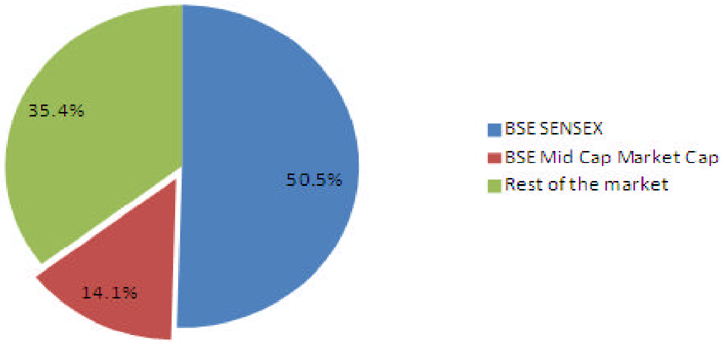
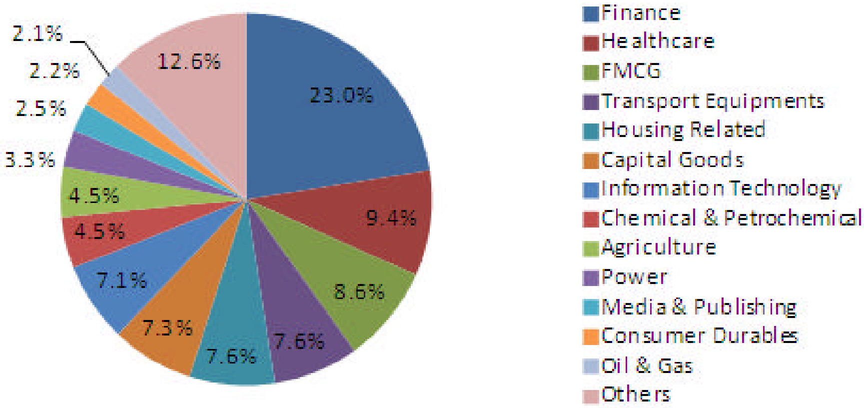


Exhibit 2: Sector-wise contribution* of BSE Midcap Index



*Source: BSE, ICRA Estimates,*Based on free float market cap*

As organization grow larger, they typically start enjoying better economies of scale , and business also attain a greater level of maturity and stability, thereby 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 in some cases. On the other hand, mid-cap companies offer prospects of better growth rates due to factors like lower base effect, greater flexibility in terms of adapting to changes and possibly 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 is required to identify those that 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 midcaps during the market up cycle 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

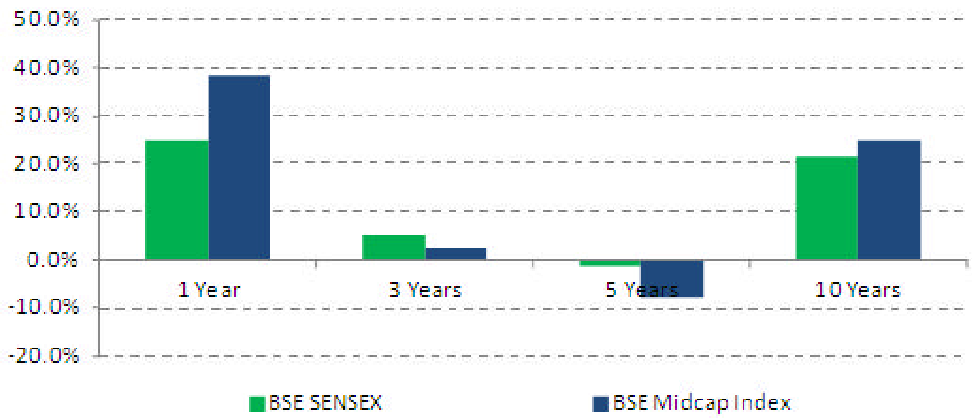
Domestic and foreign institutional investors are key players in the stock market accounting for a large proportion of investible funds. A large number of institutional investors are constrained by their investment charter to invest only in liquid and large-cap stocks. This apart, disclosure levels, research 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 relations set-up. In contrast, many of the 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 independent research outfits are geared more to deal with large cap companies. In contrast mid and small companies typically tend to have weak coverage from both from research and other information providers, leading to a situation where informed decision making on this category can be a challenge.

In ICRA's view, the other key challenge that investors generally face while selecting investible stocks in the midcap universe is the diverse nature of midcaps. Besides belonging to diverse sectors, companies in the midcap domain tend to have varying business models and strategy for growth, which makes projecting for future financial performance a very challenging task This trend is especially visible in emerging or sunrise sectors where some of the companies could be in the scale-up phase and ongoing investments may yield results only over a period of time Given these considerations, at times, investor community is also challenged by dearth of comparable benchmarks to analyze performance of midcap companies.

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

The BSE Mid-cap index, representing a wide gamut of 233 stocks across diverse sectors has outperformed the SENSEX; by delivering 25.0% return over the past ten years compared 21.4% return posted by SENSEX. However, the scenario changes significantly for shorter periods of investments - the mid-cap index has underperformed the broader indices. For instance, in the past three years, the mid-cap index has generated a meager 2.7% CAGR return, while the SENSEX has posted a return of 5.4% p.a.

Exhibit 3: Returns generated by BSE SENSEX & BSE Midcap Index over different time frames



Source: BSE, ICRA Estimates; CAGR (%)

Exhibit 4: Returns over five year period (i.e.2008-12)

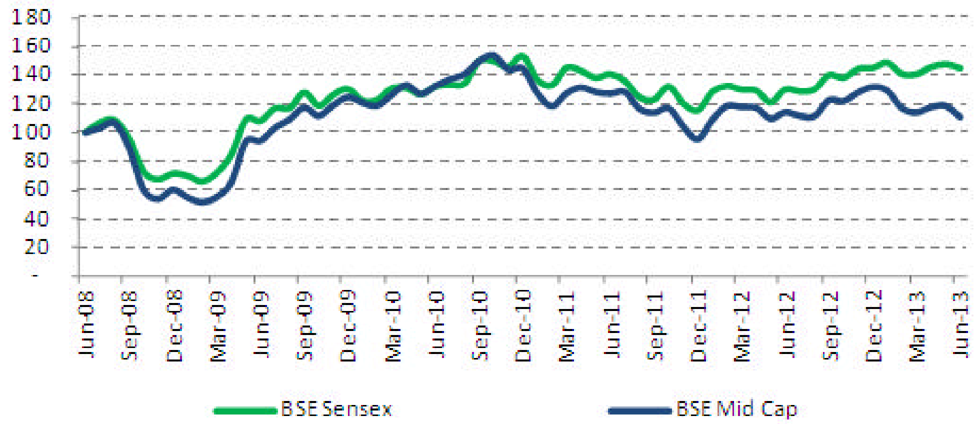
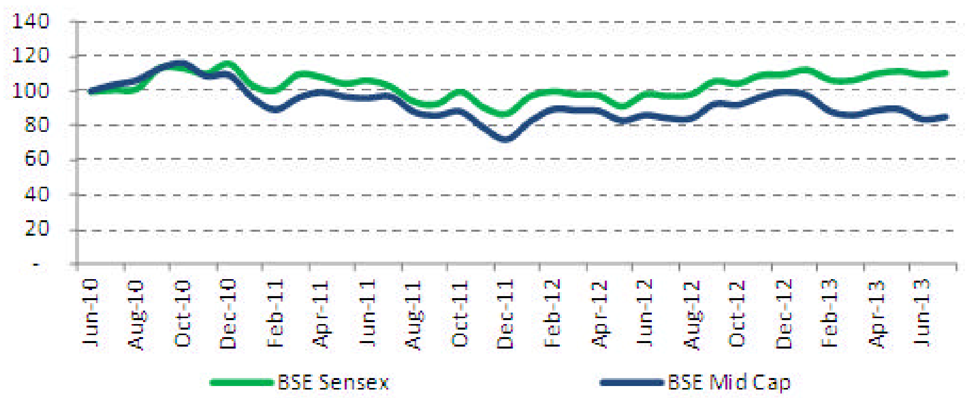


Exhibit 5: Returns over three year period (i.e.2010-12)



Source: BSE, ICRA Estimates

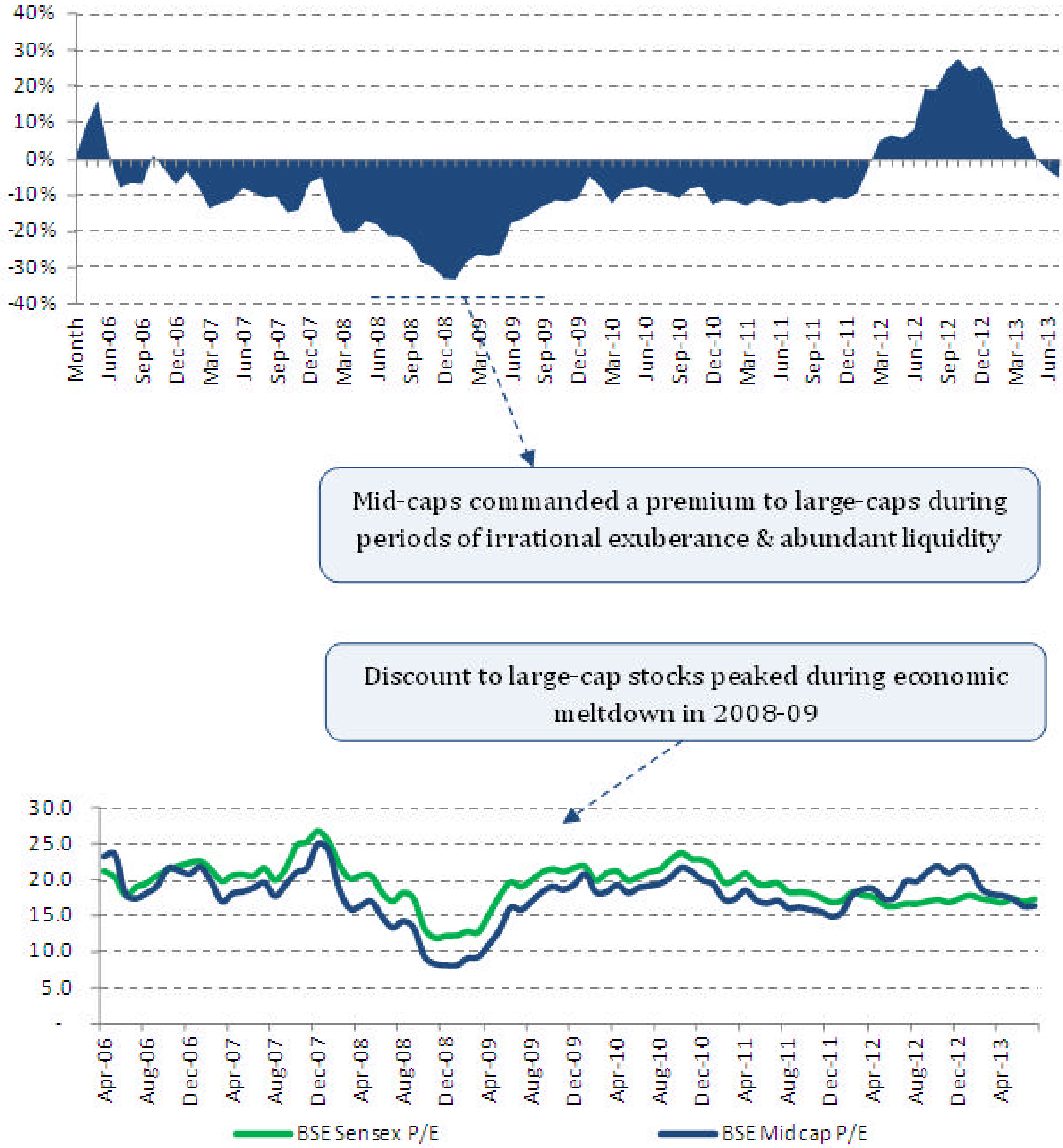
The severe underperformance of mid-cap companies as a whole over the past five years can be primarily analyzed by splitting the period in two phases i.e. 2009-10 and 2010-12. The underperformance of midcap stocks from the end of 2008, just after the start of global liquidity crisis primarily reflects the bouts of risk aversion by investors across the board and flight to safety during the period of crisis. The midcap companies, by nature of its scale of operations, also are typically more vulnerable to systemic shocks – e.g., liquidity conditions post Lehman crisis.

The performance of midcap sectors has also remained muted over the past three years as overall business environment has been under pressure given the weakening macro-indicators and inflationary pressures. In 2012-13, India's GDP growth slowed down to 5.0% compared to 6.2% in 2011-12. The index of industrial production (IIP), which is recognized as the barometer of industrial activity in the country has also been weakening since the second-half of CY 2011 owing to weak trends in manufacturing and mining sectors. The economic environment during this period was also characterized by inflationary pressures which have put pressure on disposable incomes and thereby demand for consumer-driven products and services. Accordingly, while on one hand, companies have been struggling to meet their revenue growth targets, on the other, inflationary pressures and rising financing costs have dented their earnings profile. It must be admitted, though, that the performance of large cap stocks too during this period has been relatively modest.

Within the midcap space, the performance of individual sectors however varies, broadly depending on the extent of influence of macro-economic indicators. In ICRA's view, sectors like pharmaceuticals, healthcare and IT are relatively less dependent on domestic economic environment, while auto components manufacturers, capital goods, real estate, metal & mining which account for a sizeable chunk of midcap universe have faced the economic headwinds in the recent past.

Bottom-up approach key to selecting stocks in mid-cap segment
Barring a brief period in 2006 and recently in 2012, 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.

Exhibit 6: Midcap stocks in general trade at a discount to large cap stock – Midcap P/E discount (%)



Source: BSE, ICRA Estimates

Although there are sharp variations in discount levels, the mid-cap stocks have usually traded at a discount of ~20% to large caps in the Indian context. However as mentioned earlier, 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.

Mid-cap companies are generally in the growth & investment phase, often in fast-growing or emerging sectors

Large number of midcap companies can be found in sunrise industries – as the industry itself is at an evolving stage, smaller companies with new approach to services or products are often able establish themselves quickly in these businesses. Also, 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 and large sized players having advantages of scale, the opportunities for smaller players however has diminished to an extent.

Strong growth prospects, robust business models, transparent governance standards 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. At the same time, companies in the midcap sectors, which may be operating in sectors with good growth prospects, often tend to go in for huge investments to capitalize on the opportunities available. This has been seen in the organized retail, healthcare services and infrastructure sectors. Since this is largely debt-funded, valuation can be affected if companies do not manage the investments prudently. 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

However, 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 companies in respective sectors. Ability to achieve and sustain market leading position is largely a function of long-standing presence in the business, strengths in technology, product profile and even marketing & distribution reach. Most players in the mid-cap sector exhibit few or most of these traits. Some of the companies in mid-cap sectors have also been "Industry first", leading their sectors both in terms of growth as well as 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 companies 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 midcap 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 2nd largest in air conditioning
Pantaloon Retail	One of the leading organised retail companies
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 associated with 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 especially during periods of down cycle in midcap index stocks highlight the importance of selective approach to stock selection backed by solid research in this segment.