Discovering Value in Mid-cap Companies and Importance of Research

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The 'catch them young' mantra is not restricted to only marketers but is also practiced as an investment philosophy by seasoned investors. By the time 'young' companies mature, investors would have reaped multi-fold returns on their investments and become millionaires long before the general public even got a whiff of the same. However, some 'boys' remain boys forever and there are numerous instances of dream stocks turning out to be non-performers at best and losing money at worst. Thus, the skill and knowledge of separating wheat from the chaff amongst these small and growing companies is of immense help for an investor.

How do investors identify the rising stars of tomorrow? What differentiates them from the rest of the pack? We have identified certain key characteristics of mid-cap companies and provided a perspective on research aspects to be covered for value investment. Low liquidity and high impact costs, typical of mid-cap shares, aggravate the loss in case of insufficient/incorrect analysis. Thus, the requirement of thorough research is probably higher in case of mid-caps than for large caps. However, it is precisely in this area that research coverage is lacking: sellside research is restricted to the top 150-200 companies out of the universe of 6,000 companies listed on Indian bourses. Given the restricted flow of information and high complexity in stock evaluation, CRISIL's Independent Equity Research (IER) coverage on small and mid-size companies has been providing significant benefits to the investor community, in particular to individual and other non-institutional investors.

Mid-caps: Different definitions, common traits

Technically speaking, there is no uniformity in the definition of a mid-cap company. It varies across geographies; even within the same geography different class of investors bucket midcaps differently. In India, the BSE Midcap Index comprises companies which have market capitalisation in the range of Rs 1,000-10,000 crore. While the defining terminology is market capitalisation, the businesses of mid-caps typically share a few common traits:

a) The business models have been defined and stabilised. Advantages of increased size are beginning to emerge and the companies are in the next phase of capturing growth.
b) These companies have survived teething troubles common to all small caps. The volatility in their performance has decreased.
c) Mid-caps are more nimble and have smaller earnings base than large caps, which help them grow at faster rates.
d) Their financials have strengthened but there is room for improvement.
e) Many of them may be transitioning from being promoter-driven to professionally-managed.

Catching them 'young': A perspective on discovering value and indentifying winners

Certain aspects are common to analysing a company, be it large, mid or small-cap. However, due to the peculiar characteristics of mid-caps explained earlier, we look at a few of these aspects with specific application to mid-caps:

a) **Scalability of business model**: Shareholder value is created by mid-caps which later become large caps. Thus, an increase in the scale of business is of critical importance. The prime ingredient for a scalable business is strong industry growth prospects. Is this a sunrise industry? If yes, will this lead to: favourable industry dynamics, increased opportunities for players, demand-supply mismatch, rising pricing environment, policy actions, etc. Is there a regulatory risk attached to the industry? If yes, how material is it?

   For absolute scalability, companies have to sustain their competitive advantages in the form of 1) strong brands, 2) niche products/services, and 3) new technology. These advantages are reflected in sustained high Return on Capital Employed (RoCE) and Return on Equity (RoE). It is also important that the company is able to replicate its advantages in various products, market and across geographies?

b) **Financial strength to support growth plans**: Lack of financial strength to support higher growth could restrict the potential of the company. During business expansion, the funding requirement of the company increases, which could lead to equity dilution and higher leverage. Analysis of financial strength is also critical to assess the ability to withstand any cyclical downturn in the economy. Indicators of good financial strength include a) low gearing b) high RoE that is greater than the cost of equity c) strong operating ratios and d) adequate free cash flows.

c) **Management capabilities**: It is the most critical evaluation parameter in equity investment but often the least talked about. At the end of the day, an investor is entrusting his money to the management for wealth creation and they are the brains behind success/failure of any company.

As mentioned, most of the mid-caps are in a growth phase and have major capex plans or product / geographical diversification on the anvil. Investors should check the track record of successful project execution or product diversification. An investor should also evaluate the management's risk appetite while chasing growth. While there is no clear line between aggressive risk appetite and moderate risk appetite, one should look at the track record of successful acquisitions, if any. Is the management paying too much for growth and thereby stressing the balance sheet?

Adding the right kind of manpower is also an important aspect for growing companies. Most of the mid-caps are tightly-held, promoter-driven companies. An investor should look at the management's willingness to delegate decision making.

d) **Corporate governance**: An equitable distribution of rewards and risks is critical for shareholders to benefit from business growth. Corporate governance issues in mid-cap companies need to be tightly analysed as most of these companies are promoter-managed. While this is a soft area and difficult to assess, investors should thoroughly look at various reports of the company, such as annual reports, DRHP (if the company has listed recently) and disclosures available on the website. While there is no specific guideline, the following provide insight into the management's philosophy and thinking:

   a. Promoter friendliness vs. shareholder friendliness: Is the company increasing remuneration to the promoters despite bad financial performance? Are the decisions expected to benefit the promoters? Track record of paying dividend?
   b. Board participation: While one may not get access to the board meeting minutes, attendance record of the independent directors at the board meetings reported in the annual report may indicate the level of seriousness at a board discussion.
   c. Are group companies present in a similar line of business or are there frequent intergroup transactions? If yes, are the inter-group transactions at arm's length.

Carrying out research and making investment decisions involve significant qualitative and quantitative assessments. While there are no right or wrong answers, each element stated above feeds the overall decision making. The job does not end after the investment decision has been made, it actually just starts. The aforelisted evaluation parameters are dynamic and have to be constantly monitored. However, monitoring such companies can be a tedious task as the information flow on various business and financial aspects of these companies to investors is low and not easily accessible. This may lead to incorrect assessment of the company's business and its value. One option for an investor is to refer to CRISIL's independent equity research which ensures ongoing research on companies under coverage.

What happens if the 'young' fail to grow?

Wealth erosion is as good a reality as wealth creation. If the 'young' mid-caps fail, the value destruction for investors could be large.

We analysed returns from all listed mid-caps of 2003 (market capitalisation between Rs 150 crore and Rs 1,500 crore as of March 2003). The returns of the top five wealth creators ranged from 6399% to 12958% over March 2003 – March 2011, indicating tremendous wealth creation by these companies. At the same time, the five worst performers during the same period delivered returns between -73% and -99%.

Since midcaps are characterised by low volumes and therefore, high impact costs, they are prone to greater volatility in share prices which further increases the risk of investing in them. Here's an instance of a typical roller-coaster: Over April 2003-January 2008, when the Indian equities market witnessed a strong bull run, the BSE Mid-Cap Index (return of 716%) outperformed the BSE Sensex (return of 496%). However, during the recent economic crisis, mid-caps suffered value destruction. The BSE Mid-Cap Index has given a return of -12.0% as compared to 10.0% by BSE Sensex over January 2008-March 2011. Further, exiting these stocks became difficult because the volumes had dried up.

Mid-caps need more research and analysis

Ironically, mid-caps, which require in-depth research, have been historically under-researched in India. A survey by CRISIL indicates that only 150-200 of the 6,000 listed companies on Indian exchanges receive adequate coverage. The key reason is the vicious circle of lower trading volumes (In 2009-10, the top 100 stocks contributed over 74 per cent of the turnover in the cash segment of the National Stock Exchange) leading to lower attention by sell-side firms, which in turn results in lower investor interest.

Whatever research is available on mid-caps focuses primarily on industry trends, company analysis, and target price for the companies. This could be appropriate for large-cap companies where information flow is strong, and a professional management and board are in place. However, research on mid-caps requires taking a few more steps to study management capabilities, financial strength, and corporate governance standards. In growing companies, these soft factors assume great importance.

CRISIL equity research provides comprehensive analysis of a company

To address this mismatch in research, CRISIL introduced the concept of Independent Equity Research (IER) in September 2009. As part of its equity research process, CRISIL carries out a detailed assessment of business, industry prospect, financial strength, management capability and corporate governance standards. Further, CRISIL also comments on the fair value of the company. CRISIL uses a proprietary model, the CRISIL Fundamental and Valuation matrix, to present its view on companies in a succinct manner. In the matrix, CRISIL assigns a fundamental grade that provides overall assessment of the company's fundamentals in relation to other equity securities listed in India. Fundamental grade 5 indicates excellent fundamentals, while fundamental grade 1 indicates poor fundamentals. Both tangible and intangible factors are considered to assess the potential intrinsic value of the company's equity stock over a 12-month period. Valuation grade 5 indicates a strong upside from the current market price, while valuation grade 1 indicates a strong downside from the current market price.

How does CRISIL equity research help in discovering value in mid-caps and bridging the gap?

CRISIL introduced equity research to bridge the gap in availability of research, especially on mid-cap and small-cap companies. CRISIL's experience indicates that consistent research and regular updates increase liquidity in stocks, thus driving the process of value discovery. The principal benefits of CRISIL IER are:

Improved liquidity: Consistent research, published through detailed initiation reports and quarterly updates, increases liquidity and helps the market trade the company's stock closer to its intrinsic value.

Increased transparency: IER creates an investor-friendly image for the company, and raises transparency levels.

Enhanced visibility: IER positions the company to domestic and international investors in both the retail and institutional segments.

Easy access to capital: IER generates awareness among investors and positions the company as a long-term player during fund-raising programmes.

Encouraging market response

Investors have responded enthusiastically to CRISIL's equity research initiative as is evident from the regular downloading of reports. Further, institutional investors have also found great value in CRISIL's equity research reports and they regularly interact with CRISIL analysts.

CRISIL currently has coverage on around 100 companies and the reports are freely available on www.crisil.com. Research reports commissioned by the National Stock Exchange (NSE) are also available on the exchange's website; this ensures that a wide spectrum of investors have access to the reports. Companies that sponsor research generally place the reports on their websites, giving investors yet another route for accessing the reports.

With time, increasing coverage and the growing sophistication among small investors, CRISIL equity research has the potential to transform equity investing in India – especially in mid-caps – into a more fundamental-driven and better-informed activity than it has been so far.