

## **Midcap long term story still intact post Demonetisation**

### **What is the impact of demonetisation on mid-cap and large cap companies, more specifically is the impact higher relatively on mid-cap companies?**

The demonetisation drive is set to impact certain sectors more than others. Sectors such as, Consumer Discretionary (Auto, jewellery, consumer durables), Materials (Cement, building materials), Financials (NBFCs – Vehicle financiers and Loan against Properties), Real Estate are likely to get more impacted than the others. There are midcap and large cap companies within all these sectors and most of these companies deal through banking channels with their respective dealers or distributors. While that leg of the distribution channel largely remains unaffected, the leg where dealers sell to the retail segment and then retailer further sells to the end consumers, where the transactions are in cash, are expected to take a hit. Given the discretionary nature of the business, the impact is almost immediate and hence would impact both mid-size and large size companies alike as most of them have the same distribution channel. For e.g. one can safely say that the impact on Ultratech Cement will be quite similar to the impact on Orient Cement from a business perspective.

### **How different are the business models of midcap companies vs large caps?**

Most of the Midcap companies are in very niche businesses and have superior growth prospects as they work on unique business models. Two companies (for e.g. Can Fin Homes & HDFC Ltd.) in the same sector but with different market capitalisation, catering to the needs of different market segments, could grow at different rates. Even though most of the financial ratios for both the companies could be similar, in terms of valuation, one might have an edge over the other and hence could have a higher portfolio allocation. Also one must not forget that midcaps have the potential to generate huge wealth as they can adapt to the changes easily not being constrained by scale or size. We have seen many such examples where midcaps are leader in a particular sector and there is virtually no listed large cap present. For e.g. movie exhibitions, diagnostics & healthcare, print media, building material, micro finance, brand & retail, exchanges, credit rating, specialty chemical etc.

### **But do good investment opportunities still exists in the Mid cap space given the rise in valuations?**

India offers a very unique set of investment opportunities. Investments in the large cap universe are relatively limited as not many companies have achieved the scale and size in that segment. There are still many sectors where not too many companies are available with significant size. For e.g. if one were to buy companies focussed on exports, the only areas where one can find large cap companies is in the IT or Pharma sector. On the other hand if one were to pick up mid cap companies focussed on exports, apart from IT and pharma, one can look at the speciality chemical space, textile, auto ancillaries and also engineering.

Valuation of any company depends on the growth of the business and the amount of Return on Capital the business is able to generate. This is perhaps why some businesses trade at a significant premium to others. Valuation premium is applicable irrespective of size. For e.g. one may find companies with higher valuation in the Large Cap segment like Eicher Motors. The market ascribes a higher P/E multiple to companies delivering superior growth and returns. Similarly, even in the midcap segment, one may find companies trading at high valuations if it is able to deliver consistent growth and returns. It has also been observed, that as a category, mid-caps would almost always tend to trade at premium to large caps during phases of a bull market. Similarly, mid-caps would trade at a discount to large caps during bear market phases. Since 2014, stock markets have been in a bull phase and in our opinion this trend is likely to continue given the expected improvement in corporate performance over the next 3 to 5 years. Hence, even at the current valuations, we might get opportunities to invest in the mid-cap space.

### **Should one look at switching out of mid-caps in the current volatile environment?**

In our view, market volatility is likely to remain elevated in the foreseeable future. What is more important, is to see if individual business or earnings are also volatile. There are several businesses in India which have demonstrated superior and consistent growth over the past several years and are expected to do so in the coming future. We believe, that allocation to mid-caps is an entirely a strategic call which should not be altered dramatically during the investment period. Midcap allocation is a function of individual risk/return profile and would differ from person to person. Individual investment advisors have a significant role to play in determining individual risk/return profile of the investor and suggest tailor made asset allocation solutions.

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