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Investing in Small Cap Stocks

Small caps attract significant attention, especially in growth markets. Some say they are very risky, some say they are highly attractive investment opportunities for long term investors. Viktan was publishing an edition with a special focus on small cap stocks and reached out to us for our take on investing in small cap companies. We decided to let the data speak.

Definition of small, mid, and large cap is not standardized, definitions we used for this analysis:

Market Cap	Classification
0-1000 Cr	Small Cap
1000-5000 Cr	Mid Cap
5000+ Cr	Large Cap

For this analysis we assumed that the objective of investing is to beat the market average. We used Sensex as the market average and grouped companies into groups that beat Sensex and those that did not.

Here is a quick snapshot of the data – we will be looking at individual elements in a bit of detail.

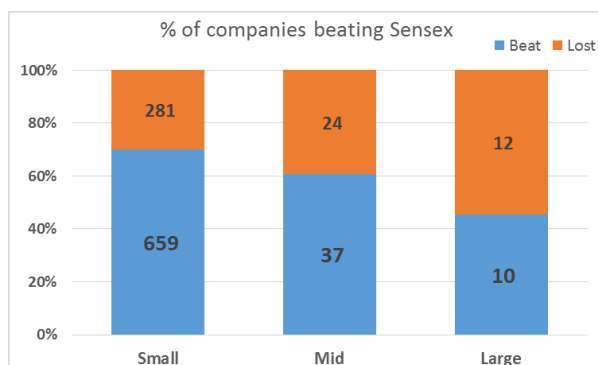
Year	Beat Sensex	# of Companies			Starting Market Cap			2015 Market Cap			Return		
		Small	Mid	Large	Small	Mid	Large	Small	Mid	Large	Small	Mid	Large
2000	Beat	659	37	10	48,042	84,520	129,619	2,138,655	1,738,607	1,831,245	44.5	20.6	14.1
	Lost	281	24	12	38,843	52,770	395,444	95,791	143,559	762,921	2.5	2.7	1.9
	2000 Total	940	61	22	86,885	137,289	525,063	2,234,446	1,882,166	2,594,165	25.7	13.7	4.9
2005	Beat	620	80	39	87,185	161,288	721,621	1,028,323	1,650,931	4,521,529	11.8	10.2	6.3
	Lost	391	56	24	85,026	117,493	473,169	109,118	142,208	826,223	1.3	1.2	1.7
	2005 Total	1,011	136	63	172,211	278,781	1,194,790	1,137,441	1,793,139	5,347,752	6.6	6.4	4.5
2010	Beat	674	123	86	129,083	313,682	2,446,949	564,817	1,026,956	5,859,246	4.4	3.3	2.4
	Lost	422	149	78	118,234	365,214	2,591,281	71,391	198,933	1,640,382	0.6	0.5	0.6
	2010 Total	1,096	272	164	247,317	678,896	5,038,229	636,207	1,225,889	7,499,628	2.6	1.8	1.5

Year 2000:

- There were 1023 companies that were listed in 2000 that continue to exist in 2015.
- In the 1023 companies, there were 940 small cap, 61 mid cap, and 22 large cap companies.
- Market capitalization of small cap companies was 86,885 crores in 2000 and their market cap in 2015 was 2,234,446 core - a 25.7 times increase.
- If we consider the number of companies that beat Sensex returns from 2000 to 2015, 70% of small caps (659 of 940) beat Sensex as opposed to 60% of midcap (37 of 61) and only 45% of large cap (10 of 22)

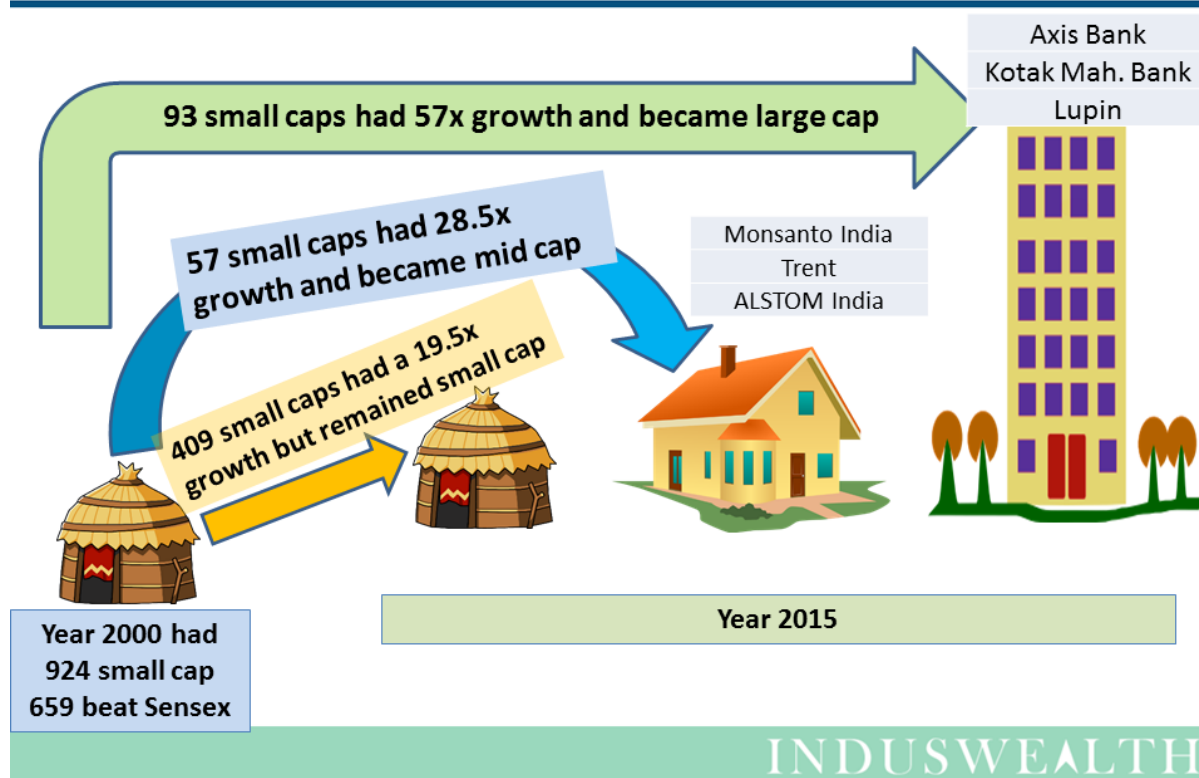


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- Small cap companies that beat the index had a 44.5x increase in their market cap, as opposed to 20.6 times in midcap and 14.1 times in large cap.
- Of the 659 small cap companies in 2000 that beat Sensex return
 - 409 remained small cap till 2015, they grew about 19.5 times in this period
 - 157 of them became midcap companies by 2015, they grew 28.5 times in this period
 - 93 of them became large cap companies by 2015, they grew 57 times in this period.

Small caps in 2000 that beat Sensex from 2000 to 2015

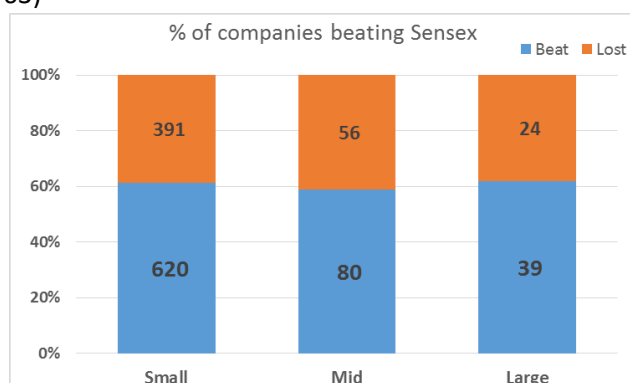


- Of the 61 midcap companies 37 beat Sensex returns upto 2015, they became Large cap companies in 2015 with 20.6x increase in their market capitalization.

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Year 2005:

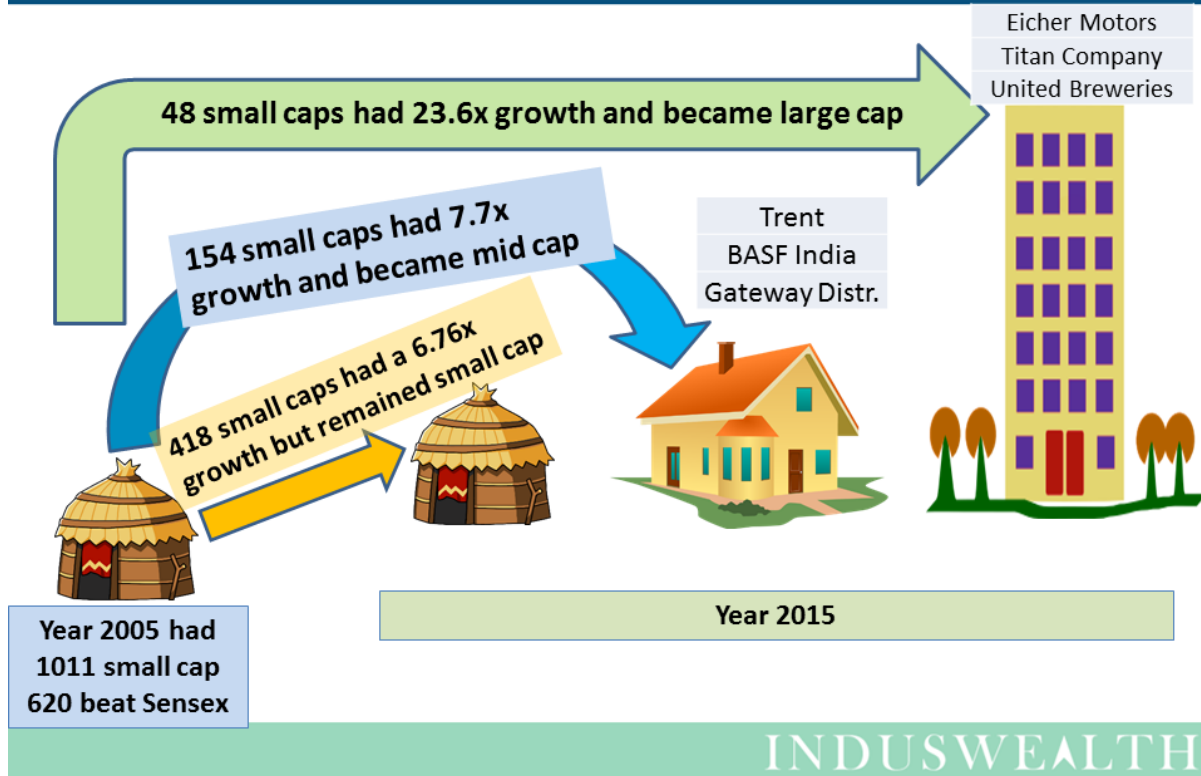
- There were 1210 companies that were listed in 2005 that continue to exist in 2015.
- In 1210 companies there were 1011 small cap, 136 mid cap, and 63 large cap companies.
- Market capitalization of small cap companies was 172,211 crores in 2005 and their market cap in 2015 was 1,137,441 core and 6.6 times increase.
- If we consider the number of companies that beat Sensex returns from 2005 to 2015, 61% of small caps (620 of 1011) beat Sensex as opposed to 59% of midcap (80 of 136) and 62% of large cap (39 of 63)



- Small companies that beat the index had an 11.8x increase in their market cap, as opposed to 10.2 times in midcap and 6.3 times in large cap.
- Of the 620 small cap companies in 2005 that beat Sensex return
 - 418 remained small cap till 2015, they grew about 6.76 times in this period
 - 154 of them became midcap companies by 2015, they grew 7.7 times in this period
 - 48 of them became large cap companies by 2015, they grew 23.6 times in this period.

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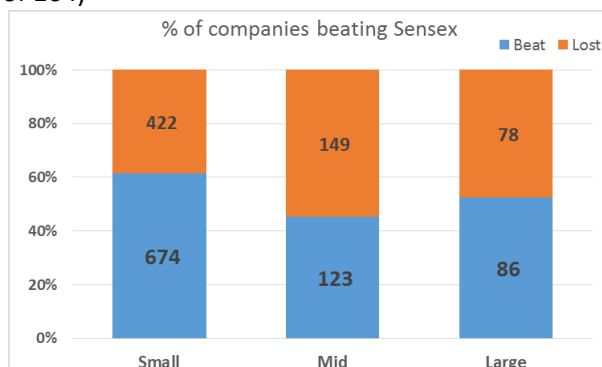
Small caps in 2005 that beat Sensex from 2005 to 2015



- Of the 136 midcap companies in 2005, 80 beat Sensex returns upto 2015,
 - 9 remained mid cap till 2015, they grew about 3.4 times in this period
 - 71 of them became large cap companies by 2015, they grew 10.74 times in this period

Year 2010:

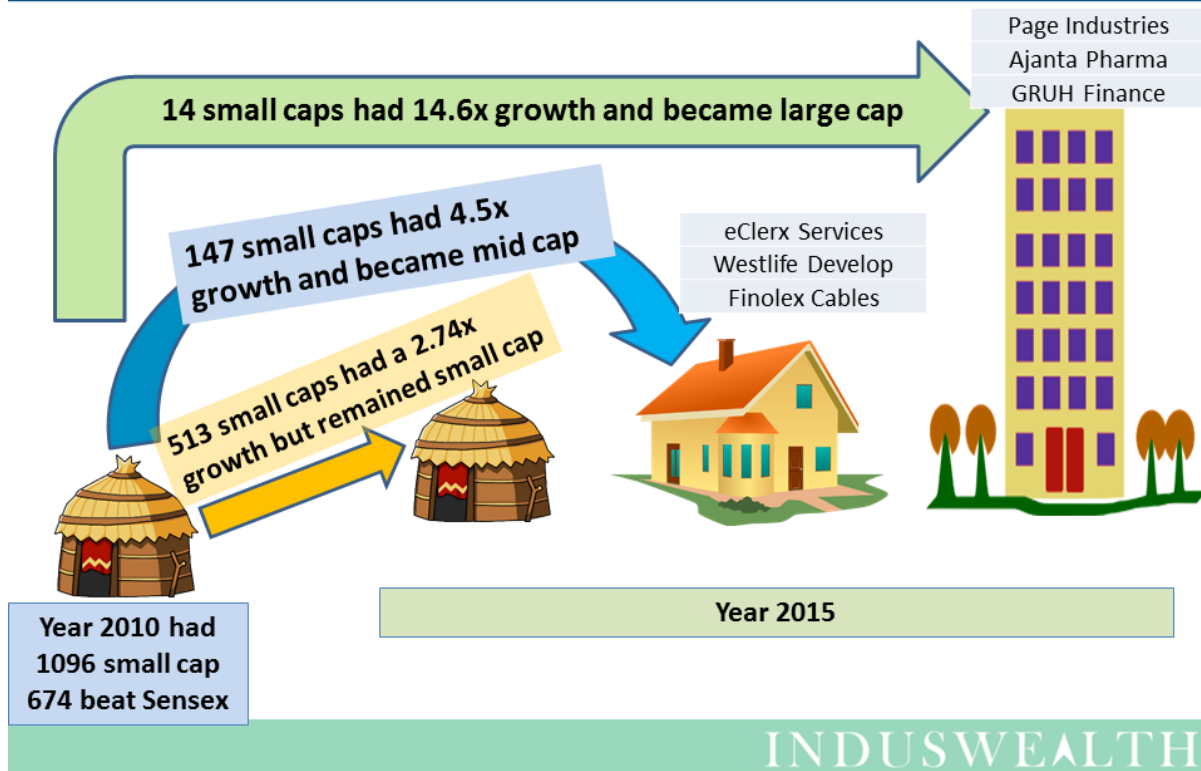
- There were 1532 companies that were listed in 2010 that continue to exist in 2015.
- In 1532 companies there were 1096 small cap, 272 mid cap, and 164 large cap companies.
- Market capitalization of small cap companies was 247,317 crores in 2005 and their market cap in 2015 was 636,207 core and 2.6 times increase.
- If we consider the number of companies that beat Sensex returns from 2010 to 2015, 61% of small caps (674 of 1096) beat Sensex as opposed to 45% of midcap (123 of 272) and 52.4% of large cap (86 of 164)



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- Small companies that beat the index had a 4.4x increase in their market cap, as opposed to 3.3 times in midcap and 2.4 times in large cap.
- Of the 674 small cap companies in 2010 that beat Sensex return
 - 513 remained small cap till 2015, they grew about 2.74 times in this period
 - 147 of them became midcap companies by 2015, they grew 4.5 times in this period
 - 14 of them became large cap companies by 2015, they grew 14.6 times in this period.

Small caps in 2010 that beat Sensex from 2010 to 2015



- Of the 272 midcap companies in 2010, 123 beat Sensex returns upto 2015,
 - 41 remained mid cap till 2015, they grew about 2.1 times in this period
 - 82 of them became large cap companies by 2015, they grew 3.6 times in this period

Based on the data we can see that:

- Small caps represent over 70% of the listed stocks
- Small caps can experience significant growth for a prolonged time period as they start with a low base.
- Small caps as a group have done much better than the market average (SENSEX) if one stays invested for a long time (this analysis is looking at 15, 10 and 5 year time frames)
- More than 50% of the small cap stocks are beating the Index on a long term basis, as there are a large number of stocks it could be a challenge to identify the right ones.

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We also know that

- Small caps can experience significant volatility
- Small caps with a very low market cap can experience significant fluctuation if some large investors buy or sell that stock
- Small caps can be significantly impacted by change in the competitive landscape and are more prone to be exposed to “key person” risk as some of them may be significantly dependent on a few key individuals
- Small caps are not well tracked by the market research hence there could be significant information asymmetry

Based on this analysis investors should

1. Consider investing in small caps only if their investment horizon is very long (at least 5 years)
2. Consider investing in small caps through index funds – that allows one to get exposure to the sector average and minimizes the risk of incorrect selection of stock
3. Investors who are considering direct stock investment, should do their research and can look to build their positions over a period of time.

Based on our analysis, some small cap stocks that we believe have a good potential:

	Co info			RoCE			RoNW			Returns over Sensex for a monthly SIP investor						
Co name	Mkt cap	P/E	D/E	5 yr	3 yr	1 yr	5 yr	3 yr	1 yr	3M	6M	12M	18M	3 YR	5YR	10 YR
Shilchar Tech.	114	12.5	0.49	16.0	19.2	24.0	11.0	15.6	21.7	11.7%	27.2%	59.3%	87.9%	208.4%	291.6%	226.2%
Capital Trust	498	24.6	3.66	19.6	25.4	34.3	21.3	33.1	64.6	14.7%	51.1%	65.0%	110.8%	870.3%	997.2%	2839.4%
Kalyani Steels	829	7.3	0.49	13.4	15.0	18.7	13.0	13.8	19.1	6.0%	12.6%	27.7%	32.3%	111.0%	159.4%	60.6%
Waterbase	351	16.4	0.14	16.2	22.0	29.5	12.7	16.9	21.2	-6.4%	0.7%	-2.6%	24.0%	250.3%	443.9%	1095.7%

Shilchar Tech.

Shilchar manufactures Transformers for Electronics, Telecom and Power distribution. Shilchar has a decent product and its client list is impressive.

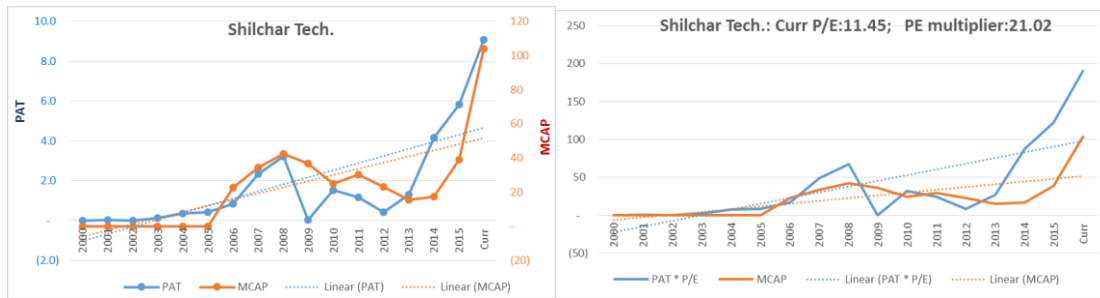
6082	Shilchar Tech.										Capital Goods - Electrical Equipment					
											Electric Equipment - Transformers					
CMP	Co size wrt Ind	0.1%	Cons Prc	1.75	NW/Mcap	0.26	P/B	3.05			Upside					
298.45	Sales/WC	Div Yld %	Mcap	P/E	EV/EBITD	D/E	PBIDTM	APATM	ROCE	RONW		1 yr	3 yr	5 yr	Ind	Curr
Company	6.83	0.8	114	12.51	7.35	0.49	9.77	5.07	24.02	21.68	P/E	42%	80%	73%	49%	59%
Industry	5.88	0.62	189,218	43.64	22.07	0.54	10.52	2.05	16.58	11.91	EV/EBITD	32%	73%	51%	89%	51%
Piotroski F score	9	Mohanram G score	7	A BSD Scr	0.60	Pmtr Hldg	65.8	Pldg Shrs	-	D/E scr	0.66	PO ratio	9.8%	Z score		
IW Score	0.54	Sale Gr Scr	0.32	OPM Scr	0.49	CF Scr	0.76	E Gr Scr	0.47	E M'tm Scr	0.54	Return Scr	0.64	PO Rto Scr	0.46	6.3
ABS Score	5	BMT ABS	6	Int Cover	0.57	CF/Ni	0.69	Δ NW	0.67	Div Yld	0.64	Div g	0.61	Stk Perf	1.00	
Scorecard of adjusted prices (cume perf vs NIFTY)										Depth Scorecard (period perf vs NIFTY)						
83	3M	6M	12M	18M	3 YR	5YR	10 YR	15 YR	2016	2015	2014	2013	2012	2010-11	2006-09	2000-05
1 of 50	11.7%	27.2%	59.3%	87.9%	208.4%	291.6%	226.2%	LT15 YR	67.84%	36.73%	156.75%	NA 2013	-55.38%	213.17%	143.52%	NA 00-05

Shilchar is a tiny player with decent and return parameters. Their debt is bit high but is in line with the industry average.

Shilchar has been growing at a very good clip and being a tiny player the risk of owning a small firm could be considered as a tradeoff for potential above average growth.



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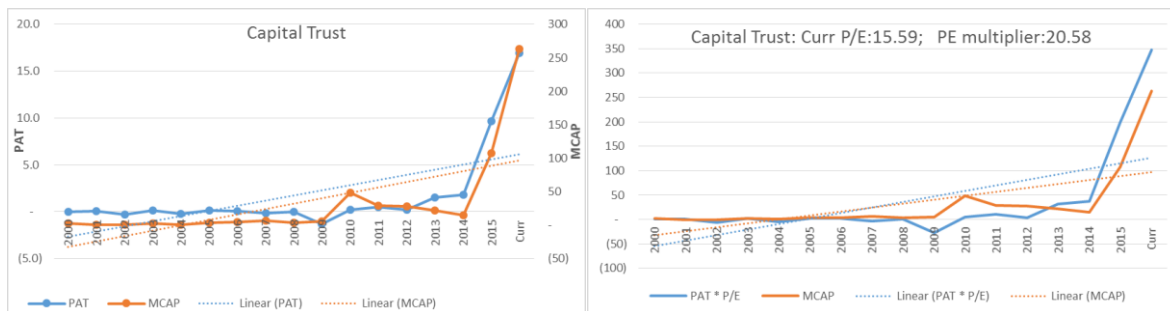
Capital Trust

Capital Trust is providing Enterprise Loans in rural and semi-urban areas to people who cannot get loans from the organized sector due to lack of income documents. It operates through 84 branches in 4 states and 17 districts.

It has engaged with YES Bank Limited to provide loans to Self Help Groups and loans under microfinance of YES Bank.

3853			Capital Trust										Finance				
												Finance - Small					
CMP	Co size wrt Ind	0.1%	Cons Prc	1.25	NW/Mcap	0.04	P/B	3.37				Upside					
429.85	Sales/WC	Div Yld %	Mcap	P/E	EV/EBIDT	D/E	PBIDTM	APATM	ROCE	RONW	P/E	1 yr	3 yr	5 yr	Ind	Curr	
Company	0.49	0.4	498	24.58	13.28	3.66	75.75	24.07	34.27	64.63	P/E	58%	56%	45%	5%	33%	
Industry	1.96	1.70	658,028	30.04	20.73	5.10	78.60	22.42	10.46	15.82	EV/EBIDT	111%	108%	107%	60%	34%	
Piotroski F score	6	Mohanram G score			A BSD Scr			0.50	Pmtr Hldg	62.7	Pldg Shrs	-	D/E scr	0.68	PO ratio	13.4%	Z score
IW Score	0.65	Sale Gr Scr	0.79	OPM Scr	0.55	CF Scr	0.60	E Gr Scr	0.53	E M'tm Scr	0.71	Return Scr	0.72	PO Rto Scr	0.27	3.0	
ABS Score	5	BMT ABS	7	Int Cover	0.40	CF/Ni	0.52	Δ NW	0.59	Div Yld	0.25	Div g	0.46	Stk Perf	1.00		
Magic formula rank	Scorecard of adjusted prices (cume perf vs NIFTY)									Depth Scorecard (period perf vs NIFTY)							
1733	3M	6M	12M	18M	3 YR	5YR	10 YR	15 YR	2016	2015	2014	2013	2012	2010-11	2006-09	2000-05	
1 of 196	14.7%	51.1%	65.0%	110.8%	870.3%	997.2%	2839.4%	5912.9%	77.53%	105.40%	172.58%	-20.30%	-8.50%	336.95%	579.70%	NA 00-05	

D/E is better than industry average and return parameters are very good.



Capital trust is lending to a segment which is expanding at a good clip and hence the company has an opportunity to grow.



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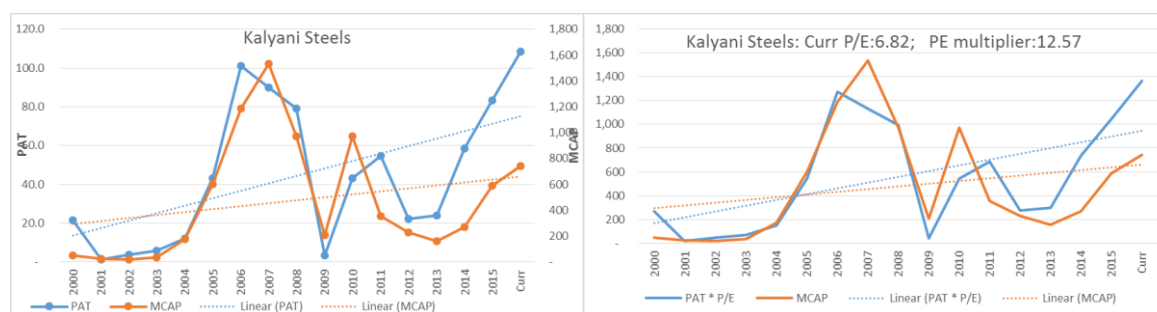
Kalyani Steels

Part of Kalyani group (Bharat forge etc). Impressive client list (automotive who is who).

Ratios and margins are better than the Ind avg. valuation is reasonable with a P/E of 7.

322	Kalyani Steels										Steel					
											Steel - Rolling					
CMP	Co size wrt Ind	0.7%	Cons Prc	2.03	NW/Mcap	0.57	P/B	1.41	Upside							
189.80	Sales/WC	Div Yld %	Mcap	P/E	EV/EBIDT	D/E	PBIDTM	APATM	ROCE	RONW	P/E	1 yr	3 yr	5 yr	Ind	Curr
Company	6.31	0.0	829	7.30	4.40	0.49	10.98	5.39	18.71	19.07	P/E	70%	94%	57%	22%	62%
Industry	(0.61)	0.94	126,490	13.89	10.30	1.25	10.62	(18.05)	9.84	6.82	EV/EBIDT	40%	68%	32%	33%	77%
Piotroski F score	7	Mohanram G score	4	A BSD Scr	0.59	Pmtr Hldg	60.6	Pldg Shrs	-	D/E Scr	0.90	PO ratio	0.0%	Z score		
IW Score	0.62	Sale Gr Scr	0.54	OPM Scr	0.52	CF Scr	0.58	E Gr Scr	0.65	E M'tm Scr	0.62	Return Scr	0.80	PO Rto Scr	0.62	4.2
ABS Score	5	BMT ABS	5	Int Cover	0.69	CF/Ni	0.54	Δ NW	0.47	Div Yld	0.15	Div g	0.42	Stk Perf	0.94	
Magic formula rank	Scorecard of adjusted prices (cume perf vs NIFTY)									Depth Scorecard (period perf vs NIFTY)						
215	3M	6M	12M	18M	3 YR	5YR	10 YR	15 YR	2016	2015	2014	2013	2012	2010-11	2006-09	2000-05
9 of 73	6.0%	12.6%	27.7%	32.3%	111.0%	159.4%	60.6%	197.4%	14.01%	18.04%	94.07%	-0.39%	37.52%	90.83%	182.70%	192.72%

D/E of 0.5 which is high in absolute terms but is par for the course for Steel industry. Disputed claims is 10% of the reserves – not high enough to cause a worry.



The industry is fairly beaten down, and Kalyani is one of the better run firms and is doing well in the down turn. It can be expected to better when the industry turns around.

The Waterbase Limited

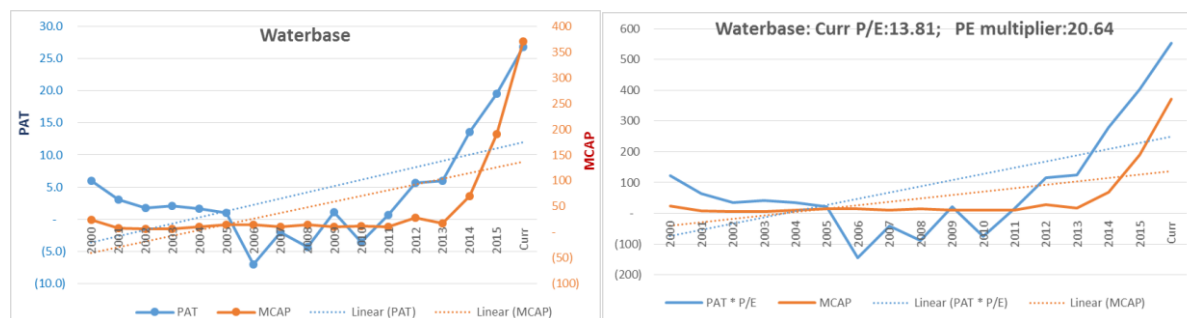
TWL is into Shrimp Feed, and Shrimp processing. TWL is promoted by the Karam Chand Thapar Group, KCT, a diversified conglomerate.

2815			Waterbase										Miscellaneous					
Aquaculture																		
CMP	Co size wrt Ind		0.3%	Cons Prc	0.59	NW/Mcap	0.28	P/B		3.55	Upside							
90.85	Sales/WC	Div Yld %	Mcap	P/E	EV/EBIDT	D/E	PBIDTM	APATM	ROCE	RONW		1 yr	3 yr	5 yr	Ind	Curr		
Company	2.97	0.0	351	16.43	85.23	0.14	11.85	7.03	29.53	21.24	P/E	41%	55%	83%	47%	-6%		
Industry	(5.28)	0.60	139,155	46.50	27.55	0.47	33.68	(11.31)	19.71	16.74	EV/EBIDT	53%	77%	113%	79%	#N/A		
Piotroski F score	7	Mohanram G score		3	A BSD Scr		0.46	Pmtr Hldg	52.4	Pldg Shrs	-	D/E scr	0.86	PO ratio	29.7%	Z score		
IW Score	0.60	Sale Gr Scr	0.72	OPM Scr	0.39	CF Scr	0.70	E Gr Scr	0.53	E M'tm Scr	0.64	Return Scr	0.63	PO Rto Scr	0.40	6.1		
ABS Score	3	BMT ABS	5	Int Cover	0.57	CF/Ni	0.41	Δ NW	0.38	Div Yld	0.06	Div g	0.15	Stk Perf	0.69			
Magic formula rank	Scorecard of adjusted prices (cume perf vs NIFTY)										Depth Scorecard (period perf vs NIFTY)							
124	3M	6M	12M	18M	3 YR	5YR	10 YR	15 YR	2016	2015	2014	2013	2012	2010-11	2006-09	2000-05		
8 of 79	-6.4%	0.7%	-2.6%	24.0%	250.3%	443.9%	1095.7%	1266.1%	4.11%	109.40%	191.62%	-19.05%	-41.72%	450.95%	413.07%	379.85%		

D/E for TWL is about 0.14 which is low. APATM is low but return parameters are very good. TWL has reasonable growth in revenues and profits and are generating decent returns for the shareholders.



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There are just a couple of players in this space and as the wealth grows, consumption of shrimp is expected to increase, hence they could be looking at a market that has a decent growth potential.

Disclosure: Author and the clients of IndusWealth own some or all the stocks discussed in this article and may transact in them for their own portfolios.

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