

IMPACT OF SIZE ON EQUITY VALUATIONS IN THE INDIAN MARKET

By: Mukul Gulati and Amit Mantri

As most observers of the Indian equity markets know, large capitalization stocks in India trade at significantly higher multiples of earnings and book value than small cap stocks. In fact, this difference in valuations between small and large cap stocks has been a prominent feature of the Indian equity market for many years. Over the last five years, PE ratios of small cap stocks have been 20% to 60% lower than large cap stocks.

So in the current market, what is the magnitude of these valuation differences? Why do such differences in valuations exist? What are the implications for investors?

First, let's look at the magnitude of these valuation differences across the Indian equity markets. Our study of more than 2,000¹ listed companies on the National and Bombay Stock Exchanges indicates that market capitalization is strongly correlated to valuations as measured by multiples of earnings and book value. Small cap stocks (less than US\$ 200 million in market cap) trade at trailing P/E multiples of less than 10x compared to 12-14x for mid cap stocks and 16x+ for large cap stocks with capitalization greater than US\$1 billion.

Market Cap US\$ million	Median P/E	Median Price/Book
> 1,000	16.7	2.7
500 – 1,000	13.6	1.9
200 – 500	12.5	1.7
200 <	9.5	0.9

Table 1: Median P/E & Price/Book multiples of companies based on Market Cap in the Indian equity markets

However, the impact of size does not appear to be as significant in developed markets as it is in India and other emerging markets. For instance, in the US equity markets, the difference between the P/E ratios of small cap stocks² (14x) and large cap stocks (16x) is not as significant as in India.

Market Capitalization is, of course, a market based measure subject to investor bias and may not be an accurate reflection of the economic footprint of a given business. So it may be useful to understand the impact of non market variables on valuations. The data suggests that accounting measures such as Revenues and Fixed Assets have weak correlations with PE multiples. However, Net Income appears to be strongly correlated to PE multiples. This observation is consistent with the old fashioned view of value investors that a Company's ability to generate profits is more important than growing sales without profits or building new factories.

Now that we have learned that size really does matter – let's find out why. We asked some veteran observers of the Indian stock markets and they suggested the following reasons:

- Institutional investors generally do not invest in small cap stocks due to lack of liquidity and high impact costs (purchase/sale of small quantities of stock can significantly move the stock price).
- Foreign institutional investors (FIIs), who are important players in the Indian equity markets, typically seek to make investments of at least US\$ 10 million and generally prefer to have less than 5% ownership of each of their portfolio holdings. Therefore, companies with a market cap of less than US\$ 200 million are unable to generate interest from FIIs.
- Investors also avoid investing in small cap stocks due to poor corporate governance, lack of analyst coverage and lack of professional management teams. Smaller companies also have higher business risk and higher volatility, thus, implying a higher risk premium.

¹ Source: Accord Fintech. Companies with a P/E multiple greater than 50 and lower than 3.5x were excluded from the study

² For the purposes of this study, US stocks with a market capitalization < US\$500 million were considered as small cap stocks

Is there a way for investors to benefit from these trends? Possibly, but one has to be careful. Public market investment strategies, which rely on multiple convergence, may not work in the Indian markets. For instance, an investor expecting a company's valuation multiple to 'converge' to those of larger companies in the same industry may be disappointed.

However, patient long-term investors can benefit from the valuation arbitrage between small and large companies. Fast growing small companies, once they reach a certain scale, can generate strong returns for investors due to earnings growth as well as multiple expansion.

The impact of size on valuation multiples has important implications for private equity (PE) investors. For instance, exit via public markets, during or subsequent to the IPO, is the preferred route of exit for most PE investors in India. However, the earnings multiples of new listed issues are also impacted by size - smaller companies listed in the last three years are trading at lower earnings multiples than the larger companies. Therefore, PE investors may wait for their companies to achieve a certain minimum size before considering a public offering. Alternatively, before the IPO investors may seek other exit avenues such as a strategic or a secondary sale.

PE investors could also benefit from the attractive valuations of listed small cap stocks via PIPE (Private Investments in Public Equities) transactions. PE investors with a focus on professionalization of management and good corporate governance can assist small companies in developing strategies that result in sustainable earnings growth. Strong financial performance over the long-term combined with a management team with a reputation for professionalism can result in a positive re-rating of a company's trading multiple and generate excess returns for investors.

Private companies seeking to raise capital also need to be cognizant of the impact of size on valuations when considering a public listing of shares. There are several listed companies that have gone public too early and now suffer due to lack of liquidity and low valuations. For instance, during June, out of about 5,000 companies listed on the BSE, more than 1,700 companies did not even trade a single share. Such companies may be better served by raising private equity than by prematurely listing on the exchanges. Over time, as these companies reach a minimum level of profitability, the public markets can become a highly attractive avenue for raising capital.

Small brokerage firms and independent research providers may increase awareness of smaller stocks by providing research coverage of smaller stocks. Regulators and exchanges may develop stricter norms for listing and discourage smaller companies from listing since it is easier for private companies to raise capital than listed companies with low liquidity and low valuations. Regulators may also consider making the delisting process easier for companies seeking to exit from the stock exchanges.

In summary, the impact of size on valuations has important implications for various participants in the financial system including companies seeking capital as well as public and private investors:

- Patient, long-term investors can benefit from attractive valuations of fast growing smaller companies.
- Private equity investors should resist premature public listings of their portfolio companies. PE investors can also benefit from attractive valuations of thinly traded public companies and assist these companies in developing sustainable growth strategies.
- Companies seeking capital should seek to develop a minimum scale before considering a public listing.
- Small brokerage firms and independent research providers can differentiate themselves from their larger peers by providing research coverage for promising smaller companies.
- Regulators and exchanges may also consider making the delisting process easier for smaller listed companies with low trading volumes.



Mukul Gulati
Portfolio Manager
Zephyr Peacock India Funds



Amit Mantri
Investment Analyst
Zephyr Peacock India Funds