THE DOUBTFUL NARRATIVE OF SMALL CAP

OUT PERFORMANCE IN THE NEAR-TERM

Small cap stocks have significantly underperformed large cap stocks over the last couple of years. The Nifty 250 Small cap index has underperformed the Nifty 50 index by 20.3% in last one year and by almost 30% over the last two years. This remarkable underperformance has given birth to a popular narrative that small cap stocks have become cheap and are ready to outperform from here on.

While this narrative may be popular it need not be the right one. Indices are made up of all kinds of companies and their performance at times may hide more than it reveals about the real performance of the broader market. Market is a poor judge of character in the short-term, but it rewards the good companies handsomely over the long term. Therefore the investors will be better served by focusing on investing in good companies, irrespective of their size, rather than going solely by the cheap relative valuation. The cheap relative valuation itself is questionable. Nifty 250 Small cap index is currently trading at a historical P/E multiple of 49.5x, not cheap by any standards (https://www.niftyindices.com/Factsheet/ind_Nifty_Smallcap_250.pdf).

This period of underperformance has followed a stunning outperformance in the year 2017 when even dart throwing monkeys, speculating in small and micro caps, outperformed experienced fund managers by a factor of 10. A large part of the subsequent underperformance can be explained as adjustment of the hubris of year 2017. However, there are also more serious and structural reasons for this underperformance that the investor should be aware of since some of these reasons may lead to continued underperformance by small caps.

The slowdown in the economy over the last 18 months has created far more challenges for smaller companies than their large competitors. Large companies have been able to continue to grow sales volume even in the face of slowing demand. In consumer staples industry companies like HUL and Dabur were able to grow sales by providing working capital support to their distributors and by continuing to invest in advertising and promotions. The smaller players in the same industry have suffered because they do not have the balance sheet strength to support their channels. This has led do the channels destocking their products and stocking the products of larger companies with better brands and financial strength. We have also seen instances where the larger player has increased its market share in the downturn by forcing the channel partners to destock products of smaller competitors. The recent spat between Asian Paints and JSW Paints is a case in point (for details: https://www.financialexpress.com/industry/cci-orders-probe-against-asian-paints-alleged-threat-to-jsw-paint-dealers/1824428/). We expect to see many more such complaints in the coming months. But the damage to the business will be well and done by the time any legal remedy becomes available.

The impact of lack of financial capital is evident immediately. There is a reduction in capex (even maintenance capex), marketing and promotion and research and development. The stress is severe for

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companies that have high debt and fixed operating expenses. To protect their credit rating they typically react by reducing working capital which has an immediate impact on sales volume. Some are forced to sell parts of businesses or assets that would have provided long term growth (for instance, Shankara Buildcon's sale of its steel business to APL Apollo). While the larger companies are able to sacrifice part of their profit margin to increase sales volume and market share, the smaller companies are left with no choice but to protect their margins even if the sales growth is negative. This continuous loss of market presence and market share has along-term damaging impact.

The equally significant long-term negative impact of a slow-down on smaller companies is the deterioration of human capital. To cut costs these companies typically lay off middle and junior level managers leading to poor morale in the remaining work force and a deterioration in their market presence. These layoffs impact the long term culture that these companies build over a period of time. More importantly, by creating leadership gaps these companies sacrifice their ability to grow in line with the industry growth when the industry and economy pick up. In a nutshell, they are forced to sacrifice their long term competitive edge in order to survive the down turn.

This is one of the main reasons that industry leaders emerge from downturns with higher market share. We have seen this play out in multiple sectors that now have a strong leader with a market share of over 50% like in aviation, mortgages, four wheelers etc. Even in telecom, the financially strong company has taken away market share from the weaker competitors. In many of the industries, the smaller companies will be left with broken business models and balance sheets. At best, many of them will just muddle along for many years without creating any shareholder value.

Therefore, the investors should not get carried away by the theory of mean-reversion of valuation. It is not the time to blindly switch from large caps to small caps. Even if an investor would like to selectively allocate capital to small cap companies she would do well to ensure that such companies have not lost their competitive edge in the downturn.

A good way to invest in small caps then would be to focus only on small caps that are market share leaders of their industry. For instance, our investment strategy, Piper Serica Leader Portfolio Strategy ™, is a unique top-down strategy that is market cap agnostic. We first identify the sectors that will grow for next 15-20 years and then use the 5 Forces Competitive Edge Model to rate the competitive edge of the leader of that industry. If the rating is favourable, we invest in the leader. As the name suggests we invest only in the leader of an industry. Then we dynamically manage the allocations to reduce risk and generate the alpha return. This disciplined process has allowed us to generate market beating returns for our investors. To conclude this write up I would like to share the relative performance metrics of our Leader portfolio with the Nifty 250 Small cap index:

FINANCIALS	PIPER SERICA LEADER PORTFOLIO STRATEGY	NIFTY 250 SMALL CAP INDEX
3 Year Sales CAGR	16.3%	11.6%
3 Year EBITDA CAGR	20.2%	15.1%
EBITDA Margin	19.1%	14.9%
Average ROE	20.3%	14.5%
Debt/Equity	0.7x	1.95x

So our portfolio is made up of companies that are growing faster, are more profitable and are using much less capital than the companies that constitute the Nifty 250 Small cap index. This is a better way to invest in stocks across the market cap spectrum rather than getting carried away by questionable narratives that are predicated only on the theory of mean reversion.