SMALLCAPS That Will Race Ahead of the SENSEX

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The investor's best friend

Dear investor,

Small-cap stocks are fascinating. They have a unique place among all the asset classes.

They're highly volatile. Yet they have their charms.

With all its up and downs, within equity investing, this is the space that interests me the most.

For I have seen ordinary men becoming millionaires and living their life king size, all thanks to the one bet that turned around their lives.

And that too without taking any of the pains that promoters of these businesses go through.

Think about it. The failure rate in businesses is high.

Yet, there are people who take big risks in life... quitting their steady jobs and putting their entire capital in one business idea they are passionate about.

They even resort to debt to realise their business dreams.

Of these businesses started with huge zeal and high stakes, only a few survive.

Even fewer see the light of listing day and witness their stocks trading.

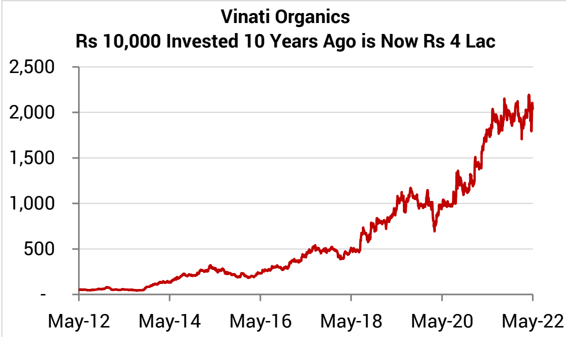
Now getting listed is just an initial step... the beginning of a long struggle. Thousands of companies get listed. Only a few survive. Most get lost in oblivion.

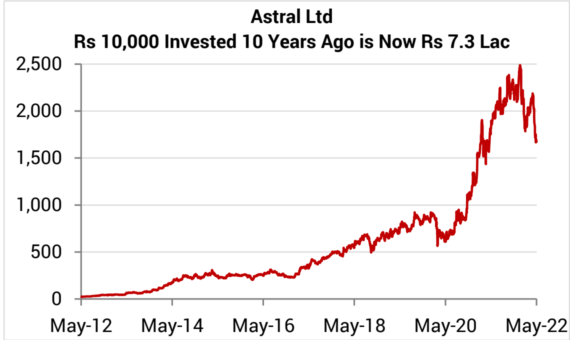
Again, amid the survivors, there is a company that is the first among equals. It grows spectacularly. Then its stock becomes popular and a talk of the town.

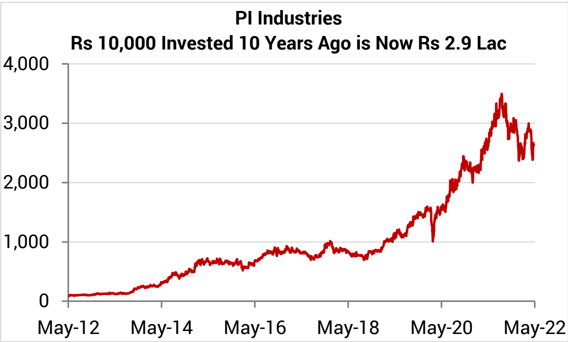
Here are a few stocks with such fascinating stories...

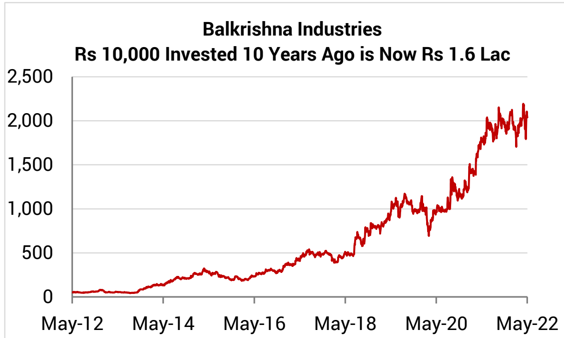
Vinati Organics, Astral Polytechnik, Pi Industries, Balkrishna Industries...

They have gone up so much that they made millionaires out of ordinary folks...in just a few years.









Source: Ace Equity Equitymaster
Return as on 24 May 2022

All they had to do was to enter the stock at the right time and hold on.

All the hard work was done by the management of these companies.

Could there be a smarter recipe to become Crorepati?

I can't think of any, except perhaps a fine inheritance.

But then, I'm over simplifying.

If it was this smooth, smallcaps would not be such an ignored lot.

And there wouldn't be so much fear around them.

For every Vinati Organics or Astral Polytechnik, there are tens of stocks that never take off.

And if you play in this space without a strategy, or look for short cuts to get rich, you might end up losing even your initial capital.

So, what does it take to become 'One Stock Crorepati'?

In almost a decade long experience of dealing in smallcaps, I have recommended many winners.

And let me tell you that this is a great track record in a space as capricious as smallcaps.

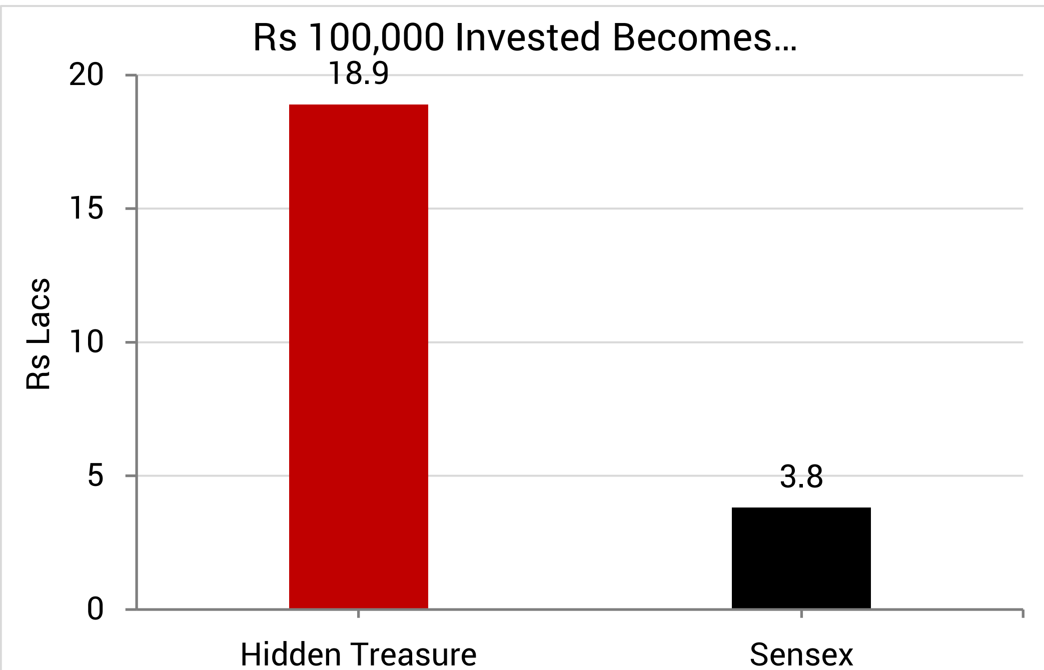
> *In this business, if you're good, you're right six times out of ten. You're never going to be right nine times out of ten.* **– Peter Lynch.**

Now I wasn't interested in just being right. I wanted to surpass benchmark returns by a wide margin.

From February 2008 when *Hidden Treasure* was launched, to December 2020, the IRR (internal rate of return) for Hidden Treasure is 25.6% as compared to an IRR of 11.0% for Sensex and 11.4% for Smallcap index.

That's an outperformance of almost 2.3 times around 13 years.

This means with *Hidden Treasure*, a sum of Rs 1 Lac would have multiplied more than 18 times over 13 years, versus just 4 times in case of Sensex.



As on December 31, 2020 Source: Company, Equitymaster

Over these years, there were many winners.

There were many reasons why these stocks surged. Mostly different reasons for each case.

The stock of GMDC, for instance, was available for cheap and a surge in the profits of the business was the reason of the mean reversion in the stock.

Swaraj Engines, (up 115%), was piggybacking on rising demand of tractors in the farm sector.

For Suprajit Engineering, it was the market leadership in automotive cables and the company's low-cost advantage that helped the stock return 166% in 2 years.

For Accelya Kale, the reason for the 105% gains in just 2.5 years was an asset light business model leveraged on growing air travel.

There are many more examples.

But a few stand out.

You see, these companies achieved a lot more than what I expected of them.

The reason?

As these companies grew, their market size too kept expanding and profit growth exploded.

This was unlike most companies that reach a saturation level after a point.

The business model they had ensured an expanding topline (revenues) came along with growth in profits (bottomline) – driven by an increasing competitive edge.

This edge could be a network effect that strengthened as the company grows in size, such as in case of Naukri.com. This is the virtuous effect of higher number of employers bringing more traffic of job seekers, which in turn leads to more and more recruiters to come to the website.

Or it could be a strong and robust sales and distribution network and economies of scale. Page Industries was one such recommendation. It broke all records and became our first hundred bagger!

Or it could be access to an exclusive technology, something that Astral Polytechnik enjoyed a few years ago as the first and only Indian licensee of US-based Lubrizol Corporation, a 100% subsidiary of Berkshire Hathaway.

This is an effort to decode what makes a small company not only a great business but also a great investment. Yes, they are two different things.

But then the question is...

Why invest in smallcaps when there are big stable businesses to bet on?

Here's the reason...

You see, big companies in my view are already past their prime.

The days of fast growth and glory are behind them. It does not help that most of the big money in the market is already chasing them. This makes them expensive, thus shrinking the upside.

Both these factors combined make multibagger returns an elusive goal in case of well-established large cap companies.

Small companies, on the other hand, are still sitting on the runway, waiting to take-off.

Further, unlike large caps, where are you set up against the big investors with better access to information, your competitive edge is higher in the case of small caps.

You see, most of the big players have to stay out of smallcaps due to regulations (liquidity issues), or because playing in this space does not move the needle much for them (given the huge amounts they deal in).

Smallcaps: How to Find Great Companies in the Making

For smallcaps, what works the best is growth at reasonable price (GARP) investing. I believe this is a variation of value investing.

My approach is bottom up – i.e. I focus on the business fundamentals, growth prospects, management, and valuations. I do so with a time frame of 3 to 5 years.

There are cases when the stock prices meet true value well within my horizon of 3 to 5 years. However, that's the time horizon I expect while recommending stocks. This is because sometimes markets can be moody and it may take a while before valuations reflect the fundamentals.

It varies from the mainstream approach which is more top down, focused on relatively shorter term, and chases stocks expected to gain from macro themes.

Now the problem I have with the mainstream approach is that macro-economic variables are complex. They are highly interlinked and difficult to predict. If you make these variables the center of investment thesis, there is a high probability of going wrong.

I prefer to arrive at an intrinsic value of the business (true value or present value of all the distributable cash flows that the business generates during its lifetime) through fundamental analysis. I recommend stocks that trade at a discount to this value (a margin of safety). Now this does not mean that the macro factors are not given due regard. I try to be conservative on the macro front, and factor this in my estimates and valuations.

Now this approach uses both quantitative and qualitative factors.

Getting the former part right is relatively easy in my view. It requires knowledge of financial basics and analytical skills, and works with a lot of data. In my view, it's okay if you don't get your estimates 100% on the mark, as long as you don't go wrong directionally or differ by a wide margin.

On the other hand, getting qualitative aspects (management quality, regulatory aspects, demand and supply dynamics, consumer behavior, understanding competition, and industry disruption and sector dynamics) right is critical.

Here's all that goes into the making of a great small cap company.

- ## The first is an economic moat

Dictionary defines moat as a deep, wide ditch surrounding a castle, fort, or town, typically filled with water and intended as a defence against attack.

In investing, it refers to a business's ability to maintain competitive advantages over its peers to protect market share and ensure sustained profits. It is what allows a business higher returns on cost of capital over time.

The wider the moat, the stronger the business is. If the moat is weak, ultimately, the competition will spoil the game and erode returns, market share, and profits overtime.

A moat could come from cost advantage (lowest cost producers), brands (such as Castrol), exclusive licensing or patents (Astral Polytechnik and its tie up with Lubrizol), network effects (like in case of Facebook), higher switching costs (like in case of private sector banks).

But remember, the presence of one or even all of these does not ensure great returns.

Kodak, Orkut, Indian utility companies are some examples.

A true moat needs to stand the test of the time.

In the absence of that, one might end up with companies like Kodak that used to be the market leaders, but could not stand up to the technological disruptions from the digital cameras. The moat did not just get eroded, it was completely wiped away.

So, what does true moat look like.

True moat gives a business scalability, and with every growth milestone crossed, it gets strengthened further.

Think about Coca Cola. The company has been in decade for existence. There are businesses that compete with it, be it aerated or non-aerated drinks. Yet Coca Cola has not just survived but expanded its market multifold. The market opportunity it has is unlimited. The more it grows, the more difficult it becomes for a new player or existing players to compete with its distribution network.

- **The second is a circle of competence**

Warren Buffett said:

> *Everybody's got a different circle of competence. The important thing is not how big the circle is. The important thing is staying inside the circle.*

As I write this, I'm reminded of an interesting incident during an Equitymaster Conference.

During the Conference, one of our subscribers asked Rahul Shah:

Why don't you cover Reliance Industries?

Pat came the reply from Rahul Shah *'We have never recommended Reliance Industries because we don't understand the business'.*

You see, the company has multiple segments and moving parts. For someone to make predictions about each segment and get them all right, especially if you bring in the macro variables that impact the business, is next to impossible. Rahul Shah was speaking for all of us when he said this. The analyst community is full of people with shallow opinions. You would not often hear someone saying, 'I don't know', which needs a certain integrity and honesty. However, this over confidence serves neither them nor people who act on their advice.

We instead rather stick to recommending businesses we understand and are happy to ignore that we don't.

- **The third is management quality**

Investing in a stock is not buying a share with a price tag. It's owning a part of the business, in which case, the management are your business partners.

So what kind of partners should you look for?

You're looking for three things, generally, in a person," says Buffett. *"Intelligence, energy, and integrity. And if they don't have the last one, don't even bother with the first two.*

That is as succinct an advice that could ever be given while assessing the management quality of the businesses you may want to invest in.

The quality of management does not get captured in quarterly or even year on year profit growth numbers as businesses have their ups and downs.

A good quality management is passionate and transparent. It is honest about admitting mistakes when they are committed rather than justifying them. And it creates long term value for minority shareholders, sometimes at the cost of letting short term or quick profits go.

While it's a qualitative parameter, and there is no substitute to meeting the managements in my view there are a few quick insights that one can get from looking at numbers. These include returns on capital, management's compensation as a share of total profits (a very high share beyond the industry norms should be a matter of concern), skin in the game (insider ownership – a higher ownership is better).

- **Last but not the least is a Margin of Safety.**

Margin of safety is what differentiates a good business from a good investment.

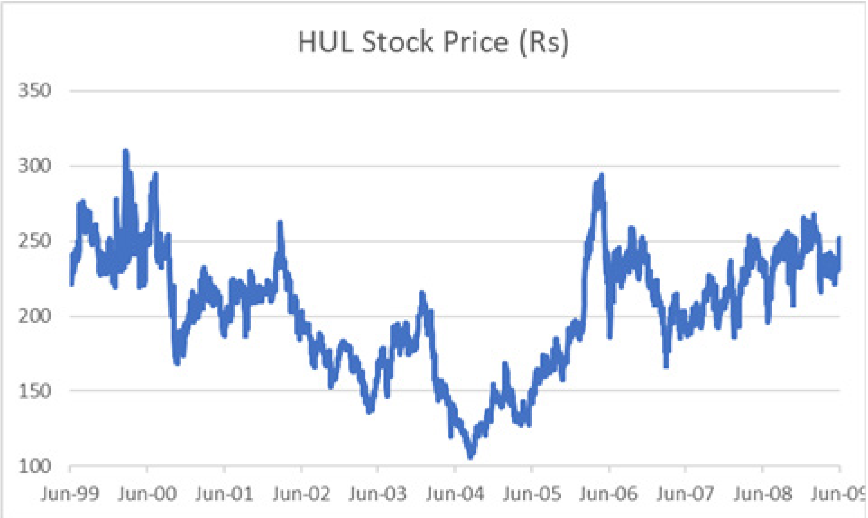
In case you wonder what this difference is, you should take a look at the stock price of Hindustan Unilever Ltd.

Despite being backed by a great story and fundamentals, its stock remained stuck at around Rs 220 for around 10 years. In nearly last two decades, the return on the stock has been lower than the return on the Sensex.

You see, a good business does not always make a good investment bet.

A margin of safety ensures that you buy a stock only when it trades at a reasonable discount to its true value.

A Bluechip's Journey to Nowhere in Almost a Decade



Source: Ace Equity

Coming to the practicalities of the selecting smallcap multibaggers...

More than 5,000 companies are listed on BSE. Over 90% of come under the category of smallcaps. It's a different thing that non-smallcaps account for over 80% of the total market capitalisation of the listed companies.

So how do you find the gems in this sea of smallcaps - the Hidden Treasures, as we like to call them.

I'll be answering this, and a lot more, very soon.

Plus, I'll share an actionable idea – A stock that has the elements of a 'crorepati' stock.

Along with the 'Crorepati' stock, I'll share a report - **One Stock Crorepati: The 3 Multibagger Stocks** Collection on three stocks, that I believe stand strong both on fundamentals and management quality, and could be potential multibaggers

So stay tuned for my webinar on June 7 @5 PM.

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Nariman Point, Mumbai - 400 021. India. Telephone: +91-22-6143 4055. Fax: +91-22-2202 8550.
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