AlfAccurate Advisors

AAA Insights

Sep 2020

Do not focus on market cap instead focus on net profit + growth

During the last 3 years, we often got a question from the investors “Which Market cap category is expected to outperform? Large or Mid or Small”? Market-cap based allocation is commonly used by many participants as most of the stock market indices are market-cap based. We at AlfAccurate, strongly believe that investment solely based on the market cap is not the correct approach and instead one should focus on absolute net profit and net profit growth [Net Profit Size x (1+ growth)] as the investment criteria because it is the net profit growth which drives market cap and not the other way round.

Why focus on market cap is not rewarding?

It is a common perception that the best way to reduce risk is to invest in large companies. However, in reality, 41% and 46% of the Top-100 companies by Market-cap underperformed the BSE100 index CAGR return over 10 year (2009-19) and 5 year (2014-19) period respectively (Fig1). (Since Mar20 was impacted severely due to pandemic, we selected Mar19 for our analysis).

Fig.1: Large Mcap Cos Don't Always Outperform

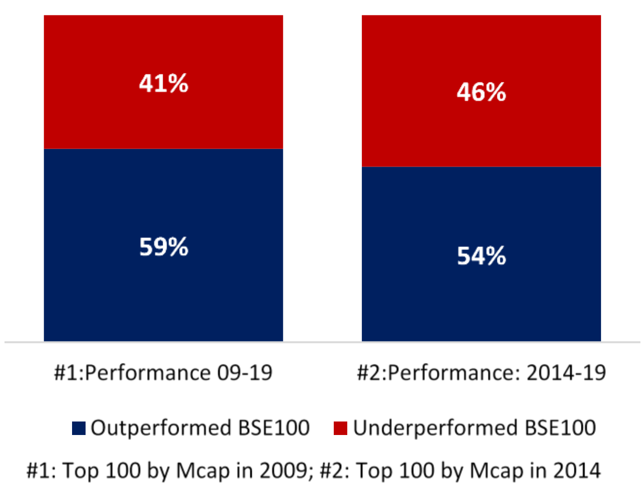


Fig2: No of Cos that left Top 100 club (2009-19)

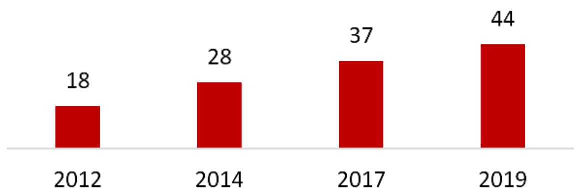
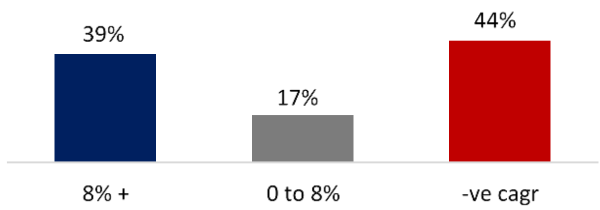


Fig3: Top 100 Cos - MCAP CAGR (2009-19)



Source: AAA Research, Ace Equity

Importantly, market cap leadership also kept on changing, as many leaders becomes laggards in the long term. During last 10-year period, out of top 100 companies by market-cap in the year 2009, whopping 44% companies were not part of Top 100 club in 2019 (Fig2).

Ironically, 40 out of 95 companies i.e. 44% of companies registered negative returns despite 10 year holding period (Fig3) – this is eye opener and further confirms that investment solely based on market cap criteria is not rewarding.

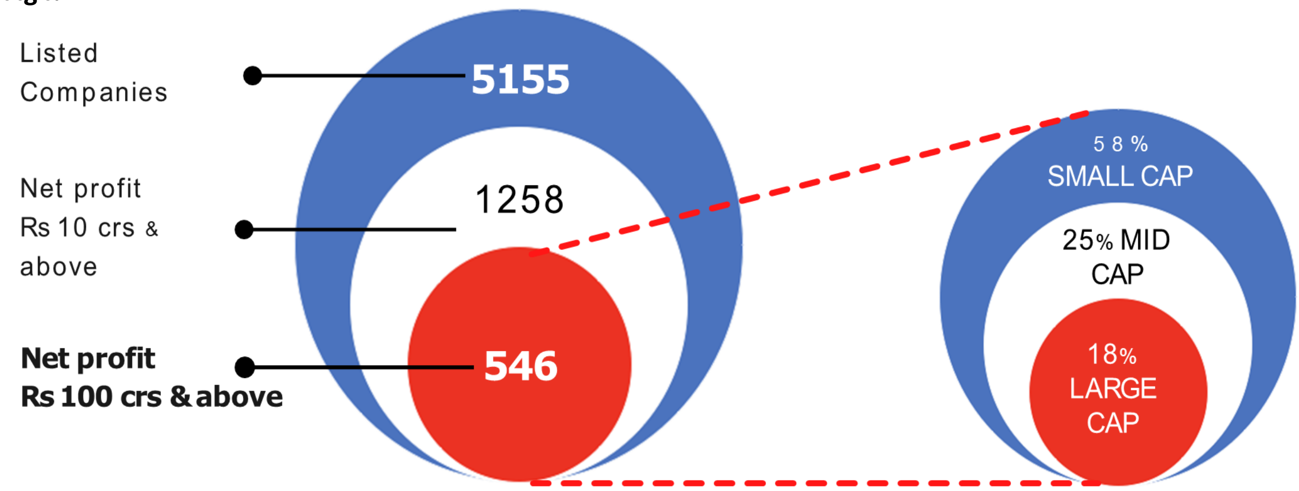
Moreover, market cap of firm tends to get skewed depending upon its up/down business cycle which results into expansion/contraction in its valuations. For instance, Infosys PE contracted from peak of 221x in Mar00 to 32x in

Mar05 and further to 20x in Mar19. Similarly, during infra boom, L&T PE expanded from 6x (Mar03) to 36x in (Mar08) and then contracted to 23x in Mar19. Hence investor who would have selected stock based on market cap criteria would have lost significantly despite selecting one the highest market cap company.

Focus on Net profit + Growth

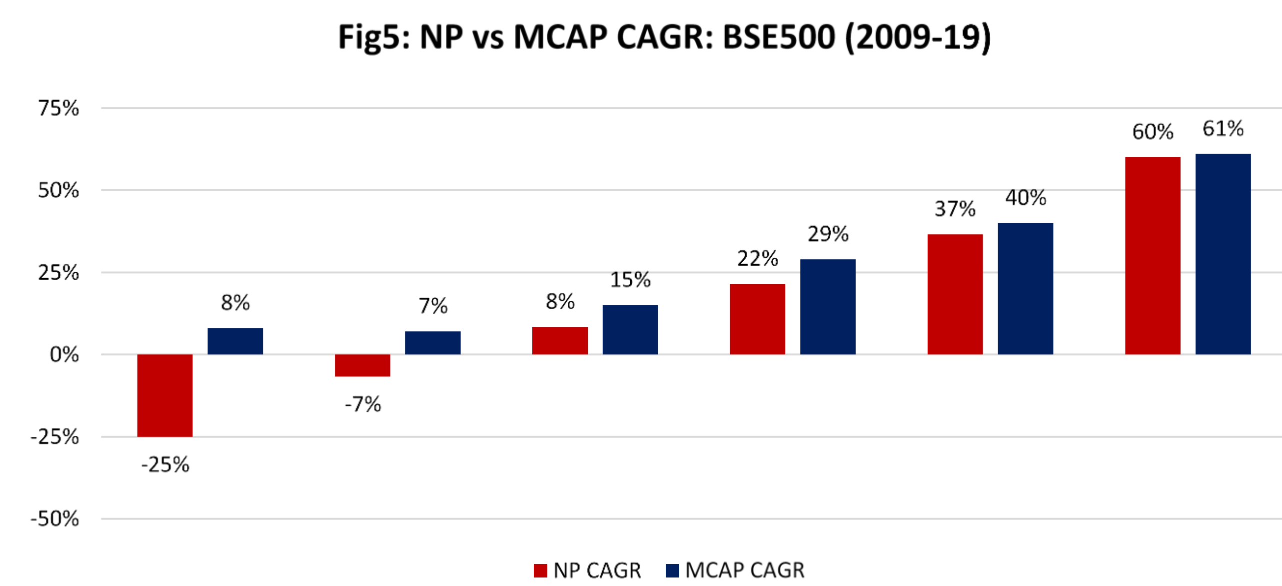
We strongly believe that true measure of size of company is its Net profit size rather than market cap as the objective is to own a slice of firm's profits. Out of the 5155 total listed companies in India, only 546 companies have net profit of more than Rs 100crs i.e. ~10% of the universe. We believe that a Rs 100 crs net profit is good milestone to measure the success of any firm as companies with large net profit size can better navigate the business cycles. Although large in size, 83% of these companies falls in mid and small cap categorisation (as per new market cap categorisation regulations) as reflected in Fig4. However, this categorisation does not make the company risky investment as many of these names have become multi-baggers during last 10 years.

Fig4:



Source: AAA Research, Ace Equity

We emphasise on Net profit growth as important criteria as net profit growth drives market cap growth. As can been in Fig5, the companies which delivered strong profit growth also registered strong stock price returns. For instance, companies which reported 22% NP CAGR witnessed 29% CAGR in its market cap during FY09-19. Similarly, companies which witnessed poor earnings registered poor stock price returns as well.



Source: AAA Research, Ace Equity

At AAA, we consider the entire 100cr+NP universe irrespective of its market cap worth evaluating as this bucket has potential to deliver outsized net profit growth as well as outsized stock price returns. Since last 10+ years, AAAIOP PMS remained True Multicap Plan with current exposure of ~51% in large cap and balance in mid/small cap. However, in terms of net profit, 92% of portfolio companies are large in size (Rs 100 crs+ net profit). These companies have strong business moat with market leadership, strong balance sheet and have demonstrated resilience during the tough period. In terms of earnings growth, AAAPMS registered earnings growth of 18% in FY20 compared to Sensex earnings growth of 6% and reported ROE of 18% vs Sensex ROE of 13.3%.

Market outlook

The Federal Reserve kept interest rates pinned near zero with a promise to keep them there until inflation is on track to "moderately exceed" the US central bank's 2% inflation target "for some time." The new guidance allows the economy to keep adding jobs for as long as possible. The Fed also used its policy statement to begin to pivot from stabilizing financial markets to stimulating the economy, saying that it would keep its current government bond-buying at least at the current pace of $120 billion per month, in part to ensure "accommodative" financial conditions in the future.

Indian economy is coming back to normalcy slowly - Electricity consumption, e-waybill generation, NETC FASTag transactions and railway freight volumes are back to pre-Covid level. However, indicators like petroleum product consumption, job postings, port volumes and civil aviation are still well below their pre-Covid level. Growth in GST collections to Rs 955 bn in Sep20 for the first time in 5 months is a positive surprise. We expect market to remain volatile as we enter the US Presidential election season over the next 5 weeks and recommend to take any decline as an opportunity to add to the equity asset class.

AAA PMS Performance

Compounded Annual Returns (%)	1 Year	2 Year	3 Years	5 Years	10 Years	Since Inception*
AAA IOP PMS	8.2%	3.4%	2.0%	8.9%	14.8%	16.5%
BSE 500 Index	-0.3%	1.4%	2.9%	7.2%	6.4%	7.7%
BSE Midcap Index	3.1%	-0.2%	-1.6%	6.4%	6.2%	7.8%
BSE Smallcap Index	12.9%	1.5%	-2.6%	6.2%	3.8%	6.4%
Nifty	-2.3%	1.4%	4.7%	7.2%	6.4%	7.6%
SENSEX	-1.9%	2.5%	6.8%	7.8%	6.6%	7.6%

*(23 Nov 2009 – 30 Sept 2020)(Performance after all expenses & fixed management fees but before performance fees).

Note: Returns of Individual clients may differ depending on time of entry in the Strategy. Past Performance may or may not be sustained in future and should not be used as a basis for comparison with other investments. Performance related information provided herein is not verified by SEBI.