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▶ TOP MID AND SMALL CAP PICKS

Quality takes centre stage as investors seek safety

Ram Prasad Sahu

When there is a flight to safety, it is stocks which are lower down the market cap ladder which get impacted the most. That has been the case over the last year with the BSE SmallCap and MidCap indices down 25-35 per cent from their peaks while the S&P BSE Sensex still remains in the green. There have been multiple reasons for the rise of the small and mid-cap companies in 2016 and 2017 and the slide in the current calendar year. Analysts highlight incessant domestic fund flows into smaller companies driven by need for high returns and expectations of higher earnings growth. While these stocks got re-rated, earnings however did not follow, which coupled with a deteriorating macro environment led to the correction. Says Gautam Duggad, head of research at Motilal Oswal Securities, "Valuations had reached an unsustainable premium (over large caps) in January this year and though it has corrected, the premium is still there." He believes that one needs to tread with caution while looking at companies in this space and look for opportunities from a bottom-up perspective.

Thus, the key theme which emerges from the risk-on mode of the markets is the focus on quality. Analysts at JM Financial believe that volatility often compels investors to search for pockets of safety. They suggest that when investors position themselves for a deteriorating environment, their portfolios should consist of companies which are high-quality, cash-generative entities that could do well on market reversals. Quality thus boils down to managements, which have a proven track record of delivering consistent growth without compromising on profitability and cash flows. Business models also have to be strong or stable enough to weather the changes in industry and market cycles.

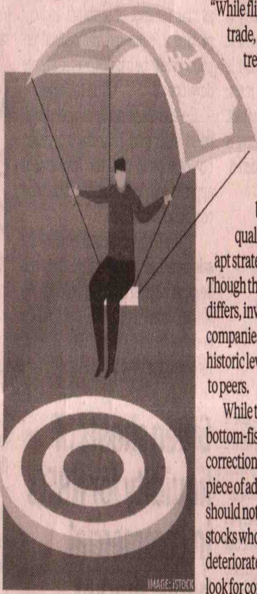

IMAGE: iSTOCK

The other factor is valuations. Experts say after a long spell of overvaluation, pockets of value are emerging across the market capitalisation spectrum. This means investors can look at both quality and value names without compromising on one for the other.

Says Naveen Kulkarni, head of research at Reliance Securities, "While flight to quality is a consensus trade, the market is witnessing a trend reversal with value investing making a certain degree of comeback. Thus, exploiting the best of the both worlds, which is quality backed by value or value backed by quality, seems to be the most apt strategy at this juncture." Though the definition of value differs, investors could look at companies trading below their historic levels as well with respect to peers.

While there is opportunity for bottom-fishing after the steep correction, analysts at IIFL have a piece of advice small-cap investors should not ignore: Avoid averaging stocks whose fundamentals have deteriorated significantly. Instead, look for companies which can deliver sustainable earnings growth. To get you started on this process we have picked some companies suggested by brokerages which could deliver good earnings growth over the next couple of years and outperform the overall markets.

Company	CMP (₹)	Target price (₹)	Upside (%)	EPS CAGR (%)* (FY18-FY20)	PE ratio (x)
Arvind	317	467	47.0	35.3	26.5
Mphasis	911	1,328	45.8	20.9	21.4
Zensar Technologies	240	335	39.8	28.9	22.3
HeidelbergCement India	148	200	35.5	40.2	25.1
Jubilant FoodWorks	1,044	1,410	35.1	39.6	70.2
Parag Milk Foods	248	329	32.6	27.7	23.9
Oberoi Realty	438	574	31.2	58.8	32.4
Mold-Tek Packaging	264	345	30.6	26.7	26.3
Mindtree	835	1,081	29.5	25.7	19.9
Praj Industries	108	140	29.5	45.2	49.4
Sundram Fasteners	535	677	26.5	26.2	29.1
Ashok Leyland	121	149	23.3	20.7	19.9
United Spirits	626	770	23.1	24.6	70.0
L&T Technology Services	1,662	2,042	22.9	24.5	33.5
Exide Industries	253	309	22.3	22.6	31.1
L&T Infotech	1,692	2,068	22.2	21.7	26.1
Biocon	629	768	22.0	70.9	53.9
Trident India	71	86	20.8	25.8	13.4
Apollo Hospitals	1,134	1,368	20.7	91.0	134.3
Dr Reddy's Labs	2,451	2,952	20.4	49.9	41.5

* estimates; Price is rounded off; Upside is potential gain (target price over current price); EPS: earnings per share; PE: price-to-earnings ratio; CAGR: compounded annual growth rate; List includes companies with minimum upside potential of 20 per cent and estimated EPS CAGR of 20%; Source: Brokerages

Compiled by BS Research Bureau