THE HINDU Business Line

From the Ring

# Large-caps, big attraction

## Liquidity and size make them better performers compared to mid and small-caps

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Asset allocation among different instruments has always been one of the prime drivers of portfolio returns for any investor. Even within specific asset classes, there are divergences. With regard to equities, it is always a matter of debate whether to go for large-caps or mid and small-caps as a long-term investment. Historically, large-caps, mid and small-caps have given good returns to investors.

In the last 13 years (August 2003-August 2016), the Nifty has given returns of 17 per cent and the Nifty Midcap Index 19 per cent approximately on a CAGR basis.

Large caps have garnered greater attention and time from both domestic and foreign institutional investors because of their size and liquidity. They command the majority weight in India's total market cap and constitute a bulk of the portfolio weight for both foreign as well as domestic institutional investors. The financial metrics of large caps has been superior compared to mid-caps on a fundamental basis. Here are some highlights of key financial metrics based on an analysis of data for the past 10 financial years (FY 06-16) for large caps that make up the Nifty, compared to mid caps in the NSE Mid Cap Index.

### Good financials

From an earnings strength perspective, large-caps have better profitability metrics. Large-cap firms have higher EBIDTA margins (average 22 per cent against 16 per cent for mid-caps) and higher net profit margins (average 11 per cent versus 8 per cent for mid-caps). Large cap firms fare better on return ratios too. Large-caps have higher return on equity at an average 18 per cent against just 12 per cent for the mid-cap companies. They also feature higher return on capital employed at an average 10 per cent against 6 per cent for mid-cap firms.

Large-cap companies display better sustainability with lower leverage (net debt-to-equity at 0.4 times versus 0.8 times for mid-cap companies). They have superior interest coverage ratio too showing higher ability to repay debt with an average six times interest cover versus three times for mid-cap firms. From a stability perspective, large-caps suffer lower earnings volatility and stock price volatility relative to mid-caps too.

### Rich valuation

From a valuation perspective, the recent out-performance of mid-caps has made them relatively expensive. Over the last three years, the returns for the Nifty and NSE Mid Cap Index have been 19 per cent and 35 per cent respectively. Clearly, there has been a big out-performance relative to long-term trends.

Mid-caps also look richly valued compared to their past average trading multiples and from a relative premium/discount to large-cap valuations. Valuations of mid and small-cap companies have seen a re-rating and are no longer cheap. We think that mid-caps and small-caps can still deliver returns to investors from a three to five-year perspective, but with some volatility.

Investors must also note that return dispersion in mid and small-caps is usually high. Therefore, the key is bottom-up stock selection. Large-caps offer relatively more stable returns with lower volatility. Looking at current valuations as they stand, along with return and risk potential, large-caps appear the relatively more attractive choice for investors.

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**More stable**

**Large-caps are exposed to lower volatility on earnings and stock price relative to mid-caps**