

UNVEILING HIDDEN GEMS: EXPLORING THE WORLD OF MICRO CAP INVESTMENTS



CA Dhruv Bheda
Email : dhruvsheda@gmail.com

In the vibrant landscape of India's financial markets, there's a quiet revolution brewing in the micro-cap segment. Investors are turning their attention to the dynamic world of micro-cap stocks, where hidden gems sparkle with potential. Diving into the micro-cap index reveals a thrilling journey of growth and opportunity. Over the recent years, these pint-sized powerhouses have been delivering returns that punch above their weight. With agility and adaptability, micro caps have danced through market fluctuations, consistently outperforming expectations. For the last 12 months, Nifty Microcap 250 rose by 88.72% clocking the highest gains when compared to other major indices including Nifty 50 and Nifty 500.

The Indian economy has grown by a CAGR of 7% over recent years, propelling it from the 8th largest to the 5th largest globally. Projections suggest that it is on track to become the 3rd largest economy by the fiscal year 2027. This remarkable economic expansion owes much to the Micro, Small, and Medium Enterprises (MSME) sector. The MSME sector in India has been a vital engine of growth, contributing significantly to employment generation, innovation, and export earnings. Its dynamism and resilience have played a crucial role in driving economic development, fostering entrepreneurship, and promoting inclusive growth across various sectors and regions of the country.

Following the pandemic, the economic recovery is fueled by an increase in gross fixed capital formation (GFCF) and discretionary spending at the higher end. GFCF expansion is bolstered by the upswing in real estate and government expenditure, while corporations have exhibited strong growth from fiscal year 2023 onward. Observations from empirical data indicate that industries tied to manufacturing activities thrive in such conditions, which are further maintained by governmental policy initiatives like Production-Linked Incentive (PLI) schemes and broader support for manufacturing in India. Thus, considering the Nifty Microcap 250 Index, it has a significantly higher weight of ~68% in the broader industrial sector and discretionary consumption, which could benefit from the current demand environment in the economy.

In previous bull markets encompassing broader equities, there has been a trend where the earnings yield spread between microcaps and large caps narrows significantly, potentially nearing zero. If the current bull market persists, propelled by a widespread investment surge, there remains a possibility of observing a recurrence of this historical pattern. Meanwhile, mid and small caps currently exhibit a slight earnings yield spread over large caps, albeit without reaching the levels of extreme bull market valuations where they trade at a premium. Currently the PAT to GDP of small caps is at 0.7% of GDP and has more room for expansion from a long term cycle perspective.

As India continues to progress towards becoming a global economic powerhouse, the MSME sector is expected to remain a cornerstone of its growth trajectory, fueling innovation, productivity, and competitiveness.

Finding the best micro-cap stocks requires a combination of research, analysis, and risk management due to the volatile nature of these stocks. Here are a few investment philosophies to consider when identifying potential multibagger micro-cap investments:

1. **Search For Business which have a Sustainable Moat:**

Always look for companies, which have unique businesses or unique products that lack direct peers and have a significant edge over the competitor's product thus leading to superior moats being created and sustainable profits over the long run. The capability of a company to expand its operations at a pace significantly surpassing that of its competitors or the industry's growth rate, whether due to exceptional execution or other factors, can result in the establishment of a formidable competitive advantage. One can use simple stock screening tools or platforms to filter micro-cap stocks based on criteria such as industry growth, revenue growth, and profitability ratios to narrow down the selection of companies that demonstrate superior capital allocation within their operations.

2. **Strong Sectoral Tailwinds:**

When a company benefits from a robust sectoral tailwind, it gains the momentum to achieve accelerated organic growth, thereby minimizing the risk of cash burn. Additionally, it becomes crucial to have a certain level of assurance that the positive trends within the industry will endure over an intermediate timeframe, generally ranging from 5 to 7 years. This sustainability ensures a conducive environment for the company's continued expansion and success.

3. **Look for the Quality of Management:**

It is prudent to prioritize companies led by individuals of high caliber, such as technocrats or seasoned professionals with extensive experience. These members of the management often possess the expertise and strategic vision necessary to navigate complex business landscapes and capitalize on opportunities effectively. Their track record of success and deep industry knowledge can drive innovation, operational efficiency, and long-term value creation for the company and its stakeholders. Therefore, investors should always seek out companies with leadership teams characterized by a strong blend of technical proficiency, industry insight, and managerial prowess over family owned businesses as family-owned businesses may offer stability and a long-term perspective but they could potentially face challenges related to succession planning or conflicts of interest.

4. **Investing at reasonable valuations:**

"The stock market is filled with people who know the price of everything and the value of nothing."

- Philip Fisher

Investing at reasonable valuations is crucial for preservation of capital and risk management, which provides for potential long term sustainable returns. Valuing micro-cap companies can be uniquely challenging for investors. However, several crucial aspects can guide the valuation process, including financial ratios, relative valuation metrics, volatility, growth potential, liquidity etc.

5. **Communicating with the management:**

Communicating with company's management, such as engaging with the Investor Relations (IR) team, participating in shareholder meetings like Annual General Meetings (AGMs), and attending post-earnings conference calls and visiting the company's plant provides valuable insights into the business and operations of the company. These actions offer investors a deeper understanding of the company's strategy, performance, and outlook.

6. **Continuous due diligence:**

In addition to thorough research, it's crucial to maintain ongoing due diligence on the company's operations and sectoral dynamics. Building a 'Coffee Can' portfolio of micro-cap companies is challenging due to their limited track record and higher risk profile. Investors must remain informed about the company's performance and strategic direction after investing. Having a timely exit strategy is essential if the company fails to meet expectations.

7. **The Scuttlebutt Approach:**

Famously advocated by renowned investor Peter Lynch, entails gathering insights about a company through informal channels like industry contacts, suppliers, customers, employees, and competitors. This method relies on grassroots research and firsthand observations to understand a company's operations, potential, and competitive standing.

The principles highlighted above are not a one-size-fits-all endeavor, especially given the dynamic nature of financial markets. Instead, one must recognize the need for flexibility and adaptability in investment strategies, acknowledging that what works for one investor may not necessarily work for another. This acknowledgment creates space for investors to explore, experiment, and develop their own unique approach tailored to their specific circumstances, risk tolerance, financial objectives, and long-term aspirations.

Micro-caps, by their very nature, carry a higher degree of risk compared to their larger counterparts. Their smaller size often translates to greater volatility, susceptibility to market fluctuations, and sometimes, limited liquidity. However, it is precisely this risk factor that makes them an essential component of a well-rounded portfolio strategy. Thus it's crucial to approach micro-cap investing with caution and discipline. Given their inherent volatility, it's advisable to limit the allocation to micro caps to a percentage of your overall portfolio that aligns with your risk tolerance and investment goals. This ensures that while you harness the growth potential of micro caps, you also maintain a balanced and diversified portfolio that can weather market turbulence.

