MITIGATING HIGH ‘EQUITY CAPITAL’ RISK EXPOSURE TO ‘SMALL CAP’ SECTOR IN INDIA
Analysing ‘Key Factors of success’ for ‘Institutional Investors’ whilst Investing in Small Cap sector in India

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MITICATING HIGH 'EQUITY CAPITAL' RISK EXPOSURE TO 'SMALL CAP' SECTOR IN INDIA – ANALYSING 'KEY FACTORS OF SUCCESS' FOR 'INSTITUTIONAL INVESTORS' Whilst INVESTING IN SMALL CAP SECTOR IN INDIA.

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ABSTRACT

This paper deals with the subject of mitigating high ‘Equity Capital’ Risk Exposure to ‘Small Cap’ Sector in India. Institutional investors in India are prone to be risk averse when it comes to investing in the small cap sector in India as they find the companies risky and volatile. This paper will help analyse ‘Key Factors of success’ for ‘Institutional Investors’ whilst investing in Small Cap sector in India as some of these Indian small cap stocks offer handsome returns despite economic downturn. This paper has been harnessed carefully under the influence of expert investors, which includes Benjamin Graham (Security Analysis); Warren Buffet; Philip Fisher (Common Stocks and Uncommon Profits); and Aswath Damodaran.

Keywords: Small cap (business) firms in India; equity capital; risks; risk management; credit market; Mitigating Risks; Institutional Investors; Analysing Key Factors to Investment; Value Investing; Indian economy
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ABBREVIATIONS

Cap: Market Capitalisation of the Stock
BSE-Sensex: Bombay Stock Exchange Sensex
RBI: Reserve Bank of India
FY12: Financial year 2012
GDP: Gross Domestic product
Capex: Capital Expenditure
FIIs: Foreign Institutional Investors
FY13: Financial year 2013
FY11: Financial year 2011
CPI: Consumer Price Index
WPI: Wholesale price Index
EBITDA: Earnings Before Interest, Tax, Depreciation, and Amortization
FY14: Financial year 2014
PPE: Plant, Property Equipment
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1 INTRODUCTION

1.1 Overview

The world we live in is no longer a simple one. It is complex. Within this complexity, we wish to live simple lives. The topic of my research is “Mitigating High ‘Equity Capital’ Risk Exposure to ‘Small Cap’ Sector in India.” The main reason for choosing this topic is to analyse as an Investor the risks associated with equity capital investment in the Indian small cap sector and how to mitigate these capital risks and thereby making an Institutional Investor’s life simpler.

Hypothesis: The hypothesis in this case is the diminishing returns in the ‘small cap sector in India’ especially in the last 5 years leading to high capital risks for the institutional investors. The diminishing returns, negative performance of the Indian small cap sector and high risks such as economic, technological, and regulatory are dissuading both local and international equity investors from investing in small cap sector in India and leading many smaller Indian firms to bankruptcy or with very high debt.

At the same time, these stocks are the best option for an equity investor who wishes to generate significant gains in the long run. Good reliable small companies are very scarce and it takes time and research to find them. The research on this topic is important, as one of the biggest hurdles faced by the small cap sector is lack of risk capital at right junctures propelling them to higher growth and sometimes sustaining themselves during difficult times. Risk averse investors have a blanket approach towards small cap sector in India leading to scarcity of funds for small cap firms. At the same time, researchers have found that role of an Institutional Investors is extremely important in the well being of a small cap firm. Institutional investors have an advantage and an incentive to influence firm’s management and their decisions to growth i.e. influencing corporate governance, reducing agency costs and affecting firm’s performance.'

Methodology: The methodology for my research will be an action-oriented research on a small cap firm (listed on Indian stock exchange) to support my hypothesis analysing the ‘key factors of success’ (details given in successive pages). The company is
publically traded stock on the Indian stock exchange and I would be analysing and investigating its balance sheet; profit and loss accounts and other qualitative factors such as ownership, corporate governance, industry analysis, and innovation affecting the small-cap firms. The methodology is derived under the influence of investment Gurus that includes Benjamin Graham; Warren Buffet; Philip Fisher; and Aswath Damodaran.

1.2 Objective

The main objective for choosing this topic is to assist investors analyse the high ‘equity capital’ risks associated with small-cap sector by identifying right individual stocks giving handsome returns and thereby mitigating risks.

We will discuss despite the economic crisis, how a prudent analyst still could earn handsome returns over a period mitigating his risks whilst investing in the small cap sector in India. Historically, we have observed higher risks associated with capital investments in small cap as compared to mid-cap or a blue chip company.

However, we also know that high risks resonates higher returns to the investor if he/she is able to analyse these risks correctly, i.e. map the financial, technical, and management risks connected with each country, industry and a specific firm. We all know that no large, mid or small cap companies have exactly the same degree of risk. Even if they operate in the same sector, their business dynamics, managements and valuations are different. That is why it is important to evaluate the risk involved in each case separately and avoid the blanket approach of not investing into small cap sector in India.

2 INDIA AND THE SMALL CAP SECTOR

2.1 Small cap (Hindu) companies In India

Small and medium enterprises in India are the backbone of Indian economy contributing 45% of the industrial output, 40% of India's exports. Small business in India is the second largest employer of human resources, after agriculture. 

ii
Small Cap companies have smaller revenue and client bases, and usually include the start-ups and companies in the early stage of development.

In India, generally companies that have a market capitalization (listed on Indian Stock Exchange) in the range of Rs 60 – 600 Crore i.e. US $ 10 million – $ 100 million are small cap stocks as compared to the US where a small cap has a market capitalization of between $300 million – $2 billion. iii

On the other hand, the market cap of large cap companies in India ranges from Rs 200 bn to Rs 3,500 bn i.e. US $ 350 million to US $ 5 Billion and Mid cap stocks are those that generally have a market capitalisation within the range of Rs 50 bn and Rs 200 bn i.e. US $ 100 million to US $ 350 million.

While the benchmark Bombay Stock Exchange (BSE)-Sensex (Indian stock exchange) was near its all-time high, small caps are still underperforming their larger peers by a very wide margin as compared to peak levels in the past. For instance, the BSE Small cap index (given below) is still more than 40% down from its peak levels in 2008 (Statement recorded in 2014). iv

![BSE Small-CAP](image)

*Figure 1: BSE small cap*

Foreign Institutional Investors’ (FIIs) holdings in Bombay Stock Exchange (BSE) top 100 stocks climbed 17.6%, the highest since the end of March 2007 while their interest
in small-cap stocks shrunk by 7% in the comparable period. (statement recorded in mid of 2013)⁷

The small cap sector’s performance is generally co-related to the macro conditions of a country and in the case of India we see a decline of small cap stocks due to the economy being under stress. However, though the small cap firms are highly risky and volatile, it is important for an analyst to remember that small cap companies in India have a lot of potential to reach the mid-large cap space.

2.2 Role of Institutional Investors in India

In India, institutional investment activities have a short history. Before the economic reforms, only a few institutions were operating in the Indian market, which were mostly owned by the government. However, post economic reforms in 1991, the environment for institutional investors expanded. Government policies promoted private participation and foreign investments in Indian financial markets, and there has been a significant growth in institutional investment since then. Institutional investors could be categorised as Mutual Funds (MFs), Banks and Financial Institutions and Foreign Institutional Investors (FIIs)⁶.

FII investments are critical component of capital flows to the Indian economy as the flows also bear significant risks of reversal if the domestic outlook or market performance weakens. Domestic Institutional Investors, on the other hand, play the all important role of channelizing domestic savings into the financial market. This role takes on a far greater significance in developing markets like India where a vast majority of investors are not yet comfortable whilst investing directly in the stock market.

A study by the World Bank (2005), a survey involving institutional investors, companies and market participants, found that the domestic mutual funds take up only a passive role in scrutinising the management’s actions in their portfolio companies; however, the FIIs become active and exercise their ownership rights.⁷
2.3 Debt market in India

Due to the under-developed equity markets in India, the corporate debt market in India has been important. Unlike in the advanced economies, where debt ratios more than half of nominal equity capital values are considered high, in India very high debt to equity ratios are the norm (Majumdar & Sen, 2007). Banks are the most important source of borrowing for firms in Indian industry, at an average level of 39.7 percent of total borrowing, followed by borrowings from other financial institutions at 29.7 percent.viii However, In India, the debt capital borrowing (10%-20% Interest rate) is very high as compared to other nations giving entrepreneurs very little legroom to take risks and grow.

2.4 Indian Economy and Business Environment

'There were no safe havens anymore'. Bank deposit is not safe anymore and with real interest rates being negative for quite some time now, even government treasuries fail to keep up with purchasing power. The only thing that is keeping them higher is the ultra low interest rate by the US Fed, which is forcing people to go into riskier assets in search of better yields.ix.

Now, coming to India, we also lack a safe haven when it comes to investing our money. If we are talking about fixed income securities here, our interest rates are below the inflation. The fundamentals of the Indian economy for FY13 were amongst the worst seen in a decade. India's GDP grew by less than 5% in FY13, a sharp deceleration from the 6.5% and 8.5% growth witnessed during FY12 and FY11 respectively. This coupled with high inflation, rise in interest costs, low capex and rupee depreciation left even the largest Indian companies with little leg-room to display sales growth and margin expansion.x
India’s current account deficit remains a big worry as it has been steadily increasing in the few years. Also India faces High Inflation as we can see below both the Consumer Price Index (CPI) and Whole price Index (WPI) have risen considerably in the last 5 years.
Figure 4: India’s Inflation index in the Last 15 Years
Source: Reserve Bank of India (RBI) published by Business Standard newspaper

No doubt India is in troubled waters right now – high inflation, lack of jobs, extreme volatility, however, as compared to the US markets, India is a developing country and has a big growth story ahead. Lots need to be done in India from building Infrastructure to stabilising prices of food; from building a word class education system to arresting the current account deficits. The big growth story ahead, which is slowly shaping upwards after the turmoil in the last few years, will create big opportunities for small cap companies in India as well. Smaller businesses are flexible and could adapt to change with the changing times. New policies, Investments into the country will benefit the small cap companies, as their growth potential is much more than the mid to large companies.

2.5 India as compared to other Emerging Nations

Back in 2007, BRICS were in the reckoning and helped the world in balancing the troubled recession times and this led to a quicker turnaround much faster than we thought.

The same countries have slowed down but India’s budget and CAD deficits are the worst in BRICS as seen below (Year 2013):
India is not the only emerging economy feeling the heat of current account deficit on its currency. Several others like Brazil, South Africa, Turkey and Indonesia have seen their currencies lose value against the US dollar over the past year. In fact, even countries like Philippines and Russia that have a current account surplus have seen their currencies depreciating by 6% and 4.5% respectively since April 2013.\textsuperscript{xii}

Countries such as China, Japan and Brazil are expected to record lower GDP growth in 2014 as compared to 2013. Others are expected to do better. India in particular is estimated to grow by 5.1% in 2014 as against 4+% in 2013 (see below chart). This year has been a challenging one for the country as economic activity has remained sluggish, rupee has weakened and consumption has dwindled. (See the charts)
Another indication of India’s high growth potential is Foreign Institutional Investors (FIIs) considering India as an investment destination, apart from the FII investments, is the ever-increasing number of FII registrations with the stock market regulator, Stock Exchange Board of India (SEBI). These have increased from about 882 in March 2006 to 1,757 by March 2013. However, most of the funds are invested in blue chip & midcaps, leaving the small cap devoid of the much-needed funds.\textsuperscript{xii}

India growth story has just started and will continue for the next few decades if it becomes better structured and organised, the next couple of decades could easily be one of the best growth stories the world has ever seen.

2.6 The Indian Entrepreneur

Big Ideas and successful entrepreneurs in India have made a large mark on the global business forum. From Tatas to Birlas to Mittals to Ambanis, Indian entrepreneurs have been regularly featuring in the Forbes top Entrepreneurs list. After India’s Independence from the British Empire in 1947, it has been a tough ride for Indian entrepreneurs. Indian economy has always been a mixed bag of socialist reform policies catering to the large and poor Indian population and few capitalist family houses monopolising the Indian business.

It is worth recalling that when India had a very low rate of economic growth, as was the case until the 1980s, a common argument was that democracy as hostile to fast economic growth. It was hard to convince those opposed to democracy that fast
economic growth depends on an economic climate congenial to development rather than on fierce political control, and that a political system that protects democratic rights need not impede economic growth. That debate has now ended, not least because of the high economic growth rates of democratic India (Amartya Sen). \textsuperscript{xiii}

This trend continued until early 1990s; however, things changed in 1991 when India opened up its economy as a result of lingering defaults from the loans courtesy IMF and World Bank. Indian economy was entering the stage of liberalisation, globalisation and being part of a highly desirable economy in today’s world.

Amid the nation’s fears of foreign companies having a leeway back to India and ruining the domestic business, it turned out to be blessing in disguise for India, as it opened up new avenues for Indians living in a closed economy for more than 4 decades. In particular, for the new Indian entrepreneurs who got an opportunity to connect with the outside world, the foreign entrepreneurs, investors, & corporates, and a bigger export market for its goods and services. The globalisation translated the burning desire of many of the 1\textsuperscript{st} generation Indian entrepreneurs to accomplish and achieve greater value to the surprise of the entire world. Many of the automotive, pharma, and IT services firms in India is a result of globalisation; hunger for success, and persistency of the Indian entrepreneurs.

Globalisation also led to the emergence of neo middle class in India, which was otherwise missing in a nation with more than 1+ billion people. With the rise of the Indian middle class (250 million people) and access to technology, Internet, and knowledge base, we have seen the emergence of Indian mobile companies, e-commerce firms, and technology companies competing with the best around the world.

Things have changed a lot for the Indian Entrepreneur since the days back then; however, there is still a long way to go. Many big ideas and highly qualified entrepreneurs have struggled to get their ventures reach a critical mass because of lack of equity capital funding options and a suitable eco-system that will accelerate innovative ideas into big businesses.

Indian Entrepreneurs and their companies who have made it into the small league of businesses (small cap) but have failed to deliver and reach the status of a mid-cap or a
blue chip cause of risk-averse investors and lack of Infrastructural support causing a great deal of distress to the Indian businessmen.

3 METHODOLOGY: Analysing the ‘Key Factors of Success’ for ‘Institutional Investors’ whilst investing in Small Cap firms in India – Mitigating Risks

To invest in a common small cap stock in India, it is important for institutional investors to analyse and determine the risks associated with each stock, industry and of course the country risks. The small cap sector is different from mid to large companies and the risk management techniques for small cap vary as compared to large enterprises. It is vital to analyse for each stock its key factors i.e. earning power & dividend return; sales & industry growth potential; product innovation & technological capability; ownership control & corporate governance; and country & macro risks.

Contrary to what you might have been taught in your valuation classes, valuations are and should never be just about the numbers. To the extent that you will be making choices on these number, this will be your estimate of valuation, reflecting not only what you know about the company (and its products, management etc.) but also your personal biases (whether you like the company or not) [A. Damodaran].

This model has been harnessed carefully under the influence of expert investors, which includes Benjamin Graham (Security Analysis); Warren Buffet; Philip Fisher (Common Stocks And Uncommon Profits); and Aswath Damodaran.

This methodology will assist an institutional investor in developing an investment philosophy whilst investing in small cap (listed companies) sector in India and keeping in mind the local factors. Investors are free to use or add their own philosophy or variables such as IRR; NPV; Free Cash Flows to further their research. Please note that the factors taken into account have arrived from the readings and investment styles of expert investors as given above; however, these factors have been customised to present times and local conditions (emerging country such as India).

3.1 Estimate Earning power and Dividend Return of a stock

A valuation of a small cap stock would be classified under the three headings:
1. The dividend rate and record
2. Earning power
3. Balance-sheet factors (asset value)

**Dividend Return as a Factor in Common-stock Investment:**
A successful company is one that can pay dividends regularly and consistently. A good dividend return is one, which is usually adjusted or correlated to the earning power within a reasonable time. The idea of investment is closely related to that of dependable income, it follows that investment in small cap stocks should be confined to those with a well-established dividend.

When a management withholds and reinvests profits, thus building up an accumulated surplus, it claims confidently to be acting for the best interests of the shareholders. It is considered proper managerial policy to withhold current earnings from stockholders, for the sake of any of the following advantages:

1. To strengthen the financial (working-capital) position
2. To increase productive capacity

Stockholders are entitled to receive the earnings on their capital except to the extent they decide to reinvest them in the business. The management should retain or reinvest earnings only with the specific approval of the stockholders. Such “earnings” as must be retained to protect the company’s position are not true earnings at all. (Security Analysis by Benjamin Graham, 1934)

**Earning Power and Balance Sheet Factors:**

Most of the analysts look at the market valuations; price to earnings (P/E) ratios; predicting the future trends; technical & trend analysis to ascertain the performance of a common small cap stock, which could be misleading, speculative, and may not always give you the real picture. Intrinsic value of a stock establishes the true value of a stock, which an investor should look at before investing.
An analyst should carefully examine the individual small cap firms in order to discover undervalued stocks (Intrinsic Value), which are available even when the equity market is not low. The principle of ‘margin of safety’ validates the discounted price at which the stock is selling below its intrinsic value and Liquidation value.

*The analyst should also scrutinise the way the company displays its financial information and Balance Sheets. The earnings statements could be subject to misleading presentation and mistaken inferences when scrutinized by an investor.*

Below are 6 key parameters determining the Earning power and Balance Sheet Factors of a small cap stock in India. An investor should closely study these parameters along with the regular ones for at least the past 3-5 years to understand the reasons behind the change in different ratios and its impact on the market (stock) price.

i. **Stocks Selling below Liquidation Value:** Liquidation Value as the name suggests is the total worth of a company's physical and current assets minus liabilities when it goes out of business or if it were to go out of business.

   It is important to observe that there is a widespread discrepancy between price and current-asset value. Stocks selling below liquidation value are in many cases too cheap and so offer an attractive medium for purchase.

   To calculate the liquidation value of a stock, an analyst should estimate the actual value of its cash assets (including receivables, inventory, investments, advances) and fixed assets (such as plant, machinery, equipment) and subtract it from current & fixed liabilities. If the liquidation value is more than the market capitalization value of the stock, it implies that the stock is undervalued and is attractive to buy.

ii. **Net (profit) Margin:** The net margin is a measurement of what proportion of a company's revenue is left over after paying for all the variable and fixed costs inclusive of interest and depreciation charges. Net margin is the final measure of profitability. It reflects the total profits the company takes home. Higher the margin, better it is for the company as it indicates better pricing power and effective cost management.
iii. **Operating Cash Flows Ratio (OCF):** It is important to ascertain the real earning power for a company by dividing the operating cash flows to net profits of a company. Higher the ratio better is the quality of earnings. OCF is a key parameter for small cap firms.

\[
\text{Net Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales (Revenue)}}
\]

Cash Flow From Operating Activities = EBIT + Depreciation - Taxes

iv. **Net Working Capital** is a method of increasing enterprise value by maximizing efficiency of working capital. Every dollar of EBITDA added to the bottom line is worth five or more dollars to investors in enterprise value. Working capital efficiency has direct effect on EBITDA. Therefore, maximum return on working capital is a key lever to increasing enterprise value. Every day a company employs a substantial amount of working capital in operations. Before any additional new capital is invested toward growth, it is important to ensure that return on working capital already invested has been maximized.

After all, the cheapest form of capital is internally generated cash flow. Working capital is one of the most critical parameters for companies in the small cap segment xviii

While anything over 2 means that the company is not investing excess assets. Most believe that a ratio between 1.2 and 2.0 is sufficient.

\[
\text{Net Working Capital} = \text{Current Assets} - \text{Current Liabilities}
\]

v. **Debt to equity ratio:** A highly leveraged business is the first to be hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. We believe that a debt to equity ratio of greater than 1 is a high-risk proposition. (Investopedia definition)

Debt-to-equity ratio = total liabilities / total shareholders' equity
vi. **Return on Equity (ROE):** The amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. RONW is calculated as

\[
\text{Return on Equity} = \frac{\text{Net Income}}{\text{Shareholder's Equity}} \]

The analyst must seek to protect himself against this danger as best he can from irrational and speculative behaviour of the market by seeking the actual value of the stock and not based on speculative public sentiments.

The irrational behaviour of the markets leading to inflated prices caused by the over enthusiasm or artificial stimulants and at the same time undervalued stocks caused by neglect or prejudice may persist may exist for an inconveniently long time.

The stock market is more of a voting machine and not a weighing machine where the actual value of a stock is defined by more votes and not by its actual weight. An analyst should stay away from the stocks where the value of analysis diminishes and the element of chance increases.

3.2 **Sales and Industry (nature of business) growth potential:**

The 2\textsuperscript{nd} key factor for an investor is to analyse the past and future sales prospect; Industry growth potential; competition and market rivalry; nature of the business and scalability for each small cap company it is seeking to invest. Defining the industry in which competition actually takes place is important for good industry analysis not to mention for developing strategy as well. (Porters Five Forces)

**Porter’s five forces analysis** is a key framework to better understand the industry, its entry barriers, bargaining power, cost of inputs, and other key parameters in which a small cap company operates. Using the Five Forces Framework, an analyst may be able to spot an Industry or a Company with a good future. Porters Five Forces Framework is key to analyse the industry; understand the characteristics of the business i.e. superior sales organization, leading industry position and proprietary products or services.
Before we go deep into the five forces analysis, it is vital for an analyst to study small cap’s sales and revenue growth for at least the past 5 years. It is important to understand the reasons for its percentage (%) growth or dip in sales as compared to the industry. At the same time, it is essential for an analyst to realise that a continuous positive or a negative revenue growth is no guarantee that the future forecast will remain the same. There are instances where sales of a company has grown for 10 years continuously; however, its revenues have dipped in the next few years, with the entry of new players, rivalry among existing players, and management changes.

**Porters 5 Forces Analysis**

-- **Bargaining Power of Buyers**

-- **Bargaining Power of Suppliers**

-- **Rivalry among Existing Players**

-- **Threat of Substitutes**

-- **Threat of New Entrants**

*Figure 8: The five forces that shape industry competition*

*Source: The Five competitive Forces that shape strategy by Michael E Porter (2008)*
A. Threat of New Entrants

Threat of new entrants puts a cap on profits with the increasing competition in the market. When threat is high, incumbents must hold down their prices or boost investment to deter new competitors. The threat of new entrants in an industry depends upon the height of entry barriers that are present and on the reaction of the incumbents.

Entry to barriers is advantages for incumbents over new entrants. There are seven major sources:

- **Economies of Scale**: Firms when produce large volumes enjoy lower costs per unit because they can spread fixed costs over more units, employ efficient technology or command better terms from suppliers. Supply side scale economies deter entry by forcing the aspirant enter on a large scale or accepting a cost disadvantage.

- **Demand Side benefits of Scale**: Differentiation of production, which means that established companies hold recognized trademarks and enjoy brand loyalty as a result of marketing efforts or tradition. The new entrant must spend a lot of money to break down existing loyalties.

- **Customers Switching Costs**: Switching costs are fixed costs that buyers face when they change suppliers. The larger the switching costs, the harder for an entrant to gain customer.

- **Capital Requirements**: The need to invest large financial resources in order to compete can deter new entrants. Capital may be necessary for fixed costs, build inventories and fund start up losses.

- **Incumbency Advantages**: Incumbents would have advantages related to cost or quality such as proprietary technology, preferential access to raw materials that is not available to potential rivals.

- **Unequal Access to Distribution Channels**: The more limited the wholesale or retail channels, the tougher the entry into an industry will be. Sometimes access to distribution is so high that entrants might find new channels and remove the barriers.
✓ **Restrictive Government Policy:** Government policy can hinder the entry of potential rivals as well amplify or nullify the other entry barriers. Governments could regulate industries through license requirements and restrictions on foreign investments.

B. **Bargaining Power of Suppliers:**
Powerful suppliers capture more of the value themselves by charging higher prices, limiting quality or services, or shifting costs to industry participants. A supplier group is powerful if:
✓ It is more concentrated than the industry it sells to
✓ The supplier group does not heavily depend on one industry for its revenues and may serve many industries
✓ Supplier group may offer products that are differentiated
✓ There is no substitute to what supplier group provides

C. **Bargaining Power of Buyers:**
Buyers compete with an industry by exerting a downward pressure on its prices, negotiating for higher quality or better service, and playing off one competitor against another, all at the expenses of an industry’s profitability.

A group of buyers is powerful if it meets the following criteria:
✓ It is concentrated, or buys large volumes in relation to the volume of suppliers’ sales
✓ The products it buys from the industry are standardized or undifferentiated.
✓ Buyers face few switching costs in changing vendors
✓ Buyers can threaten to integrate backward and produce industry’s product themselves if vendors are too profitable

A buyers group is price sensitive if:
✓ The product it purchases from the industry represents a significant fraction of its cost structure or procurement budget
✓ The buyer group earns low profits and is strapped for cash
✓ The quality of buyer’s products or services is little affected by industry’s product

D. **Threat of Substitutes:**
A substitute performs the same or a similar function as an industry’s product by a different means. Videoconferencing is a substitute for travel. When threat of substitutes are high, industry’s profitability suffers. The threat of a substitute is high if:

- It offers high price-performance trade off to the industry product
- The buyer’s cost of switching to the substitute is low

E. Rivalry among Existing Players

Rivalry among existing competitors takes many familiar forms, including price discounting, new product introductions, advertising campaigns, and service improvements. High rivalry limits the profitability of an industry. The intensity of rivalry is greatest if:

- Competitors are numerous and or are roughly equal in size and power
- Industry growth is slow leading to fights for market share
- Exit barriers are high. These barriers keep a company in the market even though they are earning low or negative returns
- Rivals are highly committed to the business and have aspirations of becoming leaders in the market

Porters 5 Forces Analysis for Emerging Countries (India)

Along with Porters Five Forces Framework, an analyst should also look at three qualifiers that are shaped by institutional context of an emerging country and in this case for India, which includes:

i) **Transaction costs**: The influence of transaction costs may be too significant to be ignored in a country like India. The institutional framework lacks the formal structure, enforcement and opacity of information due to existence of institutional voids.

This imposes high costs on firms unless they can device mechanisms to overcome them through personal ties. In addition, the absence of third party contract enforcement mechanisms or deficient Intellectual Property laws companies suffer from higher costs as compared to developed economies.

ii) **Capital flows** in and out are slow in emerging economies unlike the developed economies as financial, legal and regulatory institutions do not provide investors the opportunity to reduce the risks of loss of capital or wealth. Emerging countries like India are working towards developing institutions that promotes intellectual property
rights, information transparency, risk cushions via bankruptcy laws, and risk capital through venture capital

iii) **Legitimate norms of rivalry:** The third facet is the legitimacy of competition that is both nurtured and enforced. In emerging economies such as India, a state has to ensure economic bases of rivalry instead of unfair trade practices. In emerging economies laws pertaining to legitimate rivalry are still in developing stage and the informal norms may not be readily transparent. This may alter the nature of competitive rivalry in emerging economies.

Thus, a fundamental difference between emerging and market economies is the existence in the latter economies of ‘market-supporting’ formal institutions (Peng, 2003 World Bank, 2002).

### 3.3 Product Innovation and Technological Capability

Small Cap firms in India are playing catch up with their counterparts in developed countries (US or Japan). On one hand, the capabilities of firms may catch up with global industry leaders with respect to the technologies they use in production. This is what reflects Technological capability in emerging markets, defined as the capacity to select, absorb, assimilate, adapt, imitate and perhaps improve given (imported) technologies\textsuperscript{xxv}

To build up technology capability, a country needs to pursue a clear-cut technology policy defining the broad guidelines for technology development within the country.

India’s technology policy framework could be defined as a pre (before 1990s) & post reforms period. In the pre reforms period, Indian economy operated within a framework of an inward looking policy regime of protection and interventions. Prior to the 1990s, the main thrust of the R&D incentives was to generate indigenous technologies primarily in the institutional sector (public funded R&D institutions) and facilitate effective commercialisation, transfer and absorption of such technologies in the industrial sector.

In the post reforms era, from 1991, with the liberalisation of the Indian economy, restrictions on imports, FDI and technology transfer have been progressively removed. In the post reforms period, industrial productivity and technological capability in a more market driven (profit
maximising) framework have perhaps been given priority over indigenisation (import substitution) of technology and self-reliance. xxvi

There has also been a move to encourage collaborative R&D between industry and R&D laboratories. Industry captured the lion’s share of the incentives for R&D provided in 1990s compared to the earlier decade, when the majority of the incentives were directed to public R&D institutions. xxvii

This brings us to the important question of the role played by investors and entrepreneurs to support and promote the smaller firms and start-ups. The investors need to work closely with experts and entrepreneurs to better understand the product/services, and the business model. Analysts should be able to identify and discern the right companies for their investments by ascertaining their technological innovation capabilities.

Four Dimensions of Innovative Capabilities: xxviii

![Diagram of Four Dimensions of Innovative Capabilities]

*Figure 9: Four dimensions of innovative capabilities
Source: Paulo N Figueiredo-Innovation Management CIM (2013)*
The level of innovative activities in a company depends upon its technology capabilities defined in the form of:

1. **Human Capital:**
   - Formal and Informal qualifications
   - Tacit knowledge
   - Skills and Talent

2. **Physical Capital:**
   - Production systems, equipment, machinery
   - Database, software
   - Technical specifications
   - Blueprints and Packaged” Technology

3. **Organisation Capital:**
   - Organisational routines (“way of doing things”) procedures in the company
   - Management structures and techniques
   - Integration and coordination of expertise and specialised knowledge bases across functional areas and product lines
   - Institutional system (e.g. norms, beliefs, and values)

4. **Products and services of the company**

To conclude, an Indian small Cap’s technology capabilities include a stock of resources, which permit them to undertake production and differing degrees of innovation activity. Such capabilities both involve the nature of ‘human capital’ (i.e., specialist professionals, knowledge bases and skills/talents that are formally and informally allocated within specific organisational units, projects and teams) and ‘organizational’ aspects (the firm’s internal and external organizational arrangements such as their routines and procedures, linkages, and managerial systems) (Bell and Pavitt, 1993; Kim, 1997; Dutrénit, 2000; Teece, 2007).
3.4 Ownership and Corporate Governance (in India)

Indian Small cap firms predominantly are ‘Family Owned Businesses’; however, in the last few years we have seen very few professionally run companies outperforming as well. In India family-run businesses account for 95 per cent of all Indian companies (Varma, 2007).

Family Ownership and Control:
Since the mid-19th century the Indian business landscape has been dominated by entrepreneurial ventures. Some of these businesses have maintained their competitiveness despite changes in the Indian economy and have been passed on successfully from one generation to another. Research indicates that only a little more than 30 percent of family owned businesses survive the transition from founder to second generation leadership (Grassi Jr & Giarmarco, 2008) and just 15 per cent survive into the third generation (Vries, 1993). However, often these businesses have failed during the transition due to lack of preparedness of the incoming CEO.

To make such leadership transitions work, meticulous planning is required in these small and medium sized businesses. xxx It is important for an analyst to understand the formula (given below) of an Indian business and discern the governance structure of a company:

![THE FORMULA](image)

Figure 10: The formula
Evolution of Corporate Governance in India:

At the time of independence in 1947, India adopted a socialist way, characterized by a regime of central planning, permits, and quotas for industrial production. This regime continued with varying degrees of change, until finally in 1991 the government embarked on a major policy change. Successive democratic governments, under different political parties and coalitions, have continued down the path of economic liberalization, although with varying degrees of zeal. One important difference between advanced economies and India is that many of even the largest listed Indian companies are majority-owned or otherwise controlled by founding families (known as promoters in India). These characteristics of the Indian ownership model make it quite distinct from the developed model of widespread equity ownership. Earlier, in India, the promoters took actions that can hurt minority shareholders, such as by issuing preferential shares to the promoters or their relatives at a discount relative to market price or investing in or transacting with entities in which the promoters or their relatives have an interest. However, with the passing of the new company’s bill by the Indian parliament known as Companies Act, 2013 includes several new provisions rewritten extensively for investor protection, better corporate governance and corporate social responsibility.

The law is intended to separate ownership from management, and encourage companies to regulate themselves. The move is intended to separate ownership from management by defining the roles, duties and liabilities of promoters and directors.

The bill provides for class action suit, which is key weapon for individual shareholders to take collective action against errant companies. Better disclosure requirements in financial statements and disclosure of interests of directors. It has also streamlined procedures relating to disclosure of transactions with parties related to directors, promoters and others.

The new law will mandate the setting up of a National Financial Reporting Authority, which will monitor compliance with accounting and auditing standards. It will also have the power to investigate auditors that are registered under section 22 of the Chartered Accountants Act, 1949.

With increasing globalization of the Indian economy, the country’s accounting, auditing, and
governance standards are being harmonized with the international standards. Indian accounting and auditing standards are now aligned more closely than they were ten years ago with the standards issued by international standard-setting organizations, such as the International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC).

While Indian companies that access international capital and product markets may be keen to demonstrate their commitment to high standards and go beyond the requirements of Indian regulations on disclosure and governance, companies that operate largely in the domestic market may not feel these market pressures.

Parameters to Measure the Corporate Governance in India (Investor’s perspective):

![Diagram of corporate governance parameters]

**Figure 11: Parameters to measure corporate governance in India**
*Source: Corporate Governance in India: Investors’ Perspective Journal by JP Sharma and Mr G. Sachdeva (2011)*

**Regulatory Framework:**

Although, various laws have been enacted in India for protecting the interests of common investors, their enforceability is the great question. The regulatory authorities in India are not able to provide the effective regulatory environment for ensuring corporate governance.
Although, the regulatory environment provides the broad guidelines of governance within which the companies have to work.

**Corporate Practices:**

It is vital that companies conduct themselves in investor-friendly ways; however, in reality corporate practices are not very investor-friendly. The dissatisfaction is more evident with regard to aligning management interests with investors’ interests, the management is interested in their personal benefits and perks rather than taking care of the investors’ interests. At the same time, respondents are dissatisfied with the ethical issues of business, as the companies disclose minimum information required by law and sometime try to conceal important information.

The new Companies Bill Act 2013 addresses most of the above issues *(given in the chart)* and we should see a drastic change in enforcing the framework by the regulators and the companies following more investor friendly practices going forward. This would lead to the stock market functioning and the intermediaries being on the right track as well.
Therefore, an analyst should carefully discern the information provided by the companies and ensure corporates should take active steps for implementing the governance norms. The responsibility to implement the governance norms in spirit is on the part of those who are at the helm of affairs of the companies including independent directors and audit committee.

4 ANALYSING KEY FACTORS OF SUCCESS

The next step in our research is to demonstrate the outperformers in the small cap sector despite of high economic, financial, regulatory risks and sliding of the small cap index by 40% in the last few years. We will showcase these small cap outperformers (treasured jewels) and prove that despite high economic, financial, regulatory risks and the downward trend; if an analyst is ready to be committed, follow the fundamentals and the key factors of success explained in section 3, he will be able to succeed in the market with extraordinary results.
It is important for an analyst to identify these small cap firms, which are adhering to the key factors of success or are nearly there. No small cap company will be a perfect fit for an investment and there could be certain missing links in these potential companies. However, an analyst should be able to monitor and influence the decision-making to ensure these companies, follow the success path and do not get diverted. An analyst could pick out some high potential small cap companies, which have gaps (such as lack of transparency in corporate governance or diminutive dividend returns and others) in adhering to key factors of success; however, an analyst should work with the management to plug these holes thereby bringing these companies to the path of success.

Below is a small cap case study, which has seen a huge jump in its stock price in the last few years owing to the ‘key factors’ explained above under section 3:

Identifying Outperformers (small cap firm):

1. Plastiblends India Ltd (PIL):

   Plastiblends India Ltd. is India's largest manufacturer and exporter of compounds (masterbatches) that add colour and properties to plastic. Its compounds are used in the plastic processing industry to add colour and anti bacterial, anti rodent, flame retardant properties to plastic products. Plastiblends is headquartered in Mumbai, India, with its manufacturing and product development located in Daman (Western India) and Roorkee Uttarakhand (Northern India).

   Plastiblends offers over 800 varieties of compounds to suit the customized requirements of user industries including Agri, Appliance, Automotive and Transportation, Electrical, Telecommunication, healthcare and Pharma, Packaging, and Textiles. With over 50% share in the organized market and about 14% share in the overall plastic master batches and compounds market, Plastiblends is the most significant player in India in this space. Growth in the user industries is expected to accelerate going forward as sectors like telecom, pharma, textile and retailing to add capacities.
As you can see, the stock price sky-rocketed (a growth of 150% ) from the low of Indian Rupees (INR) 60 in 2013 to INR 150s in mid 2014 despite the BSE small cap index being 40% down from its peak levels in mid 2014 and with little presence from institutional investors.

**Analysis of Key Factors:**

**A. Ownership and Corporate Governance:**

Mr S V Kabra who is the Chairman and Managing Director is the promoter of the company. PIL is a family owned business with 62% of holding with the Kabra Family, 35% with Indian Public, & Public Corporate Bodies, and only 3 % with Foreign financial institutions & other Institutional Investors. The second generation of the family is on its way up as Anand S Kabra has succeeded the Chairman and MD Shreevallabh G Kabra in late 2013 as the new CEO. Anand Kabra has worked in the company for more than a decade before moving into the top position.

**Category of Shareholders as on 31st March, 2014**

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Category</th>
<th>Number of Shares</th>
<th>% of Shareholding</th>
<th>Number of Shareholders</th>
<th>% of Shareholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Promoters</td>
<td>8016074</td>
<td>61.60</td>
<td>9</td>
<td>0.13</td>
</tr>
<tr>
<td>2.</td>
<td>Banks &amp; Mutual Funds</td>
<td>4200</td>
<td>0.03</td>
<td>2</td>
<td>0.03</td>
</tr>
<tr>
<td>3.</td>
<td>Private Corporate Bodies</td>
<td>370462</td>
<td>2.85</td>
<td>111</td>
<td>1.68</td>
</tr>
<tr>
<td>4.</td>
<td>NRIs &amp; FFI</td>
<td>477796</td>
<td>3.68</td>
<td>70</td>
<td>1.06</td>
</tr>
<tr>
<td>5.</td>
<td>Indian Public &amp; Others</td>
<td>4126068</td>
<td>31.75</td>
<td>6402</td>
<td>97.10</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>12994800</strong></td>
<td><strong>100.00</strong></td>
<td><strong>6594</strong></td>
<td><strong>100.00</strong></td>
<td></td>
</tr>
</tbody>
</table>

*Table 1: Category of Shareholders
Source: Bombay Stock Exchange Website*
The Kabra family has always stuck to its core business of masterbatch/polymers business and have not ventures into unrelated areas since the inception in 1991, which shows their commitment to the company and industry overall. They have slowly built their way up into the top position in the Indian market and have steadily increased their capacities and exports as well. The management expertise and their long linkage with the plastic industry have always been an added advantage for the company.

The structure development of the company is in place as given below:

1. **Institutionalization**: Family business control with the existence of Foreign financial institutions, board of directors, Non-executive members and executive committees proves that the company is well institutionalised

2. **Family Business Differentiation and Succession**: The work between the promoters of the company is defined with adequate control and accountability (60% family ownership) and the succession plan in place. The CEO and Executive Director of the company Anand S Kabra has succeeded the Chairman and MD Shreevallabh G Kabra

3. **Management Practices and Communication**: Internal Audit Team consists of well experienced members, which constantly review various aspects of control systems and conduct audit under well laid down audit programmes to ensure effectiveness of the controls.

Further, the management and the promoters (the Kabra family, which has been in the business of plastics for decades) have ever diverted into unrelated territories and nor does it have any plans to look beyond its circle of competence.

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Director's Name</th>
<th>Designation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Mr. Shreevallabh G Kabra</td>
<td>Chairman &amp; Managing Director</td>
</tr>
<tr>
<td>2</td>
<td>Mr. Shri Anand S Kabra</td>
<td>Executive Director &amp; CEO</td>
</tr>
<tr>
<td>3</td>
<td>Mr. Haridas S Sanwal</td>
<td>Independent Director</td>
</tr>
<tr>
<td>4</td>
<td>Mr. Sudarshan K Parab</td>
<td>Independent Director</td>
</tr>
<tr>
<td>5</td>
<td>Dr. Yatish B Vasudeo</td>
<td>Independent Director</td>
</tr>
<tr>
<td>6</td>
<td>Mr. Pushp Raj Singhvi</td>
<td>Independent Director</td>
</tr>
<tr>
<td>7</td>
<td>Mr. Satyanarayan G Kabra</td>
<td>Vice Chairman &amp; Mng.Director</td>
</tr>
</tbody>
</table>

*Table 2: directors*

*Source: Bombay Stock Exchange Website*
Corporate Governance:
Further PIL separates ownership from management, and created a Shareholders Grievance Committee including Independent Directors to look into redressing of Shareholders’ and Investors’ Complaints. The move is intended to separate ownership from management by defining the roles, duties and liabilities of promoters and directors.

B. Earning Power and Dividend return:

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>Financials and Key Ratios</th>
<th>Mar-14</th>
<th>Mar-13</th>
<th>Mar-12</th>
<th>Mar-11</th>
<th>Mar-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Revenues</td>
<td>455.84</td>
<td>408.99</td>
<td>341.12</td>
<td>276.93</td>
<td>210.29</td>
</tr>
<tr>
<td>2</td>
<td>Operating Profit</td>
<td>47.22</td>
<td>32.44</td>
<td>32.17</td>
<td>28.93</td>
<td>19.5</td>
</tr>
<tr>
<td>3</td>
<td>Net Profit</td>
<td>27.24</td>
<td>15.36</td>
<td>16.71</td>
<td>18.12</td>
<td>10.43</td>
</tr>
<tr>
<td>4</td>
<td>Net Profit Margin (%)</td>
<td>5.8</td>
<td>3.75</td>
<td>4.89</td>
<td>6.53</td>
<td>4.95</td>
</tr>
<tr>
<td>5</td>
<td>Net Cash From Operating Activities</td>
<td>37.19</td>
<td>4.1</td>
<td>10.59</td>
<td>12.67</td>
<td>1.04</td>
</tr>
<tr>
<td>6</td>
<td>Operating Cash Flows Ratio</td>
<td>0.79</td>
<td>0.13</td>
<td>0.33</td>
<td>0.44</td>
<td>0.05</td>
</tr>
<tr>
<td>7</td>
<td>Net Working Capital Ratio</td>
<td>2.25</td>
<td>2.69</td>
<td>3.06</td>
<td>2.93</td>
<td>2.28</td>
</tr>
<tr>
<td>8</td>
<td>Current Assets</td>
<td>179.86</td>
<td>167.15</td>
<td>134.85</td>
<td>121.39</td>
<td>69.98</td>
</tr>
<tr>
<td>9</td>
<td>Current Liabilities</td>
<td>80.02</td>
<td>62.03</td>
<td>44.44</td>
<td>41.41</td>
<td>30.7</td>
</tr>
<tr>
<td>10</td>
<td>Debt to Equity Ratio</td>
<td>0.22</td>
<td>0.48</td>
<td>0.46</td>
<td>0.49</td>
<td>0.26</td>
</tr>
<tr>
<td>11</td>
<td>Return on Equity (%)</td>
<td>21%</td>
<td>14%</td>
<td>17%</td>
<td>20%</td>
<td>25%</td>
</tr>
</tbody>
</table>

Table 3: Plastiblends India Limited Standalone Result in Indian Rupees (\textdollar in Rs Crores)
Note: 1 crore = 10 million; $1 = Rs 60 (Source: www.moneycontrol.com)

From the above chart, we could see a strong performance in the revenues and operating profits over the last few years. At the same time ‘net profit margin’ has seen an increase in the last couple of years.

The ratios to look out for here are the Operating Cash Flows ratio (no. 6), which has seen an increase of 200% and the Debt to Equity ratio (no. 10) has seen a decrease of 60% as compared to the average of last 4 years.
Significant improvement in working capital management:

PILs business is highly working capital intensive. As such, effective working capital management is extremely important to ensure viable operations in the long term. To ensure this, the company has implemented SAP system in FY14 and it seems to have made significant improvement in the inventory management.

The company's inventory days have come down from 60 days in FY 11 to 46 days in FY14. During the same period, the payable days have gone up from 14 days to 22 days. As a result, despite the growth , its short term debt (used to fund working capital and day to day operations) has come down significantly , by around 66% in FY14, bringing down its Debt to Equity ratio to 0.2 times in FY14 from 0.5 times in FY13. This is indeed a major development in the favour of the company.

Dividend Return:

PIL has been exceptional for a small cap in India paying out extraordinary dividends to its shareholders over a period. PIL has increased its dividend to 100% in FY 2014 from 70% in FY-13 and FY-12. PIL has consistently paid dividends in the past with payout ratio varying from 24% to 39% (current dividend yield at 2.9%) and is likely to do so in future as well.
To ascertain the liquidating value for PIL, we take all the current and fixed assets at the book value other than Inventory, which is taken at a 50% discount of the book value.

This is because when you sell the inventory in the market, typically it will realise 50% of the book value. Similarly, PPE (Plant, Property Equipment) need to be looked into carefully and its market price should be ascertained as a fair value. In this specific case, we have taken PPE as a book value.

The market cap of PIL in March 2013 was Rs 60*12994600 shares = Rs 77,96,76,000 (USD 12 Million). The estimated liquidating value of PIL was Rs 143,90,00,000 (USD 23 Million) almost double of the market cap in 2013 implying that PIL stock was a good buy and selling cheap in the year 2013.

C. Business Sales and Industry Growth

Industry Growth Potential for Plastics and Masterbatches:

Environmentalists would like us to believe that the use of plastics is on a decline; and the use of polymers has health hazards; however, longevity, and cost effectiveness of plastic is so high that industries ranging from agriculture to telecom to healthcare to textiles consider it indispensable.
In fact even for a process like drip irrigation, there is no other viable substitute for plastic pipes. Hence, we have enough reason to believe that the industrial usage of high quality plastic is far from getting substituted. There will be increasing demand towards packaged products, retail, consumer durables, Automobiles. With growing consumption of polymers, the Masterbatch Industry will be a direct beneficiary and the outlook is very good for Masterbatch Industry.

![Masterbatch](image)

**Figure 15: Masterbatch**  
*Source: PIL Annual Report*

As we can see with the above chart survey done by plastindia foundation, the increase in demand forecast for Masterbatch (additives) is close to 60% in the next 4 years.

The development of anti-statics, flame retardant, anti-microbial Masterbatches demand is set to boost substantially across various end user industries.

**Masterbatch - Growth drivers include:**

- New specific applications like cling film, anti bacterial film
- Foaming agents and by demand of high speed extrusion
- Growth in consumption of LL film, milk film
- Higher consumption of Black Masterbatch in Pipe
- Increased usage in Molding sector
- Boom in raffia market
Porters 5 Analysis for PIL:

- **Rivalry among Existing Players:**
  PIL with close to 60% share in the organized market and about 14% share in the overall plastic masterbatches and compounds market, it is the most significant player in India in this space. The second largest player and its key competitor, Poddar Pigments has less than 20% of Plastiblends’ capacity.

  At the same time, there is a threat of competition from the unorganized segments. However, Plastiblends with significant economies of scale, robust balance sheet and focus on high margin products and exports is well geared to meet this challenge. Though, the unorganized segment dominates around 75% of the industry, the small players have hardly any bargaining power.

- **Threat of Substitutes:**
  Currently there is little or no substitute for Masterbatches and additives and Plastiblends offers over 800 varieties of compounds to suit the customized requirements of user industries. Plastiblends that counts Reliance Industries, Supreme Industries amongst its key customers is expected to stand out because of the quality and customization of its products.

  Also, with no substitute of plastics in the near future for certain industries, Masterbatches and additives industry looks encouraging and positive.

- **Bargaining Power of Suppliers:**
  The raw material prices (50% share of polymers) are linked to crude oil prices over which company has little control. This leads to volatile input costs as there is no substitute to what supplier group provides.

- **Bargaining Power of Buyers:**
  Plastiblends is the market leader in masterbatch manufacturing business and is operating at a capacity utilization of around 75%. The company has been consistently increasing its production capacity and marketing agency network in India and abroad. The company has increased its market share from 8% to 14% in a period of 3 years in the total domestic masterbatch manufacturing industry and claims around 60% market share in the organized domestic market. Its key competitor, Poddar Pigments, is not even one fifth of its size.
As India remains relatively underpenetrated market with regards to plastic and polymer consumption, and with huge demand growth expected from across industries, PIL is well placed to ride on this demand.\textsuperscript{xl}

\begin{itemize}
  \item \textbf{Threat of New Entrants:}
  
PIL has its current capacity at 75,000 tonnes per annum and plans to increase it by around 2 to 3 times over next five years to meet the potential demand growth. Economies of scale, differentiation of the product, Incumbency advantages, and greater access to Distribution Channels leaves PIL in a very strong position and Entry to barriers for new entrants.
\end{itemize}

\textbf{D. Product Innovation and Technological Capability}

Plastiblends, being a market leader in the organized masterbatch business (to add colour and other properties to plastic) is set to ride on the high demand growth. In house Research and Development, strong distribution network, growing presence in international markets and value added products further make it stand apart. Plastiblends offers over 800 varieties of compounds to suit the customized requirements of user industries. The business is not very technology intensive; however, PIL has its focus on new product development supported by dedicated R&D Facility recognized by the Department of Scientific and Industrial Research (DSIR).\textsuperscript{xli}

\textbf{Conclusion}: Plastiblends India Ltd. is a growth stock and an investment in FY 13 would have resulted in a gain of 150\%, which is phenomenal as compared to many Blue chip firms and other safe havens.

PIL has been able to maintain its leadership position by managing well its financial risks including working capital & short term debt; adoption of new technology, meeting the customers’ high expectations, consistent quality and after sales service. At the same time, since they are leaders in their segment, they have a market control and with a base of more than 2,500 customers, there is no excessive dependence on any single customer.

The huge capacity and R&D helps them in achieving economies of scale and keeping their competitors at bay especially the unorganised sector in India. One of the recommendations in the near future could be acquisitions within India or globally, which will help them consolidate their market share further.
5 ADVANTAGES OF INVESTING IN INDIAN SMALL CAP SECTOR

There are many advantages investing in Indian small cap sector and with proper research and effort, a prudent investor could make phenomenal returns. Small cap sector has a huge growth potential as compared to large cap companies; however is a risky proposition.

Many of the small cap stocks are under recognised and are off the radar because of which their growth is stagnant. These small cap sectors offer phenomenal returns and are available at low prices; however, investors are reluctant, as these stocks could prove volatile. There are couple of examples below of such unrecognised small cap stocks:

- If you had invested Rs 100,000 in Crompton Greaves on 1 January 2002, your money would have grown to Rs 1,000,000 by now. A growth of 10,000% in 12 years.
  
  Back then, Crompton Greaves was a small capital goods company with a market capitalization, or market cap, of Rs 115 crore and a stock price of Rs 1.80 and the stock trading at 194 Current Market cap of Crompton Greaves is Rs.12000+ crore.

(Please note that 10 million is equal to 1 crore. $1=60 Indian Rupees)

- On 2 January 2002, Sesa Goa had a market cap of Rs 99 crore and its stock was at Rs 1.28. On 28 November 2011, the stock was trading at Rs 277 and the company’s market cap is currently Rs 82,000+ crore plus. A growth of 18,000% in 12 years.xlii

To achieve extraordinary success rate, it is vital for an analyst to follow the principles of value investing (given below) along with key factors of success explained in section 3.

Principles of Value investing whilst investing in Indian Small Caps:

1. Companies Have Intrinsic Value (Liquidation Value):

Intrinsic value is the actual value of a stock price as compared to the market price listed on the stock exchange. An analyst should discern the actual value of the stock price and not get carried away with the hype or the trend prevailing in the market. The liquidation value as explained earlier gives a sense to an analyst of the actual value if the company is liquidated as compared to the prevailing prices. If the actual value of the stock is less than the liquidation value it implies that the stock is available at a bargain and selling cheap.
2. **Always Have a Margin of Safety:**
   Buying stocks at bargains gives an analyst a margin of safety in case to earn best returns and minimize investment downside. The principle of ‘margin of safety’ validates the discounted price at which the stock is selling below its intrinsic value and Liquidation value.

3. **Be a Contrarian:**
   Value investors don’t follow the herd and are contrarians when it comes to investing. At a time when Small Cap companies are getting beaten down in Indian markets, there are huge opportunities emerging in this space to create wealth.

4. **Diligence and Patience:**
   Value Investing is a long-term strategy and not an instant gratification. A value investor needs to be patient and diligent and stick to it investment philosophy over a period.

5. **You should be open to revisiting:** Following up on the last proposition, it stands to reason that the choices you make in valuing today will not be the choices that you will make tomorrow or a week from now. So, keep the door open for changes not just at the margins but in your central narrative. (A. Damodaran)

6 **CONCLUSION**

Though having some minor hiccups, India is a compelling investment opportunity with the economy expected to grow at 6%-8% per year over the next 5 years reaching $4 trillion economy and lot of undiscovered Small Caps companies with the highest quality management teams and regulatory environment within emerging countries. (Mckenzie & Co. Report – A Compelling Global Resource)

Small cap industry in India is been overlooked and Investors need to discern the right stocks, and nurture those companies to achieve exceptional results. Institutional investors should become the decision influencers and guide the Indian family owned businesses towards growth, expansion, and transparency. Investors must analyse the key factors affecting the Indian small cap sector and adhere to investment principles best suited to their investment philosophy.
Irrespective of how an economy plays, an investor should choose a stock at a bargain, have a margin of safety, and be a contrarian, not following the herd mentality.

Small cap companies do work in India and as we can see from the above few examples in section 5 of how small businesses have seen a huge creation of wealth in the last 10 years. Investors need to play an important role of identifying more such small caps and influencing the decision-making leading to a big success. An investor must study the industry trends, competition landscape, growth prospects of a company including technological capabilities before investing in it. At the same time, an analyst must be patient, diligent, and committed when it comes to investing in small cap sector in India.

On the other hand, entrepreneurs and owners of small cap firms need to draw equity investors into their firms and not to burden themselves with high debt. They should ensure stability and a robust corporate governance structure in place creating further transparency and protecting the investors from any misdeeds. Small cap firms in India need to invest more in technology and product innovation whilst competing with Indian and Global companies. Family owned businesses should separate ownership and management and have a professional approach whilst taking business decisions and sketching succession plans. This would lead to not only attracting risk capital; however, also generate better net margins, cash flows, and building a firm for the future.

The government, private institutes, banks, investors, networks, and entrepreneurs need to work ever so closely to ensure increasing number of small cap firms in India flourish. The government and central bank of India should also play a vital role in changing the Indian bankruptcy laws as the process is lengthy with poor enforcement mechanism leading to great impact on the economy, credit processes, rates of interest and credibility of companies. Earlier, bankruptcy laws in India did not focus on revival of a business.

However, the new company act 2013 looks into the bankruptcy laws and providing the debtor with various mechanisms to restructure and revive its business, be it acquiring finance on favorable terms or providing a stay on litigation. Still lot needs to be done and the reserve bank of India should play an important role in coming out with new laws and codes for bankruptcy.
Overall, this paper is a reflection on Indian small cap sector and the need for institutional investors to recognize the true potential of some of the small cap stocks in India. The need of the hour is both for the institutional investors and the entrepreneurs to work together & collaborate, producing phenomenal results for the country, industry, smaller investors and alas for themselves. This will ensure survival and turnaround of more number of small cap firms into mid to large cap firms in years to come.
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