Performance of midcap companies typically tend to outperform when the market cycle turns up. We have seen a repetition of this trend during 2007, 2009, 2012, 2014 and in 2017 too. During 2019, two distinct trends was seen before and after the corporate tax cut of Sep-19. While midcaps significantly underperformed during pre-tax cut period, it matched the performance of largercap during the post-tax cut period. During 2020 so far, midcaps have outperformed the large cap.

Underlying this performance variation, however, is the variation in fundamentals that are distinctly more volatile for the midcaps. The significant underperformance of midcap during 2015 and 2017-2018 period can be traced back to their waning fundamentals during the prior period. The projected EPS growth of midcaps during the period 2020 to 2022 is however, expected to exceed that of large cap by a significant margin. This augurs well for midcap outperformance for the coming period.

The valuations of the midcap companies have corrected significantly and now at par with large cap reflecting the near convergence of 1yr forward P/E of the two. However, since historically, midcaps have enjoyed a higher valuation, on long-term P/E multiple band, they provide higher margin of safety now. As opposed to large caps ruling near the top quartile of their 10yr valuation band, midcaps are well within their second quartile.

Reflecting the above we have seen a higher flow of funds toward midcaps vis-à-vis large caps. The net investment by MFs of dedicated midcap funds are now higher than large cap only funds. There are indeed possibilities that a higher allocation to midcaps by other such fund categories including multcaps and by other set of institutional investors.

All these factors augur well for midcaps for the coming period. Investments in midcaps, however, are subject to usual risks. First as highlighted above, they tend to be more volatile. Second, they have shown some weakness in their balance sheet which is expected to improve at the margin in the coming 2-3 years. However, economic upturn is likely to result in more discernible improvement in these fundamentals, perhaps explaining their outperformance during such periods in the past.

**Figure 1:** Midcaps tend to outperform during upcycles and underperform during downcycles

**Figure 2:** Midcaps outperforming large caps during 2020 after becoming even post tax-cuts

Sources: Bloomberg, ASKWA Research.
I. Medium term fundamentals stacked better for midcaps now

Similar to market performance, the corporate fundamentals too appear to be more volatile for midcap than large cap. Midcaps witnessed a very sharp upturn in revenue growth during the period FY17 explaining their outperformance during this period too. Subsequently, their topline growth plunged into negative territory during the quarters between Sep-17 to Jun-18 and expectedly it reflected in stock price under-performance albeit with a lag. As is seen the revenue growth since then has reverted back to positive territory and now a tad higher than large cap.

A similar but double dip collapse in earnings expectation is seen in midcap first during FY16 and then again during FY18. However, earnings expectations for midcap are now well ahead of large cap in the medium term improving the prospects of stock performance. This too found its reflections in the performance of midcap stocks.

Figure 3: The sharp variability in revenue growth of midcaps have affected their performance

Figure 4: Earnings prospects of midcaps far outweigh that of large cap in the medium term

Sources: Bloomberg, ASKWA Research.

II. The valuation for midcaps has corrected significantly and now lower based on long-term P/E

Historically midcaps have enjoyed a higher valuation as long-term performance is superior albeit with higher volatility. With the benefit of hindsight, it is clear now that the valuations of mid-cap corrected during 2017 to 2018 period corrected on account of flagging fundamentals. However, valuations have now come down closer to their large cap peers and as highlighted above fundamentals for midcap is slated to run ahead of the large cap now.

Moreover, if a long-term perspective is adopted on the valuation aspect, midcaps are indeed cheaper. Compared to the valuation bands within which midcaps have rallied in the last decade, present valuation is at the second quartile of long-term trend while the large cap is near about the first quartile of high valuations. This accords greater margin of safety for the midcaps in comparison with large cap once again.
Why midcaps may outperform

Figure 5: Valuations have converged now on a forward basis between large cap and midcap

Sources: Bloomberg, ASKWA Research.

Figure 6: As the forward EPS estimate has converged too

Figure 7: Nifty is near about the top quartile of its long term P/E multiple bands

Source: Bloomberg, ASKWA Research.

Figure 8: While midcaps are still well within second quartile of long term P/E multiple bands

Source: Bloomberg, ASKWA Research
III. Mutual funds’ incremental flows to midcaps rising

The latest trend indicate the flow of MF investment to midcaps have increased somewhat. Tracking the fund flow from the ACE database for 20 mid-cap funds vs. 20 front ranking large cap only funds, we get the evidence that allocation for midcap has increased off late. This is ignoring the possible higher allocation that midcap stock within a multicap or large & midcap funds might have received. As the performance has improved too, AUMs of midcap funds are now growing at a higher rate than their large cap counterparts.

Figure 9: The top-20 midcap MF schemes now outweigh the flows received by top-20 large cap funds

Figure 10: Together with better performance, AUM growth of midcaps are now higher

Sources: ACE-MF, ASKWA Research.

IV. Volatility and indebtedness

It is, however, pertinent to note that midcaps display higher volatility in performance and their outperformance is demonstrated only over longer period. As seen earlier, variation in fundamentals across time itself can explain this to a large extent. Lower liquidity and insipid corporate governance standards too are factors that affected a few of them which led to higher volatility. Indebtedness for midcap companies are on the higher side although at present it is expected to improve in the medium term.

Figure 11: Volatility is much higher for midcap than the large cap

Figure 12: Although slated to improve, midcap companies have much higher indebtedness

Sources: CMIE, ASKWA Research.
V. Investment portfolios to play on the key investment themes:

Our top recommendations on the midcap space at present include the following.

i) ASK Emerging Opportunities Portfolio

ii) Invesco R.I.S.E PMS

iii) Axis Midcap Fund,

iv) Kotak Emerging Equity Fund,

v) Mirae Asset Midcap Fund:
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**Why midcaps may outperform**

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