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Mid-cap rally in India

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The Indian stock market has been bustling with activity in the past few weeks. Surprisingly, the excitement seems to be more in the mid-cap segment (shares of medium-sized companies) whose average returns far exceeded those of other stocks.

The scorching pace set by Indian mid-cap stocks has left global peers far behind. With a massive 27.81% gain in the June-September period, the Indian CNX Midcap 200 has outperformed its ilk in the United States, Europe, Japan and Australia by a wide margin. The only other such index that has just about managed to cross the double-digit mark in terms of percentage gains is the Australian one, with a gain of a little over 11% during the same period. The Brussels and Barcelona indices rose by 7.94% and 5.55%. In the US, while frontline stocks have rallied in the last few weeks, the mid-cap index has been very subdued. In France, mid-caps just about managed to stay afloat while those in Japan yielded negative returns.

But is this rally purely technical or has it been driven by fundamentals? It's a mix of both. Evidence does point to the emergence of strong fundamentals, apart from some technical reasons. The capital market and the regulatory environment In India have seen a lot of changes over the past few years. With the liberalization policies set rolling in the 1990s, competitive pressures have increased and tariff protection has come down over the years. The result: a more efficient system with a reduced risk of systemic failure and a far more stable macro-economic environment.

With continuing reforms and high economic growth, a variety of opportunities have opened up for Indian companies. There are several reasons behind the rush for mid-caps. The winners in the mid-cap segment are set to evolve into large-caps in the years to come and thus create long-term wealth. According to a study by Cholamandalam mutual fund, of the top 50 stocks in terms of market capitalization, as many as 20 were mid-caps seven oreight years ago. This is a natural process of evolution of companies in a dynamic and fast-growing economy like India's.

Proving wrong the fear that Indian companies would be washed away in the flood of global competition following reforms, many mid-cap companies have actually emerged much stronger. And, seem to be on pretty strong footing, with the Indian economy poised for a 6%-plus growth rate in the years to come. There are also enough reason to expect a surge in domestic demand. These are:

- Young population. With only 17.4% of India's population above 45, India is among the youngest nations in the world
- Distinct change in the Indian family structure, from the joint to nuclear family systems. This entails a larger number of consuming household units
- With the increasing importance of the service sector in India's gross domestic product (GDP), the total number of households with a higher propensity to spend has been increasing rapidly
- Steadily decreasing domestic interest rates and increasing focus on retail lending by banks and financial institutions, which have fuelled higher consumer spending

According to DSP Merrill Lynch, India has the potential of doubling her GDP to $1 trillion by 2010, backed by strong domestic demand. This is expected to lead to the creation of a million jobs per year. Many of the mid-cap companies are well poised to take advantage of this likely change in the domestic scenario.

Fundamentals apart, the mid-cap rally is also fueled by technical factors. Historically, mid-cap companies have a higher return profile than large-cap companies. Being neither small nor large, mid-cap firms have attractive risk/return profiles. Again, the mid-cap segment offers a variety of stocks. There is a large and diverse group of companies to choose from among the mid-cap universe of stocks, which enables investors to create a well-diversified portfolio. Unlike large-caps, many of these companies are under-researched and provide opportunities for being identified as undervalued companies.

Mid-cap stocks that are relatively "under-owned", or owned by fewer people and less talked about, give much higher returns than "over-owned" stocks. If a stock is under-owned, it is chased by fewer people and thus sells low. Over-owned stocks, on the other hand, are the ones everybody wants, most often overvalued and offer little upside as there are too many sellers at every price rise.

Foreign institutional investors have also contributed largely to the demand for mid-caps. The FII stake in the top 50 stocks in terms of market capitalization has already crossed 20%, leaving little room for them to buy large-caps. As a result, they are increasingly investing in mid-cap stocks. Currently, 20% of the incremental foreign institutional flows come into mid-caps, compared to about 5% about three years ago.

As mid-cap stocks surge, the future return potential gets capped. Moreover, as increasing demand makes the mid-cap companies increase their capacity utilization, the need for further capacity expansion will affect their margin in the future. But for the time being, the story still looks good.

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