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Invest in the early signs

Midcaps of today have the opportunity and ability to grow!

Today, there are number of exciting early signs of growth across sectors to justify optimism on long term prospects in the midcaps space. Be it private sector capex numbers or export momentum across specialty chemicals, Pharma API, Mobile manufacturing, textile, Aquaculture – there's a lot that's happening in the midcaps space, throwing up significant wealth creation opportunities.

Economic upcycle and growth story

Over the longer term, the returns generated by any index is dependent on the performance of their underlying constituents. How the businesses are growing and expect to grow in future has far larger impact on the performance of indices than any other factor. We remain very constructive on the growth story of our country in the coming years and its corresponding impact on the corporate earnings growth. We believe we are at the cusp of an economic upcycle and midcaps of today are very well positioned to take advantage of this growth opportunity. Current consensus estimate point toward the same and are building in strong growth in midcap earnings over the next two years. Considering our outlook on the economy, we believe this is the most opportune time for mid caps.

Valuations

While we remain cognizant of valuations, we don't believe they are a cause of any worry at the moment. One needs to look at valuations in conjunction with the growth a business is witnessing. Corporate earnings have grown at single digit growth rate annually over the last decade and the valuations over the last decade was based on this relatively low growth rate scenario. However, the current consensus estimates point to a strong earnings growth for midcap companies. In addition, the cost of capital currently is close to a decadal low. The current valuation in the market reflect this higher growth expectation and low cost of capital scenario.

Themes and opportunities across the spectrum

There are many signs that are making us positive currently. FY21 was first year of robust corporate earnings growth, after almost a decade of single digit growth. On the manufacturing side, capex to GDP ratio increased to ~2.3 in FY21 and expected to reach ~2.5% in FY22 after being about 1.6-1.8% for the last 7-8 years. We are seeing positive momentum on exports also. We saw highest ever exports from India in the first quarter of current fiscal. These early signs are making us positive on the strength of the growth going forward.

We are seeing opportunities across the spectrum and are positive on quite a few themes that we believe will play out in the coming years. One big theme that we are positive on is that of exports. Global growth momentum has been on an upswing. As the growth picks up so does demand for goods and services. This strong global growth coupled with diversification of global supply chains where global customers are trying to reduce their dependence on one country, is providing a strong growth opportunity for Indian corporates. Supported by these tailwinds, we expect exports to grow at rapid pace in coming years.

We are seeing opportunities emerging in various sectors such as specialty chemicals, Pharma API, Mobile manufacturing, textile, Aquaculture amongst others which is leading to our positive view on this theme. Another such theme is make in India. Government of India has come out with a lot of incentives in the form of PLIs to promote domestic manufacturing. These incentives are making Indian businesses a lot more cost competitive allowing them to compete with cheaper imports as well as making them competitive in global trade. It's a long term opportunity available to domestic corporates and we believe they have a long runway of growth in front of them driving our positive stance.

Midcap opportunities

Midcap stocks offer more diversified universe for Investment than large cap. We believe there are opportunities available across many sectors that find little space in large cap indices. To that extent we have an opportunity to invest into more diversified themes vis-à-vis large caps. Many of these additional sectors have a very large opportunity size which many midcaps companies are taking advantage of and continue to grow at a rapid pace. We are excited by this opportunity and definitely see midcap companies being big gainers there.

We believe many midcaps of today have the opportunity and ability to grow at a rapid pace and become large caps of tomorrow. They are on a journey to become much larger players in their respective segments as long as they execute well and capture the opportunity that the strong economic growth cycle is providing. Typically, maximum returns are generated when investment period coincides with the evolution of the business till it becomes stable. Since, the time period for the stability of businesses should come in 5-7 years, an investment horizon should also have the same time frame.

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