



Stop Monitor Explore

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Small words make up our most powerful thoughts. Small things grow and are more efficient over time. Corporate history is replete with examples where a diminutive company, with far fewer resources, changed the game and put larger, established businesses to shame. Hence, the timeless adage: small is beautiful.

And when it comes to the stock market, small stocks can generate giant rewards. In just the last one year, the average return of smaller stocks is more than twice that of large stocks. This is why a steady stream of adventurous investors are wading into India's stock market in a bid to uncover outsized returns from tiny firms.

Welcome to the brave new world of SME (small and medium-sized enterprises) platforms on the BSE and the NSE. Names you have probably never heard do IPOs, and boy, have they given prominent companies a run for their money when it comes to delivering stock returns!

But merely talking about India's SME stocks and their supernormal returns will sound like spiels by a sharp-suited Jordan Belfort aka The Wolf of Wall Street. It is time to take a step back and quell the adrenaline coursing through your veins if you were thinking of having a go at SME stocks on Monday. The devil is in the detail, as they say. Here are 3 things you must know before you bet big on SME stocks.

Runt of the litter

In the corporate hierarchy, SMEs are the smallest. Given their humble size, they do have the capacity to grow their earnings faster than their larger peers but the possibility of a harder knock during slowdowns stares you in the face.

terms of m-cap it would still rank as the 182nd company. The SMEs have total annual sales of ₹26,000 crore in the last reported year but cumulative profit of less than ₹280 crore, which is less than what Infosys made per week in FY2021.

Agreed, a Covid-impacted year depressed profits from ₹330 odd crore in the year before, but indebtedness increased from ₹6,000 crore to ₹6,500 crore too. About 90 per cent of listed SMEs serviced some form of debt, which means a tough year can be brutal, especially when about one in four companies made losses. Financial cushion in SMEs is thin, so to speak.



Scan & Share

As a whole, average profit margins of SME stocks are paltry, at 1 per cent for the last reported year compared to 10 per cent for large-cap companies, 5 per cent for mid-cap companies and 3.4 per cent for small-cap companies represented in the BSE AllCap index. This indicates lack of scale and business models that are yet to reach critical mass for SMEs.

Similarly, Return on Capital Employed (ROCE) for SME stocks is 8.5 per cent and Return on Net Worth (RONW) is 6.5 per cent. This fares poorly against 12-16 per cent average ROCE for large, mid and small-cap stocks and their average RONW ranging between 11 per cent and 16 per cent.

Do note, most listed SME stocks are not in high-tech or unique businesses. In fact, they are often engaged in commonly found businesses areas where there are already entrenched players with deep pockets. About half a dozen each are in cables, chemicals, auto ancillaries, logistics, hotels, packaging, steel, etc. There are a dozen each in entertainment, food, FMCG, healthcare & pharma, plastics, electric equipment. Two dozen each are in finance and IT-Software. Trading has over 50 SMEs, 'Miscellaneous' accounts for nearly 40 firms and about 20

Given that SME stocks are high-risk bets due to smaller size, do proper research before adding them to your portfolio

SME stocks are seeing increased traffic right now. Here's a reality check for investors wanting to hit the road

Cap to Sales, etc., to get a broad idea of how SME stocks stand vis a vis bigger peers. For instance, Kwaliti Pharma trades at a trailing PE of 55 times in line with much larger peers such as Divi's, Gland Pharma, GSK Pharma, Abbott India, Natco, etc. Brokerage East India Securities, at a trailing PE of 7 times, trades at a discount to the 19-20 times PE of ICICI Securities and Angel One.

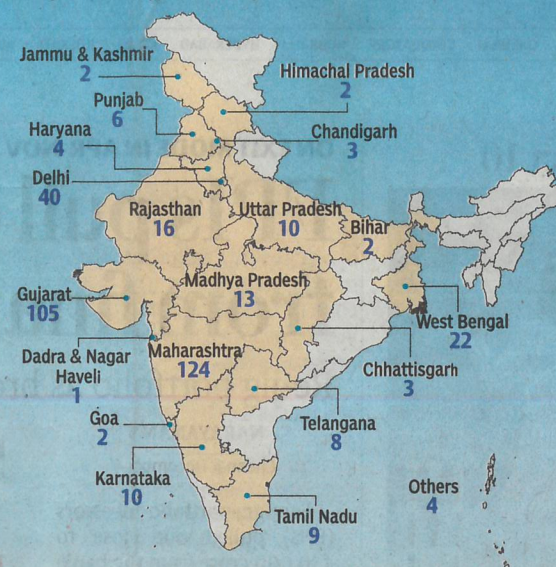
In many high-valuation stocks such as those of MNC companies, there is some sort of protection during downturns. We have historically witnessed this phenomenon playing out during various crashes. But this trend doesn't appear in SME stocks, which trade at premium valuations. During the February-March 2020 crash, two out of three SME stocks, listed in BSE SME and NSE Emerge, fell more than the 25 per cent plunge in the domestic bellwether indices during the Covid-induced mayhem period.

Investors must bear in mind that since liquidity is low in SME stocks, small amounts of investments by a handful of participants can push the stock price and consequently, their valuation, through the roof.

Poor liquidity also can raise your impact cost during exit and entry. You should keep in mind that all SME stocks don't trade regularly. For instance, out of the 201 SME stocks eligible for trading on BSE SME, about 90 stocks are traded in a regular manner. Trading volumes are poor and hence small bursts of heavy buying can drive up prices quite high within a few sessions. On a typical day, barely a few thousand SME shares exchange hands via 10-100 trades in actively traded counters, with turnover in only 20 names individually crossing the ₹10-lakh mark — BSE SME scrips, which are listed under the "M" group (trading and clearing & settlement is done on a net basis) and those listed under "MT" group (trading and clearing & settle-

Decoding SME stock universe

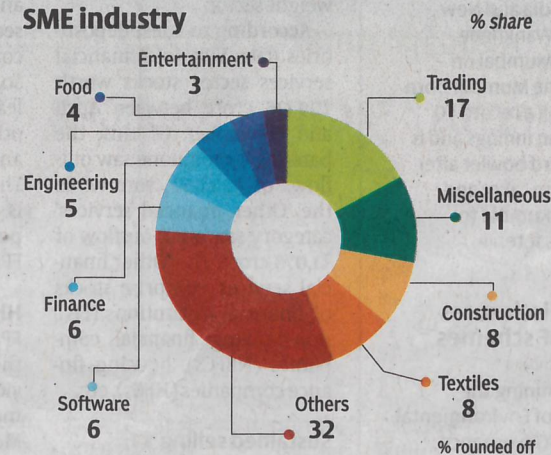
Registered office State/UTs



Age of SMEs



SME industry



Source: Capitaline

ally the last in the line when it comes to knowledge about companies.

The bottom line? Don't get bewitched by those 42 SME stocks that have at least doubled in the past 12 months; try to assess if there are solid reasons for such price performance or it is purely a liquidity-driven rally.

Easy reporting give-n-take

One thing is for sure, BSE and NSE have built credible and efficient marketplaces to help SMEs raise capital. These companies tap the potential to unlock value and emerge on a bigger stage. But SMEs often do not have the wherewithal to deal with compliances like filing annual reports. Hence, some

Ultra-low revenue base and smithereens of profit spell a precarious financial position. A bad year for a big company can mean a dividend cut, but a bad year for an SME can be its last.

To better understand SME stocks on BSE SME and NSE Emerge platforms, let us take a close look at their financials. Put together, 380-odd stocks are listed there with a combined market value of about ₹25,600 crore. But, there is wide disparity in market value. The SME stock with largest mcap is about ₹4,000 crore while the smallest one is just ₹1 crore. If all the 360-odd listed SMEs were one company, in

How top 10 SMEs by mcap fare

Company	Market cap (₹ cr)*	FY21 Gross sales (₹ cr)	FY21 Adj. PAT (₹ cr)	ROCE (%)	RONW (%)
EKI Energy Services	3,948.9	190.8	18.6	149.8	120.2
Thejo Engineering	1,164.6	327.1	27.4	31.9	26.3
Kwality Pharma	852.3	262.0	15.2	23.8	28.2
Jash Engineering	565.8	299.4	30.5	20.6	21.7
Beta Drugs	493.9	116.1	11.7	21.3	18.6
East India Securities	469.4	108.9	71.8	22.2	16.8
Supershakti Metaliks	461.0	376.8	13.0	14.1	11.1
Orissa Bengal	385.8	339.0	5.7	10.2	8.2
Ksolves India	365.1	28.3	8.9	162.1	125.6
Race Eco Chain	345.8	58.7	1.2	9.5	6.5

*as on Dec 1, 2021 Consolidated numbers wherever available
ROCE - Return on Capital Employed, RONW - Return on Net Worth
Source: Capitaline

Rip-roaring performance of SMEs

	1-month	6-month	1-year	5-year
	% change			
S&P BSE SME IPO index	43	241	706	61
NIFTY SME EMERGE index	9	57	125	29
Sensex	-2	12	31	17

As on Dec 2, 2021 Returns are rounded off and for more than 1 year period annualised
Source: BSE, NSE and Google Finance

counts for nearly 40 firms and about 30 each in textiles and construction. The rest are scattered across smaller sectors. Naturally, the competition is tough and the chance of plain-vanilla SMEs outperforming rivals is bleak. So, picking the right stock belonging to a unique theme becomes ever more crucial.

Of course, the success stories in the SME IPO space have meant that investors think of SME IPOs as big money-spinners. Those who did careful selection and due diligence have surely gained. Stocks such as BEW Engineering, Prevest Denpro, Omnipotent Ind and Focus Business Solutions have shown listing day pop of 50-125 per cent. However, 17 of 45 IPOs ended their respective debut session with no profit in 2021. SME IPOs in 2021 such as EKI Energy, Rangoli Tradecomm, Knowledge Marine & Engineering, BEW Engineering, Promax Power and Platinumone Business Services have shot up between 100 and 5,000 per cent from their public issue price. But on the flipside, 24 of 48 IPO listings are trading below their issue prices.

Given that SME stocks are high-risk bets due to smaller size, it is key that you do proper research before adding them to your portfolio.

Valuations, liquidity matter

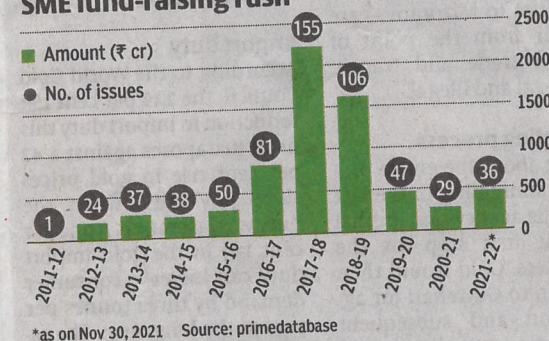
Since returns are good during bull markets, concerns about valuations take a back seat. But, this is exactly the kind of mistake one should avoid when dealing with SME stocks. Remember that SME stock bets are much larger than your usual purchases. In other stocks, you can buy even one share, but this isn't possible in SME stocks. So, you will end up investing quite a bit. For instance, the lot size of EKI Energy stock is 50 and each share costs ₹5,700, which means your minimum investment could be ₹2.85 lakh in a stock that trades at a 212 times trailing Price to Earnings (PE) multiple!

It is important to compare valuations of SME stocks with mainboard players, to get perspective. Though the general lack of profitability or low profits makes valuing SME stocks difficult using the PE metric, one can use other valuation ratios such as EV to PBIDT, Price to Book Value, Market

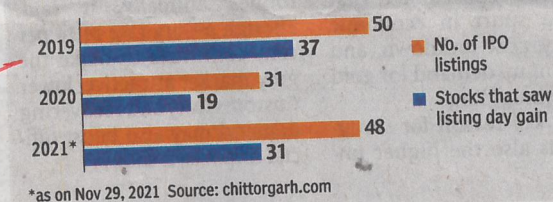
group (trading and clearing & settlement done on gross basis).

Add to that, research around SME stocks is virtually non-existent. This can distort understanding about SME stock fundamentals and valuations. While both BSE SME (<https://tinyurl.com/bsesme>) and NSE Emerge (<https://tinyurl.com/nseme>) on their respective websites have provided some research reports about a handful of SME stocks, many of them are old. Without a clear idea about future earnings potential and lack of proper research coverage around SME stocks, their stock price can be merely governed by supply and demand, and not fundamental factors. Also, when price discovery mechanisms are weak, investors with better access to information have an advantage over retail investors, who are usu-

SME fund-raising rush



SME IPO performance in last 3 years



to deal with compliance like frontline peers. Hence, some relaxations have been given to SMEs listed on the platforms. Any potential investor should understand these norms governing SMEs.

To make fund-raising easier for SMEs, the IPO process has been simplified. The SME IPO documents are not vetted by markets regulator SEBI. So, it is the exchange that gives observations on DRHP. The minimum number of shareholders in SME IPO is 50.

Also, SME IPOs are 100 per cent underwritten. Besides, subsequent disclosure norms are not as stringent as in the case of SME listed shares. For instance, reporting requirements such as audited accounts have to be disclosed every six months in SME platforms compared to 3 months in a mainboard listing. Requirements to publish results in newspapers, circulation of annual reports and e-voting facilities do not apply to these companies.

As you may realise, SME marketplaces are built as capital formation platform. This is not a trader's market. So, investors with a short-term horizon must stay away from dabbling in SME stocks. Only those investors with the capability to hold for the medium to long term can invest in these companies. Notably, SME companies have the option to migrate to the main board when they meet certain criteria. Once they do that, the liquidity is similar to that of other companies on the mainboard. For instance, on BSE SME, 125 firms have migrated to mainboard till date.

The easier reporting and fund-raising mechanism have an important takeaway for you as an investor. For each relaxation provided to SME companies, there is a consequence for the investor too. To compensate for the higher risk in SMEs, the reward has to be adequate. So far, SME stocks at a broad level have delivered. The NSE Emerge index is up 124 per cent in the last one year and up 28 per cent CAGR since inception in November 2017 versus Nifty's 31 per cent gain and 14 per cent CAGR gain respectively.

Like in India, globally too, SME stock type platforms exist in FTSE AIM (Alternative Investment Market) and even there, the returns are higher compared to bluechip benchmarks. For instance, the FTSE AIM 100 Index has outperformed the FTSE 100 by 40 percentage points over the last five years.