

STUDENTS' ECONOMIC FORUM

A monthly publication from South Indian Bank

To kindle interest in economic affairs...
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Market Capitalization

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The "Students' Economic Forum" is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly publication. Topic of discussion for this month is **"Market Capitalization"**.

Introduction

Market Capitalization, commonly called Market Cap (MC), is the market value of a publicly traded company's outstanding shares. Understanding what a company is worth is an important task, and often difficult to quickly and accurately ascertain. Market capitalization is a quick and easy method for estimating a company's value by extrapolating what the market thinks it is worth for publicly traded companies. In such a case, simply multiply the share price by the number of available shares. A company with 20 million shares selling at INR 100 a share would have a market cap of INR 2 billion. A second company with a share price of INR 1,000 but only 10,000 shares outstanding, on the other hand, would only have a market cap of INR 10 million.

Understanding Market Capitalization

A company's market cap is first established via an initial public offering (IPO). Before an IPO, the company that wishes to go public enlists an investment bank to employ valuation techniques to derive a company's value and to determine how many shares will be offered to the public and at what price. For example, a company whose IPO value is set at INR 100 million by its investment bank may decide to issue 10 million shares at INR 10 per share or they may equivalently want to issue 20 million at INR 5 a share. In either instance, the initial market cap would be INR 100 million. After a company goes public and starts trading on the exchange, its price is determined by supply and demand for its shares in the market. If there is a high demand for its shares due to favorable factors, the price would increase. If the company's future

growth potential doesn't look good, sellers of the stock could drive down its price. The market cap then becomes a real-time estimate of the company's value.

Market capitalization is one of the most effective ways of evaluating the value of a company. It is crucial to understand that this evaluation of a company's value is done based on a company's stocks. Essentially, this is defined by the total market value of the outstanding shares of a company. This simple fact also means that publicly owned companies are the only ones which can be evaluated by this method of evaluation. Using market capitalization to show the size of a company is important because company size is a basic determinant of various characteristics in which investors are interested, including risk. Since outstanding stock is bought and sold in public markets, capitalization could be used as an indicator of public opinion of a company's net worth and is a determining factor in some forms of stock valuation.

Importance of Market Cap

While the importance of market capitalization has been touched upon in its definition, it is crucial for potential investors to understand its need in further detail. This can also help them in understanding the market as well as its impact on the shares and value of a company.

- **Universal method:** This is the most widely used method around the globe to evaluate a company. Since this is one of the universally accepted methods, this makes it easy for investors to understand a company's value irrespective of their geographical or economic locus.

- **Precise in suggestion:** Suggesting market conditions is always subject to risks since it can fluctuate due to many factors. Nevertheless, the market cap is one method which is quite precise in its evaluation. As a result, though not fool-proof due to obvious reasons, it is a reliable method to judge the risk associated with investing in a company.

- **Affects the index:** This method is also used to weigh the shares of different companies for the index in the share market. Using this method, stocks with higher market capitalization gets better weight in the index.

- **Helps in comparison:** Since this is a universal method that can be applied to evaluate any company's market worth, it is a convenient method for investors to compare different companies. This comparison not only helps in understanding the size of a company, but also the risk associated with investing in them.

- **Balanced portfolio:** Investors should maintain a balanced portfolio to ensure they do not run the risk of any major loss. This includes opting to invest in a few top companies by market cap, along with the high-risk investments in developing enterprises.

It is vital to understand what is market capitalization, especially for investors, since this can guide them in choosing the correct shares to invest in. Fluctuating market conditions and stock prices also impact the evaluation of a company when this method of evaluation is being used. For investors, understanding the value of a company is imperative while creating a long-term investment plan. Understanding the value and risk associated with a company also helps an investor to make a balanced investment which is distributed across stocks from different companies. While judging companies by their market cap, it is important for investors to understand that this shows the stage of development of a company in its business venture. Investors should keep in mind this stage of development of a company while evaluating them to build their

investment portfolio.

Market Cap and Investment Strategy

Based on this popular method of evaluating a company, there are 3 different types of stocks from which an investor can choose. Given its simplicity and effectiveness for risk assessment, the market cap can be a helpful metric in determining which stocks you are interested in, and how to diversify your portfolio with companies of different sizes.

Type of Stock	Market Cap
Small Cap	Up to Rs.500 crore
Mid Cap	From Rs.500 crore up to Rs.7,000 crore
Large Cap	From Rs.7,000 crore up to Rs.20,000 crore

The 3 major types of stocks which investors go on to invest in are discussed in further detail underneath.

• Large Cap

These are some of the most stable groups of companies in the market. Consequently, investing in these companies is the least risky option. However, another important factor to keep in mind is that since these are stable companies, the return from these companies is comparatively low. Typically, these companies have reached the pinnacle of their growth, and as a result, there is a lesser chance of any drastic change in stock prices. However, the low risk accompanied by less aggressive growth makes investment in these stocks a conservative option.

• Mid Cap

Companies which have had a certain growth and are somewhat stable; and yet have immense potential of growth, come under this group of evaluation by market capitalization. These stocks indicate that a company is established to a certain extent in its industry, along with the promise of further growth. While investing in these companies can still be risky since they are not established in their industry, the risk in investing in their stocks is much less than that of the next group of companies. Subsequently,

the return on them can be potentially higher than those of large-cap stocks.

• **Small Cap**

Constituting companies which have the least market cap are the riskiest of all stocks. These are companies who are budding and are yet to establish themselves in their industry. This makes them highly risky. Success can sky-rocket their stock prices while failure can lead to a major loss for their shareholders. These are the most aggressive investment options.

The factors which impact Market Caps

There are quite a few factors which impact the market cap of a company. Learning these factors can aid investors in judging if a specific company is expected to offer good returns.

- Demand for the products or service of an institution and its ability to serve that demand, both are crucial factors which impact the MC of a company.
- Fluctuations in the market can impact the MC. This can be in the specific industry or an economic downturn, or both.
- Exercising warrant on the stocks of an enterprise can reduce its value.
- Performance and ingenuity of competitor brands or institutions.
- The reliability and the reputation of a company.

The number of outstanding shares of a company depends on factors like buying

back of shares or issuing of new shares. In case of stock splits to issue new shares, the market capitalization of a company remains unchanged. While understanding the impact of different factors on the MC, it is also advisable for investors to understand how investments grow or decline over the years.

What is in the news?

» M-cap of 6 of top 10 valued companies jump more than Rs. 1.18 lakh Cr., with major contribution coming in from Reliance Industries Ltd. – The Economic Times, 14 Nov 21

» India's equity market is on the cusp of overtaking that of the U.K. in value to join the world's top-five club, at least by one measure. India's market capitalization has surged 37% this year to \$3.46 trillion, representing the combined value of companies with a primary listing there. That's closing in on the U.K., which has seen an increase of about 9% to \$3.59 trillion, though the number is much larger if secondary listings and depository receipts are included. – Business Standard, October 12, 2021

» India is now the world's sixth-biggest stock market, overtaking France for the first time in market capitalization. US stock market is the world's most valued with an m-cap of \$51.30 trillion followed by China (\$12.42 trillion), Japan (\$7.43 trillion) and Hong Kong (\$6.52 trillion) – livemint, 16 Sep 21

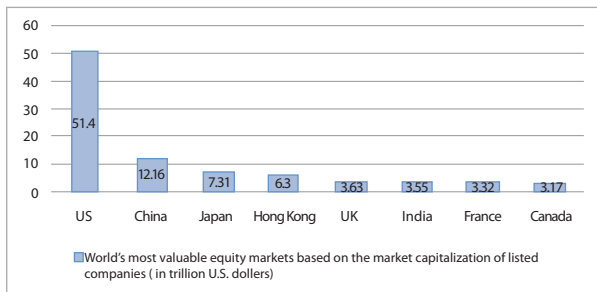
Additional Information

Vital valuation ratios to be kept in mind

While learning about market cap, investors should also learn a few relevant ratios which come into play. These ratios take MC into consideration.

- **Price-to-earnings ratio:** This is used to estimate the future return that can be expected from buying shares of a company. The MC is divided by 12 months' net income to calculate this ratio.
- **Price-to-free-cash-flow ratio:** This ratio is calculated by dividing the MC by free cash flow of 12 months. It is also used to project the expected returns.
- **Price-to-book value:** To calculate this, MC is divided by the total book value of the company. It is computed by deducting the total value of liabilities from the total book value of assets of an institution.
- **Enterprise-value-to-EBITDA:** This measures the operational returns that can be expected in the short term. EBITDA stands for Earnings before Interest, Taxes, Depreciation and Amortization. Enterprise value (EV) is calculated by adding the market capitalization with a value of preference shares, debentures and deducting total cash. The ratio is calculated by dividing the EV by EBITDA.

World's most valuable Equity Markets based on the Market Capitalization of listed companies(in trillion U.S. dollars)



(Source: Bloomberg; Data as on Sep 16, 2021)

Do You Know?

The top two companies in the world with highest Market Cap are Apple (2.62 trillion USD) and Microsoft (2.58 trillion USD).

Market cap of all companies listed in India is only 70% of the combined market cap of Apple and Microsoft.

Top 10 Indian companies based on market cap

Company Name	Last Price	% Chg	52wk High	52wk Low	Market Cap (Rs. cr)
Reliance	2,512.10	-2.58	2,750.00	1,830.00	1,646,595.28
TCS	3,555.15	0.04	3,990.00	2,608.05	1,315,068.25
HDFC Bank	1,547.45	-0.61	1,724.30	1,342.00	857,352.53
Infosys	1,790.60	0.28	1,848.25	1,091.05	753,038.83
HUL	2,406.45	-0.74	2,859.10	2,095.00	565,417.39
HDFC	2,975.15	-0.85	3,021.10	2,179.45	538,339.26
ICICI Bank	764.50	-1.14	859.70	465.95	530,509.05
Bajaj Finance	7,557.85	0.31	8,020.20	3,789.70	456,187.55
SBI	495.00	-2.31	542.20	231.10	441,768.27
Kotak Mahindra	2,082.90	-0.58	2,252.45	1,627.25	413,093.02

(Source: Moneycontrol; as on Nov 16, 2021)

Source:

- a) www.investopedia.com
- b) <https://groww.in>
- c) www.wikipedia.com
- d) www.moneycontrol.com
- e) www.bloomberg.com
- f) www.statista.com



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