Growth Vs Value OR Valuing Growth

The debate over Growth vs Value has heated up over the last few months. As equities ran into rough weather and ever since it became clear that the Fed Put is past its expiry date, this has been a point of debate in columns across the financial world. India has seen its share of discussion on this as well.

First of all, the fall in equities has been somewhat asymmetric. The rise was also similar in nature. Not all stocks have fallen big time just as the rally was skewed. As easy money left the table, lazy returns went with it. In recent days, many high-flying stocks that were seen at the forefront of the growth brigade have come back strongly. In the intensely volatile environment we are in, any views may prove to be premature before the ink on this dries up.

That said, what should be at the nub of the debate is a clear understanding of what fired up growth stocks in a period of somewhat lackadaisical growth. In other words, growth stocks did well sans high growth. The decade after the global financial crisis saw slower growth by any measure and that applied to India as well. Yet the valuations for a select set of stocks re-rated and how. We had long since moved past the classic valuation metrics used by traditional value investors such as Dividend Yield, Price in relation to cash/equivalents (so-called deep value) et al. Even before the global financial crisis (2007-08), we had started to use PE to growth (PEG), P/E on 12-18 month forward and for select sectors, metrics like EV/EBITDA. When growth dried up after the crisis, liquidity gushed in. Professional investors gamed the concept that stocks should discount the future as history is in the price. Since no one really knows the future for sure, limitless optimism on the distant future seemed to come without strictures in an easy money environment.

What followed in the decade before Covid was a synchronized effort at celebrating the future as it suited the interests of most of the actors in financial markets. We have seen analysis based on relative valuation take the pole pulpit – valuation not just relative to peers in India or elsewhere. Investors welcomed valuation relative to a stock's own trading history based on whether there was a beat in earnings compared to expectations from analysts. No matter whether the expectations were low-balled to suit the narrative as it were. Then there was the quality premium. Leaders in industry segments in a list approved by opinion makers were accorded this premium and once that was bestowed on a stock, misses to estimates were papered over as fleeting events. Research notes talked solely about upgrades/downgrades, beats/misses and incremental changes to select metrics. All this left one wondering whether relativity was the only force left in financial markets.

Asset valuations are indeed relative and have been so always. Equities are no exception. Supply-demand factors eventually dictate such relative valuations. All that said and done, **relative valuations have a context**. In other words, relative valuations over the last 10-15 years have been driven not necessarily (and certainly not entirely) by companies and managements delivering sustainable growth. In many instances, it was questionable whether the business models were sustainable or whether the growth drivers were as robust as they were made out to be.

Equity valuations have been propped by an unprecedented fall in interest rates across major geographies. The Fed Put was always an imaginary creation of the market. It was good while it lasted. However, 2022 will go down as the year when the mythical Put expired. Note that the inflation in the US/Euro Zone at well over 8% and counting is not just at 40-year highs. It is at levels which a couple of generations have never seen – and threatens quality of day-to-day life leave alone prosperity and wealth. Therefore, we remain convinced that stock valuations lack the tailwinds from policymakers. We are not entirely sure whether the markets have digested this fact. In this decade, we believe growth will be evaluated and will need to stand out to be counted. While relative measures may have their own merits, growth will also be measured by metrics that are absolute and calibrated by numbers that make sense. For instance, a PE of 70-100 cannot be sustained if inflation (cost of capital and interest rates have to follow inflation directionally if not linearly) is likely to remain above 4% in the developed world for the foreseeable period of 1-2 years. We see little merit in any forward predictions beyond that for most things in life.

Source: Bloomberg, Spark Fund research

The chart above amply illustrates the point. This portends a decadal shift. Notice the sharp turn after 2020 when value has started to come back. While hard to generalize, these shifts have a lasting impact. In this context, the recent rally in the market and the rally in expensive pockets of the market should be viewed with caution that it richly deserves.

The Indian context

India never saw the same low cost of capital that the developed world (and China) saw. Interest rates in India never went anywhere close to zero. But it is global capital that came into India and chased assets in India whose underlying businesses were for most part subject to Indian cost of capital. This was one of the reasons for the distortion in valuations. Additionally, the risk aversion in India skyrocketed after the UPA era scams broke out as these scams affected large sectors like banking (through NPAs), telecom, real estate, airlines and mining. This was the genesis of the quality premium. The table below captures the steady rise in valuations.

Valuations (x)	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22
HUL - P/E	27	32	26	33	43	45	44	55	61	74	71	54
Asian Paints - P/E	29	31	42	43	56	48	54	55	66	59	78	97
Nestle India - P/E	45	41	45	46	52	100	58	62	67	72	85	89
Bajaj Finance - P/B	1.9	1.7	1.7	2.2	4.3	5.0	7.1	6.4	8.9	4.2	8.6	10.4
HDFC Bank - P/B	4.3	4.1	4.1	4.1	4.1	3.7	4.1	4.6	4.2	2.8	4.0	3.4

Note: Prices as of financial year ends, P/B - Standalone figures; Source: Bloomberg, Spark Fund Research

These stocks and many midcaps re-rated because

1.They were asset light or as financiers had exposure to pockets not impacted at all by factors that went wrong In India.

2. They have great managements and the quality premium morphed into scarcity premium.

3. Lack of consistent growth in India meant that incumbents consolidated their lead and competition was rather weak.

In a sense, this set of stocks and their ilk were beneficiaries (in a relative sense) of slower growth in India. Look at how some other segments suffered. While these businesses did not deliver in the past decade, the environment had a large role to play. This may well be changing.

Valuations (x)	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22
L&T - P/E	22	17	16	24	34	27	24	25	23	13	60	29
SBI - P/B	2.7	1.7	1.4	1.2	1.6	1.0	1.2	1.0	1.3	0.8	1.3	1.6
DLF - P/B	3.3	2.4	2.7	1.9	1.6	1.4	1.8	1.5	1.9	1.3	2.7	3.5

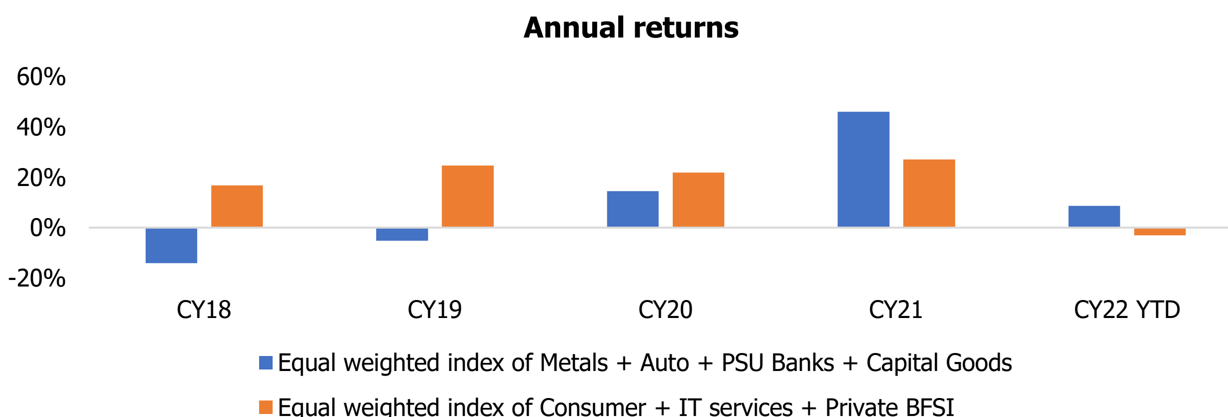
Note: Prices as of financial year ends, P/B - Standalone figures; Source: Bloomberg, Spark Fund Research

The thrust of the analysis is not about whether the asset-light, well-managed businesses and high-quality banks were (are) great businesses or not. They are indeed great franchises. It is about the context in which they turned in a relative performance which looked impressive and in turn enjoyed a re-rating that was excessive. This context has undergone a change now.

Global cost of capital is not likely to see a one way plunge now. Secondly, growth in India is likely to be driven by a balanced mix of consumption and investments. While it is early days yet on this one, that is what the trend seems to suggest.

The way forward

We have been consistent in our position that the so-called growth stocks cannot be exempt from scrutiny when it comes to valuations based on hard numbers. The following table gives the performance of an equal weighted index of Consumer/IT services/Private banks/Financials versus Metals/Auto/PSU Banks/Capital Goods in the Nifty. We do not want to call this Growth versus Value. On a representative basis, these pockets may be capturing the big shift in trend that we are witnessing now.



Source: Bloomberg, Spark Fund Research

Stereotyping stocks as Growth and Value in India will end up missing the woods for the trees. IT services is less cyclical but can have a down-cycle nevertheless if global economies enter recession, even if the recession is to be a shallow one. Capital goods may be prone to cyclical impact but may have created enough room for growth over a period which people underestimate at present. This is because investment spending was a virtual no-show for a decade-and-a-half. We cannot build an economy in India with just digital infrastructure firing. It stands to reason that growth pockets in India will have a rotational aspect to them most of the time.

The point of emphasis from the discussion above is that growth drivers in India are undergoing a shift which could be decadal in nature. The change in the global environment means that the growth you get will be measured for what it is worth by global investors. Such measurement will not just be on optics or on metrics that suit select interest groups. The weightage of exaggerated terminal value in current market price will meet with resistance. Nothing exemplifies this more than the virtual collapse in the market capitalizations of the listed Unicorn ecosystem.

Particulars	Market Capitalisation (INR cr)		Change (%)
	As on 31/12/2021	As on 29/07/2022	
Top ten listed Unicorns based on market cap	4,76,322	2,83,395	-41

Source: Bloomberg, Spark Fund Research

Even as the hype has come off, there is intensifying scrutiny on governance of these companies. Not all is going well over there to say the least. Sectoral, situational and thematic hype should not be misconstrued for quality.

Good quality growth can come about in select PSUs or in other pockets such as those related to infrastructure and in industrials. Growth can certainly come through in consumer franchises with high valuations. However, the investor lens will then focus on what you pay for what you get. Thus, it will be about value systems and values in companies. It will also be about valuing what growth we get.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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