Not Growth vs Value. It is how to put the right value for growth.

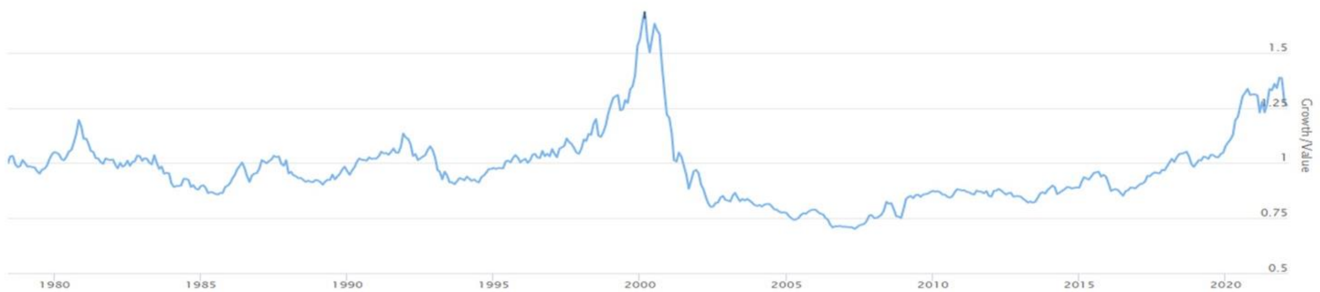
The debate is on. Will value start to outperform? Will growth stocks stage a dramatic comeback?

First of all, there are definitional issues. What is growth and where? Growth stocks are broadly the bunch that exhibit growth in excess of the average or the peers. But then, growth in what? In the discourse that has characterised the debate in recent years, growth in bottom-line or cash flows was often given a go-by as against other metrics such as revenues, eyeballs, clicks, customer acquisitions, gross merchandise value et al. In an earlier era, buying growth without profits by raising capital indiscriminately was considered dilutive to shareholder value. For instance, all of us know that increasing the size of a loan growth is child's play. The moment of reckoning arrives when the loans are due for payback. In a similar vein, offering cashback to customers in order that they transact does not automatically mean they will be loyal. No doubt there is brand-building. No doubt that some of these spends lead to accounting losses and accounting losses in a new age business should be viewed in proper perspective. But if this kind of businesses form the core of the current growth stock ecosystem, the cost of such growth will be counted one day. It was sheer greed that resulted in such scrutiny being postponed. Now that the cracks have started to appear and widen, the debate on growth vs value is back.

If you cared to lift the thin veil that camouflaged the reality, the cracks were always visible. The following chart is not a bad place to start.

Wilshire Growth vs. Value Stocks (US)

(Ratio of Large cap Growth Index/Large cap Value Index)

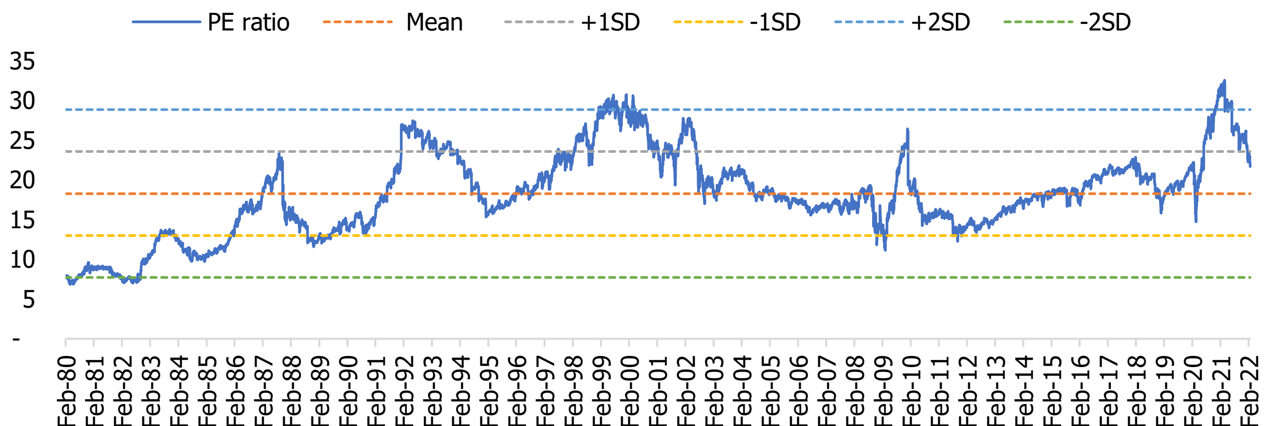


Source: Longtermtrends.net, Spark Fund Research

The sharp uptick in the chart over the last few years was the hype building up. As it often happens, the problem for investors begin to compound when the excesses spill over to the wider market.

Growth stocks got an extra oomph when the phenomenon of falling interest rates got conflated with growth to justify higher valuations. The following chart is interesting in the sense that it shows the journey of valuations for the S&P 500 stocks over the entire period when equities as an asset class have seen an ascent. The forty-year period also saw the inflation falling and interest rates getting near 1% from the starting point in double digits. It is clear that the valuations went through the roof in the recent past and the fall has been partially facilitated by the reduction in US tax rates to some extent and upgrade to earnings from concentration of earnings power.

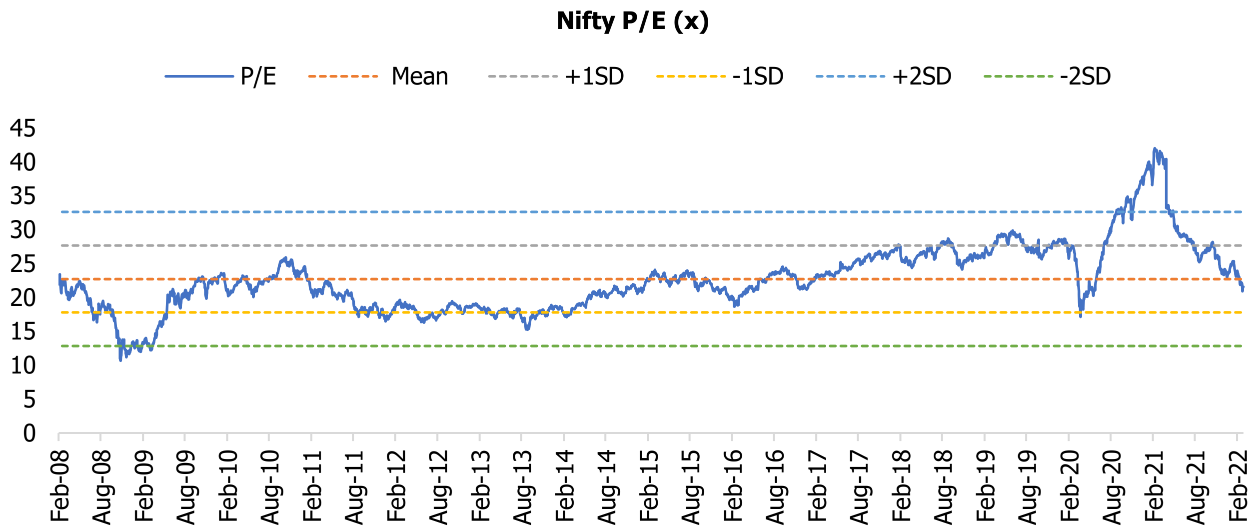
S&P 500 P/E (x)



Source: Bloomberg, Spark Fund Research

The important point to note is that the valuations are falling (though the gradient of the fall can start to taper if earnings see downgrades). The impending rise in interest rates is beginning to have a sway. This is the context in which the debate on growth versus value is attracting more attention.

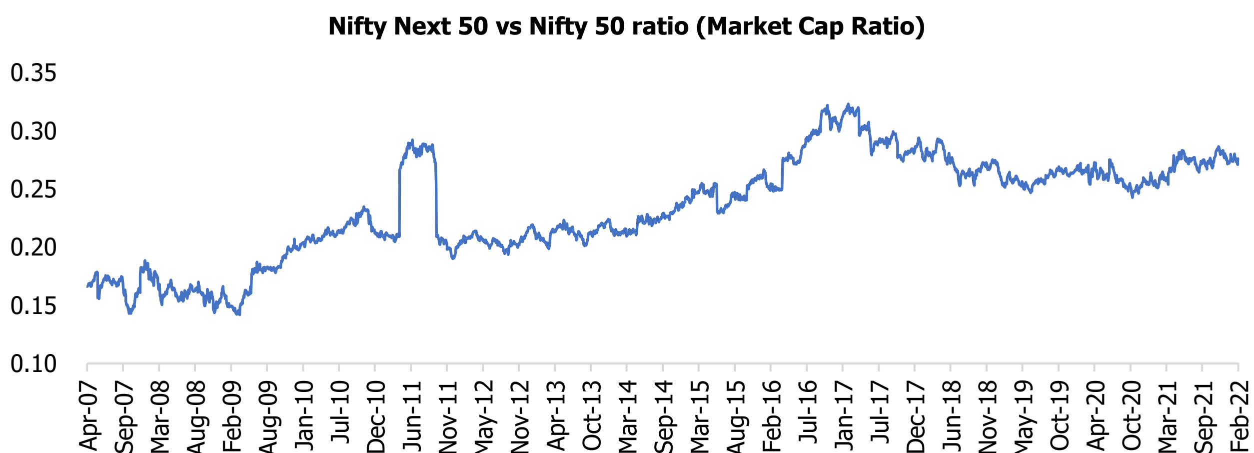
Let us look at the Indian story



Note: From 31-Mar-21, NSE started using consolidated earnings instead of standalone earnings. Source: NSE, Spark Fund Research

Though the time period for the analysis is shorter, it can be seen that the Nifty valuations have been influenced a lot by the valuations in the US. We view the fall as the result of a combination of factors at work. While the recent correction is part of the mix, the recovery in earnings for financials/commodity names and the concentration of earnings power have all been behind this fall. We have to be careful in interpreting this. For one, if earnings start to get downgraded, the valuations may still stay above the mean. It is a bit early to conclude. The other point is the bipolar nature of earnings. This chart plots the PE of a very diverse mix of earnings streams. Some of the constituent segments such as the consumer, technology and private financials have been trading way above the mean of the market thereby distorting this picture.

In order to understand the relative valuation in the wider market, let us look at the ratio chart of the market cap of Nifty Next 50 versus Nifty 50.



Source: Bloomberg, Spark Fund Research

While it is not a plot of the Growth stocks versus Value stocks, it may be noted that the Nifty Next 50 has been increasingly getting populated with stocks with a growth bias. Nifty Next 50 is the waiting room for stocks to enter the Nifty 50 and in the last decade, most of the entrants into this index had a tilt towards growth. Indices do reflect the requirements and preferences of the consumers of the indices. Institutions tend to be the consumers. It is always useful to bear in mind that the markets do not always respect the will of these institutions. The increase in relative market cap weight captures the ascendancy of the so-called growth stock universe. We may be nearer to a point where the markets start to introspect

over the anomalies created by the seemingly unstoppable bull market in interest rates and liquidity. All good things moderate eventually if not come to an end.

Time for pause and calibration

We can infer from the above discussions that the markets have a tendency to mean revert. No trend lasts forever. Once the markets realize that they had done too much on one side and start to turn, they tend to do this with a flair. This is evident from the way some of the hyped-up Unicorns have reacted in recent weeks. The writing was clearly on the wall and we read that out aloud a few months back. It is time now for looking at what constitutes growth, where growth needs to be rewarded and *by how much*.

The data below clearly tells the story of how much the market went in one direction to reward growth.

Nifty 50 index - Key stocks return breakup (FY17-22)

Company Name	EPS CAGR (%)	Returns CAGR (%)	Share of return from PE rerating (%)
Tata Consumer Products	11	39	72
Asian Paints	8	25	67
Infosys	11	28	61
Reliance Industries	12	31	60
Bajaj Finserv	14	33	58
Wipro	11	25	55
Divi's Laboratories	21	41	49
Bajaj Finance	25	45	44
Titan Company	25	42	40
Hindustan Unilever	12	20	38
ICICI Bank	16	24	34

Source: Ace Equity, Spark Fund Research

Nifty Next 50 index - Key stocks return breakup (FY17-22)

Company Name	EPS CAGR (%)	Returns CAGR (%)	Share of return from PE rerating (%)
Adani Transmission	26	103	75
Pidilite Industries	8	29	71
Larsen & Toubro Infotech	17	52	67
DLF	8	18	56
PI Industries	11	24	54
Berger Paints India	11	24	53
Cholamandalam Investment and Finance Company	21	29	27
Havells India	18	24	25
Procter & Gamble Hygiene and Health Care	13	17	22
Muthoot Finance	27	31	11

Source: Ace Equity, Spark Fund Research

Note that these are mostly growth stocks. They have for most part delivered earnings growth better than the market and better than peers. However, the price return reflects the excesses driven by the interest rate/liquidity bull. All the stocks in this brigade are profitable companies with a good standing in their businesses. If we go past this into the broader market of small/midcaps and then the Unicorns, wider cracks will be visible. There will also be opportunities no doubt.

In summary, the debate that has started off on value stocks will get to a point of what constitutes value in the Indian context. Our answer remains unequivocal. Value in India resides where growth potential shows up. But growth should not be taken for granted in places where the so-called growth capital or private equity money goes. We need to look at the cost of acquiring growth. Business model sustainability and the aim of managements need to be scrutinised. Is the path to profitability a key objective? Is there a realistic line of sight to profits? Is that a spreadsheet game or a real commitment?

Elsewhere, consumer sector has always been given the growth tag whatever the business is all about. Consumer sector of the future is not just about traditional consumption areas such as staples and durables. Services, experiences and a lot else have thrown themselves into the cauldron.

We need to highlight another important point. Secular growth can only go as far as the cycle allows it. Competition, disruption, globalization and choices pave the way for cycles everywhere. Infrastructure can be a growth area in India till it runs into rough weather. Identifying growth areas should be contextualised with the time horizons we focus on.

Finally, we need to measure growth or value growth. What we pay for growth will likely be coming to the fore as we find our way forward through a difficult phase in the market. Finding value in what you invest in is not about to go out of fashion. How to find value in growth may define the new age value investing approach.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

Disclaimer: The contents of this document are for general consumption only and are not to be construed as either a Research Report or a recommendation of any manner by Spark Capital Advisors (India) Private Limited or its affiliates ("Spark Group"). Spark Group shall not be responsible for any investment decisions made by the readers and recipients of this report.