PGIM India Mutual Fund

FOOD FOR THOUGHT

Case for Growth Investing in India

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January 2025

Indian markets have seen increased participation in the last 5 years. Almost 4 out of 5 investors have started investing in the last 5 years. For many such investors, one of the biggest questions confronting them is 'What moves the stock price?'

Chat GPT gives the following response:

Supply and Demand: Imbalance between buyers and sellers.	Earnings Reports: Actual vs. expected company earnings.	Economic Data: Inflation, unemployment, GDP, etc.
Market Sentiment: Investor confidence and trends.	Interest Rates: Changes by central banks.	News: Company-specific news, global events, or geopolitical risks.
Industry Trends: Sector performance and innovations.	Competitor Activity: Competitive moves or disruptions.	Dividends: Announcements or changes in pay-outs.
Government Policies: Tax laws, regulations, or subsidies.	Currency Exchange Rates: Impact on multinational companies.	Technological Developments: Innovations affecting industries.
Insider Trading: Insider buying or selling activities.	Technical Factors: Chart patterns, volume, and algorithmic trades.	Global Markets: Movements in foreign stock indices.

While all of these are relevant, one is unclear. Should I focus on the economy and ignore a company's fundamentals, or should I focus on technical factors and global markets while ignoring industry trends?

Simple Mental Model:

According to our research, we have tried to arrive at a simpler answer, which is not only intuitive, but also tried and tested.

Following is a simple mental model to understand the total expected returns from owning equity assets:

In the above equation:

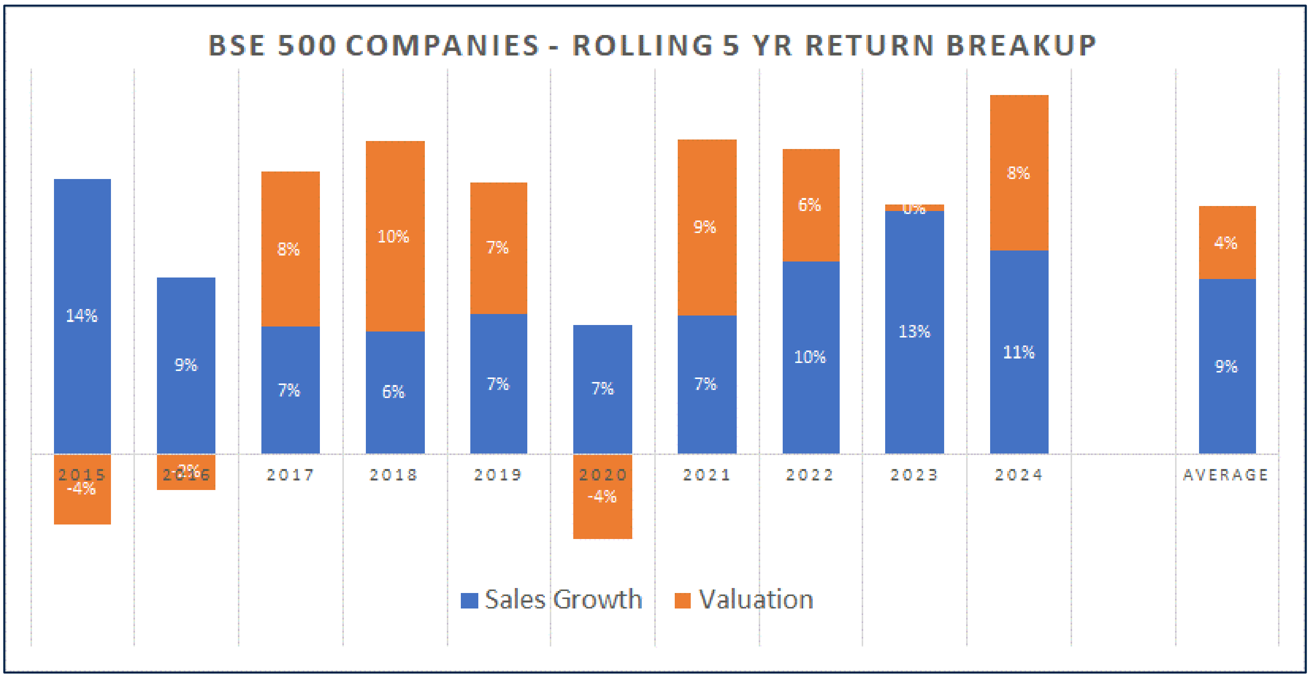
- Growth in business can measured by growth in Sales, Gross Profit, EBIDTA, or Net Profit.
- Valuation multiples can be Price/Sales, Price / Net Profit which is also popularly referred to as P/E multiple, EV/EBIDTA, etc.

Note that we have ignored dividend yield in the above equation of total returns, as it is generally a smaller component of the total returns in India.

Within the equation, valuation keeps fluctuating in the short-term. However, it is not a large determinant of total returns over a longer period of time. Over the medium to long term, the change in valuation multiples is likely to be smaller. The bigger influence in stock price returns over the long term is from growth in business. Higher the long term growth, higher is the return.

In this research note, we have considered growth in sales for our studies as it's the least volatile component of the income statement. Following is the order of complexity and difficulty in forecasting due to increase in the number of variables at each stage: Sales < Gross Profit < EBIDTA < Net Profit. As we move from sales towards net profits, the correlation with returns may improve further (which is why as investors it is imperative for us to forecast profit margins and its long term trajectory as well). However, the predictability of those components also becomes increasingly difficult. Since the objective of this note is to provide a simple and solid mental model for investors to achieve superior long-term investment performance, we will avoid introducing unnecessary complexity.

Aggregate Equity Returns in India - Dissection of Components (2010 to 2024):

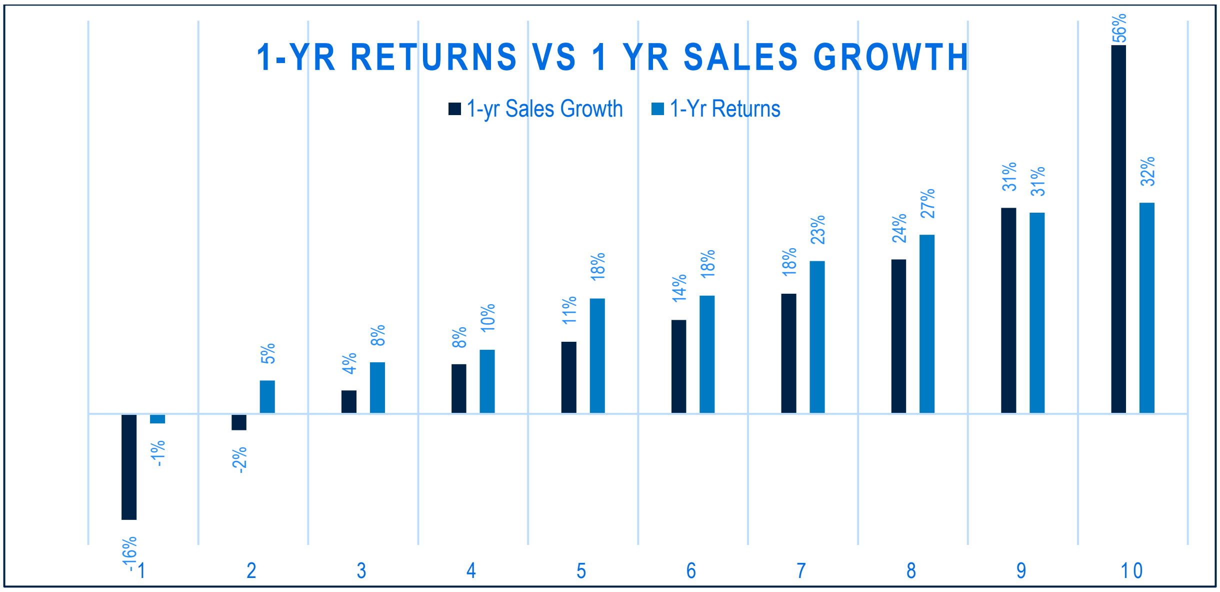


Data source: PGIM India AMC Analysis, Ace Equity, Data as on 31st March of each year.
Note: Data for all BSE 500 companies, which have data consistently from 2010 to 2024. Measure of central tendency used is Median

We have segmented the aggregate market capitalization-based returns for all current BSE 500 companies (as of December 31, 2024) that have consistent data from 2010 to 2024. There are 300 such companies, which make up 76% of the current BSE 500 market cap.

Based on our analysis, the aggregate rolling 5-year compound annual growth rate (CAGR) return since 2010 has been 13%, of which 9% is attributed to sales growth and 4% to changes in valuation. **Thus, over 70% of the returns are driven by growth, while 30% are explained by changes in valuation.**

Relation between Sales Growth and Stock Price Returns (2010 to 2024):



Data source: PGIM India AMC Analysis, Ace Equity, Data as on 31st March of each year.
Note: Data for all BSE 500 companies, which have data consistently from 2010 to 2024. Measure of central tendency used is Median

We also tried to analyze the relationship between sales growth and share price returns. In the table above, we considered the top 500 companies within the study period and mapped the relationship between their sales growth and returns over a one-year period. The results, segmented by deciles, confirm the hypothesis that growth is directly related to stock price.

On average, companies with the slowest sales growth (a 16% decline) delivered a negative return of 1%, while companies with the fastest sales growth (56%) delivered a return of 32%. Similarly, companies with 4% sales growth delivered returns of 8%, while those with 24% sales growth saw their stock prices increase by 27% over the same one-year period.

Thus, future sales growth has a direct relation with future returns and thus provides a solid mental model to understand potential returns from investments.

An important takeaway for investors is that those seeking superior long-term investment performance should target companies that are expected to grow their sales—and, by extension, profits—at the fastest and most sustainable pace.

That said, if starting valuations are excessive, the potential returns from business growth may be offset by a de-rating in valuation multiples. Therefore, it is crucial to maintain valuation discipline in the pursuit of higher growth.

Summary:

Growth drives the value of any business; it is the single most important factor in driving stock prices. Superior long-term returns are generated by investing in high-growth companies acquired at reasonable valuations.

Pillars of a superior investment strategy include:

- Actively seek growth: Focus on businesses that are expected to grow their sales (and, consequently, profits) at the fastest and most sustainable pace. Such businesses are compounding machines.
- Maintain valuation discipline: If starting valuations are unreasonable, the potential returns from business growth may be offset by a de-rating in valuation multiples. Therefore, it's crucial not to overlook valuation discipline in the pursuit of higher growth.
- Diversify portfolios: Ensure that portfolio performance is not dependent on the fate of only a few securities. Companies in the high-growth segment tend to be volatile, so building a diversified portfolio is essential to reduce portfolio volatility driven by individual securities.

India is a high-growth economy, offering numerous investment opportunities in companies that are expanding their businesses at a rapid pace. As T. Rowe Price aptly put it, India represents a perfect 'fertile field for growth.' Importantly, many high-growth companies have underperformed in recent years, creating investment opportunities. Therefore, we believe now is the ideal time to seek out such opportunities.