PGIM
India Mutual Fund

Opportunities in the Market Today

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Indian stock markets are on a tear. Large cap heavy Nifty50 Index has delivered 14% on a 6m FY24 basis (1st April 2023 to 30th September 2023). However, the action has been in broader markets. Nifty Midcap 150 Index and Nifty Smallcap 250 Index have delivered 34% and 40% returns respectively in the same period. Number of investors, as visible from number of demat accounts, have gone up approximately 4x in last 5 years, from 3.4crore in March 2018 to 11.4crore in March 2023.

In such a scenario, everyone would like to participate in this metaphorical gold-rush. Should you participate. If yes, how.

India Story:

India is fastest growing economy in the world. In simple words, if countries were stocks, India is expected to have the highest earnings growth amongst most countries in the world. And since India is 5th largest economy in the world, we are a high growth Large Cap stock.

World Bank in its latest update, dated 3rd October, 2023 noted that "India was one of the fastest-growing major economies in FY22/23 at 7.2%. India's growth rate was the second highest among G20 countries and almost twice the average for emerging market economies. This resilience was underpinned by robust domestic demand, strong public infrastructure investment and a strengthening financial sector". The International Monetary Fund (IMF) in its latest report dated 25th July, 2023, forecasts India's GDP growth for FY24 to be at 6.1%, compared with its forecast of 3% for global economy and 1.5% for advanced economies

Country	2022	2023E	2024E
World	**3.5**	**3.0**	**3.0**
Advanced economies (AEs)	**2.7**	**1.5**	**1.4**
India	7.2	6.1	6.3

Source: IMF, India 2023E represents FY24E and 2024E represents FY25E

Why does growth matter. Let's look at some data.

What has worked in Investing in India:

We analyzed 1500+ large companies (which were part of NSE 500 Index over last 20 years) and looked at fundamental parameters like 3-Year Sales Growth (proxy for Growth) and 3-Year Average Return on Equity (proxy for Quality) to see whether any pattern emerges for succeeding as an investor.

We derived a very simple outcome: Investors can outperform markets by buying a basket of companies which exhibit both of these characteristics: 1) higher than average historical 3-Yr Sales Growth and 2) Higher than average historical Return on Equity.

Summary	Median	Avg No of Cos.	Alpha	Batting Avg
Quality AND Growth	11.8%	375	2.0%	63%
Quality OR Growth	8.8%	672	-1.0%	38%
NEITHER Quality NOR Growth	7.0%	270	-2.8%	13%
Universe	9.8%	1047		
Quality = Higher than Average Last 3 Yr RoE				
Growth = Higher than Average Last 3 Years Sales Growth				

Source: Bloomberg, PGIM India analysis as on 31st March, 2023. Universe – All companies in NSE 500 Index from 2002 to 2022.

Key Takeaway:

Stocks exhibiting both Growth and Quality characteristics have outperformed the broader markets over the long term.

Why has high quality and superior growth combined together delivered good returns:

Why is Growth important
Lets look at simple hypothetical examples to analyze this conundrum. Dividend Discounting Model can help us understand how growth drives share prices. This model states that current fair value of a stock equals the sum of all of the future dividends discounted back to their present value. In the below example, we consider the discounting rate as 10%, which is our required rate of return. The fair value is given by the following formula:

Fair value = Dividend / Discounting Rate

Given a constant discounting rate, faster the dividend growth, more the increase in share price (see table below).

Growth	A	B
Year 1		
Dividend	10	10
Required Return	10%	10%
Fair Value	100	100
Year 5		
Dividend	20	15
Required Return	10%	10%
Fair Value	200	150
Dividend Growth	**15%**	**8%**
Returns	**15%**	**8%**

Source of this table is PGIM Internal Analysis

Note: 1) The above example is for illustration purposes only.

2) For simplicity sake, above computation only measures price returns and excludes dividends received in Year 1 to 5.

As can be seen in the above example, growth in Dividends, which in turn are dependent on growth in profits determine the returns for an investor

Why is Return on Equity important
Based on simple financial and accounting facts,

Profit Growth = Return on Equity * (1 - Dividend Payout Ratio)

Thus, for a company to grow fast it needs to retain its profits and has to earn a high return (RoE) on those retained profits.

A Company with RoE lower than its growth needs to borrow capital to finance its growth.

A Company with RoE higher than its growth can payout dividends while maintaining high growth.

Thus, both growth and RoE are spokes of the same wheel and both need to remain higher than average for an investor to earn better than average returns.

Examples

No	Sector	Name	10 Yr Mcap CAGR	10 Yr Sales CAGR	10 Yr Average ROE
1	Jewellery Retail	Titan Co Ltd	26%	15%	27%
		Tribhovandas Bhimji Zaveri Ltd	-12%	11%	16%
		Difference	38%	4%	10%
2	Cement	JK Cement Ltd	28%	13%	14%
		India Cements Ltd	8%	1%	1%
		Difference	20%	13%	13%
3	Utilities	Indraprastha Gas Ltd	23%	16%	24%
		NTPC Ltd	4%	10%	13%
		Difference	19%	6%	11%

4	Banking	HDFC Bank Limited	20%	18%	22%
		Bank Of Baroda	12%	12%	6%
		Difference	8%	6%	15%
5	NBFC	Bajaj Finance Ltd	50%	31%	20%
		Edelweiss Financial Services	8%	16%	3%
		Difference	43%	15%	18%
6	Pharma	Divi's Laboratories Ltd	19%	13%	25%
		Lupin Ltd	0%	3%	12%
		Difference	19%	10%	13%
7	Construction	Larsen & Toubro Ltd	14%	9%	13%
		Jaiprakash Associates Ltd	-19%	-10%	-39%
		Difference	33%	18%	53%
9	Information Technology	Infosys Ltd	14%	14%	33%
		Wipro Ltd	6%	9%	23%
		Difference	7%	5%	10%
9	Tyres	Balkrishna Industries Ltd	31%	11%	21%
		Apollo Tyres Ltd	17%	7%	12%
		Difference	14%	4%	8%
10	Materials	Vinati Organics Ltd	43%	14%	27%
		Graphite India Ltd	13%	5%	16%
		Difference	30%	9%	11%
11	Auto Ancillaries	UNO Minda Ltd	60%	24%	14%
		Bosch Ltd	7%	6%	13%
		Difference	53%	18%	1%
12	Automobiles	TVS Motor Co Ltd	42%	16%	23%
		Ashok Leyland Ltd	22%	13%	10%
		Difference	20%	3%	13%
13	Textiles	KPR Mill Ltd	48%	14%	23%
		Arvind Ltd	1%	4%	9%
		Difference	47%	10%	13%
14	Capital Goods	Timken India Ltd	38%	15%	17%
		Bharat Heavy Electricals	-6%	-7%	2%
		Difference	43%	22%	15%
15	Pharma	Ajanta Pharma Ltd	26%	15%	31%
		Glaxosmithkline Pharmaceutic	2%	3%	26%
		Difference	24%	13%	5%
16	Paints	Asian Paints Ltd	19%	12%	29%
		Akzo Nobel India Ltd	8%	6%	19%
		Difference	11%	7%	10%
17	Nbfc	Can Fin Homes Ltd	38%	22%	19%
		IFCI Ltd	-7%	-10%	-13%
		Difference	45%	32%	32%
18	Auto Ancillaries	Suprajit Engineering Ltd	28%	20%	24%
		Bharat Forge Ltd	22%	11%	15%
		Difference	6%	9%	9%

Source: Bloomberg
Note: Data from 31 March 2013 to 31 March 2023

Key Takeaways:
Why are Growth and Quality (ROE) important considerations in stockpicking: Shareholder returns are largely determined by profit growth and capital efficiency. Growth can impact both dividends and stock price.

Companies that have high ROE can finance their growth through internal accruals. If ROE is low, companies may need to take on debt to finance their growth.

Current Market Positioning:

Current positioning of markets may seem very dangerous for short term investors, but presents a great opportunity for long term investors.

We analyzed all the NSE 500 companies, based on last 5-year sales growth and RoE.

Based on this study, High Growth+Quality companies have significantly underperformed their counterparts which have lower Growth and weaker quality, over the last 1 year and three years.

However, over a 5 year and 10 year period, High Growth + Quality companies have significantly out performed their weaker counterparts

NSE 500	1yr	3yr	5yr	10yr
G + RoE	8.30%	25.70%	18.70%	27.50%
G or RoE	14.20%	25.30%	11.20%	20.10%
Neither	23.60%	34.30%	9.30%	15.50%
Universe	**14.60%**	**27.40%**	**13.00%**	**20.50%**
NSE 500	**1yr**	**3yr**	**5yr**	**10yr**
G + RoE	-6.30%	-1.70%	5.70%	7.00%
G or RoE	-0.40%	-2.20%	-1.70%	-0.30%
Neither	9.00%	6.80%	-3.70%	-5.00%

As on 26th October, 2023
Source: Bloomberg, PGIM India MF Internal Analysis

Thus, High Growth + Quality companies have under performed their weaker counterparts, which is contrary to the last 21 years of analysed history.

In the last 21 years, on a rolling 3 year basis, there we only two times that this has happened, once in March 2015-2018 period and second in March 2020 to 2023 period. Also note that this trend continues even from March 2023 to September 2023 period.

Why is this happening:

Primary reason appears to be dramatic rise in interest rates. Over the last 3 years, we have seen an unprecedented rise in interest rates. The US Fed Funds rate has climbed to around 5.25% from 0% around 3 years back and India's repo rate has climbed from 4% about 2 years back to 6.5% currently. Due to such a rapid rise in rates, Bonds with a higher duration are impacted more than those with lower duration. Similarly, stocks which have a higher duration will have a bigger impact of rise in rates compared to those with a relatively lower duration. Duration measures how long it takes, in years, for an investor to be repaid a security's price by the security's total cash flows. Duration is also used to measure the sensitivity of a security's price to changes in interest rates.

Which types of stocks have higher duration. Lets look at a hypothetical example.

Impact of Interest Rates	A	B
Starting Dividend	10	10
Life of company (Yrs)	50	50
Growth in Dividend	**5%**	**20%**
Fair Value:		
@ 10% Cost of Equity	180	7652
@ 11% Cost of Equity	156	5368
@ 9% Cost of Equity	211	11035
Impact of 1% rise in Interest Rate	**-13%**	**-30%**
Impact of 1% fall in Interest Rate	**17%**	**44%**

The above example is for illustration purposes only.
Note: Fair Value is computed as sum of present value of all dividends received over the life of the asset, discounted at cost of equity.

As can be clearly seen from the above hypothetical example, companies which have a high growth expectation have relatively higher impact of interest rates, which means they have a higher duration. Thus in a rising interest rate scenario, high growth + high quality companies got impacted much more than those with lower growth and lower quality.

As the interest rates rise, the future cash flows get discounted at a higher rate, pulling down the overall value. This re-adjustment keeps on happening till the rates keep rising. While this process is instantaneous and linear in bonds, its not so in case of equities and the process of re-adjustment in valuation in equities can happen over months or years, either before (in anticipation) or after increase in rates.

As the rise in interest rates plateaus the re-adjustment of valuation starts to stop.

The valuation multiple can rise again as interest rates start falling or the markets start to anticipate fall in rates.

Key Takeaways:
While investors may be skeptical of investing in equities after the recent sharp run-up, there are opportunities available for long-term investors. Share prices of high growth companies are more adversely impacted by interest rate hikes as compared to their low growth counterparts presenting attractive investment opportunities. A re-rating of high growth + high quality companies may happen once the interest rates plateau or start falling.

Summary:
We think the unprecedented rise in interest rates is behind us and incrementally, after a long plateau, we will start to see some fall in rates from the second half of 2024. Markets may stop the compression in valuation of high growth + high quality companies in anticipation of no further rise in rates. This along with strong earnings growth of this basket of companies should result in resumption of their outperformance compared with the overall market. Hence, buying into high growth and high quality companies is the best approach to participating in the Indian Equity Markets.