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Valuations in India

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Is India Expensive?

Given that India's equity market has historically traded at premium valuation multiples versus the broader emerging market (EM) universe, it's important to address the question: "Is India expensive?" Our answer is, in short, no. One of our general goals of investing is to find companies trading below what we deem their intrinsic values. Nobody looks to buy overvalued companies, but putting on blinders and buying something simply based on price can lead to a "value trap."

While many goods and services are pure substitutes, other goods and services are not. Would you buy any bike helmet, a piece of fish, or a fire extinguisher just because it is "cheap?" Of course not. At the same time, growth alone is not helpful either. You wouldn't want to pay up for growth if earnings were being reinvested in dilutive projects. Growth creates value when the business model boasts a difference between its economic returns and its cost of capital. The larger the spread, the more sensitive to changes in expected growth rates.

Bottom line, we believe that one should balance valuation multiples with a company's prospects for both earnings growth and reinvestment rates.

Thus, when we look at India's valuations, the country's elevated growth and return profiles appear to justify the premium multiple.

From a P/E Perspective, we look at

$$\frac{\text{ROE} - \text{Growth}}{\text{ROE} \times (\text{Cost of Equity} - \text{Growth})}$$

RETURN ON EQUITY

We see India with a forward sustainable return on equity (ROE) profile of roughly 16-18% versus 11-13% for broad emerging markets (represented by the MSCI Emerging Markets Index) and roughly 14-16% for developed markets (MSCI World Index). We believe there are three structural reasons why India carries an elevated return profile:

1. India's market is heavily weighted towards consumption. Financials, Information Technology, Consumer Discretionary, and Healthcare combine to make up roughly 65% of the country's market capitalization.[1] Asset heavy, cyclical sectors such as Energy and Materials only account for roughly 20% of the market.[2]
2. With 22 official languages (and home to 121 official and unofficial tongues), India is a challenging market to navigate. In addition to diverse cultures within the country, India is known for a significant amount of bureaucracy, high tariffs, and a national push for self-reliance. As a result, the Indian market boasts high barriers to entry, which means that market leaders often carry pricing power and other advantages versus their competition.
3. In various areas, we noticed that India has historically waited for a buildup of demand ahead of creating supply. Real estate is a good example. Most of India is privately owned. To develop projects, the government often must pay roughly 4x the market rate to purchase agricultural land. Thus, urbanization becomes a two-stage process. Step 1 is a migration of people and a buildup of informal housing. Step 2 is local politicians seeing a growing health problem and then creating housing. Putting demand ahead of supply increases capacity utilization, diminishes the need for leverage, and improves return profiles.

IMPRESSIVE GROWTH PROSPECTS

High prospects for growth represent India's other key differentiating factor. While we see many EM countries growing gross domestic product (GDP) 3-4% annually over the next 10 years, we believe India has potential to grow at a 6%+ annual rate for the next 15 to 20. Over the last 70 years, India's population has quadrupled into the largest in the world.[3]

With this large base, the country now appears positioned for improvements in productivity. Approximately 65% of the population is below 35 years old, and the youth literacy rate stands at more than 90%.[4,5] The country is the world's largest supplier of university graduates and has the third largest group of scientists and technicians in the world.[6]

From an investment point of view, India's manufacturing sector labor cost is roughly 40% of China's.[7] At the same time, penetration rates remain low across various metrics. Household credit to GDP hovers around 50% (well below peers such as Brazil, Thailand, Korea, and China), and other per-capita metrics such as car sales, domestic air passengers, and internet users all lag China and various other emerging markets.[8]

Broadly speaking, we believe that the above backdrop sets up the best potential structural growth story in the world for the next two decades

GDP =
Private Consumption + Government Spending + Private Investment + Exports-Imports

Looking forward, we see the growing middle class driving a larger consumption pie. The government has been forthcoming in terms of plans for investment in technology and infrastructure. Regarding investment, the world seems to be looking to India as a destination for supply-chain diversification out of China.

Last, we believe exports should continue to pick up due to high education levels, a low cost of labor, and the government led Make in India program.

CONCLUSION

When you see India's equity market valuation trading above other EM countries', we believe it can be justified by plugging in expectations for superior returns and growth. In addition, India's valuation recently traded in-line with its five-year historical average, so current multiples appear aligned with market expectations through a full economic cycle.

FOOTNOTES

1. Bloomberg L.P. Data as of August 31, 2023.
2. Ibid.
3. The Guardian. (2023, Apr 24). India Overtakes China to Become World's Most Populous Country.
4. The Times of India. (2023, Feb 2). Is India's Rapidly Growing Youth Population a Dividend or Disaster?
5. Statista. (2023, Jul 10). Youth Literacy Rate from 1981 to 2018.
6. World Economic Forum. (2023, Mar 20). Which Countries' Students are Getting Most Involved in STEM?
7. Business Standard. (2022, Nov 27). China Plus One: Low Labour Costs and Growing Workforce Give India the Edge.
8. EY India. (2023, Feb 22). How India Can Fill the Credit Gap to Fuel Economic Growth.

GLOSSARY

Cost of equity is the return a company requires to decide if an investment meets capital return requirements. It represents the compensation the market demands in exchange for owning the asset and bearing the risk of ownership.

Earnings Per Share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability.

Economic Moat is a distinct advantage a company has over its competitors, which allows it to protect its market share and profitability.

Intrinsic Value Intrinsic value is a measure of what an asset is worth and refers to some fundamental, objective value contained in a financial asset.

Price-to-Earnings (P/E) Ratio The price-to-earnings (P/E) ratio measures the company's current share price relative to its per-share earnings.

Return on Equity (ROE) Return on equity (ROE) is a measure of financial performance calculated by dividing net income by shareholders' equity.

Value Trap is a stock that appears to be cheaply priced because it has been trading at low valuation metrics for an extended time period. The danger of a value trap presents itself when the stock continues to languish or drop further after an investor buys into the company.

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