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Global Fundamental

Indian valuations justified by rapid growth

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India is often considered to be the most attractive long-term investment opportunity within emerging markets, and arguably among all global markets: a powerful demographic story, supported by strong institutions, a vibrant democracy, market-friendly politics, an entrepreneurial business culture and huge growth potential.

Indian markets have lived up to this promise, especially in recent years, firmly outpacing other major markets in the post-Covid recovery. However, India's outperformance is not just a recent phenomenon. Indeed, the market has registered average annual growth of 9.9% over the past two decades, roughly double the rate of both emerging markets (4.4%) and developed markets (5.9%).

This month, India achieved a significant milestone, with the market capitalisation of companies on the Bombay Stock Exchange hitting the $5 trillion mark, having tripled over the last decade. Furthermore, the number of Indian companies with a market capitalisation over $100 billion is now 100, up from only 30 as recently as 2020 (China has 130, despite having a market capitalisation double that of India).

India's economy is expected to grow at a world-leading rate of 6.3% over the next half decade, and is on track to become the third-largest global economy (overtaking both Germany and Japan) by 2027, creating potential opportunities for investors to benefit from India's coming decade. Yet given the level of short and long-term growth in both the economy and stock market, it seems reasonable to question whether this compelling investment case is already reflected in valuations.

Indian shares trade at a premium to other emerging markets

A brief glance at traditional valuation metrics such as the price/earnings (p/e) ratio shows India trading at a healthy premium to wider emerging markets. The MSCI India Index currently trades on a ratio of 23.9 times next year's expected earnings, compared with 12.9 for the MSCI Emerging Markets Index and 19.5 for the MSCI Developed Markets Index. Looking instead at valuations based on assets rather than earnings, we find the same result; India's price-to-book ratio (comparing market value to net assets) is 4.4, compared with 3.4 for developed markets and 1.7 for emerging markets.

It should, of course, be noted that emerging market valuations are substantially dragged down by the (smaller-than-once, but still large) weighting of China, where valuations currently sit at very low levels due to well-publicised structural economic issues (poor demographic outlook and property market woes).

However, these simple metrics fail to capture two of the key attractions of investing in India: a high growth rate in corporate earnings and much higher level of corporate profitability relative to both emerging and developed markets.

The valuation premium is justified by superior growth prospects

The PEG ratio is a common tool to evaluate fast-growing companies and markets as it adjusts the p/e ratio to account for earnings growth rates. The metric – which divides the p/e by the expected growth rate in earnings – returns a high value for markets with an expensive p/e relative to earnings growth and a lower number for markets whose p/e is cheap given the expected growth.

Although India has a high p/e ratio of 24.9, underlying earnings are growing at 17% this year, considerably higher than major markets such as the Eurozone (4.9%), Japan (7.8%) and even the US (12.1%). India's PEG ratio therefore looks relatively attractive at 1.3 compared with the US (1.6), Japan (1.8) and Eurozone (2.6).

Earnings growth is supported by economic expansion and a new investment cycle

India is one of the few markets to consistently deliver earnings per share growth – since 2020, growth in India (in US dollars) has been 47%, compared with 1% for wider emerging markets. Over the next two years, analysts' consensus forecasts are for median Indian earnings growth of 16% against a 4% decline for emerging markets – the widest differential since 2010.

The trajectory of Indian earnings has clearly inflected higher in recent years and currently sits 30% above its 10-year average, reflecting robust underlying economic growth. Indeed, India is the only major emerging market that exhibits a strong relationship between domestic economic growth and corporate earnings (most other markets are more correlated with global growth in general, or trade flows). With this in mind, we should continue to expect India's rapid economic expansion – 6%+ annually in real terms, compared with 2% for wider emerging markets – to translate into strong earnings growth.

Although Modi and the BJP have been in power– pursuing a market/economy-friendly reform agenda – for a decade, the first half of this period was dedicated to tough but necessary reforms, and it has only been in the last half decade that the economy has truly been unleashed into a much-needed investment cycle, one that matches closely the step-change upwards in corporate earnings. We should therefore expect earnings growth in India to remain at structurally higher levels than global peers, helping to support current valuations.

Indian profit margins exceed emerging market peers

As well as exhibiting structurally higher earnings growth, Indian companies are also much more profitable than emerging market peers. Taking return-on-equity as a measure of profitability relative to net assets, India has one of the highest rates in emerging markets at 16% compared with 12% for the wider index. Indeed, nearly 20% of Indian companies have a return-on-equity in excess of 25% and in nearly every sector Indian returns are higher than general emerging markets.

Higher profitability from its assets helps explain the Indian market's higher price-to-book value compared with wider emerging markets. Higher returns on equity reflect a greater efficiency at profit generation and are indicative of companies with higher margins – since the pre-Covid period, India's return on equity has risen 200 basis points thanks to expanding operating profit margins.

High margins are in part a function of India's more domestically oriented stock market, with lower weightings than peers in lower-margin commodity sectors, but also due to structural advantages such as complex distribution

networks offering competitive advantages and diverse consumer preferences helping local companies outcompete foreign players.

In addition to providing higher returns on investment, Indian companies' cost of capital is also lower; India's cost of equity is 10% compared with emerging market's 12%. India's credible government, central bank and market regulators have seen investors assess the country as possessing greater macroeconomic stability and reduced currency volatility. This lower perceived risk feeds through to lower borrowing costs and cost of equity.

Rising profitability combined with a falling cost of capital is clearly supportive of share valuations. The spread between return on equity and cost of equity is a proxy for value creation, and this has increased 650 basis points relative to emerging markets over the past three years.

Do superior earnings prospects and reasonable valuations mean the market is widely owned?

Given the clear and attractive investment story India offers, along with the outstanding market returns over recent years, a common assumption is that the market must already be heavily owned by foreign investors. However, the reality is that foreign flows into India have been relatively anaemic in recent years. Year to date this trend has continued, with foreign investors selling over $3 billion, largely offset by an increase in domestic investor purchases.

Over the past decade, foreign ownership of Indian equities has fallen from 19.1% to 16.5%, while domestic ownership has risen from 3.3% to 8.9%. One of the key features of Indian domestic flows has been the rapid increase in Systematic Investment Plans (SIPs), which are monthly purchases of the market and therefore much more predictable than discretionary flows. The number of SIP accounts has increased steadily from 25 million in 2019 to 85 million today – consistently rising even throughout the market volatility surrounding Covid. The runway for growth in domestic investment is long, given that the 30-60 age cohort – those with the highest propensity to invest – is expected to increase by 150 million people in the next 20 years.

As foreign investors become less dominant in market flows, Indian markets have seen a structural decline in correlations with wider emerging markets, decreasing market volatility and increasing the quality of the market and attractiveness to investors.

As foreign funds have continually sold India ahead of the general election results in early June, many global emerging market funds have shifted from a neutral stance to notable underweight in recent months. Therefore, considerable funds from foreign investors may well be re-allocated back to India once the election is over and a key uncertainty is removed from the market.

Our outlook for Indian equities remains constructive

Higher valuations are justified and sustainable when earnings growth is higher, profitability is higher and cost of equity lower. In our view, Indian equities have the most attractive prospects among the emerging markets universe. However, we believe the market's potential is best captured through a selective approach. The Liontrust India Fund focuses on key areas of the domestic economy that are benefiting from core themes such as the build out of physical infrastructure, consumer premiumisation, healthcare services and financial inclusion. These areas benefit from both the current cyclical upswing in the economy, led by investment, and long-term structural forces such as a strong demographic profile and the emergence of a sizeable middle class.

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For a comprehensive list of common financial words and terms, see our glossary at:
https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

Key Risks

Past performance does not predict future returns. You may get back less than you originally invested. We recommend any fund is held long term (minimum period of 5 years). We recommend that you hold funds as part of a diversified portfolio of investments.

Overseas investments may carry a higher currency risk. They are valued by reference to their local currency which may move up or down when compared to the currency of the Fund.

This Fund may have a concentrated portfolio, i.e. hold a limited number of investments. If one of these investments falls in value this can have a greater impact on the Fund's value than if it held a larger number of investments.

The Fund may encounter liquidity constraints from time to time. The spread between the price you buy and sell shares will reflect the less liquid nature of the underlying holdings.

Investments in emerging markets may involve a higher element of risk due to less well-regulated markets and political and economic instability. This may result in higher volatility and larger drops in the value of the fund over the short term.

Outside of normal conditions, the Fund may hold higher levels of cash which may be deposited with several credit counterparties (e.g. international banks). A credit risk arises should one or more of these counterparties be unable to return the deposited cash.

Counterparty Risk: any derivative contract, including FX hedging, may be at risk if the counterparty fails.

The issue of units/shares in Liontrust Funds may be subject to an initial charge, which will have an impact on the realisable value of the investment, particularly in the short term. Investments should always be considered as long term.

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