Equities: Not All Growth is Created Equal

INSIGHTS

The indiscriminate sell-off in growth companies is creating potential opportunities in 'true' growth stocks, which are becoming increasingly undervalued amid the broader market decline.

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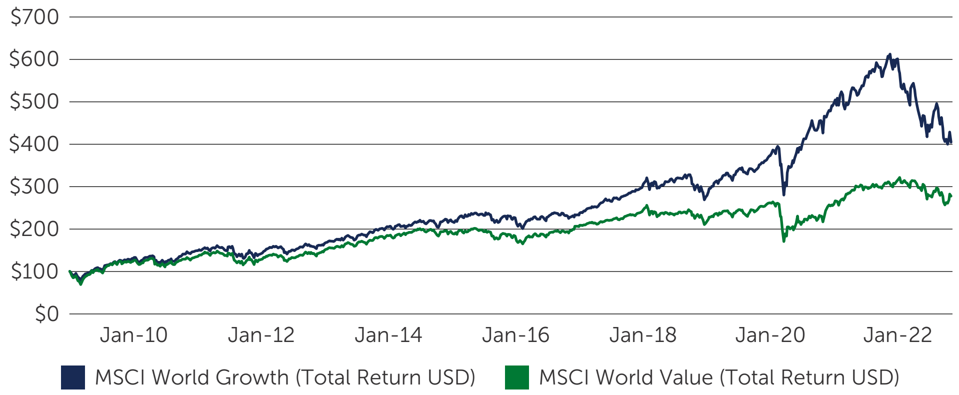
2022 has seen significant economic and financial developments alongside dramatic geopolitical events, but for the equity investor, the greatest shock may have been the sharp underperformance of growth companies.

How Much Growth is Good?

Since the post-Global Financial Crisis equity rally began 13 years ago, there has been an almost continuous outperformance of growth companies **(Figure 1)**. As this outperformance unfolded over time, a simplistic 'growth is good' assumption took hold, leading to ever-rising valuations of growth companies, which, in many cases, were undeserved.

Figure 1: After 10+ Years of Strong Performance, Growth Companies Have Declined Steeply



Source: Bloomberg. As of November 4, 2022.

Growth is an often misused term. It measures an output but says very little about the inputs required to generate it. For instance, is 10% growth good, or is 20% better? The level of growth, by itself, is not enough information to answer that question. This is perhaps best explained with an example:

SCENARIO 1

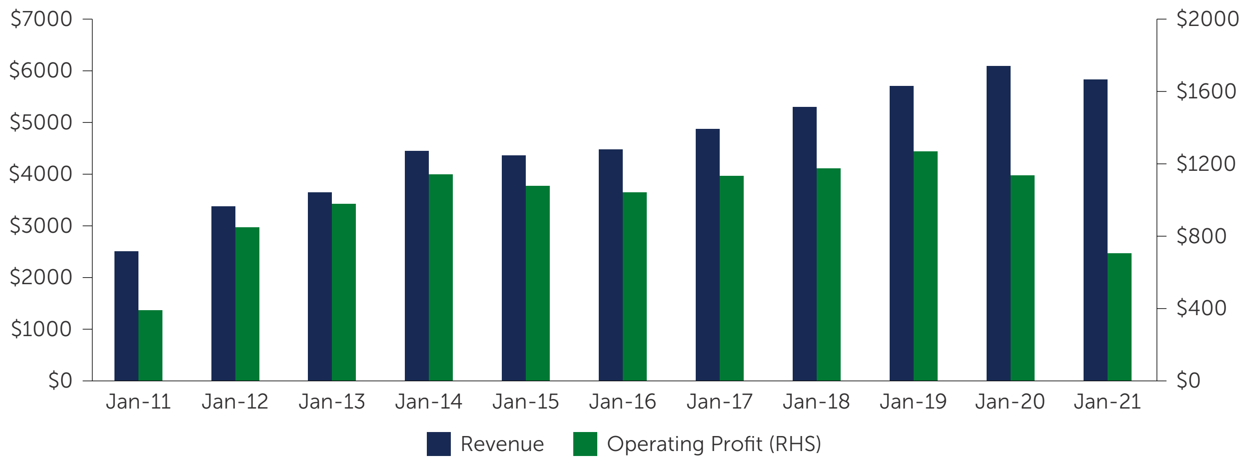
A company invests $1000, and that investment generates $20 of additional earnings. If the company currently earns $100, that equates to 20% earnings growth. While this sounds okay on the surface, in reality it only amounts to a paltry 2% return on investment for the additional $1000 invested.

SCENARIO 2

A company invests $100 to generate $10 of additional earnings. In this scenario, the company is only creating 10% growth in earnings, but the return on investment is 10%—five times higher than in the first scenario. So, to the question about whether a level of growth is good, the answer is that it depends on the returns that that growth generates.

The minimum investment return hurdle must be to exceed the cost of capital being deployed. Delivering above this level creates value to the shareholder. While this is a basic assessment, in recent years it has too often been neglected. An interesting real-world example is the experience of a Spanish-based producer of blood plasma derived therapies (Company A). The company's revenue and operating income grew well over the past decade, right up until the onset of the pandemic **(Figure 2)**.

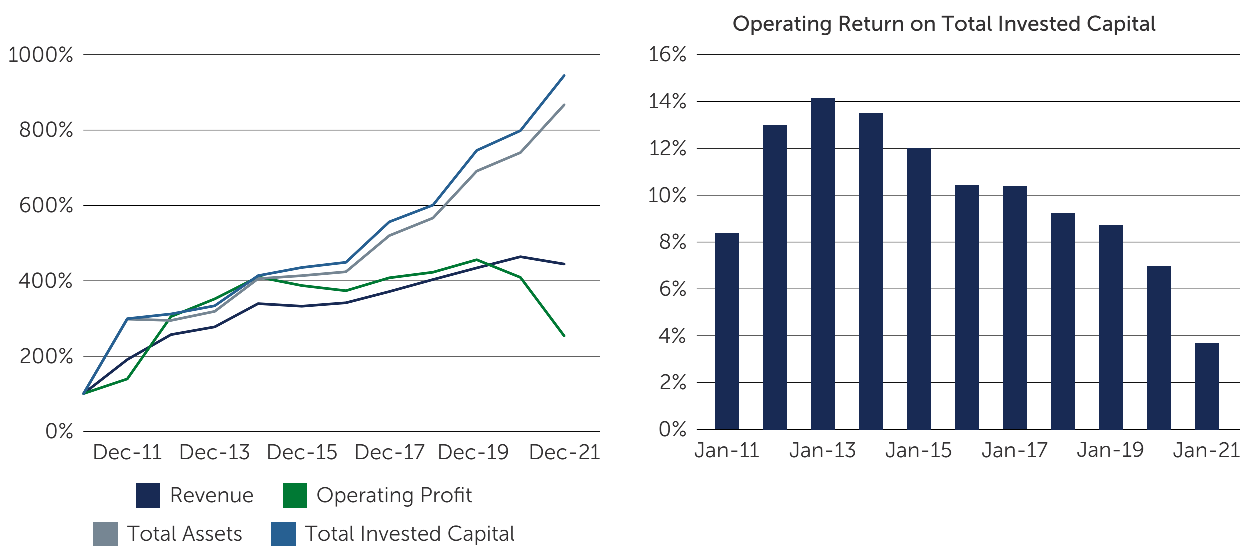
Figure 2: Company A Sees Solid Revenue and Operating Income Until Pandemic (US$ Million)



Source: Bloomberg. As of December 31, 2021.

This growth, however, required ever-increasing inputs, as shown by the rise in total assets and invested capital in **(Figure 3)**—and with inputs ultimately expanding faster than the outputs in terms of sales and earnings produced. The result has been a persistent deterioration in returns **(Figure 3)**.

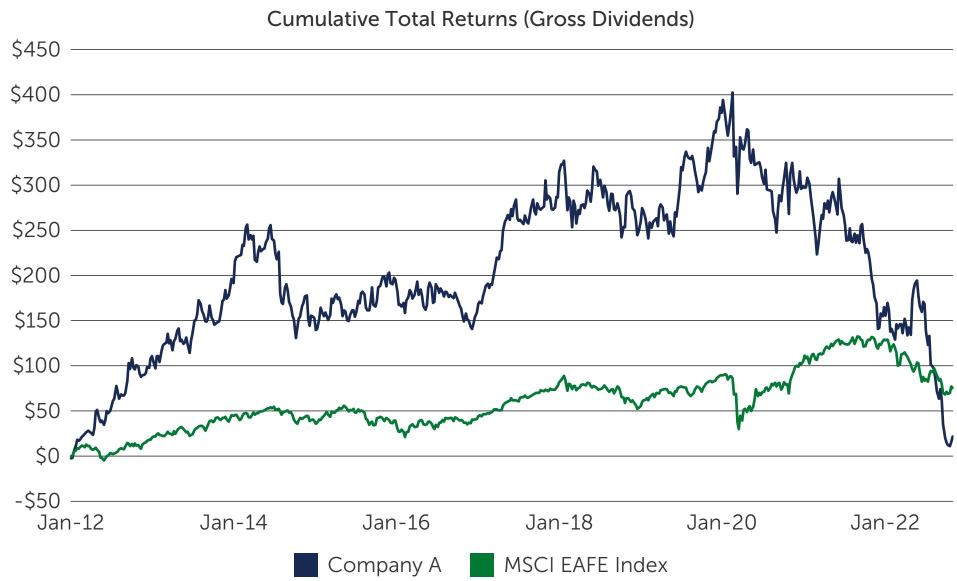
Figure 3: Company A's Growth Requires Increasing Inputs



Source: Bloomberg. As of December 31, 2021.

The company's stock performed well for a number of years as investors focused on the growing outputs rather than the ever-increasing inputs. It was only when the output 'growth' began to falter that investors noticed the long-term deterioration of returns. The result has been a sharp decline in the share price that has seen more than a decade's worth of relative performance eroded in the past three years **(Figure 4)**.

Figure 4: Significant Decline in Company A's Share Price



Source: Bloomberg. As of November 4, 2022.

Identifying 'True' Growth Stocks

As Growth-at-a-Reasonable-Price (GARP) investors, growth is one of the key elements of our process. But properly assessing an investment opportunity requires understanding the returns that a company's growth generates in addition to the reasonable price that we are willing to pay. In fact, we can only accurately gage what is a reasonable price once we understand both the growth and returns of the company.

Investors have been rediscovering this recently, and a sharp decline in the share prices of many supposed growth companies is underway. This may be broadening into a wider growth company sell-off, which could create compelling investment opportunities as legitimate high-quality growth companies become increasingly undervalued amid the wider market decline.

Our focus on fundamental, long-term, high-quality growth opportunities is core to our process. We believe this approach is well-positioned to benefit from the rising opportunity set of reasonably priced, genuine growth companies.

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