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# Secular Growth Explained

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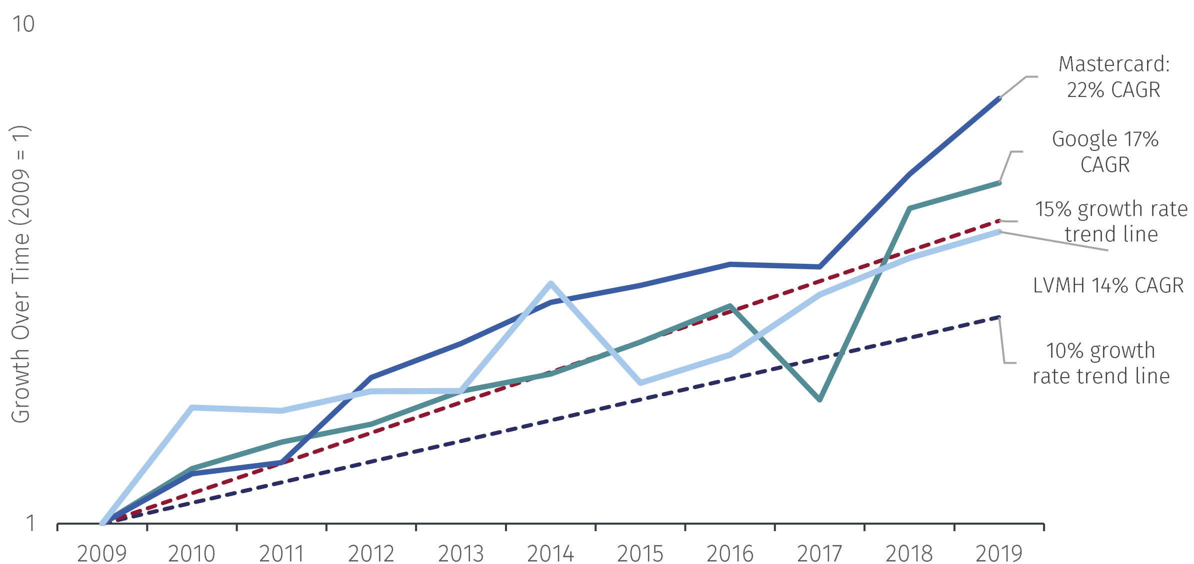
Why do we invest in equities? A key reason is that equity investments compound over time. By investing $100 in a company that grows 10-15% per year for 20 years, that $100 turns into $673 at a 10% compound rate, or $1637 at a 15% compound rate. In comparison, a 3% bond would return $181 for the same period.

These 10-15% "compounders" are not as difficult to find as one might think, with many being household names: Google, Mastercard, and Louis Vuitton. We call them "secular growers" – high quality companies with favourable secular trends (digital advertising, cashless payment, and luxury democratisation respectively).

**Figure 1. Many household companies grew 10-15% per year* over the last decade, thanks to favourable secular growth trends**




* Earnings per share (EPS) growth between 2009 and 2019, rebased to 2019. Google's 2017 EPS was impacted by a one-off tax impact.
Past performance is not necessarily a guide to the future. Source: FactSet.

This strategy has served many investors well over the decades. However, as "growth" stocks have underperformed the broader equity market more recently, one question emerges: is it the end of the secular growth investing?

To answer this question, we examine the two main causes for the recent "growth" stocks' underperformance:

1. <u>Secular growth: paused or broken</u>?

The Covid-19 pandemic accelerated some secular growth trends. One example is e-commerce. Before the pandemic, US e-commerce sales had been growing at over 9% per annum between 2009 and 2019. E-commerce penetrations (as a percentage of the total US retail sales) rose from 12.2% in 2009 to 20.8% by 2019, or roughly

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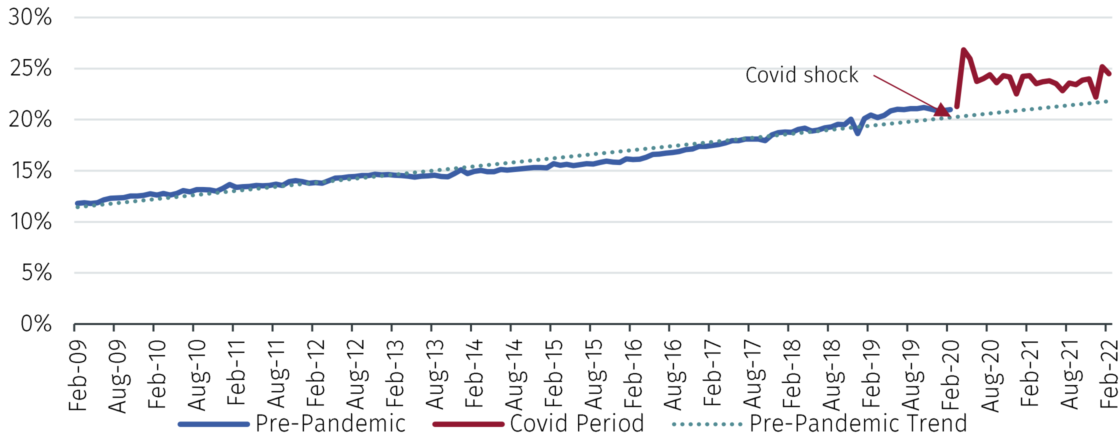
0.9% increase per year. In 2020, e-commerce penetrations soared due to lockdowns: from 20.9% in December 2019 to 26.8% in April 2020 – pulling forward four years of e-commerce growth in just four months (Figure 2).

**Figure 2. US e-commerce penetration was accelerated by Covid**



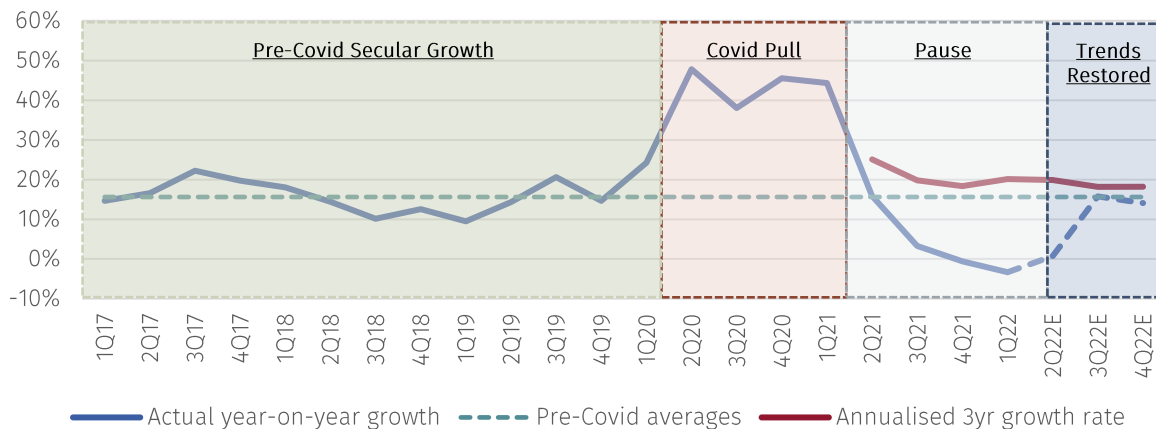

Source: U.S. Census Bureau and Wolfe Research.

Some of the pull-forward effect will stick – for example an octogenarian who learnt how to shop online in 2020 might continue to shop online in future. But in 2022 there is some normalisation between online and off-line shopping, as the world reopens.

This “pull-forward and pause” effect was evident in Amazon’s financial results. Amazon’s online stores sales year-on-year growth rate jumped from 24.3% in Q1 2020 to 47.8% in Q2 2020. The growth rate stayed around 40% for four quarters, before starting to moderate in 2021. Since Q3 2021, Amazon’s online sales have barely been growing at all.

We try to look through the Covid boost, by examining the 3-year period between 2019 and 2022. The annualised growth rate between 2019 and 2022 is around 20% - suggesting that secular growth remains healthy (Figure 3, red line). Indeed, Amazon’s year-on-year growth rate should recover to 15% by late 2022, according to FactSet consensus estimates, in-line with the long-term secular growth trend.

**Figure 3. Amazon online sales: year-on-year growth rate**




Source: FactSet and EFGAM calculations.

Similar patterns also occurred in connected TV (Netflix and Roku), social media (Facebook and Snapchat) and some software applications (Adobe and Asana). Almost anything with a screen attached.

2. Rising bond yields compress equity valuations

Not all secular growth stocks experienced the same Covid impact. For example, we look at Adyen, a modern merchant payment service provider.

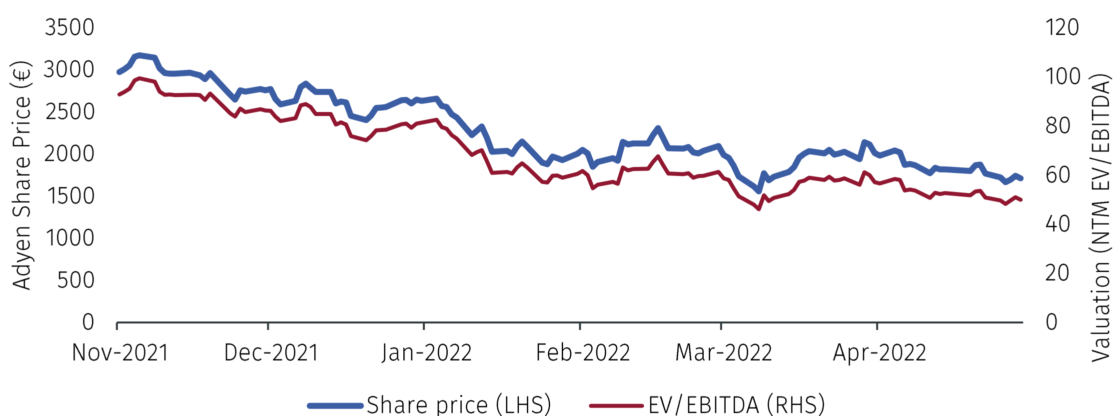
Adyen's revenue grew 28% in 2020. Despite a strong 2021 when its revenue grew 46%, Adyen is still expected to grow 39% in 2022. Further, consensus 2022 expectations, for revenue and profits (EBITDA), had not changed in the last six months between November 2021 and April 2022. Yet, Adyen's share price dropped over -40% over the same period (Figure 4).

**Figure 4. Adyen's share price dropped over -40% in the last 6 months, despite maintaining strong growth rate in 2022**

Past performance is not necessarily a guide to the future. Source: FactSet

What happened? Valuation. Adyen's valuation, in terms of the EV/EBITDA ratio, shrunk -46%, driving down the share price despite no changes to business fundamentals (Figure 5).

**Figure 5. Adyen's share price drop was entirely driven by valuations**




Past performance is not necessarily a guide to the future. Source: FactSet, including forward consensus estimates.

Inflation concern is the main reason for the valuation compression. Higher than expected inflation triggered fears that central banks would have to raise rates more aggressively than previously anticipated.

Higher rates hurt “growth” stocks more than “value” stocks. This is because when we value equities using Discount Cashflows, “growth” stocks’ cashflows are further in the future and therefore more sensitive to changes in discount rates. As illustrated in Figure 6, as the 30-year Treasury yield rose from 2.0% in November 2021 to 3.0% in April 2022, a “growth” stock’s valuation drops -30%, while a “value” stock’s valuation drops -15%.

**Figure 6. 100bps increase in Treasury yield compresses "growth" stocks' valuation far more (-30%) than "value" stocks' (-15%)**

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 | Year 9 | Year 10 | Terminal | Valuation | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| November 2021: Discount Rate = 2.0% UST 30Y + 5.5% Equity Risk Premium = 7.5% | | | | | | | | | | | | | |
| "Value" Stock Cash Flows (3% growth) | $10 | $10 | $ 11 | $ 11 | $ 11 | $ 12 | $ 12 | $ 12 | $ 13 | $ 13 | $ 224 | $ 178.4 | |
| "Growth" Stock Cash Flows (10% growth) | $10 | $ 11 | $ 12 | $ 13 | $ 15 | $ 16 | $ 18 | $ 19 | $ 21 | $24 | $1,037 | $ 571.7 | |
| April 2022: Discount Rate = 3.0% UST 30Y + 5.5% Equity Risk Premium = 8.5% | | | | | | | | | | | | | % Fall in Value |
| "Value" Stock Cash Flows (3% growth) | $10 | $10 | $ 11 | $ 11 | $ 11 | $ 12 | $ 12 | $ 12 | $ 13 | $ 13 | $ 192 | $ 152.0 | -14.8% |
| "Growth" Stock Cash Flows (10% growth) | $10 | $ 11 | $ 12 | $ 13 | $ 15 | $ 16 | $ 18 | $ 19 | $ 21 | $24 | $ 741 | $ 400.2 | -30.0% |

Source: FactSet, including forward consensus estimates.

In short, the combination of secular growth trends taking a pause and the valuation compression from rising rates, both occurred in late 2021, caused “growth” stocks to underperform.

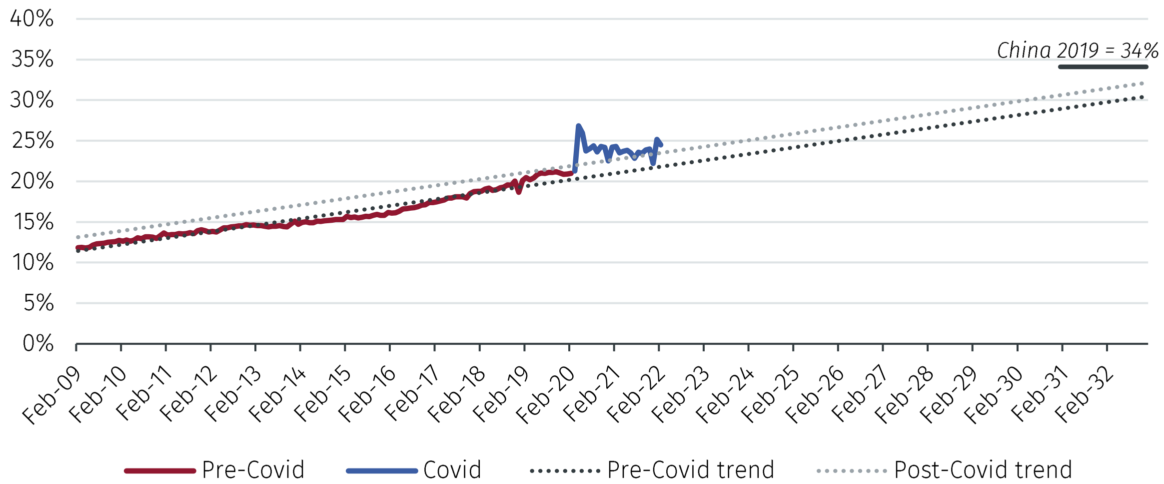
Now, is this the end of secular growth investing? It is down to two factors:

1. Is the secular growth trend broken?

We must assess each individual secular trend carefully. Some growth trends could sustain (digital cloud adoption), some are taking a pause (e-commerce and connected TV), while some might revert back to 2019 (in-house fitness?).

Staying with our e-commerce example, the US e-commerce penetration was 24.5% in February 2022. In comparison, the Chinese e-commence penetration already reached 34.1% in 2019 and jumped to 52% in 2021, according to eMarketer. The US e-commerce penetration had been rising by 0.9% per year in 2009-2019. If a similar adoption trend continues from 2022, the US e-commerce could continue to grow for at least 10 more years, before reaching China’s 2019 levels (Figure 7).

Figure 7. US e-commerce penetration has room to grow for at least another decade




Source: U.S. Census Bureau, Wolfe Research and eMarketer.

2. Is valuation sensible?

It's difficult to be definitive in absolute terms, but relative valuations are certainly becoming interesting.

Which of the following companies would you prefer to own for 5 years: A or B, and C or D?

| | Company A | Company B | Company C | Company D |
|---|---|---|---|---|
| Pre-Covid Earnings Growth (2015-2019 Annualised) | 21.1% | 5.4% | 36.0% | 12.3% |
| Expected Earnings Growth (2022-2024 Consensus) | 17.0% | 6.2% | 16.5% | 8.7% |
| Operating Margin (2021) | 30.5% | 22.8% | 41.6% | 19.1% |
| Return on Capital (2021) | 29.6% | 4.9% | 32.9% | 17.5% |
| Leverage (2021 EV/EBITDA) | -1.4 (net cash) | 6.2 | -0.7 (net cash) | 1.9 |
| Valuation (NTM Price /Earnings, 30th April 2022) | 19.7 | 19.5 | 27.0 | 30.3 |

Past performance is not necessarily a guide to the future. Source: FactSet

Solely looking at the numbers, most would prefer Company A to Company B, and Company C to Company D. A and C have far superior financial metrics, despite trading at similar valuations to B and D.

Company A is Google, B is Duke Energy (electric utilities), Company C is Microsoft and Company D is General Mills (food staples). In a volatile environment, "value" stocks, such as Duke Energy and General Mills, are in favour due to safe-haven status. These stocks may deserve some capital allocation currently. But over a longer time-horizon, it's secular growers like Google and Microsoft that deliver strong returns to patient investors.

To conclude, the underperformance of secular growth stocks since November 2021 can be attributed to a combination of 1) secular growth taking a pause to digest Covid gains; and 2) rising bond yields compressing equity valuations. Now, the questions for secular growth investors to figure out are: 1) are long-term secular growth trends intact or broken; and 2) is the valuation reasonable? If both answers are yes, then secular growth investing should continue to deliver long-term gains.

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