Morgan Stanley
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Global Equity Observer

When Money Isn't Free

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Scientists believe that it takes most of us anywhere between two months and a full year to form a new habit. It would therefore seem reasonably safe to assume that two decades of falling global interest rates have left a lot of corporate managers and equity investors accustomed to debt available on demand, and at a fairly insignificant cost.

In fact, over the last 10 years, global corporate debt has grown from $53 trillion to nearly $88 trillion U.S. dollars (USD) at the end of 2021, reaching 98.5% of global gross domestic product.[1] Undoubtably, some of these funds have helped corporates to finance productive expansionary capital expenditures or invest in long-duration infrastructure projects; but freely available cheap debt can also be corruptive. It may tempt management to "juice up" returns through balance sheet leverage, to engage in acquisitive transactions that can help them to get paid on earnings per share growth (an incentive metric we truly hate), or in some cases invest on the assumption that capital is "free" as long as they are seen as a growth story.

Our investment process favours companies that generate a high, unlevered and sustainable return on operating capital employed (ROOCE). We are naturally suspicious of companies that rely excessively on financial leverage. For long-term equity investors like us, debt represents an asymmetric risk. When credit supply is abundant, management isn't worried about bond repayment deadlines—for them it is simply a refinancing exercise. But when exogeneous shocks limit that credit availability, cash is once more king, and in a worst-case scenario, years of earnings growth compounding can be unwound by a debt call that reduces the value of equity to zero. To us this seems too high a risk to take for the few percentage points of extra return that leverage might bring. As the great Warren Buffett so elegantly put it, *"A Russian-roulette equation—usually win, occasionally die—may make financial sense for someone who gets a piece of a company's upside but does not share in its downside."* We spend a lot of time thinking about minimising downside participation.

[1] Source: Statista, "Debt of nonfinancial corporations worldwide quarterly 2008-2021," September 7, 2022.

In fact, as the corporate world adjusts to higher global interest rates, we think this balance sheet strength will become a differentiating factor for the earnings and franchise resilience of our companies. The first-order impact is simple: lower debt levels today imply a lower drag on earnings when that debt is refinanced at higher rates. However, we also believe that our companies are better placed to use their balance sheet resilience to improve their long-term prospects. As our colleague Marcus Watson argued in an earlier Global Equity Observer, *Scale and Diversification,* ultimately, being able to invest in difficult times should enhance competitive positions, increasing the sustainability of ROOCE and driving the steady, predictable growth we look for.

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Some of our companies are in the enviable position where their clients, through the normal course of business, regularly "lend" them large amounts of funds while demanding no return on it. This "float" usually comes from transaction balances that might have very short contractual duration, but in aggregate tend to be very sticky. These businesses are likely to see a tailwind to earnings as customer funds are invested at higher "risk-free" rates.

For example, the large U.S. software payroll provider we own benefits from just a few days' gap between clients sending funds in and employees receiving their salaries. In aggregate, the company had average client fund balances of $32.5 billion in the last fiscal year, and its 1.4% yield on those funds is likely to increase with U.S. short-term rates trending higher.[2]

Similarly, a European exchange that we hold in some of our global portfolios, and that owns one of the world's major settlement and custody venues for international fixed income instruments, requires its clients to post cash balances to pre-fund settlements for bond transactions. Cash balances stand at approximately €18 billion (with approximately 50% in USD) and net interest income from these deposits increased more than fivefold year-over-year in the third quarter.[3] This represents approximately 7% of group net revenue, with what is likely to be close to a 100% drop through to the bottom line.

In other instances, there is no commercial need for customers to entrust a business with funds, but they simply choose to do so for convenience purposes. For example, we own the largest e-wallet provider in the Western world, which usually holds more than $30 billion in customer accounts on its platform,[4] there primarily to help fund future purchases. Although these funds can be withdrawn at any moment, so long as this e-wallet solution remains a convenient way for consumers to pay for their purchases online, it is reasonable to expect that these balances will stick around, allowing the business to receive interest income by reinvesting those funds into relatively safe fixed income instruments (such as U.S. government bonds).

"As it becomes harder to engineer growth through debt, we think the relative value of businesses that can consistently grow organically should only go up."

As higher interest rates work their way through the economy, some behaviour that was facilitated by cheap debt is likely to disappear. Froth in the global housing market is likely to go away as consumers grapple with higher mortgage costs. We are also likely to see fewer advertisements for a shiny new grocery delivery business, for example, as investors reassess the opportunity cost of capital that is required to disrupt a new market. However, as it becomes harder to engineer growth through debt, we

[2] Source: Company Earnings Call & Webcast: Q1 Fiscal 2023, October 26, 2022.

[3] Source: Company Investor Presentation, November 2022.

[4] Source: Company 2021 Annual Report, June 2, 2022.

think the relative value of businesses that can consistently grow organically should only go up. As we've argued before, resilient earnings matter less in good times; it is when the going gets tough that the combination of recurring revenue (looking after the top line) and pricing power (looking after margins) really pays off.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect global franchise companies and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. **Stocks of small- and mid-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **ESG strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

DEFINITIONS

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

Earnings per share (EPS) growth is the weighted average of earnings per share growth for all securities in the portfolio projected for the past five fiscal years. Earnings per share for a company is defined as total earnings divided by shares outstanding.

Return On Operating Capital Employed (ROOCE) is a ratio indicating the efficiency and profitability of a company's trade working capital. Calculated as: earnings before interest and taxes/property, plant and equipment plus trade working capital (ex-financials and excluding goodwill).

Financial leverage is the degree to which a company uses fixed-income securities such as debt and preferred equity. A high degree of financial leverage means high interest payments, which negatively affect the company's bottom-line earnings per share.

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