Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Scale and Diversification

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | MAY 2021

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You may know that our favourite types of businesses are those that can generate a high, sustainable return on operating capital employed (ROOCE), while growing steadily and predictably over time. These high quality businesses often exhibit the twin virtues of scale and diversification. This makes sense: scale often lends itself to profitability and in turn a high ROOCE, while diversified revenue streams mean that potential mishaps in one business area or region need not have a significant impact on the company as a whole. This helps growth to be more predictable. Undoubtedly, the characteristics of scale and diversification have played a part in the superior earnings performance of the Portfolio compared with the index, both through the recent crisis and over time.

Winston Churchill observed that one should never let a good crisis go to waste. For corporates, this might mean investing when competitors are not able to, and taking market share as a result. Unfortunately for most companies, cash flows dry up during a crisis and investing is difficult or impossible. However, for those with scale and diversification, this need not be the case. Two leading global sportswear companies have effectively demonstrated the capacity and breadth of their capabilities to outperform and out-invest their peers. Over recent years, superior scale and profitability have allowed the two companies to grow

their revenues at high single digits and invest meaningfully in digital capabilities, while maintaining pristine balance sheets in a way that was simply not possible for competitors.

Naturally when COVID-19 hit, store closures across the world meant that the entire industry suffered significantly. However, both companies made highly effective use of their capabilities and capacity to invest. One of these companies has a $3.5 billion marketing budget and launched a massive digital marketing campaign focused on remaining active during lockdown. It reported in June 2020 that its ‘You can’t stop us’ campaign had generated over 2 billion views worldwide, driving powerful brand engagement, workout app downloads, enrollment in membership programmes, and ultimately a surge in already significant online sales: its e-commerce sales grew 54% in its most recent quarter. The company also benefited from being very well diversified geographically and was able to take lessons from China’s lockdown to refine its strategy as other countries locked down later in the year. On top of this, neither company has stepped back on its sustainability, driving ever stronger brand loyalty and making an already dominant competitive position even more formidable. While both businesses were heavily impacted by the crisis, their ability to react nimbly means that their outlook is now far better than before the crisis hit.

Turning to another sector, our diversified Health Care businesses have also shown their mettle during the pandemic—despite the peculiar nature of the crisis affecting the industry more severely than would have been expected in a typical recession. We do not think it is a coincidence that many of these large businesses, with their impressive range of capabilities, were at the forefront of providing reliable COVID tests as well as supporting the development of vaccines. This has led to significant cash flows for the companies involved, exemplified by a medical devices company’s free cash flows (FCF) growth of 135% in its most recent quarter. Given their enormous diversification, these companies have a variety of attractive areas in which to invest and are putting these cash flows to work. This will likely lead to stronger competitive positions and higher underlying growth rates than before the crisis.

Among our Information Technology holdings is a software business offering payroll and HR services to its customers who are mainly small- and medium-sized businesses. What distinguishes this company is that it backs up its impressive software offerings with a world-class service organisation. Without great scale or a wide range of product offerings, it would be difficult to justify or afford such service provisions, but it proved invaluable to its customers as companies had to adjust rapidly to lockdowns and working from home. The result is record high customer retention levels which have allowed it to continue to invest throughout the crisis, thereby improving its competitive position.

These examples are far from the only companies that have invested through the crisis. Ultimately, being able to invest in difficult times—even at the expense of short-term profitability—should enhance competitive positions, increasing the sustainability of ROOCE and driving the steady, predictable growth we look for. Happily, for many of our holdings, it is not something companies are easily able to do.

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DEFINITIONS

Free cash flow (FCF) is a measure of financial performance calculated as operating cash flow minus capital expenditures. FCF represents the cash that a company is able generate after laying out the money required to maintain or expand its asset base. **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).

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CRC 3598235 Exp. 5/31/2022 Lit-Link: GLBQOBV-0521 10024206_KC_0521
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