Morgan Stanley

INVESTMENT MANAGEMENT

Q&A with Nic Sochovsky

Consumer Staples

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Nic Sochovsky, a Portfolio Manager in the International Equity Team that manages the Morgan Stanley Global Franchise, Global Quality and International Equity strategies, has over 17 years' experience analyzing and following the Consumer Staples (Staples) sector. Here he discusses the team's significant exposure to what they consider high quality[1] Consumer Staples.

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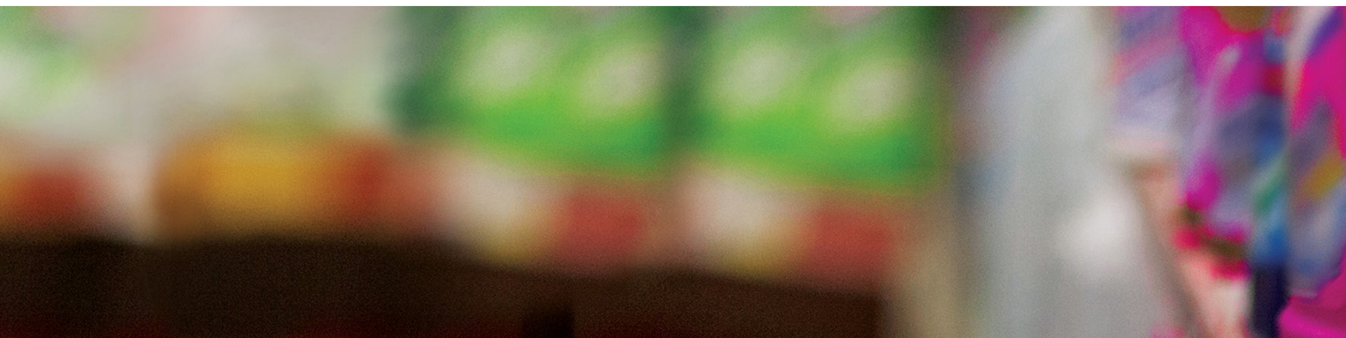
For a Staples company to win today, what do you look for?

NIC SOCHOVSKY (NS): The starting point is companies which invest in "pull" marketing strategies, principally using innovation and media to create brand loyalty and awareness. "Push" tactics that focus on promotion are far less durable in our opinion.

Second, management teams that "Act local, think global." We believe that decision making at the local market manager level, married to centralized back office functions that leverage global scale, is the most effective model.

This means the right corporate culture is key; there is no such thing as a global consumer. Tastes, culture and traditions matter

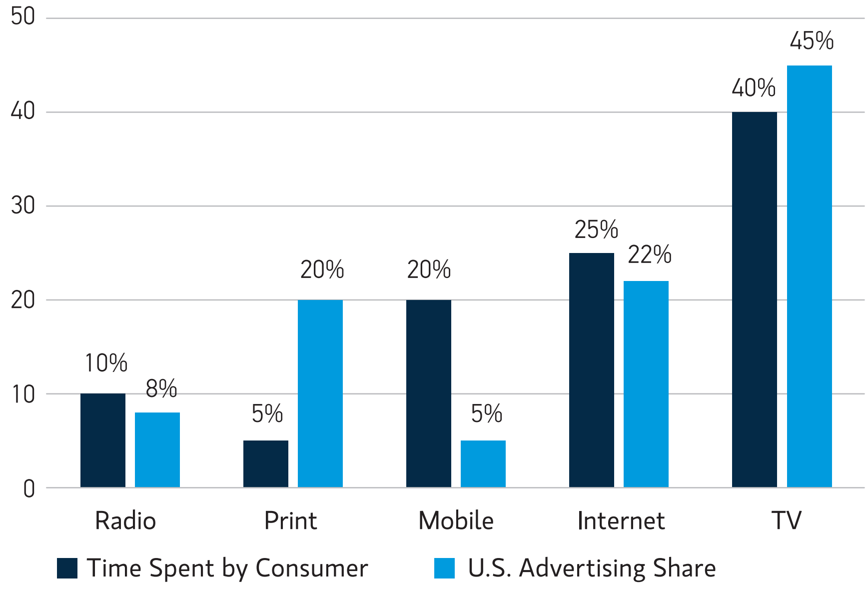
[1] References to "Quality" and "High Quality" herein reflect the investment team's opinions regarding certain factors of an issuer which may be subjective.



and they differ greatly. By running global marketing campaigns, or using global research & development centers, companies risk missing the intricacies and opportunities offered by local consumers. Local players have picked up on this, not only in Developed Markets (DM), but also in some Emerging Markets (EM). Global players are now beginning to cede market shares in key EM, none more so than China. We believe that by following a decentralized model, it offers the opportunity to manage both local and global brands. For example, a French-based global spirits company, on acquiring a foreign whisky operation from a competitor years ago, put local managers in charge. Today they run a leading local premium spirits business in that location with its leading brand accounting for 9% of group sales, growing at over 15% per annum (p.a.) and generating a return on equity over 100%.[2]

DISPLAY 1

Time spent vs. U.S. advertising spend[3]



Has the landscape for Staples become more complex in recent years?

NS: We believe so, yes. Consider Staples' key asset—their brands. In the past, the game was simple: the higher a brand's share of voice (the percentage of total advertising spend in the brand's market category) relative to its market share, the further a brand's market share would rise. This is no longer the case. Last year, for the first time in the U.S., the percentage of time spent watching television fell below the percentage of advertising spend allocated to television. In a world where the consumer is spending nearly 50% of their time on the internet and mobile devices, digital marketing is paramount *(Display 1)*. Focusing on a share of voice alone simply does not work. Data mining (and the use of age-appropriate media to reach the consumer) is as important, not simply how much money a company spends. This lowers the barriers to entry for smaller brands such as craft beer, small batch distillers and organic food producers, which in turn has introduced a new set of competitors.

What impact is e-commerce having?

NS: E-commerce is very disruptive and damaging for Staples companies' traditional route to market, supermarkets, especially the Big Box retailer. This has led the supermarkets to use excessive price promotions, potentially hurting Staples' brand equity.

Today, the Big Box format is under attack from "small box" (convenience/discounters) to "no box" (internet-only retailers.) Big Box retailers react by turning to their suppliers to make their profit, not to the shopper. The result is product line proliferation. On average, the weekly shopping basket in the UK contains 0.1% of the total product line in the store! Kantar Retail also estimates 70% of all trade promotions do not work.[4] Since this is a major lever Staples companies use to drive sales, it is no surprise, as previously mentioned, that we prefer Staples that use pull (innovation/media) rather than push (promotion) tactics. It is also a reason, among many, why we tend to avoid owning food retailers. Apart from having levels of profitability some 5x lower than the branded manufacturers whose products they stock, they barely cover their cost of capital and as a result nearly 90% of the economic profit across the entire value chain is captured by the branded manufacturers.[5]

For the brand owners, while e-commerce is nascent, we think it offers great opportunities as a new and highly focused, customer-centric route to market. Take the beauty industry as an example. Beauty's inherent advantage is having amongst the most researched products online—company research suggests 80% of people go online before making a decision.[6] That is a significant opportunity for branding, targeting, data gathering and feedback.

[2] Source: LSA. Data as of September 4, 2015.
[3] Source: XPCB. Data as of March 23, 2015.
[4] Source: Kantar Retail. Data as of March 31, 2015.
[5] Source: Credit Suisse HOLT. Data as of May 27, 2014.
[6] Source: PwC. Data as of March 30, 2012.

So what in your view drives the strongest compounding in Staples?

NS: It is all about consistency. Staples' 25-year 12-month rolling earnings growth average is 7.1% p.a. compared to the market's 5.5% p.a. Staples' volatility is 11.4% vs. the market's 18% over the same period. Not only has Staples' earnings growth been higher but its volatility has been lower. The result? Staples has risen by 7.6x vs. the market at 4x.[7]

How do you think a rising rate environment will impact Staples?

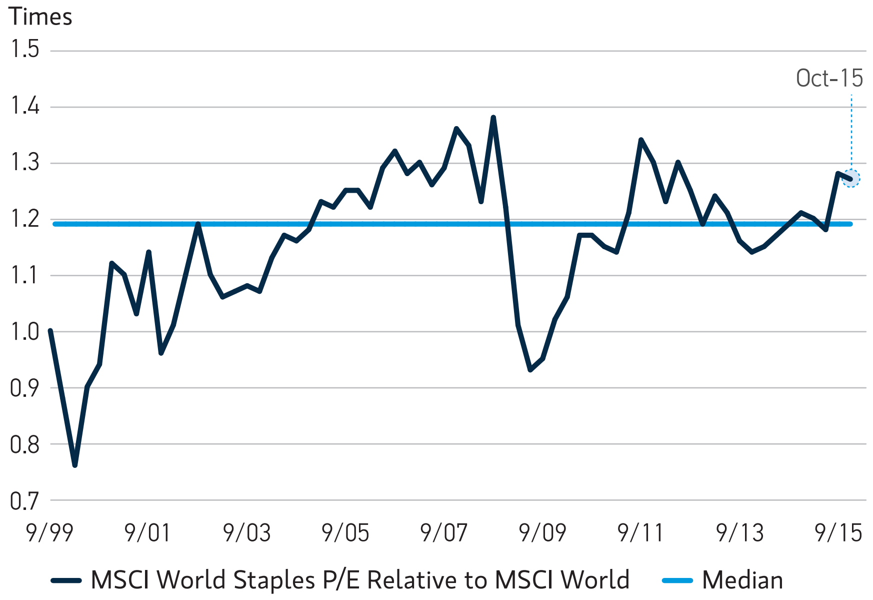
NS: Since 2011, the correlation between Staples' price relative to the market and U.S. Treasury yields has been 94%.[8] So we believe that in a rising rate environment, Staples is unlikely to re-rate. However, it is worth bearing in mind that Staples is only trading marginally above its long-term average relative P/E multiple, when compared to the broader market. Against a macro backdrop of global debt levels above those of 2008, with growth continuing to disappoint, and where "lower for longer" looks the most likely course for rates, for us—relative to the broader market which could be more vulnerable—the risk reward remains in favor of being overweight Staples.

Aren't Staples expensive?

NS: For Staples companies, advertising and promotion are one of their largest costs. They help to build their key asset: their brands. The costs involved are fully expensed annually, while a brand has many years of life. For example in the UK, 25 of the Top 100 grocery brands are over 90 years old.[10] Compare this to an industrial stock where the primary assets are its manufacturing facilities, and where the cost of maintaining and expanding their capacity, namely capital expenditure, is capitalized and depreciated over years.

DISPLAY 2

Global Staples P/E relative to the market[9]



To level the valuation playing field, free cash-flow (FCF) yields take account of the spend on all assets, intangible and tangible. Compared to its P/E premium of 25% today, the MSCI World Consumer Staples Index FCF yield is 4%, which is in line with the MSCI World Index. Moreover, Staples generated a return on operating capital of 53%, more than 3x the market's 17%.[11] In our view, this higher-return, lower-capital intensity profile enables a far more efficient conversion of earnings into FCF, and as mentioned, levels the playing field in terms of valuing companies on a more realistic measure. Finally, the sector is returning some 70% of its FCF to shareholders in the form of dividends, translating into a dividend yield of 2.7%, again in line with the broader market.[11] For example, a large Swiss-based coffee company, has a trailing dividend yield of 3% is well ahead of the 1.7% yield on its own U.S. corporate bonds (*Display 3*), and even further ahead of the -0.54% yield on its Swiss bond. When taking these factors into account Staples' valuations do not appear stretched.

What does the International Equity team think about the increasing currency volatility of the past years, particularly in Emerging Markets?

NS: Currency volatility in EM might be at the front of minds at the moment, but it is nothing new to us or to the companies we invest in. Sometimes it is a tailwind, sometimes a headwind. We are long-term investors, meaning we can participate in the journey rather than worry about the moment. We like EM which are still growing due to structural trends, such as rising populations and urbanization. Currently, EM organic

[7] Source: MSCI Europe Index and a weighted average index of the large-cap Pan European staples companies complied by Credit Suisse using Datastream, from June 19, 1989 to August 24, 2015.

[8] Source: MSCI European Consumer Staples Index relative to MSCI Europe Index, January 1, 2011 to May 30, 2015.

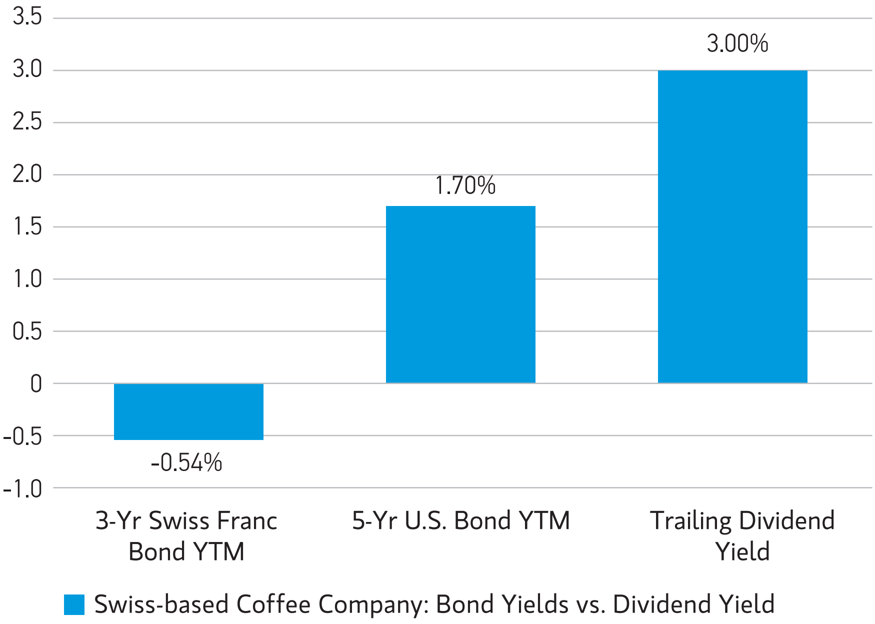
[9] Source: FactSet, 2015. The MSCI World Consumer Staples Index was launched on September 15, 1999. **Past performance is no indication or guarantee of future performance.** This is provided for informational purposes only and is not meant to depict the performance of a specific investment. It is not possible to invest directly in an index.

[10] Source: Credit Suisse. Data as of September 18, 2012.

[11] Source: Factset. Data as of November 15, 2015.

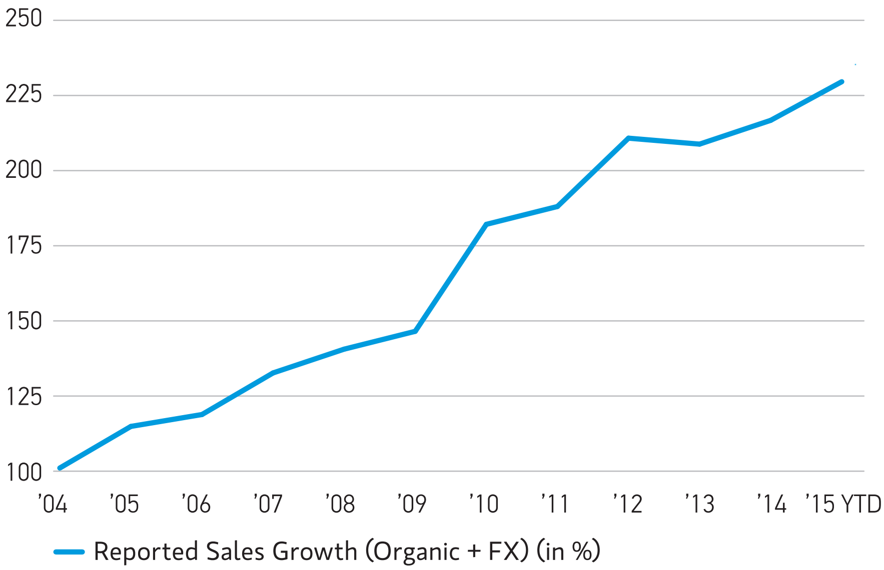
DISPLAY 3

Swiss-based coffee company's equity doesn't look overvalued vs. its bonds[12]



DISPLAY 4

Reported EM sales growth (Organic + FX) for global Staples[14]



growth rates for DM food, household and personal goods companies is 6%—three times that found in DM.[13]

On average, Staples' organic sales and profit growth falls by -100 basis points after the inclusion of foreign exchange (FX), and volatility doubles.[13] It is important to note FX's impact is mainly translational not transactional. In previous periods of extreme EM FX volatility, such as 1997 to 98, high quality Staples' margins were largely unaffected, supported by their robust pricing power as price rises were pushed through to off-set the FX volatility. For our high quality-focused global portfolios, we see short-term currency volatility as something our companies will navigate; indeed, it is our view that the best consumer staples management teams invest more in EM during a crisis.

What about China?

NS: Clearly China matters. It has been an engine of global growth, so much so that it imports nearly half of all the world's zinc, copper and iron ore. The slowdown, if it persists or perhaps even gathers pace, is far more likely to affect companies that have provided the materials for what has been the world's largest ever construction site, from metals to turbines, and escalators to lifts. It has also heralded fast-paced discretionary consumption in cars, technology, and luxury items, which are more vulnerable in a slow-down. For our high quality-focused global portfolios, our sales exposure to China is centered on more resilient, non-discretionary consumption including food, baby-care, drinks and personal care.

Your team have been underweight U.S. Staples. Why?

NS: The U.S. remains a large, dynamic and growing market where scale has the potential to deliver superior returns relative to other regions, and while there are a few "first-class" companies in this regard, they tend to be somewhat expensive. Perhaps the one area that now looks compelling to us is in the increasingly consolidating and reasonably priced U.S. tobacco market.

[12] Source: Bloomberg, MSIM. Data as of September 30, 2015. Note: Trailing Dividend is dividend for 2014 announced in February 2015. Bond yields are yields to maturity on CHF Bond maturing 02/2018 and U.S. bond maturing 12/2019. **Past performance is no guarantee of future results.**

[13] Source: Company data. Includes 12 companies for which organic EM data has been reported as of November 10, 2015.

[14] Source: Company data. Includes 12 companies for which organic EM data has been reported through October 31, 2015.

But in the main, U.S. Staples have generally been slow to expand their businesses into international markets. Two European Staples companies, one a large Swiss-based coffee company and

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the other a large Dutch-based consumer goods company, are good examples. They outgrew their home markets decades ago and so ventured further afield far sooner, in some cases well over a 100 years ago. One of the biggest challenges for any management team is moving out of their home market. Many U.S. management teams did not try and their companies became landlocked. Furthermore, they were so wedded to their core client base they also failed to adapt to the changing demographic of the "U.S. consumer", missing the opportunities offered by the growing Hispanic market, the demands of millennials, the increasing move online and the ever greater interest in organic and craft/artisanal products. This leaves slim pickings for investors with a quality bias, looking to invest for the long term. The one ray of sunshine for U.S. Staples investors, if not their management teams, has been the arrival of 3G Capital (who have recently acquired a number of U.S. staples and subsequently broadened their global footprint) and the greater prominence of activists. For us, however, trying to second guess 3G's next target is not an investment strategy.

Why no EM Staples or smaller cap Staples in the portfolio?

NS: Few EM Staples make the cut for our quality standards, be it due to the degree of return on operating capital, the capital intensity, corporate governance, the strength of the balance sheet or the quality of the basic franchise. Those that do pass our quality requirements are eye-wateringly expensive in our view. When EM stock prices take a tumble, EM investors tend to hide in these higher quality names, so they rarely get to valuation levels we find appealing.

There are very few small caps that possess the market leading, dominant intangible assets (brands) that we look for, and by virtue of being small they rarely have the liquidity we require.

Why has tobacco traditionally been such a significant portion of your Staples exposure?

NS: In a nutshell, we believe that as an industry it has one of the finest compounding profiles there is, driven by the most robust pricing power in Staples. In most markets, excise tax makes up the largest portion of the retail price of a pack of cigarettes, lowering the impact of manufacturer led price rises. For example, in the UK, excise tax is over 80% of the retail price. This means a customer only sees a 1% increase on a pack for a 5% manufacturer price rise. So, on a notional £10 pack, with tax at £8.0, the manufacturer–raises its £2 to £2.10, increasing the retail pack price to £10.10—a barely noticeable increase to the consumer, but a material 5% goes straight to the bottom line for the manufacturer. Tax increases occur regularly and consumers expect it, so manufacturers typically raise prices in tandem, baking-in price inflation. Pricing discipline in the sector is high given its consolidated nature.

Tobacco companies have been hugely profitable. The average Return on

"In our view...ultimately it is a sector that best exhibits the characteristics of economic compounding that we believe is the best route to achieve attractive long-term returns."

Operating Capital for DM cigarette companies is 96%, nearly 5x that of the broader market.[15] Generally, these high returns generate very strong cash flows which are returned to shareholders by management teams that typically exhibit good capital discipline. Finally, the earnings profiles tend to be very resilient indeed. During the Global Financial Crisis, the broader market's earnings fell 42% and took six years to get back to where they came from. Tobacco earnings fell only 10%, and recovered within six months.[16] There are challenges of course—regulation, litigation, health awareness and innovation—and we assess them regularly. However, for the industry these are not new and ones we believe they will likely continue to overcome.

Today, tobacco valuations are compelling relative to Staples. The current price to earnings multiple is below their relative 10-year average. This comes at a point in time when the risk of e-cigarettes has subsided and the recent U.S. industry consolidation is boosting U.S. and UK listed near-term earnings via synergies. Due to this consolidation, greater pricing discipline is taking hold in the U.S., one of the cheapest cigarette markets in the world. It takes only 21 minutes of labor to purchase 20 cigarettes in the U.S. compared to 60 minutes in the UK or 87 minutes in Indonesia.[17] So in our view there is plenty of room to increase prices for a number of years.

[15] Source: Factset. Data as of October 30, 2015. Equity market represented by the MSCI World Index.

[16] Source: Factset. Data as of September 29, 2008. Equity market represented by the MSCI World Index.

[17] Source: Euromonitor, 2014 data from trade sources/national statistics, June 15, 2015.

So does the team think Staples will generally perform as well as they have in the past 20 years?

NS: We try not to make market predictions. In our view the sector offers considerable benefits in terms of visibility and predictability of earnings growth, and ultimately it is a sector that best exhibits the characteristics of economic compounding that we believe is the best route to achieve attractive long-term returns.

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About the Portfolio Manager

NIC SOCHOVSKY

Executive Director

Nic is a portfolio manager on the London-based International Equity team. He joined Morgan Stanley in 2015 and has 19 years of industry experience. Prior to joining the team, Nic worked for Credit Suisse within a "Institutional Investor" top industry ranked (March 2015) consumer staples team covering food manufacturing, HPC, beverages and tobacco. Before that he headed the consumer research team at Unicredit and was a senior analyst at Merrill Lynch and Lehman Brothers covering pan-European food manufacturing and HPC. Nic received a B.A. in Economics from Sheffield University.

[18] Source: Assets under management as of December 31, 2016. Morgan Stanley Investment Management ("MSIM") is the asset management business of Morgan Stanley. Assets are managed by teams representing different MSIM legal entities; portfolio management teams are primarily located in New York, Philadelphia, London, Amsterdam, Hong Kong, Singapore, Tokyo and Mumbai offices. Figure represents Morgan Stanley Investment Management's total assets under management/supervision.

DEFINITIONS

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

The **MSCI World Consumer Staples Index** is designed to capture the large and mid-cap segments across 23 Developed Markets (DM) countries around the world. All securities in the indices are classified in the Consumer Staples sectors, respectively, as per the Global Industry Classification Standard (GICS®).

The **MSCI Europe Consumer Staples Index** is designed to capture the large and mid-cap segments across 15 Developed Markets (DM) countries in Europe. All securities in the index are classified in the Consumer Staples sector as per the Global Industry Classification Standard (GICS®).

The **MSCI Europe Index** is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in Europe. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

Dividend yield is the ratio between how much a company pays out in dividends each year relative to its share price.

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.

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.

Gross Margin represents the percent of total sales revenue that the company retains after incurring the direct costs associated with producing the goods and services sold by a company.

Organic growth excludes any profits or growth acquired from takeovers, acquisitions or mergers.

Price-Earnings (P/E) is the price of a stock divided by its earnings per share for the past 12 months. Sometimes called the multiple, P/E gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting.

Return On Equity (ROE) is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

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).

Volatility is a statistical measure of the dispersion of returns for a given security or market index.

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