Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Exploring Pricing Power

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Pricing power is one of the key attributes of a quality compounder. A key difference between a compounder and a cyclical company is that the compounder has the ability to sustain revenue even when demand in the economy contracts. Pricing power is one of the key features, along with recurring revenue, that allows the top line to hold up.

So what is pricing power? The best quantitative measures of pricing power are gross margin and margin stability. In our global portfolios, the current gross margin ranges from 51.5-52.6% versus the MSCI World Index average of 28.1% and margin stability ranges from 87.4-89.3% versus 75.5% for the market as a whole.

The mechanics of pricing power vary considerably. Not every brand provides pricing power and not every manifestation of pricing power comes from the same source.

One way to describe pricing power is to consider its opposite. Take a mining business. What they sell is a commodity. When demand drops, prices will drop in line with the cost curve, which can result in violent downward swings for relatively modest shifts in the demand outlook. For instance, between 2013 and 2015, growth in iron ore demand went from +4% to -2%, and the iron ore price dropped by two thirds. In that situation even diversified iron ore miners saw overall sales drop by one third, EBIT halve and net debt to EBITDA ratios

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“A compounder has the ability to sustain revenue even when demand in the economy contracts” rise to uncomfortable levels.[1] The better companies cut capex and stayed at low levels for several years, whilst more levered competitors had to sell their better franchises. In both cases, a permanent destruction of capital was the result, as production capacity was permanently reduced.

Companies that have pricing power should be able to mitigate the impact of falling demand. Brands are a well-known source of pricing power. The following examples show pricing power at work:

"Strong brands are a well-known source of pricing power"

One of the companies we own is a world leading adhesives business. Its pricing power stems from the fact that adhesives often constitute a very small part of the overall cost base but are a crucial element of the production process. For instance, a multi-layered paper carton contains just 0.1-0.2 grams of adhesive, yet the reliability of the adhesives plays a key role in the reliability of the end product. Often the adhesive is customised for a specific end-product that requires lengthy testing processes before it qualifies for production, say in automotive or aircraft manufacturing, creating material switching costs for the customer. That may not provide the adhesive business with the right to over-charge but does allow for the passing through of higher raw material and currency costs. Provided the company remains at the forefront of innovation, it should be able to increase prices in line with the added customer benefits the innovation generates.[2]

Pricing power in the rating business shows that compounders can even exist in the world of financials. One source of its pricing power is that, while the one-off fee for rating an investment grade bond is around 7-8 bps, the benefit of having it rated rather than selling it as an unrated bond amounts to about 30 bps per year. For example, on a $500 million corporate bond the issuer saves around $15 million by potentially paying a fee of less than $500,000. As a consequence, the ratings agency we own has been able to drive up price by 3-4% every year in this part of the business. Rating businesses are also investor facing, offering analytics and data services. By expanding data sets and delivery options, amongst other things, the company has been able to increase price/mix by 8-9% a year.[3]

Pricing power in health care is fairly straightforward as it relates to classic pharmaceuticals, where patents protect the company. In medical devices, however, the situation is more subtle but also more sustainable in the long term. Most medical devices are less costly than high profile pharmaceutical treatments, but often equally critical to medical outcomes. Diagnostics must be accurate, syringe pumps must infuse the correct amount of medication and intravenous fluids need to be safe. Hence the quality of the production process is crucial. Being one of the few producers able to meet these standards helps medtech companies to maintain pricing. However, given the pace of innovation in the field, maintaining pricing power is conditional on the ability to stay ahead of competitors.

"To sustain pricing power, companies need to constantly improve the value they offer to the customer."

While sources of pricing power vary from industry to industry and sometimes from company to company, the common thread across all forms of pricing power is that it is not sustainable due to market position alone. To sustain pricing power, companies need to constantly improve the value they offer to the customer.

Hence when we look at pricing power we do not just look at current levels, as expressed in gross margin, but also at the investment strategy of the company. If the company keeps investing in its brands, production processes or network effects, there is a good probability it can maintain its gross margins. If it does not then its customers may become reluctant to accept the price or product innovation, allowing competitors to overtake or disrupt them. This is why we care so much about governance, capital allocation and management interaction—it enables us to assess whether the current compounding, with pricing power as an essential component of this, is sustainable.

[1] EBIT = earnings before interest and taxes; EBITDA = earnings before interest, taxes, depreciation and amortization

[2] Source: Henkel AG

[3] Source: Moody's Q3 2019 Investor Presentation.

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. 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-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. **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. Option writing strategy. Writing call options involves the risk that the Portfolio may be required to sell the underlying security or instrument (or settle in cash an amount of equal value) at a disadvantageous price or below the market price of such underlying security or instrument, at the time the option is exercised. As the writer of a call option, the Portfolio forgoes, during the option's life, the opportunity to profit from increases in the market value of the underlying security or instrument covering the option above the sum of the premium and the exercise price, but retains the risk of loss should the price of the underlying security or instrument decline. Additionally, the Portfolio's call option writing strategy may not fully protect it against declines in the value of the market. There are special risks associated with uncovered option writing which expose the Portfolio to potentially significant loss.

DEFINITIONS

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