INVESTMENT MANAGEMENT

Morgan Stanley

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Investment Focus

The Equity "Compounders": The Value of Compounding in an Uncertain World

Executive Summary

The global macroeconomic and geopolitical outlook remains in a state of considerable flux, suggesting primarily an environment of lower growth with equities at raised valuations. This uncertainty presents a challenge for investors looking for assets with the potential to generate attractive returns, while still offering a measure of capital preservation during more difficult economic and market conditions.

Given the lack of clarity that exists, we believe that investors should focus on the fundamentals—assets with the potential to generate stable, consistent returns and offer potential capital protection. In our view, this involves investing in high quality companies that can consistently compound shareholder wealth at a superior rate over the long-term, while offering relative downside protection.

Our research shows that these "compounders," which exhibit characteristics such as strong franchise durability, high cash flow generation, low capital intensity and minimal financial leverage, have generated superior risk-adjusted returns across the economic cycle. Despite strong equity performance over the last few years, these compounders, or high quality franchise stocks, still offer attractive valuations relative to their long-term intrinsic value and relative to the broad market. This makes it an opportune time, in our view, for investors to adopt a "back to basics" approach to portfolio management that should help generate superior risk-adjusted returns throughout varying market conditions.

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What Do We Mean by "Compounders"?

We define compounders as companies with high quality, franchise businesses, ideally with recurring revenues, built on dominant and durable intangible assets, which possess pricing power and low capital intensity. When evaluating these companies, we focus on franchise quality and durability, financial strength, industry position, and management quality.

In our experience, relatively few companies have been able to consistently compound shareholder wealth at superior rates of return over the long term. Instead, we have found that most companies are erratic or inferior creators of long-term wealth.

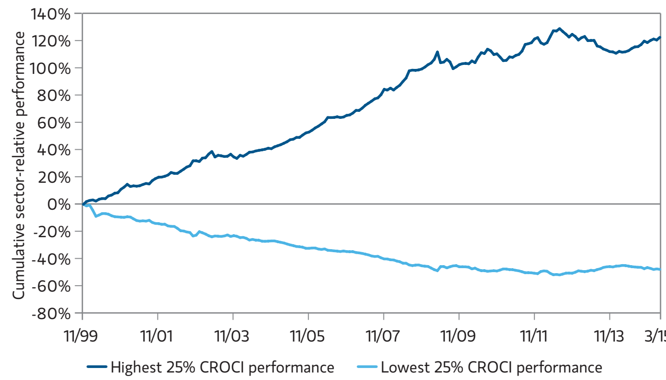
We believe that companies with strong franchise quality have a sustainable competitive advantage by virtue of their intangible assets, which competitors generally have difficulty re-creating or duplicating. These dominant and durable intangible assets may include strong brand recognition, which tends to be driven by innovation, customer loyalty, copyrights and distribution networks. In contrast, dominant assets that are physical are more easily replicated and often lead to price competition and erosion of a company's return on capital.

The key financial characteristic of compounders is that they enjoy sustainable, high return on invested capital (ROIC), which is generated by a combination of recurring revenues, high gross margins and low-capital intensity. This combination helps support strong free cash flow generation that, crucially, must be either reinvested or distributed to shareholders. Any M&A activity should be fully justifiable on ROIC grounds rather than "strategic" or "accretive" grounds at the expense of eroding overall ROIC. The financial strength of these compounders tends to come from the innovation-driven intangible assets that the companies possess, which, in turn, provide pricing power.

Compounders also tend to be relatively robust in economic downturns, with steady operational cash flows and no excess leverage. Profits are typically less sensitive to economic conditions given repeat purchases at high growth margins. This, combined with low cyclicality of top-line demand (a result of the nondiscretionary nature of products and strong brand loyalty), help insulate compounders from the negative cyclical impacts on operational cash flow. These characteristics, coupled with modest top-line growth, have helped ensure that the intrinsic value of compounders grows over time.

Display 1 highlights the difference in share price growth between companies in the MSCI Europe Index universe with a high ROIC and those with a low ROIC. As *Display 1* illustrates, companies with a strong ROIC have substantially outperformed their peers over the long term.

Display 1: **Companies with a high ROIC have outperformed over time**



Source: Goldman Sachs Research Estimates, Quantum database. Data as at March 31, 2015. Data shown is the performance of the share price of the highest 25% of companies in terms of ROIC as compared to the lowest 25% of companies. Companies are sourced from the MSCI Europe Index. **Past performance is not a guarantee of future performance.**

When seeking compounders, we believe that the relative strength of a company within its industry is more important than market capitalisation. In terms of industry structure, we typically find compounders enjoy high relative market share in monopolistic or oligopolistic markets. These companies generally enjoy high barriers to entry, usually as a result of the intangible assets they possess and their ability to continually innovate. In our experience, such an industry position provides a company with strong pricing power and organic growth potential. However, it is important to stress that the quality of growth remains a crucial consideration; in our view quality sustainable growth is preferred to both high growth of a short-term nature—which might boost earnings per share (EPS) but which does not typically create long-term value—and growth driven by a low ROIC.

In assessing industry structure, we believe that the markets in which a company does business is of greater importance than where the company is listed, especially when considering exposure to emerging markets. Generally, we would prefer to own a high quality global franchise business that sells to the emerging market consumer rather than own a potentially lesser quality company listed in an emerging market index to gain the exposure to these developing markets. While we are not opposed to direct emerging market investments, we believe the high current relative valuations and the corporate governance issues that tend to exist generally make indirect exposure to the asset class more attractive at this point.

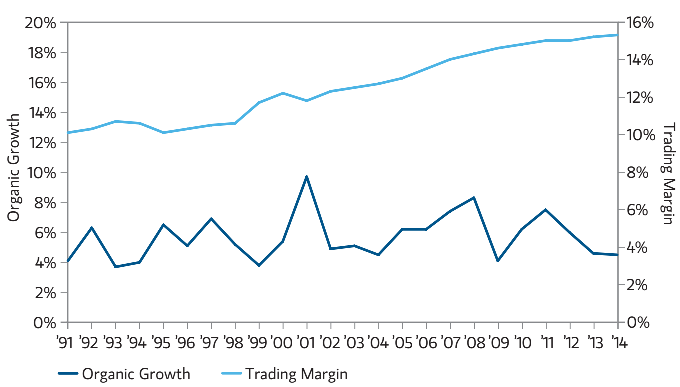
Another characteristic of a compounder relates to the quality and focus of its management. We believe it is crucial to invest in companies whose management has demonstrated a history of disciplined and efficient use of free cash flow. When evaluating the quality of a management team, we seek evidence of disciplined capital allocation and distribution practices.

Franchise or brand abuse is also an important consideration. It is vital that management not be distracted from the long-term task of building and improving the company's intrinsic value by the temptation to meet short-term targets. Cuts to advertising and promotion spending, or research and development budgets, either in absolute terms or as a percentage of sales, can have devastating long-term consequences to brand strength and recognition. As a result, we favour companies whose remuneration and incentive policies foster the compounding that is in shareholders' long-term interests.

A good example of a compounder, in our opinion, is a European coffee and chocolate company with strong long-term historical based on well-managed intangible brand assets. Demand for the company's products has been consistent rather than cyclical, which has contributed to steady top-line growth. Add in high gross margins and a capital-light operating model, and the result has been a resilient, and steadily growing, cash flow stream over time.

This same company has shown steady organic revenue growth over the last 23 years, averaging around 5 percent per annum, and never going negative, while using innovation to edge up its trading margins *(Display 2)*. While this operational performance may not look spectacular, the high ROIC compounding model means that the EPS has risen fivefold, from CHFr0.66 to CHFr3.14, and the dividend tenfold (CHFr0.20 to CHFr2.15) over the period. This consistent growth in EPS and dividends has helped drive a long-term compounding of the share price, which has risen from CHF6.91 (year-end 1990) to CHF77.1 (year-end 2013). As illustrated by this company, compounders do not require spectacular growth to outperform over time. In this case 5 percent annual revenue growth has driven 7 percent EPS growth and a 12.7 percent annual total shareholder return.

Display 2: **Swiss coffee and chocolate company – An ability to compound, through thick and thin**



Source: Morgan Stanley Investment Management. Data as of December 31, 2014. For illustrative purposes only. Data shown is for the period from 1989 to 2013. This is not a recommendation to buy or sell the security mentioned. There is no guarantee that the security referenced will perform well. **Past performance is not a guarantee of future performance.**

When searching for compounders, investors must avoid traps in the form of fading companies or acquisitive companies. By fading companies, we mean those where patents or licenses are soon to expire, where new technology or a change in fashion or new regulation can disrupt a franchise. Companies that are overly dependent on a single brand or product are more vulnerable to disruption.

Poor or greedy management is also a risk. A franchise can be eroded by management that cuts advertising and promotion spending or research and development activities to meet short-term earnings targets, that sets poor pricing policies, or is not disciplined in its capital allocation.

Acquisitions may be especially damaging for compounders. For example, a company generating a 30 percent ROIC may damage its long-term compounding potential if it acquires a company in a deal that generates 5 to 10 percent ROIC in an effort to boost EPS. Accretion of EPS does not necessarily equate to value creation and instead can result in significant value destruction, even if the target company is itself a compounder.

In the next section, we examine consumer staples, the sector where, in our experience, the greatest proportion of franchise stocks exists, helping contribute to the sector's superior long-term risk-adjusted returns.

Uncovering Franchise Stocks

As previously mentioned, our experience is that it is not easy to find compounders with the requisite franchise quality and financial strength in many sectors of the market.

We have observed that strong resilient franchises are rare in capital-intensive industries such as telecommunications, utilities, oil and gas exploration and production, commodities, chemicals and transportation. In our view, capital intensive or strongly cyclical business do not ordinarily generate sustainably unlevered returns on invested capital or alternatively, have weak pricing power in the case of many commodity producers. Likewise, we have found that financial institutions and transportation companies commonly earn low returns on an unleveraged basis. Further, we believe that growth businesses are vulnerable to rapid product or patent obsolescence and seldom generate the repeat consumer business that we believe is vital to generating long-term shareholder wealth.

Instead, we have observed that compounders are most likely to be found in industries where relatively capital-light innovation can create new demand and help support pricing power. In particular, we believe that business-to-consumer industries are best. In our experience, while there are some franchise companies in the pharmaceutical, media/publishing and information services sectors, the strongest franchise stocks are typically companies producing branded consumer goods (i.e., food and beverages, tobacco, household products, cosmetics and personal care products). While we examine the consumer staples sector in some detail in this paper, it is important to stress that not all compounders are found in this sector, and conversely, there are many consumer staples companies that are not compounders.

Over the last 10 years, strong equity performance has been associated with those companies exhibiting pricing power. During this time, the consumer staples sector has generated the highest annual returns amongst the MSCI World Index sectors, a result, we believe, that can be attributed to the pricing power differentiator that is a particular attribute of compounders *(Display 3)*. While the energy sector has also enjoyed strong returns over this period, we believe that the increase in prices enjoyed by this sector may not be sustained, as it reflects a jump in demand combined with the rising cost of supply. In contrast, we believe that the pricing power of the consumer staple sector is more sustainable, as price increases are driven by innovation, advertising and brand loyalty, rather than cyclical forces.

Display 3: **Pricing power: The differentiator in returns between sectors in the MSCI World Index**

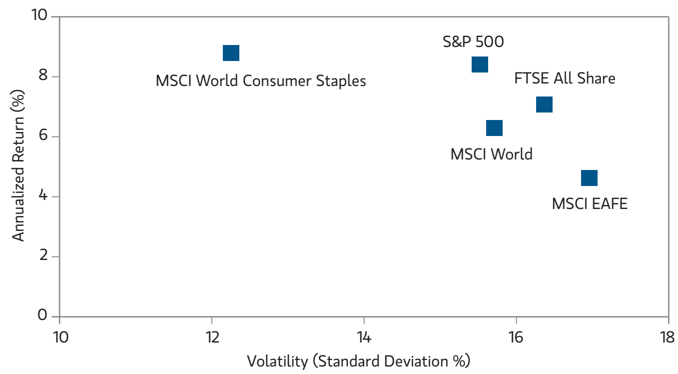
SECTOR	10 YEARS (%)	
Consumer Staples	9.74	Pricing power
Health Care	9.49	Pricing power
Energy	6.26	Increasing marginal cost of new supply
Information Technology	7.47	
Consumer Discretionary	7.49	
Industrials	6.75	
Materials	5.77	Increasing marginal cost of new supply, China demand
MSCI World	6.02	
Telecommunication Services	5.27	Price deflation
Utilities	5.88	Higher energy costs passed on
Financials	0.98	Low return on assets, high leverage, left side tail-risk

Source: Factset, MSCI. Data as of December 31, 2014.

Interestingly, the consumer staples sector has delivered significantly lower volatility over the last decade than major developed equity indices, in addition to relatively high returns *(Display 4)*. One would typically expect such a narrow focus on one sector to raise diversification risks, but as *Display 4* illustrates, the consumer staples sector, with a high number of compounder companies, has generated historical returns that are substantially less volatile than the traditional benchmarks.

Display 4: **The consumer staples sector had significantly lower volatility and high returns compared to major equity indices**

Volatility vs. Return in USD - 10 years to December 31, 2014



Source: Morgan Stanley Investment Management Limited. Data as of December 31, 2014. Data for the period September 2004 to December 2014 for the following indices: MSCI World Consumer Staples sector, MSCI World Index, S&P 500 Index, MSCI EAFE Index and FTSE All Share Index. The indices are shown for illustrative purposes only. It is not possible to invest directly in an index. See page 7 for index definitions. **Past performance is not a guarantee of future performance.**

One subset of the consumer staples sector in which we have found a high concentration of compounders that possess dominant intangible assets, is the tobacco industry. Globally, tobacco is an extremely concentrated industry with the four largest manufacturers responsible for over two-thirds of the world's total sales[1], excluding China, which is a government monopoly. These companies' primary competitive advantage is their strong brand loyalty. We have found that customers are willing to pay a premium for certain brands and this, combined with low price sensitivity, historically has translated into high repeat business for the companies. Profits are high relative to invested capital and cash flow generation is exceptional. In addition, barriers to entry are high, with strict government regulations on tobacco advertising deterring potential entrants, and weak bargaining power from tobacco growers and distributors helping ensure strong pricing power.

Compounders may also offer attractive returns in both inflationary and deflationary environments. In a low inflation environment, where there is nominal GDP growth, compounders are attractive for several reasons. In our experience, these companies can still grow earnings and deliver a relatively high return on capital in more difficult environments, as their pricing power, and therefore their earnings, remains resilient.

For investors concerned about rising inflation, we believe that compounders possess exceptional pricing power, allowing

[1] Source: MSIM and British American Tobacco, Japan Tobacco International, Imperial Tobacco, Philip Morris International company reports. Data as October 2014.

them to at least match inflation and provide an effective hedge against inflationary conditions. In our opinion, this compares favourably to other investments, such as bonds, which are exposed to inflationary environments.

Why Invest in Compounders? High Quality Assets for Tougher Times Ahead

In our view, the challenge for equities for the next five years will be more about keeping the lights burning than shooting the lights out. Markets are at high levels despite the assorted macroeconomic and political risks on the horizon. The strong equity performance of 2011 to 2014 has been driven not by significant earnings growth but by re-rating or multiple expansion, arguably a consequence of unorthodox monetary policies.

Unwinding these policies could lead to a more sustained fall in equity markets if multiples fall back. Secondly, earnings may be vulnerable. If there is no sustained recovery, companies may struggle to deliver top-line growth. If there is a recovery, higher wages could squeeze margins.

While pressure on multiples and earnings would surely be painful for the broader market initially, such a normalization would open the door to more attractive entry points down the road. Further, business fundamentals would start to matter again.

In this context, we believe that high quality companies with robust balance sheets, resilience and high profitability, strong free cash flow generation and disciplined capital allocation remain attractively valued compared to lower quality companies and the market more broadly.

Display 5 shows that currently the relative performance of high quality stocks to low quality stocks is back to 2008 and 2011 lows. S&P issues "quality" ratings for equities based on factors such as earnings and dividend growth and stability and balance sheet robustness. The chart illustrates the ratio between high and low quality indices for top and bottom quality tranches of the S&P 500.

Display 5: **S&P 500 high versus low quality indices performance**

Source: S&P 500. High and low quality indices for top and bottom quality tranches of S&P 500 were established in 2010 dating back to 1997. Data as of March 31, 2015. **Past performance is not a guarantee of future performance.**

While we concede that valuations are not as attractive, on an absolute basis, as they were in 2011, we believe that the type of high quality companies we focus on will more likely be able to keep compounding in a tougher environment. Caught short will be lower quality companies, those leveraged both financially and operationally, those lacking pricing power, those that squander shareholders' money on irrational acquisitions at the top of the cycle and those that carry valuations far from their fundamentals.

When assessing valuation, we believe there is an inherent risk of overpaying for a high quality franchise stock. In our opinion, the most accurate manner in which to measure value is on an absolute basis, rather than a relative basis, by using the equity free cash flow yield. At current valuations, an investor can buy outstanding franchise stocks at a free cash flow yield of 5 to 6 percent. In absolute terms, given the quality of the assets, we believe this is attractive when compared to other investments, such as a sovereign bond offering around 2.5 percent, which does not have pricing power, inflation protection or an ability to compound investor wealth. Compounders also offer the potential for long-term real growth in the free cash flow they are generating, as opposed to a flat nominal cash flow from a sovereign bond.

Conclusion

Against an uncertain backdrop of lower growth and less liquidity, we believe that, more than ever, investors should focus on the fundamentals when making asset allocation decisions. That is, they should seek out high quality businesses built on recurring revenues, high gross margins and low capital intensity, with the potential to help preserve capital in down markets. In addition, we believe that franchise stocks, given their quality, remain attractively priced relative to their long-term intrinsic value and relative to the broad market.

The fair valuations still on offer by these franchise companies, and the risks of holding lower-quality equities at inflated values, make such a decision, in our view, even more compelling.

About the Authors

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Bruno is a portfolio manager for the London-based International Equity team. He joined Morgan Stanley in 2009. Prior to joining the firm, Bruno worked for Sanford Bernstein in London, where he was a Senior Analyst covering the financial sector, particularly banks and insurers, for eight years. Previously, he was a manager at the Boston Consulting Group where he focused on the financial services industry. Bruno has an MBA from INSEAD where he received the Ford Prize for graduating top of class. He was also a Research Fellow in Political Economy at Nuffield College, Oxford, and received a B.A. in politics, philosophy and economics with 1st Class Honors from Keble College, Oxford.

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DEFINITIONS

Consumer Price Index (CPI): An index that is designed to measures the price of a fixed basket of market goods bought by a typical consumer.

Dividend: A distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders.

Earnings per share (EPS): The portion of a company's profit allocated to each outstanding share of common stock. Earnings per share serves as an indicator of a company's profitability. The general equation is net income less dividends on preferred stock divided by average outstanding shares.

Equity free cash flow yield: An overall return evaluation ratio of a stock, which standardizes the free cash flow per share a company is expected to earn against its market price per share. The ratio is calculated by taking the free cash flow per share divided by the share price.

Free cash flow: A measure of financial performance calculated as operating cash flow minus capital spending, working capital growth, interest and taxes.

Return on invested capital (ROIC): A calculation used to assess a company's efficiency at allocating the capital under its control to profitable investments. Our definition is earnings before interest and taxes/property plant and equipment and trade working capital.

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MSCI EAFE Index: An index is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East), excluding the U.S. & Canada.

MSCI Europe Index: A capitalization index designed to measure performance of the developed equity markets in Europe.

MSCI World Index: A unmanaged, free float adjusted, market capitalization weighted index composed of stocks of companies located in countries throughout the world. It measures equity market performance in global developed and emerging markets. The index includes reinvestment of dividends, net of foreign withholding taxes.

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

S&P 500 Index: A broad based index, the performance of which is based on the performance of 500 widely-held common stocks chosen for market size, liquidity and industry group representation.

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