J O Hambro
Capital Management Group

News

New world: old rules

Staying True to Time-Tested Principles for Capital Preservation and Growth

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"Investors still need to adjust to a world of higher interest rates,", proclaimed a recent FT headline.[1] Whilst both the US Federal Reserve and Bank of England held rates at their September meetings, we have some sympathy with the author's view that "second-round inflation effects" are likely to result in rates staying higher for longer.

The longer-term forces of inflation, like ageing populations, rising barriers to trade and the movement of people, lower crop yields from global warming and soil degradation, point to higher inflation than the levels that the world has become used to. And that, in turn, will lead to a prolonged period of higher interest rates.

What we are less convinced about is the need to radically alter our investment style just because rates are higher. As investors who believe that capital preservation is the twin sibling of long-term growth, the fundamental investment tenets that we've used over the last two decades are even more relevant in the new higher rate environment. With that in mind, here are three of the 'old rules' that we will be sticking to in the world of higher interest rates.

Rule 1: Treat All Debt With Caution

Cheap debt has encouraged a decade-long corporate binge on M&A, dividend payouts and share buybacks, which has weakened company balance sheets and increased the downside risks for shareholders. Equity owners need to remember that we are last in the line of potential creditors in a wind-down situation.

In his early days at Microsoft, Bill Gates revealed, “I came up with this incredibly conservative approach that I wanted to have enough money in the bank to pay a year’s worth of payroll even if we didn’t get any payments coming in.” This neatly sums up the relationship between capital preservation and growth. If you can’t survive the short-term downturn, you won’t ever see the long-term growth. It also resonates with our long-standing preference for balance sheets that are appropriate for the type of business and sector they’re in.

Rule 2: Stable Revenues and High Margins are Your Friend

To the younger generation of investors, it seems a bit old-fashioned to be talking about interest cover (the ability of a company’s operating profits to cover its interest bill). The maths here is simple: a highly levered company making a 10% margin might have a comfortable 3x interest cover at a 2% interest rate. But at a 6% interest rate, that cover goes to 1x, meaning every penny of profit that the company makes goes to the bank, and there is a significant risk of a covenant breach.

Companies with more stable revenue streams are less likely to see the dangerous swings in interest cover caused by volatile profits. Companies with higher margins have more levers to pull to offset rate rises in the event of an unexpected downturn. We consistently sought the combination of stable revenues and high margins even during periods of ultra-cheap debt. A higher rate environment makes these characteristics even more attractive.

Rule 3: Financial Health Enable Management to Focus on Growing the Business.

The higher cost of debt is likely to reduce the number of ‘disrupters’ and new entrants, meaning this should be a great time for those cash-generative companies with self-funding business models to be investing for growth. It is a time where the opportunity to take share from an overleveraged competitor is likely to present itself.

However, too much debt is a distraction. An executive team occupied by frequent meetings with nervous creditors spends less time discussing growth plans with the R&D team. There will be no point in coaxing funding for a new growth initiative from a finance director who is desperately trying to fend off the banks.

In many cases, a strong balance sheet gives management more options. During the recent slowdown in retail sales, Next (a company with a strong balance sheet) accelerated its online advertising spend, whilst ASOS (a company forced to raise new equity) cut its marketing budget to save cash.

The old rules still apply

For a portfolio of stable cash flow businesses, a net debt: EBITDA ratio of 1.5x puts us in a good place to navigate a period of uncertainty.

The median interest cover ratio for our fund is 13x, with a portfolio chock-full of recurring revenue and stable cash flow business models. This coverage ratio is roughly double that of the average FTSE 350 interest cover (excluding the financials sector), meaning we have a well-positioned portfolio if the outcome is indeed higher for longer. We see the growth rate of cash flows from our portfolio as likely accelerating from the 3-year CAGR of 10% pa we forecast today.

Avoiding excessive debt has always made sense, and we expect this approach to benefit our clients even more in a higher rate environment. Whilst a new approach may be necessary for some, we are convinced that these tried and tested old rules will still apply.

Source for all data: JOHCM & Bloomberg (unless otherwise stated.)

[1]https://www.ft.com/content/d3311abc-c8aa-4d3d-a78a-d332180ccde4

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