WHEN A TAILWIND BECOMES A HEADWIND

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Over the past few decades Australian companies have enjoyed watching the price of money get cheaper - a low and falling bond yield environment. But there are beginning to be signs that this multi-decade trend is reversing.

A lot of market commentary has focused on the impact higher rates will have on the prices of bonds (the Bondcano!) and the valuations of bond proxy stocks, like real estate investment trusts, infrastructure and high price-earnings ratio (P/E) stocks. I want to focus on the impact that higher bond yields may have on companies' earnings and capital allocation decisions.

This funding cost tailwind has been a key driver in how companies allocate their capital. We feel the extended period of low and falling interest rates has resulted in boards and management taking on more financial risk. A few things we have observed over this period are:

- Lower interest costs driving improved earnings-per-share (EPS) outcomes
- Use of debt to fund acquisitions - the cheap cost of debt has been a key driver in making acquisitions (EPS) accretive
- Use of free cash flow (FCF) to return capital to shareholders through on-market share buy-backs or increased dividend payout ratios
- In some cases, companies are borrowing to fund dividends

At the same time, this environment has, in most cases, penalised companies that have maintained a conservative balance sheet and used the falling cost of debt to reduce leverage in their business. A key plank of Perpetual's investment process is looking to invest in companies with a conservative balance sheet. But the rewards due to a business for maintaining a conservative balance sheet have not been seen over the last few years. However, I feel that the cost of money is now moving from a tailwind to a headwind and we are moving into a rising interest rate environment.

More conservative businesses will start to get rewarded by the market.

What do the numbers say?

Looking at the S&P/ASX 200 excluding Financials, Resources and Property stocks, we have compared the leverage and funding costs in FY14 verse FY17. During this period, the aggregated leverage of these stocks has increased from 1.6x ND(net debt)/EBITDA to 1.8x ND/EBITDA (EBITDA is earnings before interest, taxes, depreciation and amortisation and often used to assess companies' operating performance).

This increase in indebtedness has occurred while the average cost of debt for these companies has fallen from 6.5% to 4.8%. Despite higher absolute levels of debt, companies are **spending less** in real terms on interest expense. Companies have used the cheap cost of debt to gear up.

One example of a company that demonstrates this funding cost tailwind is Amcor (ASX:AMC). As shown in the table below, since FY14 AMC has added just over $US 1 billion of net debt yet net finance costs have gone **down** by $6 million. AMC's average cost of debt has fallen from 6.4% to 4.6% but leverage has **increased** from 2.1x to 2.8x over this period.

Amcor Historical Debt Metrics ($USm):

AMC (US$m)	FY14	FY17
Net debt	3,013	4,050
Net financial costs	193	187
Implied cost of debt	6.4%	4.6%
EBITDA	1,458	1,447
ND/EBITDA	2.1	2.8

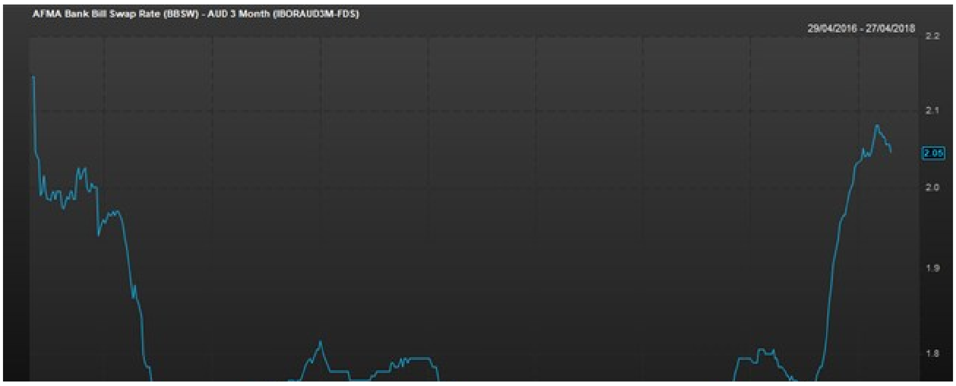
Source: Amcor Annual Reports, Perpetual Analysis

What has changed?

Most Australian companies' interest costs are a derivative of the Australian Bank Bill Swap Rate (BBSW) and a margin over this rate which is typically a factor of company specific risk. The BBSW is generally a function of the RBA cash rate. However, as seen in the chart below, the BBSW has blown out over the past two months. We have observed similar moves in other key global reference rates.

Given the significant moves higher in the BBSW, variable interest costs will be moving higher over coming months for Australian companies. Similarly, increases in longer dated bond yields and commentary from central banks point to a rising rate environment moving forward. Therefore, we think it is timely to analyse the implications this may have on companies.

Australian Bank Bill Swap Rate (3 month) over 2 years:



Source: Factset

How strong is the headwind?

Every company has a different debt structure, so each company will be affected by rising rates to a different extent. To illustrate the sensitivity (continuing with the Amcor example), if we were to assume that AMC's debt level stays flat at the FY17 level of US$4.05 billion and the average cost of debt increases from 4.6% to 5.6%, AMC's finance cost will increase by $40 million. This would represent a 4% profit before tax headwind.

For companies that are heavily geared and pay out a significant portion of their free cash flow as dividends, this headwind is likely to become material. Whilst the increased funding costs will have a direct impact on earnings and cash flow, there is a secondary effect on management behaviour regarding capital allocation.

We would expect that higher funding costs, over the longer term will result in lower payout ratios, less share buy-backs and fewer debt funded acquisitions. The latter two of these have been key drivers of earnings growth for many ASX-listed companies over the past five years.

Is the market factoring in higher rates?

We surveyed several sell side analysts on what their assumptions were for the cost of debt in FY21. The average across all companies was 4.8%. This is slightly up from 4.6% for those same companies in FY17 yet well below the 5.6% cost of debt in FY14. We strongly believe that analysts are materially underestimating the cost of debt over the medium to longer term.

Conclusion

We believe the market is underestimating the impact that rising rates will have on company earnings and the way boards and management allocate capital. The impact of rising rates will be more pronounced on those companies that are highly leveraged, pay out a substantial portion of their cash in dividends or are heavily reliant on debt to fund acquisitions. We believe that will have two big outcomes:

1. From an earnings perspective, higher funding costs will result in downgrades to EPS, especially for more highly geared companies.
2. "Manufacturing" EPS growth through debt funded acquisitions and buy-backs will become less and less attractive - providing further headwinds for highly geared companies.

We believe this is an important but under-analysed issue which needs to be considered by market participants.