Is 'quality' a shield against inflation?

Pricing power gives a company a competitive shield

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During the 3Q 2021 earnings calls, many companies raised a 'red flag' for inflation. An industry study by Bank of America Global Research assessed the number of times 'inflation' was mentioned by European businesses on these calls. The extremely sharp 350% rise over a 12-month period was in stark contrast to the previous decade. For some companies, surging labour and material costs could squeeze their profits and leave them struggling to grow.

Investors are now asking: how soon, and – more importantly – how high, will central banks hike rates in order to avoid a hot economy? Looking forward, are companies in for a bout of trouble?

Some businesses could well be facing tough times. However, inflation matters significantly less for quality growth companies than it does for others. To understand why, it is worth reflecting on the 'defensive moat' that sets quality companies apart. The moat matters because it tends to be accompanied by pricing power and high gross margins – two important factors in fighting inflation. To quote Warren Buffett: "If you have got the power to raise prices without losing business to a competitor, you have got a very good business."

It is this shield that allows some companies to pass on input costs. For example, the industrial gas business Linde would live up to Buffett's definition of a good business.

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Low price elasticity of demand for some

Nevertheless, the pricing power shield is not just about being able to pass on rising costs. For some quality growth companies, their gross margins are so high that input costs are of little consequence.

Let's explore what happened when LVMH increased prices of its Louis Vuitton and Hennessy liquor branded products by about 5% and 4%, respectively, in 2020. A decline in sales might have been expected but, in fact, volume growth continued unabated.

Why? Gross margins are supported by a brand's pricing strength. Prices can be increased without resulting in a fall in demand given a brand's appeal to high-end consumers.

Pricing through innovation

An important support for pricing power can often come through innovation. Many quality companies reach this level through introducing superior technologies or products that render additional benefits to customers.

A good example is eyewear leader EssilorLuxottica. The company sought to develop lenses to slow down the progression of myopia in children.

A two-year clinical trial in China delivered stunning results. Essilor Stellest™ lenses were proven to be among the most effective myopia control solutions that have ever been tested and could potentially transform some children's lives.

Sound balance sheets also provide a shield

Finally, it is not only pricing power that provides a shield against inflation. As rising prices lead to higher interest rates, sound balance sheets can also protect a business. Many quality growth companies have low leverage levels, which protect them against the rising cost of debt. This places them at a competitive advantage versus other companies within the comparative MSCI Europe Index. At a portfolio level, the net debt-to-EBITDA ratio of the Comgest Pan-European Equity strategy stands at 0.6x compared to nearly 1x for the Index.

To summarise, many European quality growth companies are largely shielded from the impact of strong inflation and rising debt charges. Their management teams, therefore, can continue to focus on executing their growth strategies. We believe that 'sticking to our knitting' and continuing to invest for the long-term in world class, sustainable quality growth businesses is a prudent approach. Now more so than ever.

FOOTNOTE

1 Bank of America Global Research, 'Q3:EPS growth is starting to slow', 11-Nov-2021.
2 Source: Company website, 'https://www.lvmh.com/news-documents/press-releases/lvmh-shows-good-resilience-in-the-first-half-of-2020.
3 EssilorLuxottica, 'Essilor receives FDA "Breakthrough Device" designation for Essilor Stellest, its new generation of spectacle lens solutions in the fight against myopia', as of August 2021.
4 The net debt-to-EBITDA (earnings before interest depreciation and amortisation) ratio is a measurement of leverage, calculated as a company's interest-bearing liabilities minus cash or cash equivalents, divided by its EBITDA. This ratio shows how many years it would take for a company to pay back its debt if net debt and EBITDA are held constant. Source: Comgest, data for the representative account of the European Equities Composite as of 31-Mar-2022. The index is used for comparative purposes only.

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