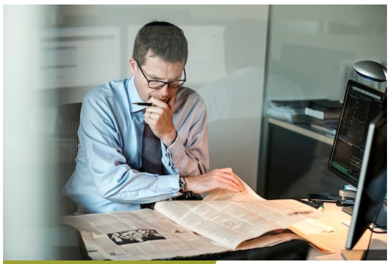


Friday Morning Coffee

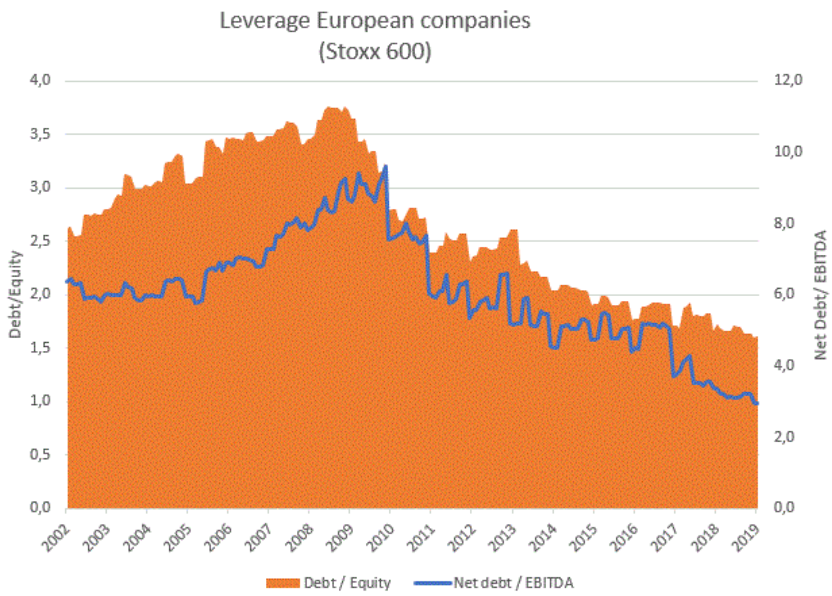
Nr. 46 — Debt Discipline

The German magazine "Der Spiegel" featured an article this week titled "Praise the debts" on the benefits of higher sovereign debt. In the article the journalists put forward the work of the Harvard Professor and former IMF chief economist Olivier Blanchard. According to Blanchard, many nations could take on more debt without creating inflationary pressures. This would be possible due to the extremely low interest rates.

While not being economists ourselves, we find this U-turn in the academic world rather remarkable. We recall the times around the financial crisis when debt was considered the mother of all economic evil and where the virtues of financial austerity were praised. **This was when the economists Reinhart and Rogoff, later criticised for methodological flaws in their work, came to the conclusion that debt levels above 90% of GDP would ultimately cut economic growth in half.**

This recent change of mind can be partly explained by demographics in the developed economies. The ageing population is saving more than ever and therefore supplying more capital to industries that at the same time become less capital intensive and need less capital. This results in a lower "price" for money under the form of lower interest rates. In many economies including the US and Germany, interest rates are now below the growth rate in GDP. In such an environment, it makes sense for governments to take on new debt to finance new investments in education, healthcare and infrastructure as the GDP will grow faster than the debt level. Does this mean Reinhart and Rogoff should go back to their laptops and write a second part of their best-selling book "This time is different" where they adjust the conclusions of their work to a new paradigm ?

While the debate on the pro's and con's of austerity is still ongoing, we looked at how the corporate world in Europe is thinking about debt. In the DJ Stoxx 600 regrouping the biggest European companies by market capitalization, we analysed how leverage had evolved since 2002. Two measures were used : first total debt to total equity measuring the strength of the balance sheet (left-hand scale) and secondly net debt to EBITDA measuring the capacity of the companies to repay their debt with the cash flows they generate (right hand scale).



Source: Bloomberg

The following note gives the opinion of the Investment team at the time of the publication. Please refer to important notice at the end of the document.

We can distinguish between two phases in this historical analysis. In the years before the financial crisis, companies appeared willing to increase their leverage year after year. Debt to Equity peaked at 3.77 in 2008 and net debt to EBITDA peaked above 9 times in 2009. The latter ratio implies that it takes more than 9 years for a company to repay its debt.

The financial crisis resulted in a complete change in behaviour as companies started to de-lever and have not stopped over ever since. This effort of austerity in Europe was of course helped by the economic and profit recovery after 2008, but still the largest companies in Europe had learned from their previous excesses and reduced their debt.

So what level of debt is the right one ? **We continue to believe that a strong balance sheet is a substantial asset for a company. It makes a business less vulnerable to a deterioration in its operating environment compared to its overleveraged competitors who are at the mercy of their corporate bankers in periods of stress**. To us, a net cash position is not an expensive luxury: on the contrary it gives companies the firepower to do M&A in periods of crisis when their competitors struggle to generate the necessary cash to cover the interest payments.

The median company in our portfolio has a net debt to EBITDA of 1.03, a level we feel very comfortable with. It indeed means it takes our median company only one year of cash flow to repay its entire debt while it takes the average European large cap company almost three years !

I wish you a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
March 1st , 2019