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Avoiding the Trap of Low Interest Rates

James J. Clarke |

How do we think about a world of ultra-low interest rates as equity investors? To us, interest rates are much more than determining what discount rate to use in a valuation model. At extreme levels, the rate environment introduces distortions that impact management behavior and valuation tools.

Taking on Too Much Debt

First of all, are we talking about interest rates or debt? Interest rates are an income statement line item which have historically been much higher than they are today. Debt is a balance sheet item of course. We are very much balance sheet thinkers, and we think the level of debt is what is important because too much of it can be an existential risk to an equity investor.

We recently met with the management of a Tokyo real estate company. It looked like a decent business but had a huge amount of debt on its balance sheet. When we asked management why the company assumed this debt level as opposed to another, it was clear they manage the balance sheet to the upper limit of what a rating agency would allow—arguing “why wouldn’t we?” With interest rates so low the money is nearly free, and the outlook for Tokyo real estate is great.

Sometimes a meeting can be very valuable in identifying a stock we will never own. We view that management’s attitude toward low interest rates as extremely dangerous. Real estate is a cyclical business, whether in New York, Tokyo, or the moon. Debt is nearly free from an income statement perspective. However, debt can be extraordinarily expensive from a balance sheet perspective when there is too much of it in a cyclical business. Nobody borrows too much when times are tough and rates are high. That’s not when lenders make mistakes either. At some point, no matter what the interest rate is, lenders want to be repaid. And when the cycle in the business becomes unfavorable—and at that point no lender will roll the loan—things get ugly.

Making Bad Acquisitions

Another management behavior we often observe in a low interest-rate world is overpaying for acquisitions. Management teams love to tell investors their acquisition is “accretive” to earnings. Higher earnings are good, right? Let’s say a company in a land of ultra-low interest rates like Europe or Japan makes a \$1 billion acquisition with debt costing 2%. The cost on the income statement is \$20 million. So if that business has \$25 million of pretax earnings, the deal is “accretive” and adds to earnings per share. But the company just paid \$1 billion divided by \$25 million, or 40x pretax earnings. The cost of capital is not 2%—it includes equity. Unless the target business is going to grow those earnings a lot, the acquirer would have been much better off lighting half of that \$1 billion on fire because there wouldn’t be an investment banker fee for that. We avoid those situations.

Distorting Multiples

From the investor perspective, we see low interest-rate debt distorting multiples. We have found stocks around the world that look very cheap on a price-to-earnings (P/E) ratio, but not cheap at all when valuing the business and subtracting the debt. Why would that be? If interest rates are very low, the interest line of an income statement is pretty much the same whether the company has \$10 billion of cash or \$10 billion of debt. If interest rates are zero, earnings would be identical. Clearly those are two very different investments, but the P/E ratio in and of itself will not tell you that.

Looking Beyond Ultra-Low Rates

One last point would be that we invest around the world, including emerging markets. Interest rates are not ultra-low everywhere. Mexico and Indonesia are places with relatively higher real interest rates—those are much more interesting backdrops as an equity investor because we are underwriting for returns above 10% and management teams are not doing dumb things because capital appears free. We would rather be an equity investor in a place with high real interest rates that can fall than in a place with negative interest rates that only have one direction to go at some point in the future. We continue to look for these higher real interest-rate opportunities while trying to avoid the pitfalls of investing in companies piling cheap debt onto their balance sheets.

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