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EP 129 | Inflation's One-Two Punch

Rob Campbell (00:01):

Though the topic of inflation has come up in most, if not all of our podcasts over the past two years, it's been a while since we dedicated an entire conversation to it. About a month ago, I sat down with my colleague Chris Silvestre to talk inflation very much through a bottom-up lens.

Chris speaks to the impacts that inflation has had so far, but crucially, the nuances that haven't fully been reflected yet on various line items of companies' income statements and balance sheets.

There are risks and opportunities there for investors that may not be fully appreciated, much in the same way that those of us with fixed mortgages or lease payments established a few years ago will almost certainly face higher cost of living surprises down the road.

With that, here's my conversation with Chris.

Disclaimer (01:02):

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Rob Campbell (01:19):

Chris Silvestre, thanks for joining me!

Chris Silvestre (01:21):

Thanks so much for having me.

Rob Campbell (01:22):

All right—Chris, you're an analyst on our U.S. equity team, and inflation's obviously been a major point of focus for investors over the past 18 months. This might be very basic, but can you just explain why inflation is potentially such a problem for companies?

Chris Silvestre (01:38):

Yeah, definitely. I think it's a great question, a good one to recap. I guess there's two major potential impacts. The first is that it raises the cost of doing business. That's the most obvious one that investors would be concerned about. It increases expenses, and to the extent that businesses can't pass on those expenses in the form of higher prices, you get reductions to earnings. So that's one major part of it.

The second major part of it is a reduction in real purchasing power. We know that wages have been increasing, but at the same time, real wages have actually not kept up with inflation. So you have inflation where consumers have less spend overall, less real purchasing power, and have to start making decisions about where to spend money. And that creates some winners and losers, where before you may not have had that tension.

So, those are the two major reasons why inflation is generally considered a problem for businesses.

Rob Campbell (02:24):

And the third, just from an investing perspective, would be the discount rate.

Chris Silvestre (02:27):

Yeah, the discount rate, of course. If we're talking about other than fundamentals, yes. From a valuation perspective, you would get rising interest rates, present value of cash flows would be lower, and you'd get a second impact on stock prices.

Rob Campbell (02:38):

Okay. Well, let's stick with the companies and their cash flows. We're recording this mid-January, and the last three or four inflation prints in the U.S. have... well, they've been encouraging in the sense that [inflation is] still high, but it's steadily coming down, and we've seen a broad market rally from that perspective.

Is there anything you think that either the market's missing, or perhaps more specific again to those company fundamentals and cash flows that you think investors should be aware of?

Chris Silvestre (03:05):

Yeah, another great question. So, I think you're right—there's encouraging signs that inflation is finally ebbing, and investors obviously seem optimistic about that. And there's probably a thought or an assumption that once this period of inflation has passed us by or has started moderating as it is, that companies are out of the woods.

I think it may not be as simple as investors are maybe hoping, and there's two reasons why that may be the case. It essentially has to do with the lagging impact of inflation on some financial statement items.

Chris Silvestre (03:35):

Investors obviously use financial statements to determine how their businesses are doing, and presume those financial statements are related usually to the valuation that you place on a business. So those two impacts are capital expenditures and inventory.

So we can go through each of them, but essentially, inflation isn't reflected in real time on those income statement items. They actually happen with a lag. And as a result, we may get some impacts from inflation that don't show up in the financial statements until later on. So that's one area that we're watching closely and it impacts different businesses differently.

Rob Campbell (04:08):

Okay, well let's get into those. Let's dig into the accounting and unpack them. Let's start with the first one—you mentioned capital expenditures. What goes on there?

Chris Silvestre (04:16):

For sure. So, if you think about how investors value businesses, I guess there's a whole number of ways that that's done depending on which type of investor you are, but classically, you're looking at price to earnings or maybe price to free cash flow. You're looking at the earnings power, the free cash flow generating power of a business. You're placing some multiple on that or thinking about how those are going to grow over time, discounting them to present, and then getting your valuation for your business.

So when you talk about capital expenditures, this is maybe a more obvious one where there's a difference between the income statement impact and the free cash flow statement impact.

Of course, on the income statement, you're getting depreciation, which is a historical number that reflects historical expenses spread over time as you use those assets. Of course, the cash flow statement impact is a real-time impact. So, capital expenditures on the cash flow statement reflect money going out the door today to replace those assets. And oftentimes, there's a difference between those two. Depreciation and amortization is lower than capital expenditures.

In the past decade or maybe two decades, the gap between those two numbers may not have been large enough for investors to pay a lot of attention to that gap. But if you have a period of rising inflation, that gap can increase pretty rapidly and pretty sizeably. And I have an example if you'd like one.

Rob Campbell (05:31):

Yeah, [I'm] interested in your example—[and] if I think about it, if I've got a factory and I built it 15 years ago and I thought it would have a 20-year useful life, the depreciation expense on my income statement is based on that historical cost. And so I still may be good for the next five years, but when I need to rebuild my factory in an era of higher inflation, I'm going to have to pay a lot more for that.

And so whereas the inflation may be coming in in CPI today, I think your point is, well, when you go to rebuild that factory, the impact on your earnings might be a couple of years out. Am I understanding that right?

Chris Silvestre (06:03):

Yeah, that's exactly right. Maybe one where the impact is closer would be maybe maintenance capital expenditures. These things happen per year instead of taking a 15-year gap, because then it's a little harder to judge. But maintenance capital expenditures—why don't we just go to the example? Because I think this is a good demonstration of it.

So, we own a company, a very high-quality business, in our U.S. equity strategy, Dollar General. Dollar General is building out its footprint of stores, still has a very robust growth profile, but I guess pre-pandemic and during the pandemic, they spent about a billion dollars on CapEx per year. Well, this year they're spending about $1.5 billion on CapEx. But they're not building any more stores. It's really just because inflation ran so hot that the CapEx number went up quite materially, but the depreciation number hasn't gone up nearly as much.

So you have a wedge, and a pretty sizable wedge, between those numbers. There [are] some idiosyncratic factors for that; it may actually come down a little bit next year, but the point is the same: that the wedge has gotten pretty sizable. So investors that are looking at earnings and earnings power of the business may actually be overestimating, especially in a time of inflation, when you're going to have to adjust for the much higher capital expenses that that particular company and others have to basically incur in order to maintain their competitive position and essentially maintain their growth plans.

Rob Campbell (07:21):

Okay, so that's the accounting—[now] put your investor hat back on. I suppose management teams know that investors are razor-focused on margins and how well companies are able to increase the revenues in line with increases in input costs. I can imagine that management teams might make some choices to preserve that margin, maybe by delaying some of that CapEx. Are you seeing that as well? And as an investor, what do you need to do in order to account for that in your analysis of businesses?

Chris Silvestre (07:49):

Yeah, I think that's an interesting question and interesting point. And I think you're right—that a lot of investors do look to margin maintenance, right? Margin percentage maintenance. Is this particular business maintaining gross margins? Is it maintaining EBIT margins? Is it maintaining EBITDA margins? Wherever on the income statement you want to take that margin.

And I guess the point that you can make is that it's not enough to maintain that margin. Because, again, you're looking at the income statement impact and that income statement reflects historical costs. So unless you are actually increasing the margin to reflect the cash flow impacts, then you may not be keeping up with inflation.

Rob Campbell (08:25):

Okay, interesting. Let's move to the second one, which, if I remember you correctly, was on inventory.

Chris Silvestre (08:32):

Yeah, another great question. So, inventory is the second major area—and cost of goods sold—that we're watching on a go-forward basis.

So, maybe [to] just take us all back to accounting class, there's three ways of accounting for inventory and cost of goods sold. The first is FIFO, then there's average cost, and then there's LIFO. So, FIFO is first in, first out. It assumes that the inventory you bought first—it could be a couple of months ago, it could be a year ago—is the first inventory out the door. So, under that method of accounting, or that accounting choice, you're going to have the lowest cost of goods sold and the highest inventory balance.

The exact opposite end of the spectrum is LIFO. So, that's last in, first out. That assumes that the inventory you purchased most recently is the inventory that goes out the door first. And in that case, you're going to have the highest cost of goods sold and the lowest inventory balance.

So how does this relate to inflation? Well, in an inflationary period, you are going to be spending a lot more on inventory. Your inventory balance is going to go up. And for businesses that are using FIFO (that's when the inventory balance is highest and the cost of goods sold is lowest), well, the cost of goods sold that you're putting through on your income statement is actually not reflecting the cost of inventory that you have to purchase. So, what you're going to get is a lagging effect where the next period—potentially 2023 or 2024—your cost of goods sold is going to go up, and if you don't raise your prices, then you're going to have potentially a material reduction in gross margins. So that's the one that we're really watching.

And I think investors are somewhat attuned to that; the difference between FIFO and LIFO is pretty well known. But I think maybe less appreciated is that for businesses that are using FIFO, they have a choice to make. They have to raise prices after the inflationary period is passed in order to maintain their margins.

So, that's where the timing gap comes in. It's not good enough to raise prices this year or to maintain margins this year because the impact is going to flow through later. And actually, one of our portfolio holdings in the U.S. equity strategy was a perfect example of this. It was Johnson & Johnson. I think it was in their Q3 results [where] they actually explicitly mentioned this exact phenomenon. They said that [they] expect margin pressures in the coming year because of the cost of inventory that we've purchased this year. So again, reflecting that impact on a lagging basis.

Rob Campbell (10:45):

But contrary to your example, they're effectively admitting that they're not going to be able to raise prices after inflation has, if indeed it does, has come back down. Is that right?

Chris Silvestre (10:52):

That's what it sounds like, yeah. That's what it sounds like. If they're indicating that the higher cost of inventory is going to flow through later and that's going to have a negative impact on margin, well yeah, that can only happen if they haven't raised prices to adequately offset that.

Rob Campbell (11:05):

Okay. So, you've basically described this "first punch" from inflation, which is higher costs, and that's maybe the more obvious one. But then these nuances with respect to the accounting, a "second punch," is that may be felt with a lag. Can you help calibrate for me? Am I right to think that it's the first punch that's the more meaningful one, and these second ones might be just more marginal? Or do you think they are actually quite a bit more meaningful than that?

Chris Silvestre (11:31):

It depends on the business. It really depends on the business model. So, businesses that have high capital intensity, well, we're really going to be looking at the CapEx of depreciation. That's a very obvious one to look for going forward. And as I mentioned earlier with Dollar General, it's quite apparent; they spent an extra $500 million dollars this year alone on CapEx. Prior to the pandemic, they were generating about a billion dollars in free cash flow. This year, zero. So that's a very obvious difference that's materialized quite quickly.

Businesses with high networking capital are the other obvious areas. So again, maybe retailers like a Walmart or a Target. There, we're going to be looking very closely at inventory and the inventory accounting method to determine whether this is something that should be on our radar going forward. And you can imagine this can lead to really significant divergence in performance, even for two similar businesses.

If you have—let's just call them X and Y—they're both facing the same inventory cost pressures. One uses one method of accounting, one uses the other... yeah, you're going to have very divergent potential outcomes in year one versus year two. So that's something that you really have to watch for and adjust for. And it's unclear whether investors are doing this.

There are so many investors in the market, there are so many actors in the marketplace... there aren't that many that, as per my understanding, have the focus that we do, which is long-only, long holding period, value-oriented investors. So for us, it's a lot more important. And I can imagine a scenario where maybe some of the high frequency or shorter-term investors and that have a shorter time horizon... the stock prices do move around a lot more based on these numbers. So, that is our opportunity to identify those situations, recognize that maybe there's a divergence between short-term performance or the short-term numbers and long-term business prospects, and act on that.

Rob Campbell (13:08):

Well that's my major takeaway—just the short-term or the heuristics to say, "Hey, a business is maintaining its margin. It doesn't give you the full picture." And so Chris, thank you so much for joining us, and I look forward to having you back soon.

Chris Silvestre (13:40):

Thanks so much. Appreciate it.