TD Global Investment Solutions

Spotlight 10 Minutes
October 2024

A Conversation With

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Corporate Spending and the Push from AI

What is the current state of corporate spending?

Corporate spending has been on the rise in 2024 and we could not have a conversation about corporate spending right now without mentioning artificial intelligence (AI). There has been no greater driver of the increase in corporate spending of late than AI. Contrary to what some might think, those assets flow through multiple sectors, not just tech. First and foremost, within tech, the spending has been largely focused on the data centers required to operate AI. Each of the Big Four tech companies laid out plans earlier this year to spend upwards of $50 billion per year on CapEx, with the lion's share of that going towards AI data centers and high-performance computing. Some of it is at the expense of traditional data center investing, which they had been spending on heavily in recent years, but much of it is truly growth CapEx. In other words, this is money that would not have been spent otherwise, were it not for the massive wave of interest in AI.

The interest in AI is driving spending throughout the supply chains. A portion of the investment is going toward tangible assets, such as building construction and graphics processing units (GPUs). Producing these GPUs themselves requires significant investment in equipment and materials such as semiconductors, thereby driving further spending, not only in the United States, but also globally. When you look at the amount of money being invested in capital equipment (semiconductor fabrication equipment) it is evident that a notoriously cyclical business has turned into one that's more of a secular growth business. When memory prices drop, like they did in 2023 and 2024, there would typically be a significant drop in CapEx on new semiconductor equipment, but recently this did not happen. The change has been driven by the demand for AI and other leading edge chips.

Outside of technology, what other sectors are being impacted?

A number of non-technology sectors are seeing increased corporate spending driven by AI. One leading example is the energy sector. AI and all things related require large amounts of energy, driving a demand surge in electricity, as discussed in our April 2024 paper **AI and Electricity Demand: The Very Hungry Caterpillar**. This has driven an increase in spending on electricity, but it has also spurred investment in the search for sustainable and renewable energy sources. Of course, AI is not the only driver of that spending, but it is a major factor. This spending is also being encouraged by some fiscal largesse, particularly in the U.S. but also in places like the EU and Japan, where a lot of government grants and loan guarantees have been offered.

We are also seeing the impact rise in some unexpected segments, including transformers. Not Optimus Prime and Megatron, but the cylindrical objects on telephone poles and even larger ones at electrical substations. There is a huge demand for transformers because they enable the distribution of power to the AI data centers. These data centers consume roughly 2% of the electricity in the U.S. today, and are estimated to consume 10% by 2030. That requires a lot more incremental investment in power transmission equipment, including transformers.

Another example is within the consulting sector. Many companies across a variety of industries understand there will be widespread applications of AI and are trying to determine how it might help their businesses. Not fully knowing what to do with the emerging trend, these companies seek consultants to help guide them in understanding where to allocate spending, what areas to explore and what software to invest in.

In pharmaceuticals and biotech, companies have already been spending on AI. Health care, especially in the U.S., tends to be inefficient, slow and expensive, which makes it a good candidate for AI productivity enhancements. For example, looking at a particular hospital operator, their doctors and nurses spend 30% to 50% of their time on administrative activities. The company is now investing in AI tools to reduce this burden. Applying AI to diagnostic imaging is another area in which some of the companies that we consider for investment are investing. Lastly, some pharmaceutical companies have partnered with tech companies to use AI to identify new drug candidates.

How have higher interest rates impacted that spending/how might expected falling rates change that?

Interest rates have more impact on speculative investing than fundamental investing. When I say speculative, I am talking largely about private equity, as higher interest rates always impact both entries and exits by these investors. If you think of the latest U.S. Federal Reserve rate raising cycle that just ended, you will see higher rates have had no discernible impact on investment. Debt financing is cheaper than equity financing, assuming you don't take on too much of it. The Fed increasing rates from 0.25% to 5.25% did not impact investing by businesses that would have done it anyway, because they are not borrowing for the spending. These companies are often using the free cash flow generated by the business to reinvest. There are some businesses that do rely on leverage to sustain themselves, like commercial real estate, but even there, companies can still access the capital markets at non-threatening interest rates levels. In terms of the companies we prefer, they are generally more sensitive to their return on capital than they are to their cost of capital. Ultimately, the return on capital that a true quality business can generate is well in excess of its cost of capital, so a company that is generating free cash flow is much less sensitive to the whims of the capital markets as expressed by interest rates.

Has inflation altered corporate spending?

The short answer is no. As we wrote in our 2023 paper **Can Quality Stand Up to Inflation?** Higher inflation almost certainly leads to higher nominal cost of capital, but that effect may be muted, especially for companies with little or no debt. One reason why inflation does not have a larger effect is because companies know when they spend today at an inflated price, there earnings will be impacted for years to come because of depreciation schedules, but earnings will likely also rise because of inflation. So, companies continue investing and, as long as they earn a return on capital that is higher than their cost of capital, that investment would still be beneficial. In addition, many quality companies have pricing power and pass along some of the increased cost to customers without hurting earnings. Other quality companies, can still earn fabulous returns without passing the cost on to the consumer. This illustrates that quality companies can weather inflation without altering their spending plans.

What is the outlook for the return on all of this spending?

It is unclear. The AI tools themselves are particularly valuable when doing research or seeking any sort of knowledge, but they have not yet cracked the code as far as making money and turning the platforms into commercial business models. There are a number of AI search platforms, but we do not yet see the ad spending alongside of it that would enhance the return on investment (ROI) related to all of these capital expenditures. AI is still largely a cost center for the companies investing in it. For the more immediate parts of the supply chain, like GPUs, the outlook is a little clearer as we can measure the ROI for selling the next unit. In the renewable energy consulting and pharmaceutical spaces, again, what the ultimate ROI is going to be on this spending remains to be seen. But we cannot deny that the money is flowing and we have to be mindful of it in our investment analysis.

Looking at the advent of the internet shows us that we might not yet have all of the information we need to properly judge the outlook. For example, the internet became widely used in the 1990's, but it was taking shape well before then. Today's leading streaming company was launched in 1997 as a DVD rental business. It did not start streaming until 2007; that would not have been possible without high-speed internet. So, we did not see all of the benefits of the CapEx invested in the late 1990s and early 2000s on the fiber that made high-speed internet possible until years later. Another example is internet search engines. They began being used by the public in the early 1990s, but today's dominant force in search did not rise to prominence until nearly a decade later. It was impossible, therefore, in 1994 to know who the ultimate winner of the search engine competition would be. Given that we do not have all of the information to extend the outlook too far forward, we have to focus instead on what we do know.

How does TD Epoch analyze a company's spending?

First, we look for companies that are generating free cash flow. In other words, they are making money today. We then look at how the company uses that free cash flow. We believe that if a company can earn a return on invested capital (ROIC) that is higher than its weighted average cost of capital (WACC), whether be through reinvesting internally or externally via acquisitions, it should. There is no better way to increase the value of a company than through internal investment that earns an ROIC that is higher than its WACC. Any free cash flow that cannot earn that return should be paid out to shareholders through cash dividends, share buybacks or debt reduction.

One way to analyze whether a company's spending will earn a high ROIC is to look at its history. That is because a high ROIC tends to persist over time. For example, looking at the companies in the Russell 3000 Index over the period between 2000 and 2023 we see that more than 90% of those companies in the top two quintiles ranked by their ROIC in one year remained in the top two quintiles the next year. There are many reasons for that, but among them are the company's economic moats and the quality of its management. When a company earns high returns on capital, that normally attracts competition, because other companies look at those high returns and want to get in on the action. So, when we talk about a moat, we mean something the company has – whether it is a unique product, a powerful brand, or legal protections (patents) – that makes it hard for competitors to capture that company's customers. This helps them to continue to generate free cash flow. When a company has a management team that has shown a proficiency in making investments that add value, by earning an ROIC that is higher than WACC, it is likely that they will continue to make good capital allocation decisions in the future. As an investment team, we will continue to analyze today's corporate spending through this lens.

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