Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Winning with sustained innovation

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At a time of heightened unpredictability in an evolving world order, where can investors find some element of consistency? We believe that companies that have mastered the art of recurring revenues and pricing power are often underpinned by strong innovation. Innovation extends beyond disruptive or breakthrough inventions; we believe incremental innovation is a core strategy for maintaining relevance, driving competitive differentiation, and enabling long-term growth. In this first piece in a series about the culture of innovation, we examine how leading companies within one sector, consumer staples, drive continuous innovation to help strengthen their market positions and meet evolving client needs and expectations.

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A sustained rhythm of innovation

In mature and well penetrated industries like consumer staples, achieving growth and maintaining pricing power requires a steady pipeline of innovations that address consumer needs, supported by sustained marketing investment and best-in-class execution. Consumer staples forms a smaller component of our quality portfolios these days and may be a sector less obviously associated with innovation than arenas such as information technology, but nonetheless we believe the select companies we choose to own within the sector remain world class operators with regards to innovation.

As an example, Procter & Gamble (P&G) allocates 14% of its revenue to research and development (R&D) and advertising,[1] ensuring continuous product innovation. Over the past five decades, its U.S. fabric care business has maintained mid-single digit organic growth in a very mature category, fuelled by a robust innovation pipeline. This year, reinforcing their category leadership in detergents, the company introduced Tide EVO, a water-activated laundry tile incorporating fifty patents. Packaged as a dry tile rather than encased in plastic, the product should appeal to consumers who want to

"In order to thrive, even the world's most enduring franchises have to keep evolving."

[1] Source: Procter & Gamble annual report 2024

reduce plastic as well as energy use (activation in colder water means 90% less energy consumption), and its 100% concentration means no waste.

In our view, P&G's growth strategy is a case study in disciplined execution. Its five pillars—product, packaging, brand communication, retail execution, and consumer and customer value—are not standalone tactics but interlocking components of a broader, integrated platform designed to drive market expansion. Innovation weaves through every element, from product design to shelf placement—a process designed for P&G to deliver products that resonate with consumers, outperform competitors and adapt swiftly to changing consumer needs. This combines to help sustain pricing power—leading to resilient gross margins—and keeps the product portfolio fresh and relevant in consumers' minds and their regular purchasing habits.

Moving to the beauty industry, L'Oréal has embedded long-term R&D investment into its corporate culture, dedicating a significant 35% of revenue to R&D and marketing.[2] This sustained commitment has enabled decades of mid-single digit organic growth. One example is the clinically tested Melasyl Serum, developed over 20 years, to address hyperpigmentation by targeting excess melanin accumulation. In our view, L'Oréal's ability to translate scientific breakthroughs into commercially successful products underscores its leadership in the beauty industry. Quality companies use data and deep customer insights to innovate with precision—building loyalty and pricing power. L'Oréal has embraced digital and AI-powered personalisation tools, green science and partnerships with incubators to stay ahead of beauty trends, enhance the customer experience and maintain brand strength in highly competitive, even mature markets.

The company's innovation-driven dominance owes much to a formidable platform built over generations. Straddling every beauty category, price point, and geography, its huge scale is an asset. L'Oréal's advertising and R&D budget gives it a share of voice 1.5 times its market share[3]—a loudspeaker unmatched by rivals. Meanwhile, a decentralised structure, backed up by a world class supply chain and digital infrastructure, lets it move with the agility of a start-up and the muscle of a multinational. That combination has allowed L'Oréal consistently to outpace the global beauty market's already respectable 4-5 percent annual growth.[4]

In consumer healthcare, global leader Haleon spends over 21% of its revenue on R&D and marketing, deploying clinical research for product differentiation.[5] Notably, studies conducted in collaboration with Harvard Medical School demonstrate that Centrum Silver—a combination of vitamins and selected minerals used to prevent or treat vitamin deficiency—actually enhances memory performance, while toothpaste Sensodyne Clinical White is scientifically proven to whiten teeth by two shades without enamel damage—setting it apart in a competitive marketplace.

Finally, in the beverages sector, Coca-Cola, which operates over 500 brands across soft drinks, waters, juices, teas and coffees, continues to expand its functional portfolio through strategic innovation. This year's launch of Simply Pop, Coke's first prebiotic soft drink, reflects an evolving consumer preference for gut health products. Meanwhile, the Fairlife brand has emerged as a leader in the U.S. protein drink segment, employing patented ultra-filtration technology to enhance protein and calcium content while reducing lactose and sugar.

Despite currency headwinds and macro-economic turbulence, Coca-Cola has continued to grow its earnings in U.S. dollar terms, a testament to the strength and alignment of its global system. Central to this resilience is the company's "Total Beverage Company" strategy, which prioritises value over volume, expanding its portfolio beyond traditional carbonated soft drinks. Coca-Cola's strategic refranchising of bottling operations has streamlined its structure, reduced capital intensity and directed focus to higher return activities. This has resulted in improved gross and operating margins, as well as higher returns on capital, supporting a more favourable valuation multiple. In our view, Coca-Cola's integrated growth strategy, underpinned by innovation and operational efficiency, positions it well to navigate economic challenges and sustain its market leadership.

In order to thrive, even the world's most enduring franchises have to keep evolving. We continue to deepen our understanding of companies that demonstrate innovation to underpin longevity, and plan to bring you further examples across other sectors we own. Whether through groundbreaking product development or cutting-edge AI applications, in our view high quality companies that prioritise sustained innovation remain best positioned to navigate market shifts, capture new opportunities, and drive long-term success.

[2] Source: L'Oréal annual report 2024

[3] Source: Morgan Stanley Research

[4] Source: L'Oréal annual report 2024

[5] Source: Haleon annual report 2024

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