Valuing Values

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When we now consider which companies have a leading position in their industry, we now build in an ESG aspect to our analysis, which rests on three pillars. First, can a company develop and maintain a 'purpose-led culture' which is attractive to a new generation of consumers? Secondly, can it maintain a sustainable business model which balances profitability and growth? And third, can a business demonstrate that it respects all stakeholders (including, but not limited to the environment, employees, shareholders, suppliers and customers), whilst displaying structures of responsible governance?

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Introduction

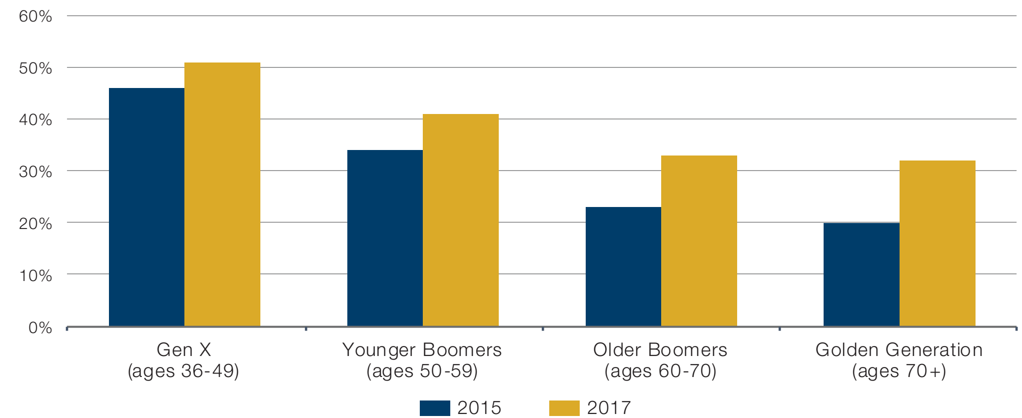
Portfolio managers often talk about replicable processes: the ability to create and apply a consistent framework for evaluating investments. It pre-supposes that all good companies are alike and have similar characteristics which can be identified, irrespective of industry or sectoral idiosyncrasies.

We have to confess that we agree. As an investment team, our careers have been built on finding companies with similar characteristics: a leading competitive position within its industry, a strong track record of growing revenues, high gross margins indicative of strong pricing power, attractive cash flows and a strong balance sheet.

However, over time, we have begun to make adjustments to our process. This isn't a question of throwing out the baby with the bath water. Instead, we have begun to consider how competitive advantage has changed over time, in lockstep with changing stakeholder expectations. More and more, companies are not just expected to be profitable, but also ethical.

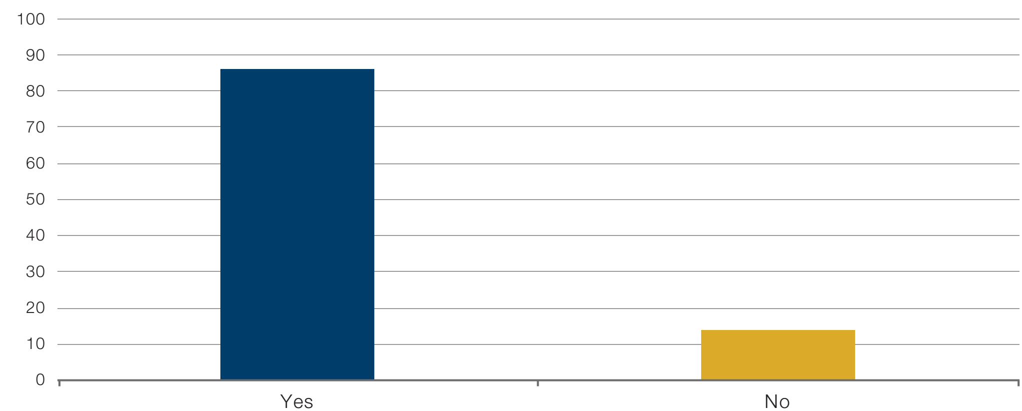
According to Forbes, for example, some 70% of millennial consumers consider a company's values when making a purchase.[1] But as Figure 1 shows, the trend is not confined to younger consumers; older generations are also becoming more attuned to the ethics of their consumption. Additionally, as employees, about 86% of millennials surveyed said they would be willing to take a paycut to work for a company whose values they agreed with (Figure 2).

Figure 1. US Consumers Who Actively Consider Company Values When Purchasing



Source: Forrester Analytics Consumer Technographics North American Omnibus Surveys; 2015 and 2017. Base: 5,005 to 5,396 US online adults (18+).

Figure 2. Percentage of Millennials Willing to Take Paycut to Work for a Company Whose Values They Agree With



Source: 'Workplace Culture Report' LinkedIn; as of 2018.

1. Source: Forbes, Millennials Call For Values-Driven Companies, But They're Not the Only Ones Interested, 23 May 2018.

Strong companies must have an equally strong sense of purpose, taking a long-term approach and prioritising long-term value creation over short-term profit maximisation. This cannot consist of paying lip-service to woke ideals, but instead must permeate the business model. ”

As such, when we consider which companies have a leading position in their industry, we now build in an environmental, social and governance (‘ESG’) aspect to our analysis, which rests on three pillars. First, can a company develop and maintain a ‘purpose-led culture’ which is attractive to a new generation of consumers and employees? Secondly, can it maintain a sustainable business model which balances profitability and growth? And third, can a business demonstrate that it respects all stakeholders (including, but not limited to the environment, employees, shareholders, suppliers and customers), whilst displaying structures of responsible governance?

We believe that a company’s values are of paramount importance to fulfilling these criteria. In this sense at least, an ESG investment is dominated by our assessment of how valuable a company’s values really are.

Pillar 1: Purpose-Led Culture

Our first pillar is the company’s culture. Over the last 10 years, there has been a sea change in how companies interact with their stakeholders. Not only has the internet and the proliferation of social media platforms allowed much greater communication between companies and their stakeholders, but it has allowed companies to demonstrate – more than ever before – what they regard as important.

Put simply, consumers (or employees) can see what companies care about, and buy from (or work for) companies whose values they share. To respond to this, strong companies must have an equally strong sense of purpose, taking a long-term approach and prioritising long-term value creation over short-term profit maximisation. This cannot consist of paying lip-service to woke ideals, but instead must permeate the business model. Examples of weak companies would be a company charging exorbitant prices for its products during a temporary supply bottleneck; or an organisation rewarding shareholders via dividends or buybacks to the detriment of the business and at the expense of other stakeholders. Conversely, if companies are able to successfully create and maintain a sense of corporate purpose which resonates with all stakeholders, it can strongly enhance their competitive position.

In our view, purpose-led companies often display similar characteristics, prioritising their vision of being a profitable and ethical organisation that endears itself to various stakeholders by consistent behaviour. This could be described as an enlightened sense of self-interest: companies with fair compensation tend to recruit high-quality staff, those with a strong record of paying suppliers tend to become a priority client in periods of high demand. This leads to a virtuous circle, with ethical behaviour rewarded as companies become preferred business partners for stakeholders up and down their supply chains. These factors, in our view, combine to give firms a long-term competitive advantage, and are a key component of our investment philosophy.

Pillar 2: Balance Future and Present Earnings

Our second pillar is the need to balance present earnings with the investment required to secure future earnings. If a company is able to balance both present and future earnings, it speaks of a management culture with a long-term view, which is able to plan strategically and reduce potential negative externalities. Those companies that outperform over the long term are able to do so by continually updating their products and talent to remain competitive at an industry level. Nevertheless, reinvestment cannot come at the expense of generating cash. This means that a company must have both strong free cash flow and a consistent level of capital expenditures or research and development spending – one without the other indicates either a business which is not profitable enough, or one whose profits may be coming at the expense of future competitiveness. In a similar way, the company’s revenues should exhibit sustainable rather than breakneck growth.

If a company can produce this kind of sustainable revenue growth and show tangible signs that it might continue into the future, then we believe it deserves consideration for investment. Additionally, sustainable earnings growth is a sign of competent management more generally, which makes it more likely that a company’s trajectory will

become self-reinforcing – strong management increases the likelihood of a purpose-led culture, which increases the probability of sustainable earnings, leading to an ongoing positive cycle of growth.

Pillar 3: Respecting All Stakeholders

Our final pillar is the need for companies to respect all stakeholders. Long-term outperformance requires a sustainable business model, which has to be based on consideration for stakeholders if it is to survive over the long-term. This requires firms to perform well on all ESG metrics: good environmental performance (especially in terms of an environmentally sustainable product line), reasonable pay for both executives and normal staff, fair treatment of suppliers, a safe working environment, investment in staff training and appropriate levels of board independence – all in addition to a consideration for the interests of shareholders.

> Sustainable models are resilient models, and should allow firms to enjoy a significant competitive advantage over their peers as regulatory and social pressures force firms to transition away from carbon-intensive and socially unacceptable practices.

In our view, the pillar is important because a sustainable business model has a direct connection to future earnings. If a product line results in high levels of carbon emissions, or causes significant pollution in the short term, this will be a drag on future earnings – either as the price of carbon emissions goes up, or the company is hit with retrospective fines and clean-up costs. The same logic applies to worker's pay: a seemingly profitable company could well falter if it is currently underpaying workers and is forced to improve its pay terms in the future. It is therefore vital that we identify companies who are already ahead of the trend, and will be able to avoid the earnings shocks that, in our opinion, will be experienced by firms who are not operating in a sustainable manner. Likewise, we seek to invest in firms who pay suppliers on time and do not use their size to drive down prices to unsustainable levels. This latter point has become especially important after the onset of coronavirus: those firms with the ability to pay suppliers should do so, and those that don't may find that they have no suppliers at all by the time the world returns to normal.

To phrase these sentiments more positively, sustainable models are resilient models, and should allow firms to enjoy a significant competitive advantage over their peers as regulatory and social pressures force firms to transition away from carbon-intensive and socially unacceptable practices.

Two Case Studies

To illustrate these points in more detail, we will give two case studies.

Our first example is Company A, a market leader in athletic footwear and apparel. The company defines its purpose as inspiring sporting achievement, aiming to produce innovative sportswear (which allows athletic breakthroughs) and to financially support the next generation of talent in grassroots sport. As an example of the former, the firm was responsible for producing a running shoe which is alleged to improve running economy by 4% and has been used in successful attempts to run a sub 2-hour marathon.

In addition, Company A has developed a new fabric product, made with at least 50% recycled natural leather fibre, greatly reducing the impact of its fashion trainers on the environment. This directly stems from the company's commitment to re-invest in its products and processes, and is attempting to move to a zero-waste, circular production process.

Furthermore, throughout the coronacrisis, the company has committed to paying its staff despite store closures, providing an important safety net for their employees. Whilst this may incur a cost in the short-term, by retaining trained employees, Company A is likely to reap a long-run benefit: employee turnover is a costly exercise and a strong retention rate is, in normal times, a key marker of a purpose-led company. By showing such concern for its staff, we believe the firm demonstrates its commitment to an all-stakeholder approach, which will pay off in the long-term.

In our opinion, having such a clear sense of the company's purpose and mission has enhanced shareholder value. By taking clear steps to innovate and act responsibly, Company A has been able to consistently connect with its market of young consumers,

and enhance its position as a world leading sportswear manufacturer.

Our second example is Company B, a market leader in diabetes care.

The company has a clear mission: to defeat diabetes. To that end, Company B produces GLP-1, a new class of diabetes drugs with much lower side-effects than traditional insulin. This provides the firm with a very defensible position within its market: there are currently 463 million patients with Type 2 diabetes, of whom only 183 million receive treatment. Of the 183 million, only 3 million receive GLP-1, leaving clear water for expansion.

In addition, the company is not afraid to invest in the future. As of end-2018, Company B invested 13.2% of its sales in R&D, a ratio that has been increasing steadily in recent years. This is evidence that the company is serious about its stated mission. To defeat diabetes and maintain its competitiveness whilst maintaining margins, the company will have to continually update its products, which requires investment in research.

The firm also scores well on other ESG metrics: it is currently committed to sourcing 100% of its energy from renewable sources by the end of 2020, and to having zero environmental impact by 2030. The latter target will require it to recycle all packaging, and liaise with suppliers to have a truly circular manufacturing process.

Importantly, the company is also showing concern for stakeholders during the coronacrisis rather than simply focusing on its own bottom line. Since the onset of the crisis, Company B has donated free insulin to selected humanitarian organisations. In addition, the company has created an assistance programme, whereby US customers with diabetes, who have lost health insurance coverage because of a change in job status due to the Covid-19 pandemic, may receive insulin free of charge for 90 days. Whilst in the short term, this could have a damping effect on the firm's revenues, we believe this will reap a long-term benefit – after all, customers will remember which companies stepped up to help in their hour of need.

Values are of ever-increasing importance – and we should value them appropriately.

Conclusion

When it comes to responsible investing, we believe that a portfolio should be comprised of companies which have a purpose-led culture; are able to balance present and future earnings by innovating and investing in R&D; and respect all stakeholders, from consumers, employees and shareholders to the environment. Values are of ever-increasing importance – and we should value them appropriately.

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Virginia Nordback is a Portfolio Manager, having joined Man GLG's European long-only equities team in 2016. Prior to joining Man GLG, Virginia spent two years at Berenberg as an equity research analyst with a focus upon Scandinavian, German and Swiss companies. This was after pursuing her own business start-up, something she developed following her time at Powe Capital where she worked with Rory as a research analyst of companies across Europe. Having started her analytical career with Deutsche Bank in 2003, Virginia's approach to stock specific research reinforces the team's knowledge of both existing and future holdings. Virginia holds a Bachelor of Arts from Yale University as well as an MBA from INSEAD.

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