Transformation as a strategy

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Investing sustainably is making the jump from niche to mainstream, but as it gains in popularity, it is also becoming far more complex. Whereas investors initially preferred to exclude problematic companies or even entire sectors, there has since been a shift in attitudes. It is not sufficient to simply distinguish between good and bad companies or, when talking about climate change, green and brown companies. Investing in, and thus supporting, only the best companies is not beneficial to either the portfolio or the environment because there are just not enough companies at the moment that are truly sustainable. According to the EU taxonomy, it is estimated that the term can be applied in the strict sense to around 2 per cent of the MSCI World index. Success from an environmental, social and corporate governance (ESG) perspective will not depend on the investees that have already gone green. Ultimately, more will be achieved if the bad companies improve than if the excellent ones optimise their business. It is therefore important to support companies that are not yet sustainable but wish to become so. This is a significant point of leverage, both for the reduction of greenhouse gases and for stock market performance.

The key term is transformation and the question is which companies are willing and able to transform themselves in order to become more sustainable? The challenge for an active and sustainability-oriented asset manager is to separate the wheat from the chaff. Companies can say what they like on paper and many are loudly proclaiming their willingness to change, but their words are not always followed by deeds. It is therefore essential to systematically compare transformation processes and successes within the specific industry. To this end, two subject areas need to be examined and clarified when analysing companies, in part by engaging directly with those companies.

Three dimensions

The dimensions to be outlined are relatively simple. As with any project, big or small, transforming into a sustainable company essentially only involves three dimensions: firstly a plan, secondly the necessary resources and thirdly the right people to implement the plan with the resources available.

But there is more to it than simply being able to clearly set out the relevant dimensions. Analysis and comparability are more important and, for an active, sustainability-oriented asset manager, indispensable. The ESG analysis therefore involves applying a wide variety of criteria in order to identify those companies that have a particularly good chance of achieving a lasting transformation and, consequently, performing well in the stock markets. Two of the main criteria are the product portfolio and the quality of production processes. The transparency of sustainability matters is also examined: How willingly and reliably does the company provide information on ESG topics and how well is it prepared for future requirements (e.g. reporting under the EU taxonomy)? The provision of a comprehensive sustainability report is key to achieving this. Investment in sustainable research, products and companies is also analysed and compared. Do the company's investments and collaboration projects offer potential to unlock promising areas of growth and gain competitive advantages? Finally, an assessment is carried out of whether senior management is able, and sufficiently incentivised, to initiate and support the sustainability transformation.

When sustainability analysts have clear and robust answers to these questions, they can identify the companies that have a good chance of transforming successfully. However, answering these questions is no substitute for the fundamental analysis traditionally carried out by asset managers. Combining this with ESG research provides a comprehensive picture of which companies are highly promising transformation candidates and which of them also boast a healthy balance sheet and income statement.

Sustainability and commercial success are becoming increasingly interdependent. Transformation concepts generally also have a clearly measurable influence on the fundamental situation of a company. After all, if a company is able to increase its future revenue through innovative products and/or lower its associated production costs and risks, this will have an impact on its future profitability. The transition to a more sustainable business model is therefore also becoming an important aspect in the decision-making processes of investors.

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This is especially the case during times of crisis because this is when a sustainable company can play to its strengths. Sustainability means future viability. Companies that operate sustainably therefore have better prospects for the future. The pandemic has not changed this. Far from it: Business models that feature a good organisational structure and take account of social and environmental concerns are proving their worth in the current crisis. And they will continue to do so afterwards. This can also be seen from their performance in the equity markets, as backed up by preliminary analysis. There is no compelling reason why this should change after the coronavirus crisis.

Success as a catalyst

Moreover, the intertwining of the different sectors of the economy means that the transformation successes of one sector also have an impact on other sectors and can have a positive catalyst effect. Manufacturers of sustainably manufactured batteries for electric vehicles have a competitive advantage because automotive companies also need to improve their green credentials and are therefore turning their attention to their suppliers. In other words, battery manufacturers benefit, firstly because they themselves become more sustainable and secondly, because their customers also have to become more sustainable.

At the same time, companies that are less well prepared for transformation will struggle to compete due to slower growth rates, increased risks and higher costs. This may be the result of an inadequate transformation concept. Particularly in a highly integrated industry such as automotive, manufacturers will not be able to risk procuring products from 'dirty' suppliers. This will mean a shift in market share from brown to green.

The transformation analysis developed by Union Investment focuses on distinguishing between promising companies and those with the potential to become a problem. It also provides many insights that can be used to enter into a dialogue with companies and to make a case for greater sustainability, which is to the benefit of investors. Ultimately, the primary objective of this research approach is to identify 'dirty' candidates that are willing to change and to help them to become 'clean'. After all, this is where the sustainability story – and the equity story – lies. Nowadays, green companies tend to have a high stock market valuation. The shares of those that are at the beginning of their transformation have catch-up potential. Investors need to exploit this opportunity.