The stories behind the numbers

While it's obvious that companies comprise their numbers, less is known about the idiosyncratic factors that make companies special. RBC's Global Equity team looks at some of the stories...

Kilian Niemarkt
RBC Global Equity team

Companies' intangible capital, such as human, social and environmental capital, are extra-financial factors that give great businesses their competitive edge. Such factors are poorly represented by financial reporting but positively impact a company's business performance, ultimately leading to positive corporate – and share price – performance.

An example is a Swiss pharmaceutical company, with strong ESG credentials observable in its business model. Its field of oncology is an area of expanding scientific knowledge but it is also one with broad social benefits. By fulfilling patients' unmet needs, the company can deliver significant improvements to the duration and quality of lives. It has become a trusted partner for medical practitioners, enabling collaboration on new research. Management has a strong record of meeting its regulatory obligations and during our research, we noted the supportive employee culture.

However, in the same way that a company can borrow against financial capital by taking a loan, it can borrow against extra-financial providers of capital, for example, from its customers by compromising on services or from its community by not paying sufficient taxes.

These contingent liabilities – or potential liabilities – are created when a company compromises the future to flatter short-term results. They might be deferred for a period of time but ultimately cannot be avoided, thus impacting the value of a business and resulting in negative financial consequences for shareholders, when realised.

An example of a company in which we didn't invest was a U.S 'energy' drinks company which has attractive margins and sales growth, but in our opinion, the business model is based upon the sale of sugary, highly-caffeinated drinks to predominately young customers. There have long been concerns about the negative health effects of such drinks, and in 2018 the company's main UK customers –supermarkets – restricted sales to over-16s. The shares have yet to price in these contingent liabilities and rewarded shareholders – so far. Nevertheless, we believe that the contingent liabilities remain, even if traditional financial analysis is blind to them.

Through active ownership and engagement we seek to ensure that positive change is effected over time and that our companies' contingent assets are stewarded. ESG-related changes cannot happen overnight due to companies' needs to respond to both their business environments and stakeholder expectations.

We engaged with a U.S. wireless network operator on its science-based targets. In 2019, the company worked with the Science-Based Targets Initiative (SBTi) to reduce Scope 1, 2 and 3 greenhouse gas emissions from a 2016 base year. It was the first U.S. wireless provider to set such targets, and it beat these four years ahead of schedule. In 2021, the company reduced Scope 1 and 2 emissions by 97% compared to 2016 and also reduced Scope 3 emissions per customer by 16% compared to 2016.

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While these are significant steps towards achieving net zero emissions, we encouraged a revisal of Scope 3 targets. The company acknowledged the proposition and suggested that new initiatives would be announced for the next year. We will continue to monitor the company's progress and engage with management.

On-going dialogues illustrate our responsibility as active and engaged investors. We act as owners of businesses and are not simply a name on a share ledger. In effect, we seek to 'shape' business models by working with companies. We believe that we make a stronger call for change via active ownership and engagement than divestment. Divestment sends out a strong socio-political message, however it also removes the ability to affect change and have a positive impact on society.

That said, there have been occasions when divestment has occurred. We invested with a U.S. teen retailer yet became increasingly concerned about the financial results. This was exacerbated by signs of over-investment when opening in new regions, and unsustainable pricing structures. Despite detailed discussions, there was no evidence of our concerns being addressed and this ultimately led to our divestment.

Increasingly, investors care not just about the returns on their investments but how those returns have been generated. They want to know that their capital is not being used to support business activities that do not align with their personal values.

There is no doubt the numbers are important, however seeking out companies with strong ESG practices, alongside winning business models, is how we add value. Ultimately, investing in these great businesses should generate long-term value for shareholders that significantly exceeds the return on the average company or the market.

RBC BlueBay Asset Management

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