Sustainability Talks

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Perspectives on Protecting Human Capital

The current outbreak of the Coronavirus disease (COVID-19) has myriad implications for the global economy and financial markets. Both policymakers and investors are struggling to anticipate its impact in terms of its scale and duration, and in turn calibrate their response. Beyond the issues of disrupted supply chains, lower economic growth, more accommodative monetary policy, and volatile stock markets, at its centre COVID-19 is a human emergency. Companies are having to make very important decisions about their responsibilities to their employees, their customers, and their suppliers as well as to their shareholders. For investors interested in sustainability, the COVID-19 pandemic is an opportunity to see how companies are reacting to a sudden and dramatic test of their business models and assess how they are weighing the interests of their different stakeholders.

Sustainability was once regarded as optional to business practices while shareholder value maximisation was mandatory. However, the ideology of shareholder primacy has come under pressure as society, through policymakers and investors, has sought a more sustainable balance between the providers of capital and the interests of other stakeholders. More recently many business leaders themselves have sought to redefine the boardroom objectives of the corporations that they manage[1].

Non-financial stakeholders can have a material impact on a company's fundamentals and its financial performance. Weak or deteriorating stakeholder relationships can be unsustainable and are undesirable for long-term shareholders because they can result in, amongst other things, loss of access to talent, a breakdown in key business relationships, higher costs of doing business, and additional regulation.

The status of these relationships with non-financial stakeholders lies outside financial reporting. We believe that fundamental company analysis should consider the state and trajectory of these relationships for a more robust assessment of a company's prospects. ESG scores provided by external ratings providers are generally static and backward looking—it is only by monitoring company performance, regularly engaging with management, and talking to other stakeholders that it is possible to assemble a full, dynamic picture. Further, it is only by bringing issues connected to sustainability into a financial context that business decisions can be properly understood.

At Lazard Asset Management ("Lazard"), we have developed a proprietary approach to assess the long-term sustainability of enterprises across the dimensions of financial, human, and natural capital[2]. This assessment is applied to both an enterprise's products/services as well as its operations. Our sustainability scorecard evaluates a company's relationship with various material stakeholders that impact the human and natural capital of a business including its customers, employees, supply chain, and the communities in which it operates.

Sustainability has generally been interpreted as an approach to day-to-day business operations, but we believe the COVID-19 emergency may be a useful diagnostic tool for identifying companies that operate sustainably from those that do not, as well as recognising which companies are taking action to become more sustainable versus those whose profile may be deteriorating. We believe that recent developments could prove to validate sustainability as an investment approach, and a way of cutting through the "greenwash" that so many corporates produce in seeking to enhance their sustainability credentials.

Some of our recent engagements with company management following the emergence of this public health emergency highlight how companies are managing the trade-off between short-term profit maximisation and long-term value creation.

For instance, a meeting with a global beverages company revealed that it does not plan to hold its Chinese wholesale customers accountable for their committed orders in 2020, recognising the pressures they face in generating revenue in the current environment. This form of contractual forbearance will likely hurt the company in the short term through delayed and potentially forgone revenues, but it should protect its key distribution partners and strategically important routes to market. This could potentially help the company to build on its competitive advantages in its main distribution channel in China at a time when its competitors are trying to share, if not fully pass on the financial consequences of a demand shock. Forcing distributors to comply with their contracts could put them under significant financial strain, potentially forcing them to liquidate inventory at a discount, damaging the equity of the brands that they sell.

In the pharmaceutical sector, companies are working hard to create a COVID-19 vaccine. No company has developed a vaccine yet and we believe that the production of one will take at least a year. Nevertheless, many diagnostic and vaccine makers have seen their share price rise sharply as some market participants have assumed that this presents them with a significant commercial opportunity. We believe this assessment is potentially misguided since very few health care companies are likely to want to be seen to significantly profit from this global emergency. Indeed, the public statements of some health care companies[3] emphasise that they are donating medical equipment and supplies and are offering financial support in affected regions. This might be an opportunity for an industry that is the focus of negative political and regulatory scrutiny to repair relationships with key stakeholders.

In the luxury retail sector, companies have emphasised that the decision to close stores was not reactive to the shortage of footfall, but proactive in the sense of protecting staff. The instinct of several companies was to protect people at the expense of profits. Stores have been closed for deep cleaning and, in some instances, have only been re-opened once the threat of transmission has receded. Some landlords in affected parts of China have been giving their tenants rent-free holidays of days or even weeks to help cushion the blow of store closures to their tenants. It is not yet clear whether this is sustainable thinking or enlightened self-interest.

These engagements highlight how Lazard's investment teams seek to understand how human capital is being managed through this health emergency and even, where justified, advocate for more robust social capital management in support of companies building long-term, sustainable value. For instance, Lazard's US Sustainability Equities team has been engaging with companies in the media and entertainment industry to understand how the most vulnerable employees, those on hourly contracts for example, are being supported at this difficult time.

These recent examples are anecdotal, but demonstrate the importance of corporate access and being able to discuss business decisions with management in a regular and timely fashion to better understand their approach to sustainability. The global economy is complex and supply chain arrangements are particularly opaque. At Lazard, our fundamental analysts have a deep understanding of how businesses and industries operate within a global context, thinking across supply chains and geographies. As global business travel slows down in reaction to transmission risk, we are grateful to have developed so many relationships with companies over time and for having investment colleagues in numerous offices around the world with strong relationships of their own that enable us to maintain this ongoing honest dialogue around sustainability.

About the Authors

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Nathan Cockrell is a Managing Director and Co-Director of Research. He also serves as a Research Analyst primarily covering the global consumer discretionary sectors. Prior to joining Lazard in 2007, Nathan worked for Credit Suisse, where he was a Director and Research Analyst covering the European retail sector. Earlier he worked as a retail analyst for Morgan Stanley and NatWest Securities in London. Nathan began working in the investment field in 1995. He has a BA in History from Cambridge University.

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Jennifer Anderson is the Co-Head of Sustainable Investment and ESG. She began working in the investment field in 2006. Prior to joining Lazard in 2018, Jennifer was an Investment Manager for TPT Retirement Solutions and during this time she also served on the Board of the Directors of the Institutional Investors Group on Climate Change (IIGCC). Her previous role was as an Equity Research Analyst in Sustainable Investment at Citigroup Global Capital Markets and she started her career as an SRI Analyst at Jupiter Asset Management. Jennifer has a BA in Economics and Economic History from the University of Leicester and an MSc in Environment Technology from Imperial College London.

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This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Notes

1 https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans

2 Developed for sustainability-labelled strategies at Lazard Asset Management

3 https://www.roche.com/dam/jcr:945deac2-dcbe-4ae0-a7a9-e9b903b142a2/en/roche-statement-on-2019-nCoV.pdf

Important Information