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PERSPECTIVE

The key to success for impact

through listed equities

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For professional investors only

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Listed equity impact is quickly becoming the golden standard of responsible investing with AUMs growing 80% from 2016 to 2018[1]. But how does one create impact through these companies?

Impact investments can be made in several ways: 1) through a traditional model aligned with the theory of change; 2) the concept of additionality; and 3) purpose-driven companies which aligns to the more traditional sense of impact investing to a more mainstream approach that focuses on medium and large businesses (listed) that deliver products or services to benefit society and the environment.

From an investor point of view, the impact of investments in listed companies is one of intentionality, in other words: investing in companies that provide products and services that intentionally and significantly contribute to the Sustainable Development Goals (SDGs). However, investors can and must have a more active role in the impact generated, which feeds through in the argument that additionality (producing beneficial social or environmental outcomes that would not occur but for this investment) can also be used for listed equity investments. The combination of intentionality and additionality is a combination that would ideally be present in a listed equity impact fund. Three ways in which this can be achieved are:

- Long term investment horizons
- Lower cost of capital requirements
- Stewardship

IMPACT THROUGH LONG TERM INVESTMENT HORIZONS

Apart from macro-economic factors, share price is a good gauge to see whether management is doing a good or poor job in the eyes of investors. A high share price would mean the company (and implicitly its management) is doing good; a low share price would mean the company is doing poor. The importance of this gauge is that this is feedback from investors to management. It means that management might react to movement in share prices and adjust their strategy in order to correct this movement and address the issues that investors have with the current strategy decisions.

So how does this tie in with additionality in listed equity investments? One key factor is the time horizon of investors. How do time horizons relate to additionality? To make the argument for additionality in listed equity investment, we have to realize that pivotal changes regarding impact and sustainability in companies and their strategies take time and bring uncertainty.

For investors, this means that the distribution of outcomes become more dispersed, which institutes risks borne by the investor in this company. However, for investors that project secular tailwinds in the longer term in the spaces of impact or sustainability these risks are partly negated by this. For investors with a shorter time horizon or that do not see these tailwinds, these risk might be too large and will sell the company when the company does not report results that are on par with investors' expectation. This comes back every earnings season with market overreactions to slight earnings misses (which in turn gives feedback to management that they are doing a poor job).

More damaging is that investment in R&D and capital equipment and long-term remuneration packages for top management are all negatively correlated with short-termism[2]. This means that due to short term thinking (due to the appeasement of short term thinking shareholders), less capital is going towards projects with uncertain outcomes and that have longer time horizons. So additionality can be created by giving management the mandate (by giving feedback in buying and holding their stock) to look for transitional projects that might not pay-out in the short term but that are likely to pay-out in the long term.

Longer time horizons and uncertain outcomes in investment decisions do not provide a carte blanche to management of course. Accountability for short term outcomes still applies. But misses in quarterly earnings or short term headwinds should for investors not be the prime reason to sell. Giving management time for execution of a sustainable/impact project can be used in making the case for additionality in equity investments.

Examples

Positive

ORSTED focussing on transitioning from a traditional utility towards one fully run on green energy: This meant mixed results due to depressed energy prices and write offs of fossil fuel assets. However, the promise (important for longer holding periods) of the company made that the stock has been stellar performance.

Negative

Kodak could not keep up with the digital revolution, for fear of cannibalizing its strongest product lines (missing earnings). For example, Kodak invested billions of dollars into developing technology for taking pictures using mobile phones and other digital devices. However, it held back from developing digital cameras for the mass market for fear of eradicating its all-important film business. Which would have led to a necessary change in strategy, that would bring uncertainty and potential earnings misses.

[1] http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf

[2] Sampson, Rachelle C. and Shi, Yuan, Are US Firms Becoming More Short-Term Oriented? Evidence of Shifting Firm Time Horizons from Market Discount Rates, 1980-2013 (May 15, 2019).

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IMPACT THROUGH LOWER COST OF CAPITAL

The link between the structure of capital markets and equity impact might be hard to see at first glance. Listed companies already are able to be provided capital from capital markets (otherwise they would not be listed on an exchange). Thus, buying a stock of a company on the secondary market would at first sight not change the capital position of a company.

There are market mechanisms that do provide insights into how listed impact does indeed create some form of additionality. There are extensive reports on the effect of the E, S and the G on cost of capital of companies. What we learn from studies performed on cost of capital and ESG is that companies that perform well on ESG/CSR have lower cost of capital[3]. In other words: they have access to cheaper capital. This means that due to the fact that these companies perform well on certain ESG metrics, investors require less dividend or yields on their investments. The returns investors look at is the secular trend in sustainability (and impact), and the **promise** of a successful business. Investors are willing to pay more for this. Another concrete example of the increased importance of ESG and capital markets can be seen in the credit facilities created for Danone and Philips, where their revolving credit facility is linked to ESG targets. Interest rates drop when sustainability targets are met. These novel evolutions of capital provisions are now linked to ESG targets, but due to the increased prevalence of the SDGs in companies' reporting and general policies, impact targets most likely will be next. And although this is anecdotal evidence, it shows that capital markets are willing to reward companies that commit to sustainability.

In short: due to investors willing to pay more for a company that shows clear signs of ESG excellence or impact (or require less yield), a company has less of burden regarding capital. This allows management of a company to act more freely in their capital allocation. This creates some form of additionality (creating impact that would otherwise not occur).

Examples

In April 2017, the healthcare technology company **Philips** agreed an innovative €1 billion loan facility with a consortium of banks that features an interest rate linked to the technology firm's year-on-year sustainability performance. The nature of the revolving credit facility means if Philips' sustainability performance improves, the interest rate it has to pay goes down, and vice versa. The potential discount is around 5 to 10 per cent of the credit spread.

February 2018, a €2 billion Positive Incentive Loan facility was issued in the market. A group of banks, grant **Danone** the loan with lower borrowing costs if Danone improves its efforts on ESG-criteria.

IMPACT THROUGH STEWARDSHIP

Stewardship might be the most direct way of actual impact that can be generated by investors. Stewardship is the interaction with a public company and its investors through engagement and proxy voting. Stewardship has almost all the ingredients that activist shareholders use in their strategies. Activist shareholders take a large position in the company, talk to the management and, when push comes to shove, force management to take actions in order to create value for the shareholders. Contrary to activist shareholders, stewardship takes also into account other stakeholders and does not necessarily force the company to change (and no large positions in the company are required). The aim of stewardship through interactions with management and proxy voting means that investors together with management steer the company towards a common goal and create value for shareholders and/or other stakeholders (through impact projects or ESG goals).

Stewardship gives managers the necessary feedback on their policies, points of improvement and even an opportunity to share knowledge with investors on latest developments in company policies or industry trends regarding impact. Proxy voting can be a valuable exercise for investors to convey messages of needed change or encouragement to managers that are on the right path. An example is voting in favour of remuneration packages for directors that are focused on sustainable projects or products that create impact or improve the sustainability of their company. These are examples of listed equity creating additionality in a more tangible way.

In short: intrinsic motivation of impact next to returns can spur change within companies and create tangible impact through listed equity investing. But above all, stewardship is about value creation through knowledge sharing, conveying the right messages to management and to other shareholders (think about shareholder proposals at AGM's).

[3] Business sustainability performance and cost of equity capital, Anthony C.Nga, ZabihollahRezaeeb (2015)

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CONCLUSION

Both listed impact and direct impact investing have a role to play in financial markets. Tangible additionality will mostly be linked to direct impact investing, but the case for additionality through *listed* equity can be made as well. Longer term holding periods (giving management time for execution), lower cost of capital and stewardship can bring additionality. In order to create impact through listed equities, investors should link intentionality (investing in the right companies) and additionality (providing impact otherwise not provided). Only focusing on intentionality, will make investment portfolios attractive, but the companies invested in will not do anything more than they are already doing. Focusing only on additionality will not automatically mean asset owners and asset managers invest in “good” companies; they might be focusing on value creation or sustainability and not on impact.

Therefore intentionality and additionality is the key to success in order to create impact through listed equities.

This is a publication of ACTIAM’s equity team, consisting of nine professionals with an average of 18 years in the industry. The team is responsible for the management of our equity products, with a total AUM of €12 billion (June 2019).

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