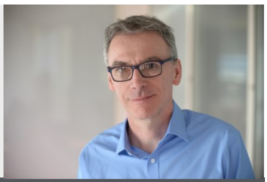
ESG Monthly Engagement



Fund Manager Commentary

Hugh Cuthbert | June 2022

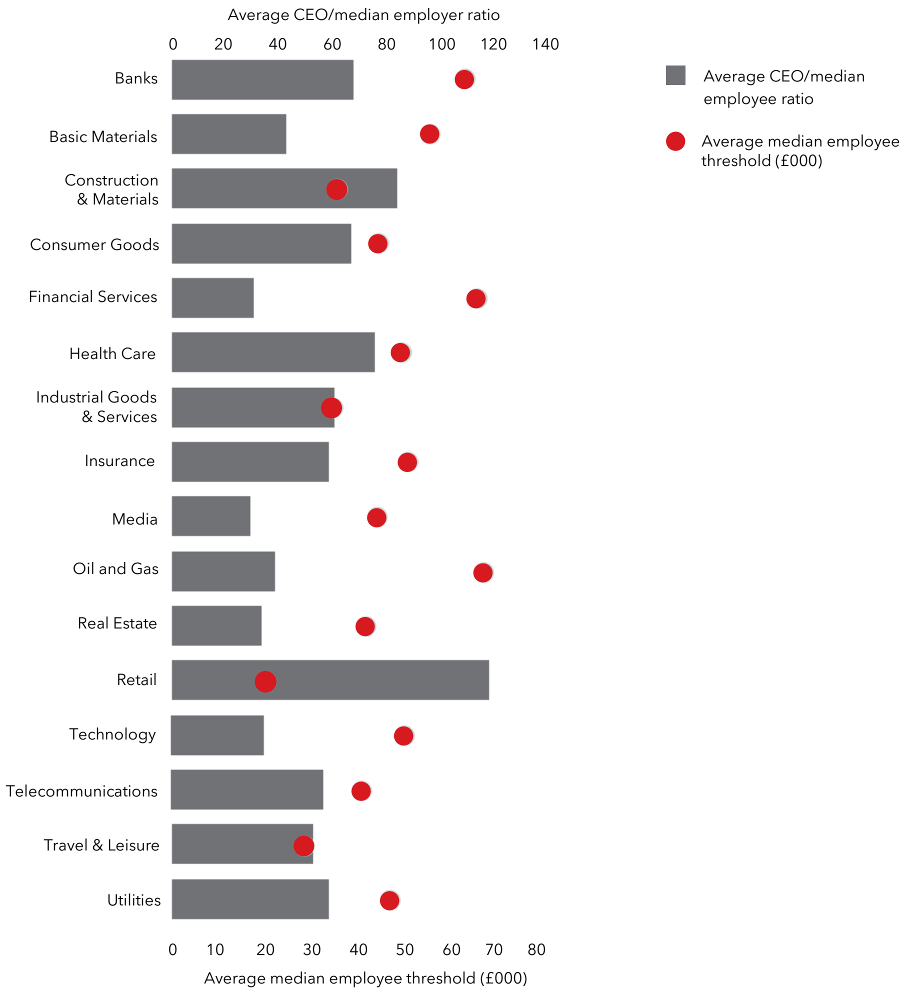
People - An Important Asset

A common refrain we hear from companies large and small is that "people are our most important asset". An easy thing to say, but it is far less easy for investors to judge the validity of such statements, barring the platitudes and glossy pictures which so often accompany these words. Yet, as so many developed economies become increasingly dominated by services as opposed to manufacturing, human capital is indeed becoming the most important asset for companies exposed to this trend. But traditional financial reporting pays little attention to people, deeming personnel to be simply a cost, not an asset featuring in the balance sheet with a contingent value to back the importance claims.

Senior executives, particularly CEOs and CFOs, gain more attention than the general workforce with hours of supervisory and remuneration committee attention resulting in a statutory report running, in many instances, to reams of paper detailing salaries, bonuses and long-term incentive plans. Of course, good governance deems this necessary, as shareholders would strongly frown upon these captains of industry setting their own reward packages, but the attention does appear skewed, especially when, in financial terms, the remuneration and treatment of the general workforce may dwarf that of senior management.

In 2020 the CEO of global pharmaceutical Astra Zeneca received a take home package of $21.5m making him the highest paid FTSE100 executive for that year, receiving much press and public attention as a result. In purely economic terms, however, the package is considerably less notable representing 0.001% of the company's operating expenses. Total employee cost for the same year was $8.247billion, a whopping 44.99% of operating expenses. While not arguing for a lack of restraint in senior executive remuneration, there is a clear case for more focus and disclosure at the workforce level than is currently the case.

In their recent analysis of FTSE 350 pay levels The High Pay Centre notes the lack of disclosure of remuneration levels of those employees between the upper quartile threshold and the CEO. While a 10% increase in the Astra Zeneca's CEOs salary would be arithmetically negligible in overall shareholder value terms, an increase of the same amount for the whole workforce would, based on 2020's numbers, have dented the company's pre-tax profit by -22%. We clearly need to pay heed to calls for more disclosure at all levels of seniority.



1. CEO/median employee ratios and median employee thresholds by industry[1]

But to properly assess the human capital of a company the approach needs to be considerably more holistic than simply levels of pay. A competitor can seamlessly offer a more attractive rate to poach prospective employees resulting in a skills drain and a burdensome level of recruitment costs. Accordingly, SVM's research process encompasses a host of different metrics to gauge the overall risk inherent in a company's approach to workforce management. Health and safety statistics for example can give an indication of the level of care imposed, while detailed policies, planning and reporting on this subject highlights a pro-active approach. Share schemes, health benefits and other perks available to all employees, not just the most senior, can provide evidence of enhanced diligence and this can be backed up by underlying levels of staff turnover and sickness. The level and willingness to disclose such information is often in itself a useful indicator of the level of commitment and care.

This research helps provide a more comprehensive analysis of this all important "asset" for the companies in which we invest and clearly has financial implications for those lagging behind in terms of standards. It also helps prove or dispute the "our most important asset" claims we so often hear and which hopefully will eventually come with more evidence based commentary based on all who work for a firm not just those at the top.

Active Management - Engagement Focus

The current resurgence in inflation is placing increasing pressure on household finances. For the companies who fail to deal with this situation in the appropriate manner, this can lead to employee unrest and industrial action with the potential to not only erode underlying profitability but also bring long lasting reputational damage. For the management teams involved there is a fine balancing act between the interest of shareholders and the welfare of their workforce. The two however are not mutually exclusive with a sustainable long-term approach likely to reap the most reward.

It is with this in mind that we contacted a number of our investee companies over the course of the month who are not accredited Living Wage employers. As accreditation helps demonstrate the fact that a company pays above the government's living wage, it not only helps assuage the potential of reputational damage, but it also provides a clear indication to investors of a company's ability to cope with today's inflationary environment. If a business was relying on a low cost of employment prior to the inflationary pressure we are currently experiencing, then their business model is likely to be under extreme strain in today's environment.

Our engagement was not to berate the lack of accreditation but rather to highlight the benefits of such an approach in terms of both shareholder value and reputational protection while at the same time stimulating discussion and placing this important topic on the agenda. We also delved into why, if the company believed so, accreditation was not appropriate, and importantly, if the company was in a position to achieve this status were it to be sought.

There was a myriad of replies. An over-riding factor was that many already met or indeed exceeded the standard required but preferred to be self-policed believing they could become hostage to fortune to any onerous demands from the Living Wage Foundation in future calculations of the rate to be set. Others were receptive to the idea, while yet more pointed to the complexity of their operations particularly the geographic reach.

Despite a somewhat mixed response so far, we will continue with this project in the coming months as we believe there is value from both a shareholder value and a business sustainability perspective in such engagement activities.

[1] High Pay Centre analysis of FTSE 350 pay ratios – High Pay Centre – May 2022 (highpaycentre.org)