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Fund manager looks beyond the financials when searching for great companies

Buy & Sell: As financial analysis becomes more industrialized, time has been freed up for investors to focus more on non-financial factors like human and social capital

Jonathan Ratner, Financial Post, May 24, 2017

For a long time, most investors assumed everything they needed to know about a company was in the numbers. They'd comb through the past five years of annual reports to determine whether or not it was a great business.

But the reality today is much different, as financial analysis becomes more industrialized through computers, common reporting and accounting standards, and automation. That has freed up time for investors to focus more on non-financial factors like human and social capital — the way businesses discharge their environmental, social and civic obligations.

"Those sorts of things define whether a business is great or not," said Habib Subjally, head of global equities for RBC Global Asset Management (U.K.), during a recent visit to Toronto.

The portfolio manager of the $2.3 billion RBC Global Equity Focus Fund never had to audit customer satisfaction or employee engagement in during his previous career as a chartered accountant. But when he talks to successful entrepreneurs and asks what makes their businesses valuable, nobody mentions factories, buildings, working capital or inventory. Instead, they typically single out customer loyalty, brand value, people and know-how in developing new products.

"Those are not typically found in annual reports," Subjally said. "Investors need to spend much more time looking at those types of things."

Investing in great businesses at expensive valuations is an "elegant way to lose money," so Subjally and his team of 11 experts take a much more forward-looking approach to find value. They try to understand what businesses and management teams are doing, and project where they will be in five, 10 and 15 years. These includes tracking competitive dynamics and sustainable business models, execution and market share, and management's attention to environmental, social and governance issues.

"If management is not focused on the long term, it often ends up being a poor investment," Subjally said, noting that executives are frequently evaluated on very short time periods.

A chief executive could cut training and development budgets — savings that would translate directly to a stronger bottom line, but employees may be unhappy. Similarly, they can borrow from clients by cutting customer service staff, but there won't be anyone to answer the phones.

"This sort of borrowing creates contingent liabilities that sooner or later become financial liabilities," Subjally said.

That's why he considers it important to find management teams that have an ownership mindset, and are prepared to invest in people, customers, suppliers, communities and the environment.

"This costs money, and does lead to lower profits in the short term, but it does lead to better long-term value creation," he said.

One of the fund's largest holdings, Fortive Corp. (FTV/NYSE), fits these requirements. The diversified industrial firm that was spun out from Danaher Corp. roughly a year ago, acquires businesses and implements a methodology for making them more efficient.

"They want to use less space, fewer resources, make businesses faster and better, and the process goes all the way up and down the organization," Subjally said. "They measure everything, and it's all about selling more, so there is both a growth element and a people element."

"They are very good at buying businesses and improving them dramatically," he added. "They are taking market share, the end markets are growing, and management is able to execute."

Another top holding, HDFC Bank Ltd. (India), has a technology-focused business model that Subjally believes makes it one of the best-managed banks in the world. He highlighted the country's largest private-sector bank's ability to use branches — sometimes with just one employee — to service small villages.

"In a country like India, where the economy and financial services are still growing, they are able to move fast and deal with the huge volumes," Subjally said.

He highlighted HDFC's roughly US$1 billion in micro finance: family-based loans that are primarily for women, as well as the bank's market share gains in areas like credit and debit cards.

"We really like the management team," Subjally said. "They have not only run the business very well with great transparency, but they also develop their people."

Estée Lauder Cos. Inc. (EL/NYSE) is an example of a portfolio holding that has professionalized its management team in recent years. The skin care and beauty giant still has William Lauder as chairman, and continues to have a long-term focus, but by purchasing small brands, investing in them, and taking them around the world, that's allowed the company to grow successfully.

Subjally pointed to Estée Lauder's very rapid growth in China, India, the Middle East and Latin America, along with the addition of new brands such as Glamglow, Tom Ford and Joe Malone.

"There is much more coming," he said. "So we can see that it is a great business, and why it is going to be much more valuable in 10 years."

Global Asset Management