Large-Cap Sustainable Value – 18 months in

A reflection on our early learnings: Targeting the intersection of value and sustainability in an evolving landscape

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In October 2022 we launched the U.S. Large-Cap Sustainable Value strategy – 18 months in we thought it would be prudent to reflect on what we have learnt since launching and to take the opportunity to reiterate the underlying tenants that drive our investing philosophy.

We set out to provide investors with a strategy that we believed answered the unmet market need to identify companies within the value space that were embracing sustainability to drive better financial performance. There is no denying that when it comes to sustainability the value universe presents more difficulty given the legacy and complexity of select industries. While many managers will avoid this complexity by taking an exclusionary approach to certain sectors, we have embraced this challenge and have approached the universe from a solutions-based and a performance first mindset. With the support of our in-house research team, I am encouraged by the progress we have made thus far which only reinforces our belief that there remains a compelling opportunity for investors at the intersection of value and sustainability.

A thoughtful approach

The terms “value” and “sustainability” are two words that can undoubtedly mean different things to different investors depending on their perspective. We define value as companies that can generate consistently high levels of free cash flow, exhibit capital discipline through the maintenance of a prudent capital structure, and trade at attractive valuations. We place a significant amount of emphasis on “financial flexibility” and believe the combination of an attractive free cash flow yield coupled with excess balance sheet capacity will help provide the portfolio with a margin of safety during times of stress, in addition to giving our investors upside optionality over time. As value investors we are very focused on valuation and entry price, believing that protecting capital on the downside to limit “drawdown risk” is a key driver to compounding capital over the long term.

We seek to identify companies and management teams that are leveraging sustainability to drive what we define as a Sustainable Cash Flow Advantage (SCFA) through the use of our 3P investment filter. Companies that exhibit SCFA are implementing sustainable strategies through their People, Process, and/or Product to drive enhanced free cash flow outcomes while actively managing material sustainable risks that could impact their business over time. At its highest level we believe sustainability is all about “continuous improvement” and companies that embrace this mindset have the opportunity to drive differentiated performance versus their peers over the long term.

Our dual approach, combining fundamental and sustainable investing analysis, not only differentiates our investment strategy in the traditional value space but also fuels our excitement about the opportunities ahead. The concept of sustainability within the value universe is still relatively new to the market as many companies are still in the early innings of their sustainable journeys. By leveraging the size and depth of our in-house research team we strive to find those companies that sit at the intersection of durable fundamentals, sustainable leadership, and attractive valuations. As long-term investors with a concentrated portfolio of just 35-45 investments, we strive to stay disciplined in our approach while actively combing through a landscape of over 1,000 companies. We do not take an “exclusionary” approach when looking at the universe and as a result we believe the strategy will look different than many other traditional value and traditional sustainable strategies. While many investors may associate the term value with a sacrifice in "quality”, we do not subscribe to that notion and believe that the portfolio is full of high-quality franchises that generate high levels of free cash flow with defensible market positions and ample financial flexibility. We look for Sustainable Cash Flow Advantages to lower the volatility and extend the duration of those free cash flows further into the future.

Putting this into practice

When we came across CRH plc[1] a little over a year ago in our research process, it was a company we and likely many other U.S. investors had little familiarity with. The company is headquartered in Ireland, was listed through a sponsored ADR, had no direct U.S. analyst coverage, and was not included in any relevant indices. This was despite the fact that CRH is one of the largest building materials companies in North America with unrivaled size and scale, generated over 75% of its total EBITDA in the region, and had a $40bn market cap. As we dug in further our excitement quicky built as we learned how the current management team had repositioned the portfolio to less cyclical, faster growing markets all while driving EBITDA margins higher (over 350bps since 2018) and balance sheet leverage down to the best level in its 50-year history. CRH’s consistent free cash flow generation coupled with its prudent capital structure has allowed the company to allocate an increasing amount of its excess capital back to shareholders through dividends and buybacks in recent years.[2]

From a sustainability perspective, CRH would have been an easy name to dismiss under a traditional “exclusionary” approach given the legacy of its industry. Yet in our opinion, CRH’s Sustainable Cash Flow Advantage centers around its leading position among its peers in terms of circularity, emissions, and innovation. CRH is the largest recycler of any material in North America (44m tons last year) and generates over 50% of its revenues from products with enhanced sustainability attributes[3]. One of every four miles of road that CRH paves in North America is made with fully recycled content. This has helped CRH not only lower its overall cost structure but also win share in the market as more customers seek out more sustainable solutions from their supplier base. Finally, with an absolute valuation at a substantial discount to its closest U.S. peers, we initiated our position. Since that time, CRH has moved its primary stock listing to the U.S. which we think will help it to get on more U.S. investors radars over time. CRH remains a core position within the strategy today.

Exploring our investment universe: a forward-looking perspective

We recognize that it has only been a short time since we launched, and as long-term investors we tread cautiously when reflecting on such a short period of time. However, it is true that our excitement level today is as high if not higher than the day we embarked on this journey. I am incredibly grateful for the extensive team of analysts that have supported the strategy since its inception. The team is running hard, and over the last 18 months we have had conversations with numerous companies across a variety of economic sectors. The further we dig, the more excited we become about our addressable universe going forward. We strive to operate with a high sense of urgency in finding the next attractive investment opportunity for the strategy but with the balance of discipline and patience from a philosophy and price perspective.

We accept the fact that markets fluctuate and certain investing styles or factors fall in and out of favor over the short term, but it is our belief that a portfolio of companies that generate consistent high levels of free cash flow, possess a Sustainable Cash Flow Advantage, exhibit capital discipline, and trade at attractive valuations will lead to compelling risk adjusted returns over the long term while providing a margin of safety for our investors.

We thank you for your support and interest in the strategy.

Mike

Disclosures

[1] CRH plc is a current holding in the Large-Cap Sustainable Value representative account portfolio as of 05/31/2024 and was selected because the investment team believes it demonstrates the strategy's stated investment philosophy regarding attractive business fundamentals, compelling valuation, and strong or improving Sustainable Cash Flow Advantages. It does not represent all the securities purchased, sold or recommended for advisory clients.
[2] Source: Brown Advisory internal research.
[3] CRH plc Sustainability Report 2023 https://www.crh.com/media/5157/crh-sustainability-report-2023_interactive_vhr.pdf

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Sustainable investment considerations are one of multiple informational inputs into the investment process, alongside data on traditional financial factors, and so are not the sole driver of decision-making. Sustainable investment analysis may not be performed for every holding in the strategy. Sustainable investment considerations that are material will vary by investment style, sector/industry, market trends and client objectives. The strategy seeks to identify companies that it believes may be desirable based on our analysis of sustainable investment related risks and opportunities, but investors may differ in their views. As a result, the strategy may invest in companies that do not reflect the beliefs and values of any investor. The strategy may also invest in companies that would otherwise be excluded from other funds that focus on sustainable investment risks. Security selection will be impacted by the combined focus on sustainable investment research assessments and fundamental research assessments including the return forecasts. The strategy incorporates data from third parties in its research process but does not make investment decisions based on third-party data alone. There is no assurance that this information will be accurate or complete or that it will properly exclude all applicable securities. Investments selected using these tools may perform differently than as forecasted due to the factors incorporated into the screening process, changes from historical trends, and issues in the construction and implementation of the screens (including, but not limited to, software issues and other technological issues).

Terms and Definitions
Free Cash Flow (FCF) represents the cash a company generates after accounting for cash outflows to support operations and maintain its capital assets. FCF yield is a measure of financial performance calculated as operating cash flow minus capital expenditures.

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EBITDA stands for earnings before income, taxes, depreciation, and amortization.

Upside/downside: to say an investment has upside is to say it has the potential to increase in value. By contrast, when an investment has downside, it has the potential to decrease in value.