Sustainable Model Portfolio Service

In partnership with LGT Vestra

Thoughts from the sustainable investing team – August 2021

As inflation rises, how will sustainable companies fare?

Phoebe Stone, Head of Sustainable Investing, and Matt Wiles, Sustainable Fund Analyst

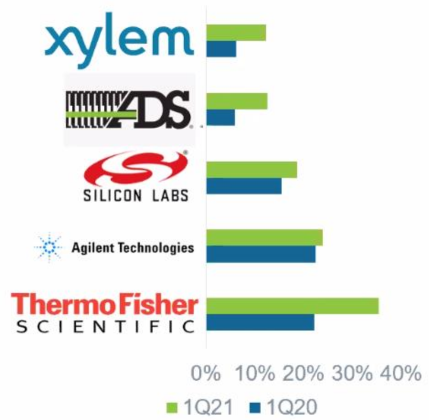
In recent months, there has been a lot written about the impact of inflationary pressures on corporate margins as the costs of raw materials, packaging and transport have increased dramatically. In response to these rising costs, we have seen business leaders suggest that price increases may be hard to avoid in order to protect profitability.

Interestingly, a company's ability to protect margins from increasing input costs is a theme we are seeing across a number of the businesses held in the sustainable portfolios and we would argue that it is one of the benefits of an investment process that prioritises selection of companies with strong sustainable credentials.

Within our sustainable investment process, we look to hold quality businesses with strong financial credentials and barriers to entry such as a strong brand, differentiated products or a loyal customer base. The inherent quality characteristics of sustainable stocks brings price protection as part of its competitive advantage.

These businesses are considered 'longer duration' due to the valuation premium based on long-term cashflow being vulnerable in a rising interest rate environment. However, these businesses also often have pricing power – they are able to pass on these increases in costs to their customers. An example of such a business is ASML, which reported its earnings last week, with net sales growth expected at around 35% in 2021 and gross margin between 51% and 52%. ASML is held in the Henderson Global Sustainable Equity fund. Other examples of companies with embedded pricing protection include companies like Trane Technologies a specialist in energy efficient indoor environments and Croda a leader in green chemistry, both held in the NinetyOne Global Environment fund.

Expanding operating margins



Source: WHEB Sustainability Fund Q2 2021 presentation

Other fund managers, such as Impax, who invest in industrials and materials companies delivering on themes such as the green transition, also believe these companies are in a position to pass on input costs inflation and demand-driven pricing power. These companies are also able to outperform in an inflationary environment as they benefit from improved profitability from economic growth. There are other companies that are very well-positioned to benefit from an expansionary economic environment associated with inflation, such as Autodesk. This is a design software company, whose customers are architects, engineers, construction companies and manufacturers. Autodesk therefore stands to benefit from a stronger housing cycle and infrastructure stimulus. However, it has been viewed by the market as a technology business, so its valuation premium has shrunk despite the fact the business has 98% recurring revenues and 40% free cash flow margins.

Many businesses are also able to manage inflation costs through managing future raw material costs. Businesses in the wind farm industry, such as Orsted and Vestas which need large volumes of steel, often lock in prices on a one year forward basis. Vestas goes even further by building any increase in the raw material costs into the client contract, so they are automatically passed through.

However, there are some sectors where inflation may have a negative impact. Some industries such as retail (outside of food and luxury) are more vulnerable to inflation, and companies without barriers to entry are unlikely to be able to pass on costs as effectively, if at all. Our active approach to sustainable investing looks specifically to avoid companies in these areas, making the sustainable strategies not only future-proofed from a long-term thematic perspective, but also when considering short-term inflationary pressures.

Eden Park Investment Management Limited, The Pavilions, Eden Park, Ham Green, Bristol, BS20 0DD, 01275 404 880, enquiries@edenparkim.co.uk, www.edenparkim.co.uk