RBC Global Asset Management

Focusing on the future

Management quality and long-term value creation

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> "From our experience, one of the most important aspects in evaluating management is in its ability to instill a strong culture and create a good company to work for."

Assessing and evaluating management quality has always been a key part of our EM Equity investment process. Here we look at culture, the importance of return metrics, and why a clear strategy and strong execution matter. We also give examples of management's ability to innovate and stay at the leading edge into the future.

Management quality is one of the three sections in our investment checklist. Exhibit 1 shows example questions in the management quality section of the checklist, including questions on management's track record of integrity, how it addresses all stakeholders in the business and if it thinks about the long term.

In 2023, we decided to develop our focus on management quality even further, by trying to identify key areas where management teams of successful EM companies have excelled. Through team discussions, offsite work and analysing case studies, we found that culture, return focus, clarity and execution of strategy and investing for the future are particularly crucial elements when it comes to assessing management quality.

Culture

From our experience, one of the most important aspects in evaluating management is in its ability to instill a strong culture and create a good company to work for. Having a winning culture can be a significant competitive advantage for a company.

The importance of culture is clear when looking at the long-term outperformance of companies in the '100 Best Companies to Work For' ranking. Between 1998 (when the rankings started being published) and 2023, these companies are up 2,286%, compared to the S&P500 Index's 664%, a 1,622% difference (Exhibit 2). Over 25 years and 7 months, that computes to a compounded annual growth rate ("CAGR") difference of more than 5%.

One company that has consistently been named as a great place to work and that has a strong culture is Mercado Libre. The company is a leading online marketplace business in Latin America, with a presence across the region within e-commerce and fintech. Mercado Libre was ranked as the fourth best company to work for in Latin America and the 20th best company to work for globally in Great Place to Work, 2021 edition (Exhibit 3).

According to the company, it has always sought to build a culture of entrepreneurship and excellence across its entire organisation. Management believes that to continue to be a leader across markets, it needs to attract, engage, and develop the best talent. As such, the company has a clear focus on people and teams in its culture, prioritising employees' physical and emotional wellbeing, and building diverse and inclusive environments where everyone can fufil their full potential.

Every time we meet with the management of a company, we ask about culture, and this is something we will continue to do. We also believe it is crucial to visit a company's facilities and speak with employees and different layers of management, and not just the top management. This is important in ensuring that the culture is consistent across the organisation.

Return focus

Another key element in our investment philosophy is investing in companies with high and sustainable Cash Flow Return on Investment ("CFROI"). This is a metric that emphasises a company's cashflow-generating abilities. We have found that some of the most successful companies in EM over time have been those that have had a sharp focus on generating consistently high returns, in metrics such as CFROI, Return on Invested Capital ("ROIC") or Economic Value Added ("EVA").

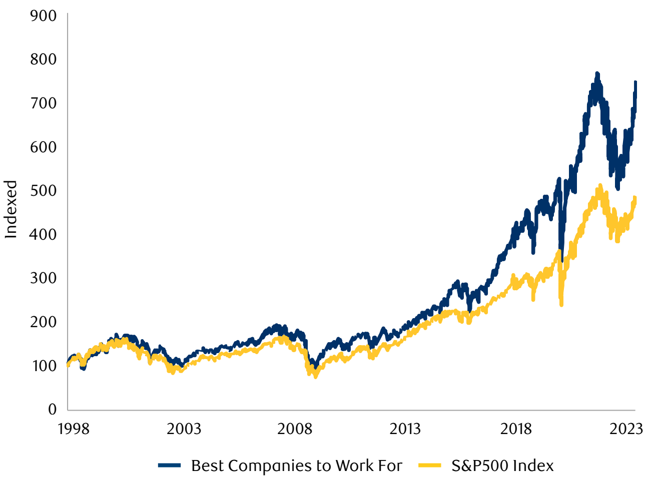
Exhibit 1: Examples of 'Management Quality' questions

	Management quality
1	What is management's track record of integrity?
2	How innovative is the culture of the firm and management?
3	Is the company addressing stakeholders in the business?
4	How would you define the company's corporate culture?
5	Does management think about the long term? Is it prepared to sacrifice short-term profit to lay the foundation for future growth?

Source: RBC GAM, as at September 2023.

One of the most compelling companies we have seen in this respect is the Brazilian company, WEG. This is a leading electric engineering, power, and automation technology company. WEG has made significant efforts throughout the organisation to have all employees working in ways that maximises ROIC. For example, in the company's factories, there are whiteboards where every employee can see how their actions ultimately impact WEG's ROIC. The level and sustainability of ROIC is also a key KPI of the management of the company, which determines variable compensation.

Exhibit 2: '100 Best Companies to Work For' have outperformed over the long term



Source: Jefferies, as at August 2023.

Exhibit 3: Mercado Libre – Great Place to Work

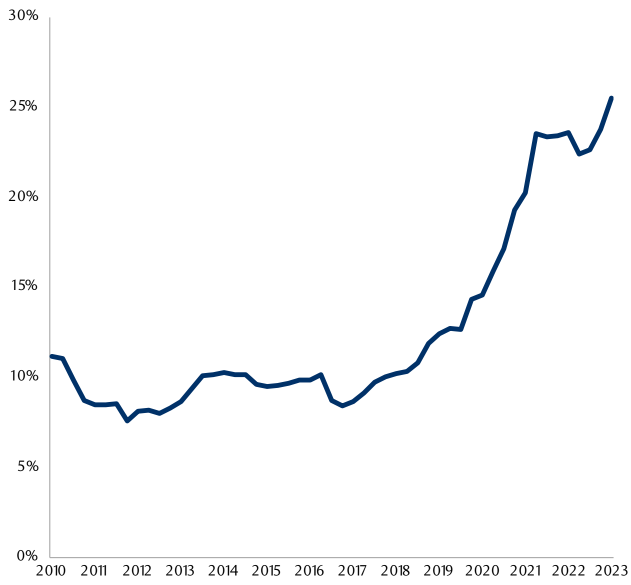
Source: Mercado Libre Impact Report, 2021.

Exhibit 4 shows the evolution of WEG's ROIC. We have seen an impressive expansion from around 10% to above 25% in the last 10 years.

WEG's ROIC has been surpassing comparable companies, which include high quality companies and international industrial peers. The company's disciplined capital allocation, exposure to resilient and rapid growing segments, combined with a constant focus on improving efficiency via its vertical integration strategy have been paying off.

We will continue to analyse how important return metrics are for companies when we meet their management teams and assess whether these metrics are part of the KPIs for management. We have also modified one checklist question to add an even greater focus on returns.

Exhibit 4: Evolution of WEG's ROIC



Source: Bloomberg, as at September 2023.

Clear strategy and strong execution

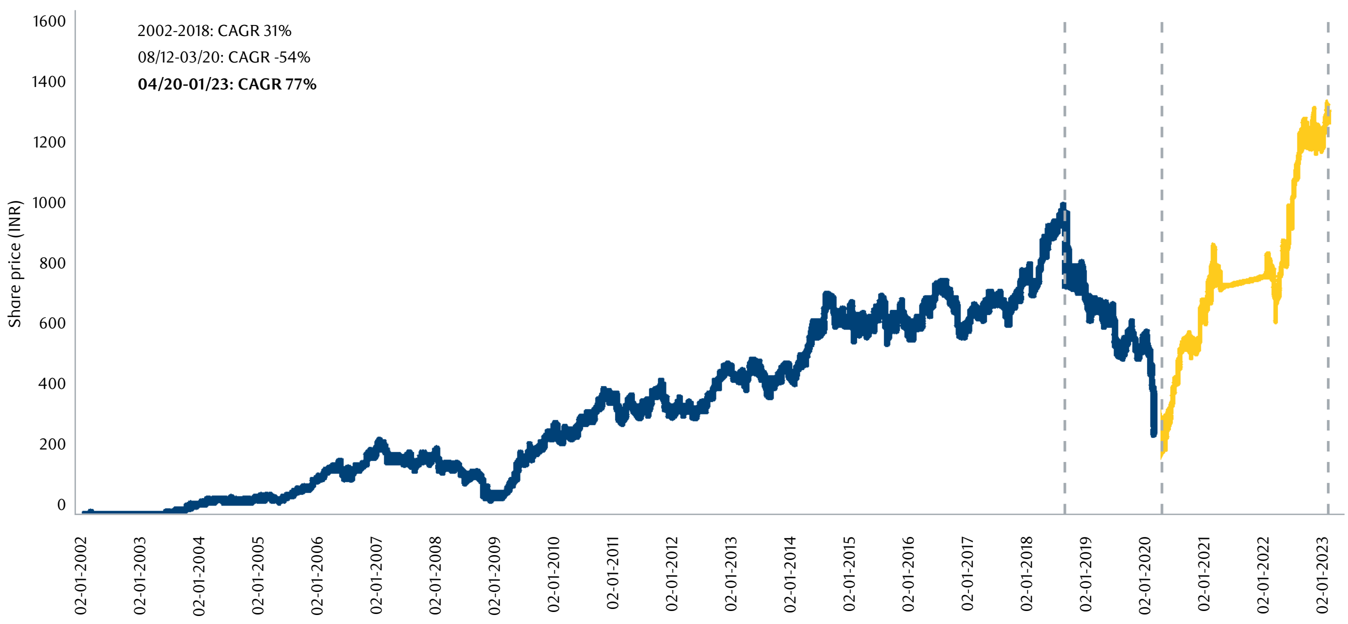
Management teams that have been able to set out a clear, transparent, and well laid out long-term strategy and diligently execute on this year after year have generally been rewarded by investors in EM. We think that one of the best examples of this has been the Indian automotive company and conglomerate, Mahindra & Mahindra ("M&M").

Exhibit 5 shows the share price performance of the company over the long term, including a period of underperformance from 2019-2021, followed by strong performance since 2021. It demonstrates the importance of capital allocation and having a clear strategy with strong execution.

> "WEG's ROIC has been surpassing comparable companies, which include high quality companies and international industrial peers."

The underperformance from 2019-2021 happened as M&M effectively started losing the focus on its core business. The company had diversified into non-core business areas and international subsidiaries that created a considerable drag on profitability and management resources.

Exhibit 5: M&M – importance of strategy and execution



Source: Mahindra & Mahindra investor presentation, as at February 2023.

This led Anand Mahindra, Chairman and grandson of Jagdish Mahindra, co-founder of the company, to professionalise the company. Anand stepped down as effective group CEO to make way for a non-family member, Dr. Anish Shah, to step in and take over as the new CEO. This was the first time a non-family member had taken the CEO role and it signified a complete change in strategy. Dr. Shah set out a strategy to be executed on over the following years. The key elements of this strategy were to turnaround or exit loss-making businesses and improve the RoE to 18%.

M&M has in fact executed very well on this strategy in the last couple of years. We started seeing significant RoE improvements from the low levels of 2020-21 (Exhibit 6). In 2023, the company's RoE reached 20%, exceeding the original 18% RoE target. And as shown in Exhibit 5, the share price performance reflected this return improvement in a significant way.

To capture the importance of this aspect of management quality, we have refined one checklist question and are now asking: "has the management articulated a clear strategy for generating future sustainable returns, and how has it executed on this?"

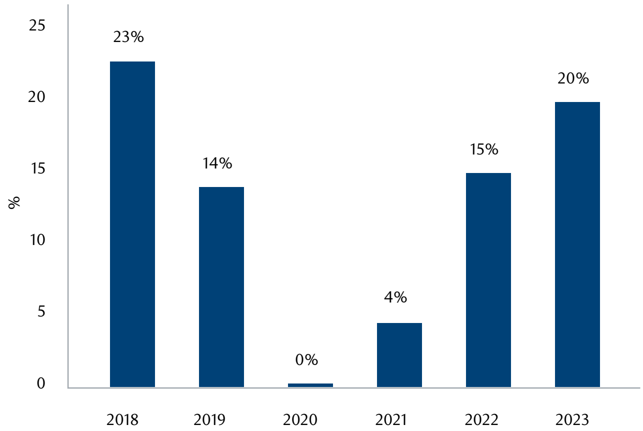
Investing for the future

Although we see disruption in every industry, the technology sector is and likely always will be at the forefront in this area, most often being the industry that sets the conditions for disruption and where disruption occurs at the fastest rate. The difficulty for long-term investors, such as ourselves, is therefore that of matching a long-term structural growth area of investment with successful stock selection in technology-related sectors, where innovation seems to disrupt existing businesses faster than in other sectors. One of the elements to look at is therefore management's ability to continue to innovate and stay at the leading edge over the long term.

The Taiwanese company, Delta Electronics, is an example of a company that has been able to reposition itself multiple times over the last two decades in areas of structural growth. Delta Electronics was founded in 1971 and is now the largest power supply component and power solutions provider globally.

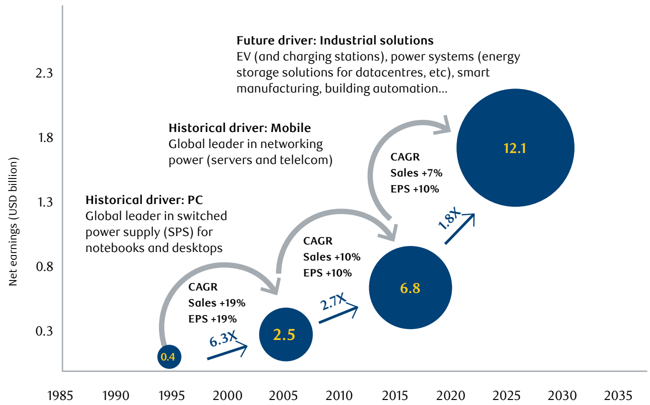
Delta's management team has transformed its business strategy to capture new growth opportunities over the past two decades (Exhibit 7). Also importantly, the addressable markets have continued to grow larger with every new technology disruption. From 1995-2005, Delta achieved a 19% sales/EPS CAGR on solid PC demand. With the rise of mobile technology from 2006-2015, the company posted a 10% sales/EPS CAGR on demand for mobile applications (e.g. mobile electronics, servers and telecom power).

Exhibit 6: M&M RoE



Source: Bloomberg, as at August 2023.

Exhibit 7: Delta Electronics' long-term business transformation



Source: Goldman Sachs Global Investment Research, as at October 2018. Note: bubble size = sales (USD billion).

Over the next 5-10 years, we believe Delta can continue to leverage its flexible business model and become an industrial solutions provider in areas such as smart manufacturing, power-system products, and electric vehicle ("EV") charging solutions.

Delta Electronics' management has been able to position the company as a natural beneficiary of the climate transition with a large proportion of its revenue tied to green technologies or energy efficiency products servicing various end markets. Most recently, it has entered markets such as EV, data centres and smart manufacturing while gradually exiting the old legacy power business, which gathered primarily to consumer electronics.

Management's ability to innovate and invest for the future has always been an important part of our management quality checklist and, as such, we have not made any specific changes to the checklist when it comes to this area.

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Christoffer is a portfolio manager on the RBC Emerging Markets Equity team at RBC GAM. He is currently responsible for research in Latin America and Korea. During his time at the firm, he has also specialised in India, China and Taiwan. Prior to joining the firm in 2013 as an investment analyst, Christoffer worked in the investment management division of a Nordic-based financial services group in Copenhagen. He started his career in the investment industry in 2010.

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