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THE QUALITIES OF "QUALITY" AND THE USE OF ESG IN INVESTING

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At Comgest, the notion of "*Quality*" is central to our business. Why? Because Comgest is a growth investor, and we believe that focusing on quality is one of the very few practical approaches to increase our odds of investing in companies that that are likely to profitably outgrow expectations already priced in their shares.

It thus raises the question "*what is quality*"? In our view, quality is qualitative in nature. I also think it should not be limited to gross and approximate yardsticks such as earnings standard deviation, a net debt/EBITDA[1] ratio or even a slightly more elaborate Piotroski[2] score. However, one could say that "Quality is determined by the durable competitive advantages of a business" and can be measured by ROIIC[3]. While I agree with this to a large extent, I would further posit that the "*durable competitive advantages of a business are determined by its quality*". These relationships show how interconnected financial and extra-financial matters can be, which is why we decided to integrate environmental, social, and governance (ESG) criteria / principles not only into our investment process, but also into our valuation framework.

— At Comgest, "Quality" is central to our business

In this paper, I will try to address what quality is at its core, while likewise illustrating ESG methods to measure it. But I should start with a disclaimer: first, not all of our investee companies possess all of the "*qualities of Quality*" presented hereafter; and second, the challenge in defining quality is that it is a very subjective concept, just like beauty. As such, one can safely say that, in the end, "*quality is in the eyes of the beholder*"[4].

— "Quality is qualitative in nature"

Quality emerges when purpose meets the need for a solution

According to Merriam-Webster, the definition of quality is obscured by the plurality of its meanings. In trying to keep things as simple as possible, two main ideas convey the notion of quality: *an essential characteristic* on the one hand and *a degree of excellence* on the other. Less dry than a dictionary, but just as enlightening, UNESCO states "*Quality is a measure of fitness to purpose*". A third definition, from the American Society of Quality, refers to the "*Pursuit of solutions contributing to successes, fulfilling accountabilities and satisfying stated or implied needs*". Stemming from the Latin word "*qualis*", which means "*of what kind*", the quality of a business can be defined by its singularity, as well as its

— Durable competitive advantages of a business are determined by its Quality

[1] Earnings before interest, taxes, depreciation, and amortization (EBITDA) is a measure of a company's overall financial performance and is used as an alternative to simple earnings or net income in some circumstances (http://bit.ly/34snoNF).
[2] Investopedia. " Piotroski Score" (http://bit.ly/1SyHV3W).
[3] Return on incremental invested capital (ROIIC) is an extension of return on investment capital (ROIC), which is itself an extension of return on investment (ROI) (http://bit.ly/2Xrj7by).
[4] To best understand "quality" read Robert Pirsig: *Lila* (1991) and *Zen and the Art of Motorcycle Maintenance* (2006), in which he writes: "The process of philosophic explanation is an analytic process...of breaking something down into subjects and predicates. What I mean...by the word 'quality' cannot be broken down into subjects and predicates. This is not because quality is so mysterious but because quality is so simple, immediate and direct". I would add that the best definition was given by my own grandmother: "I know it when I see it"!

specific purpose *and* its ability to fulfil it within its social ecosystem. When we at Comgest talk about the *"pricing power"*, the earnings visibility or the exceptional franchise of a company, we are definitively talking about the quality of a business, which largely depends on the relevance of its specific purpose.

In order to advance the topic further, let us now make a little detour to reflect on the following two questions raised by Peter Drucker[5] in the '50s: *"what is a business"* and *"what is the responsibility of a business"*. Drucker stated that *"The proper 'social responsibility' of business is to … turn a social problem into economic opportunity through economic benefit for customers, into human competence and well-paid jobs for employees, and into wealth for shareholders."* This is a very simple, but powerful concept and, if a company is doing well at this, the relevance of its purpose starts to appear. Drucker then goes on to say that a business is defined by its purpose, which is to create social utility through innovation and differentiation. Innovation enables solutions to social problems while differentiation secures economic opportunity.

— Innovation enables solutions to social problems while differentiation secures economic opportunity

Why does differentiation help secure economic opportunity? Because, as naturalist Gregory Bateson said, *"human perception is fundamentally based on difference"*[6]. To monetize a problem-solving innovation, a company needs to be strongly, sustainably and distinctively associated to it. The competitive battle occurs not in the marketplace, but in the mind of the customer. Fundamental questions to ask include: Why does the company exist? How would the world be different without it? What is its unique organisational and social architecture? What is it incredibly good at and used for? Reaching this level of essence and abstraction enables us to assess the quality of a business and to understand the business in terms of its unique social utility and work process. We would argue it is impossible to know or ascertain the quality of company if we do not firstly understand its purpose and the extent to which this purpose is sustainably in sync with some of society's deepest needs or desires. Only then can the business's relevance to existing and potential customers be determined and evaluated.

— Fundamental questions to ask include:

- **Why does the company exist?**
- **How would the world be different without it?**
- **What is the unique organisational and social architecture?**
- **What is it incredibly good at and used for?**

For instance, the core purpose of L'Oréal (*"offering beauty to all"*) is as relevant today as it was when it was founded in 1909. Coming back to my colleague Peter's arguments, why and how would a brand be a source of superior loyalty and pricing power if not because of its implicit pledges and the fact that it means something special to customers? The L'Oréal brand implies that any woman or man can aspire to appear younger and more attractive for longer, thanks to the relentless efforts of their scientists working in R&D.

A customer-centric purpose provides powerful and sustainable competitive advantages

Some companies have had a great social utility, until the social problems or desires of civil society they were addressing started to change and

[5] Drucker, Peter. *Management*. HarperBusiness; Revised edition (22 April 2008).
[6] Bateson, Gregory. *Steps to an Ecology of Mind: Collected Essays in Anthropology, Psychiatry, Evolution, and Epistemology*. University of Chicago Press (10 March 2000).

be better addressed by another innovation. The relevance of a business within its social ecosystem can either be ephemeral or long lasting. What the customer thinks he is buying - what he considers value - is decisive. This determines what a business is, what it produces, and whether it will grow or decline. Actually, what the customer buys and considers value is never a product. It is always perceived utility, i.e. what a product or service can do for him or her. Quality in a product or service has never been what the company puts in. *Quality is what the customer gets out of it and is willing to pay for.* This is notably why the software industry is so profitable. As such, the customer-centricity of a company is absolutely critical to assess the quality of its business for one other reason: the relevance of its purpose will inevitably diminish at some point in time and only the deepest care for the customers will enable the company to anticipate this, and maybe find a way to adapt itself for an adjacent and relevant purpose. So a central question for a company, as well as its Quality Growth shareholders, should not be *"how is our business doing"*, but *"what should our business be given the changing, or still unmet, needs of our customers"*. As Wal-Mart founder Sam Walton once put it: *"There is only one boss: the customer. And he can fire everybody in the company, from the chairman on down, simply by spending his money somewhere else"*. Due to the ever changing nature of the world and of the future in particular, growth investing is fraught with risks that very few tool kits can reduce. Carefully understanding the true *"Quality"* of a company is clearly one of them.

— Assessing a company's customer-centricity is critical since its purpose inevitably diminishes and only the best customer care will allow the company to anticipate and adapt

More often than not, a clear sense of business purpose can make or break the relevance and differentiation of a company, and hence its quality. If a company is not able to clearly articulate its purpose and differentiation, it is likely that it will not be well accepted or even desired. In addition, it will not easily adapt to a changing environment either, since in order to feel where the winds of change are blowing, a company needs to connect with and care about its customers at all levels of its organisation. It is easier to attract clients when you have a purpose that they value, and vice-versa, as the two reinforce each other in a feedback loop.

Purpose, singularity, relevance and character are all prerequisites for a product, a brand or a company to transition from just seizing the spirit of the times and then fading like a fad, to actually becoming a long lasting part of the societal infrastructure, which is what our style of quality growth investing is all about. Human beings differentiate themselves from other living entities notably through their insatiable need for purpose and sense. A world that does not make sense is a source of stress and rapidly becomes a cause for disengagement, then despair and illness[7]. If we feel a greater (one standard deviation) sense of purpose than the average person, it seems we then reduce our risk of dying by 15% over the next 14 years

"There is only one boss: the customer. And he can fire everybody in the company, from the chairman on down, simply by spending his money somewhere else".

-Sam Walton, founder of Wal-Mart

[7] Frankl, Viktor. *Man's Search for Meaning*. Beacon Press (2006).

according to scientific research[8].

Anchoring a purpose is the duty of its leaders and enables better governance

The company purpose and values that come with quality usually make the long term possible and visible, not only externally with customers, but also internally with employees. Most large companies tend to forget their "*why*" and see their culture weaken under the burden of processes, controls and bureaucracy. This is even more true for those who have been through big mergers and acquisitions, where the *"raison d'être"* may be lost and the cultures of different companies clash. In a fast changing world, start-ups usually do a greater job than large organisations to define their "*why*" in order to seize the *"zeitgeist"* and create new categories that make sense and solve social problems. Interestingly, this is taken as an obvious truth among venture capitalists whose investments are long term and subject to existential and liquidity risks. Those questions are much less common among equity portfolio managers. Venture Capitalist and founder of Business Objects, Bernard Liautaud recently said during an interview:

"To me, great leaders are people who do three things exceptionally well. First, they set a clear direction or a magnetic north for the company to follow and ensure that everyone knows what the broad mission and purpose of the company is. This in turn enables employees to make their own judgment on what to pursue without someone else telling them what they need to do every day. Secondly, they are able to extract the best from people around them by motivating them and pushing them to achieve extraordinary things, even when those people themselves didn't think they could. And finally, good leaders set the right examples for others to follow".

— Great leaders do three things well:

- **Set a clear direction for the company and ensure that everyone knows the broad mission and purpose of the company**
- **Motivate the people around them and push them to achieve extraordinary things, even when they themselves didn't think it was possible**
- **Set appropriate examples for others to follow**

Bernard Liautaud, Venture Capitalist and founder of Business Objects

Having a purpose has a virtue, which is to help people achieve more and push their limits. As Nietzsche reportedly wrote, *"He who has a why to live can bear almost any how"*. This is as true for people as it is for companies. The tricky thing is that in order to work, it needs to be real. It needs to be part of why the company really exists, or it breeds cynicism, disengagement and distrust. Purpose should never be an ex-post add-on to the strategy. Even more importantly, purpose is personal and path-dependent. It's something that needs to come from the history of the company and the legacy of its founder, not something suddenly created by a CEO just because it has some short-term commercial appeal.

When it comes to innovation, decades of psychology literature on incentives convincingly demonstrate that intrinsic motivations provide a much more powerful engine for outstanding performances than extrinsic motivations. Intrinsic goals are driven by a personal interest or enjoyment in a task or its outcome, while extrinsic motivations rely on the performance of an activity in order to achieve an external benefit, e.g., monetary reward or the avoidance of punishment. More specifically, intrinsic motivations tend to deliver superior results for *"heuristic"* tasks such as running a company, but lower outcomes with regard to

[8] Hill & Turiano. "Purpose in Life as a Predictor of Mortality across Adulthood". Psychological Science (2014).

"algorithmic" tasks, in which one strictly follows a set of established instructions to a conclusion. Heuristic tasks involve trial and error, creativity and discovering a solution on your own or by collaborating with a team, which requires openness, curiosity and dedication. This explains to a large extent why start-ups, whose founders are full of intrinsic goals, innovate much more than large established companies. Most companies trying to achieve high growth need such intrinsically motivated leaders since growth is difficult and usually requires innovation. As per the plethora of research on this topic, even if Einstein had been offered US$10M, it is doubtful that he would have formulated a better *Theory of Relativity*.

— When it comes to innovation, intrinsic motivations inspire more outstanding performances than extrinsic motivations

Intrinsic motivations require three essential ingredients: 1) a large dose of autonomy; 2) a healthy degree of challenge in mastery; and 3) a strong sense of purpose. Someone once said: *"If you pay peanuts, you get monkeys"*, but we would be tempted to respond: *"if you pay too much, you get super extrinsically-motivated mercenaries"*. The need for very high pay schemes may indicate motivations that are mainly extrinsic, with the purpose of a company clearly secondary. Even worse, in companies where CEOs need exorbitant salaries to feel motivated, they may adopt such extrinsic aims for all employees (carrots and sticks), leading employees to progressively lose their intrinsic goals as well as their focus on the ultimate purpose of the company[9]. While we consider that any company or industry needs to find the right balance between these two types of motivation, we believe it is not coincidental that banks, and investment banks in particular, have been largely devoid of customer-centricity and rarely inspired by a strong sense of purpose vis-à-vis their social utility. The reach of the ever-rising level of short-term bonuses has become the sole purpose of too many banks – usually at the expense of their customers and the average citizen.

— Intrinsic motivations require three essential ingredients:

- **A large dose of autonomy**
- **A healthy degree of challenge in mastery**
- **A strong sense of purpose**

As the ultimate custodian of "Quality", the board is accountable for purpose and culture

In our opinion, the link between the quality of a company and its purpose and culture should be central to the board of directors. When setting goals and assessing performances of senior executives, the board should ensure that the specific purpose of the company is clear and that everyone feels motivated by it and accountable for it. For this reason it should be part of the governance system of the company[10]. Too often the question of governance is limited to the legal organisation of administrative powers and their counter-powers within the firm or the relationships between the principals and the agents. A vibrant purpose can help deal with agency costs in a much more efficient way than just introducing carrots and sticks to (hopefully) mitigate them. Even if checks and balances have definitively proven their worth, an alternative view could be to design a system which does not let those agency costs develop in the first place. As Isaac Asimov once said: *"It's insulting to imply that only a system of rewards and punishments can keep you a decent human being"*[11].

[9] Bénabou, Roland and Tirole, Jean (2014 Nobel Prize for Economics). "Bonus Culture: Competitive Pay, Screening, and Multitasking" (http://bit.ly/1MtvslU).
[10] For a complete and formal introduction into this purpose-based governance, listen to this speech by Professor Colin Mayer of Saïd Business School at the University of Oxford: "Reinventing the Corporation" (http://bit.ly/1yLGJ37; 2015).
[11] Moyers, Bill. Isaac Asimov on His Faith in the Power of Human Reason (http://bit.ly/1AphmMk; 17 October 1988).

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— **The board should ensure that the specific purpose of the company is clear and everyone feels motivated and accountable to it**

— **A crucial board duty is to nurture and refine the business purpose and culture to ensure these essential aspects of a company outlive any current CEO**

While we agree that checks and balances are necessary to establish an efficient governance system, the importance of the role of the board becomes even clearer if its mission actually lies in optimising the level of autonomy left to the executives to nurture their intrinsic motivations. The responsibilities of the board become paramount when it has to determine how much progress and learning the executives need individually and collectively to achieve and what the risk appetite should be for the company under any current circumstances. Finally, one of the board's most critical duties is to nurture and potentially refine, if need be, the business purpose and culture of the company, and ensure those two essential aspects of a company outlive any current CEO. Ensuring that executives have superior intrinsic motivations for the job and excellent business ethics in how they do it will, in our view, often beat any system based solely on financial rewards and punishments. Robert Pirsig would have said that executives and board directors need to *"care"*[12]. They would have to care about the customers, the employees and their shareholders. This is one of the main reasons why family-owned businesses usually outperform widely-held companies, whose directors and executives may lack affection or bonds for the company, or a genuine understanding of their purpose and culture[13].

A purpose fully embodied in the culture facilitates quality growth thanks to innovation and trust

For larger companies, the best way to keep this intensity of purposefulness and differentiation is usually through a strong corporate culture. If the culture is robust, then recently hired employees as well as veterans of the organisation will rapidly be able to make decisions and implement action plans due to clarity about how *"things"* should happen and why. Indeed, culture is nothing more than the set of moral values, social norms and implicit beliefs instilled by the company regarding the do's and don'ts of what and how things should be done. Culture shapes such decisions and behaviours through the common ground shared by all members of this culture, who understand it implicitly through verbal and nonverbal codes. For example, if a culture is strong, then when someone does something wrong there would be no need for a manager to spot it and resort to company policies and punishment. Other group members would naturally condemn the behaviour and reject this person from the group for the risk this person introduces to the group's integrity and ethics. Company culture defines customer-centricity, accountability standards, tolerance for ethics breaches and key notions like respect, meritocracy, adaptability and reciprocity. In addition, an environment based on *"doing the right thing"* helps build a seamless web of deserved trust[14].

Many early choices made by the founder of the company also quickly determine how the organisation structures its culture, while various

[12] Robert Pirsig said: "Care and quality are internal and external aspects of the same thing. A person who sees quality and feels it as he works is a person who cares. A person who cares about what he sees and does is a person who's bound to have some characteristic of quality".
[13] EHDEC Business School. "Family Firms and Performance: Where Do We Stand?" (http://bit.ly/23DCtVs).
[14] It seems Henry Ford was onto something when he defined quality by saying "Quality means doing it right when no one is looking". Ford Henry. *Today and Tomorrow*. Doubleday, Page and Co. (1926).

— **Companies usually define themselves early in development in order to maintain their values despite the natural flows of people in the organisation**

— **Assessing company culture is important for an investor as it can have a large impact on the capability to turn resources into profit**

— **The goal is to hire people who believe in your ideas and are excited to solve the problems of clients who also share these values**

feedback loops reinforce what works and kill what doesn't. This is why studying the early history of companies is critical to understanding the uniqueness of this culture, as evidenced by Comgest's own investment research process. Understanding L'Oréal today requires analysis of what Eugène Schueller did, step by step, in the 1920s. At this early stage of their development, companies usually define their character and set their purpose in stone, at the heart of their culture; and only then can the culture of the company keep its purpose alive despite the natural flows of people coming in and out of the organisation. In our experience, assessing the culture of a company is actually very important for an investor as companies' cultures have an incredibly large impact on their capability to turn resources into profit. Some companies for example have a culture of making commitments and honouring them. In companies such as Gemalto or Novo Nordisk, not committing or making good on them is not normal and badly perceived. Other companies, L'Oréal for instance, have a culture of innovation and never tire of questioning and renewing themselves.

Now consider the idea of a company with a clear sense of purpose and a strong culture. It consists of a group of intrinsically motivated people who share an outstanding ability to engender genuine innovations thanks to their mutual trust. Trust between human beings emerged as we faced challenges to find food and protect our shelters, leading homo-sapiens to develop a sense of collective interest based on a common purpose and set of rules. In order to go out and hunt a mammoth, you had to rely on your partners to take care of your children and wife. If there was no trust, then no one would have taken risks. No risks would have meant no exploration, experimentation or advancement of society as a whole. That's a remarkable concept: only when individuals can trust the culture or organisations that they belong to will they take personal *"career"* risks in order to advance that culture or organisation as a whole. We believe that this is what generally pre-conditions innovation and is lacking in most large enterprises that have lost their sense of purpose and values. In our view, it is not past products or services that solidly bind a company together nor is it size, brand, R&D's budget or financial might that make a company innovative. It is its culture – the strong beliefs and values shared by everyone – from the CEO to the receptionist. In order for quality to grow, the goal is not to hire people who simply have a skill set you need nor to persuade customers who simply have money to spend. The goal is to hire people who believe in your ideas and who are excited to solve the problems of clients who also share these values.

Returning to my earlier remarks, I do believe the current quality of a business is determined by its competitive advantages. However, I would further add that the future quality of a business is best assessed by any incremental change in its core purpose and the adequacy of its culture to transform it into an economic opportunity. At this stage of this paper, I can hear you saying, "*All of this is fine and well, but how can you assess the purpose and the culture of the companies you invest in? Those subjects are way too soft, if not elusive, to be prone to serious analysis or practical use*". If you are interested by this, or even intrigued, we invite you to contact your Comgest representative to further discuss our methodologies and case studies.

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Sébastien Thévoux-Chabuel joined Comgest in 2013 and is an ESG Analyst and Portfolio Manager, responsible for the ESG coverage of developed markets including Europe and the USA, meeting and engaging with company management alongside the firm's investment Analysts, and preparing in-depth ESG reports. Sébastien is also member of the firm's Whitepaper Committee. Starting his career as a buy-side Analyst at Deutsche Bank in 1998, Sébastien later became a Portfolio Manager at BFT Gestion (Crédit Agricole) before moving to Oddo Securities where he was initially a technology Analyst before assuming the role of Sustainable and Responsible Investment (SRI) Analyst, a position he held for five years before joining Comgest. He graduated from the ESCP business school in Paris in 1997 before completing a post-graduate degree in Financial Engineering at the Sorbonne University.