

ESG Capture

JASON SPILKIN APRIL 2023

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According to President Reagan, the most terrifying words in the English language are: “I’m from the government and I’m here to help”. Reagan and Margaret Thatcher were proponents of “supply side economics”, which postulates that economic growth is best fostered through stimulating supply (through private sector investment), as opposed to demand (through government). “Supply-siders” seek to create the necessary conditions for businesses to thrive unencumbered, by lowering taxes, cutting wasteful government spending, unnecessary regulation, and reducing trade barriers. They are in the camp of Adam Smith whose “invisible hand” metaphor highlighted that society overall is better off when allowing people to pursue their own self-interests.

In the three decades post WW II, Keynesian economics was the norm and supply-siders were seen as fringe freaks. However, by the early 1980s, after almost four decades of nosebleed high tax rates (where the top rate was closer to 100% than 50%) and a decade of rampant double-digit inflation, the proletariat grew tired of empty promises and voted in these freaks. After all, they do say that the definition of madness is doing the same things over and over and expecting a different result. The results of “Reaganomics” and “Thatcherism” were spectacular, resulting in three decades of economic growth, lower taxes, lower inflation, reduced government debt to GDP ratios and reduced unemployment.

One of the ideological fathers of these paradoxical policies, was economist Alfred Laffer, who’s famous “Laffer curve” showed that by lowering the tax rate, the overall tax take (the pot) could actually be increased. One of our behavioural biases of humans is that we tend to think linearly. Yet, Laffer’s argument becomes obvious when you reduce it to the absurd: at the minimum tax rate (0%) the tax take would be zero. At the maximum tax rate (100%), the tax take would be small – similar to the Soviet Union, since there is no incentive to work, only to shirk. The optimal tax rate is therefore a number somewhere between 0 and 100%. But where? Too high and it shackles the invisible hand. Too low and you have too much inequality and the negative consequences that come with it.

Thatcherism in the UK has long been dead and buried. Though personal tax rates are nowhere near the 1970s, today the overall UK tax burden, as a percentage of GDP, is at a sixty year high (per the Office for National Statistics). On that metric, today’s Tory government seems to have more in common with Labour than with Thatcher.

Over the past few months, we have seen a proverbial queue of British companies exploring a US listing, with some being pressured by shareholders to do so. Though each situation is unique, there are some common themes. Chip designer, ARM, recently rejected a local listing in favour of the US. Who can blame them, given the higher valuations on offer and the deeper pool of capital. To be fair, the US has many unique “pull factors” - totally outside of the UK’s control which it cannot hope to emulate – e.g. Silicon Valley, the NASDAQ, etc.

That said, the UK government can and should do much better to address the “push factors”, affecting some of our largest companies - the ones that pay a chunk of our bills. Whereas we can debate the cost-benefit of imposing CO2 targets within our own territory (we would suggest readers listen to Konstantin Kisin’s address to the Oxford Union for the counterargument); the measures are nonetheless fair in that they affect all UK operations of local and foreign companies equally.

However, what is extremely unfair to UK companies, is to impose regulatory straightjackets which extend beyond our own territory, putting them at a sustained competitive disadvantage as compared to global peers not subject to the same rules in foreign territories. That creates an unlevel playing field providing an incentive for UK companies to redomicile and relist in more favourable jurisdictions. The same would have been true had energy windfall taxes been imposed on foreign sourced income of UK domiciled companies. Thankfully, these were ultimately taken off the table, though the mere fact that they were even considered has made companies skittish. The UK government is quite clearly biting the hand that feeds it, all the while signalling their virtue. One might call this phenomenon the “ESG capture” of UK government.

Per the Financial Times, Shell recently explored moving their listing to the US, though the idea was ultimately rejected. It’s not hard to see why, given Shell trades at sub 6x Price Earnings Ratio (“P/E”) - a yawning discount to US peers (Exxon and Chevron) which trade on north of 10x P/E, despite having similar assets and track records.

The big issue facing Shell (and BP) is that they have been pressured to outline plans for much steeper cuts to CO2 emissions, as compared to their US peers. Whereas we can debate the environmental merits, what is indisputable is that the returns on capital on prospective renewable investments are terrible, as compared to fossil fuels. Moreover, Shell does not have the same competitive advantages when exploiting renewables.

It was no surprise recently when BP shares were up over 10% on the day that they announced they were modestly pairing back their plans to reduce oil and gas production. Evidently, investors do not want BP (nor Shell) to invest in renewables – that seems the unspeakable truth. Neither do management teams want to invest in low return projects in order to achieve random CO2 targets foisted upon their global operations by UK and EU bureaucrats doing dark room deals in Davos. Yet it is verboten to speak out for fear of the mob. Watch this space over the coming years. Strategically, it makes sense for both companies to leave the UK; in fact, we would argue that the directors have a fiduciary responsibility to do so.

British American Tobacco (“BAT”) is facing pressure from a top five shareholder who claims BAT is an “orphan in Europe”. They are not wrong. Consider that more than half of BAT’s profits are generated in the US and more than one third of its investors are based there (four times more than for UK funds). Meanwhile, at ~7.5x P/E it trades at a gaping discount to the ~12x blended multiple of Phillip Morris and Altria. ESG disciples are more prominent in the UK and shun tobacco stocks. Though BAT shares would benefit from a once off rerating, there isn’t any obvious strategic rationale to move the listing. Given that the future cash flows of the business would be unaffected by where they are listed, the long-term returns to shareholders will be unchanged. It would simply be a case of more jam today (from rerating) but less tomorrow in the case of a US listing.

Flutter Entertainment (“FLTR”) recently announced a shareholder vote on a (special) resolution to shift their primary listing to the US. This initiative is only partially related to unlocking the valuation discount. In addition, there are real strategic advantages. The US is a nation of shareholders and so there is a lot of free marketing (on CNBC and the

why? Even the UK domestic investor base is increasingly shunning their home equity market. Holdings of UK listed companies by UK pension and insurance funds have dropped from around half to just 4% of their portfolios, over the past two decades (according to advisory firm Ondra).

As Kisin noted in his address to the Oxford Union, even if one accepts the premise that there is a climate emergency, our future will not be decided by UK leaders. It will ultimately be decided by the billions of impoverished people in the developing world, who have more important priorities – like not staying poor. Ultimately Kisin concludes, the only way to solve the climate conundrum is to make the requisite technological breakthroughs such that clean energy is both cheap and reliable. Doing so requires investment and funding, which are ultimately financed by the private sector (either directly or through taxes).

UK government policy therefore needs to pivot to use more carrot and less stick, so as to encourage local investment, listing and domiciling in the UK. Ultimately, facts must trump feelings.



Author
Jason Spilkin
Jason acts as co-portfolio manager of the Global Equity Fund.
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- UK** +44 (0)20 7968 8300
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