Forbes

Maybe Wall Street Favors the Public Company as a Good Corporate Citizen

Christopher P. Skroupa | Jan. 08, 2015

Shareholders, companies and capital market experts are working through just how to integrate ESG (Environmental, Social and Governance) performance into analyst reports so that companies with strong ratings might be considered more attractive investments. The underlying assumption is that companies that integrate ESG into their operations are more likely to shun the ills of short-termism, including our lingering obsession with quarterly earnings—a chronic symptom of our hangover from the 2008 financial crisis.

ESG: A Value Shift from Short Term to Long Term

Since the financial crisis of 2008, experts have argued that investor demand for quarterly returns has skewed decisions made by executives overseeing public companies. By definition, short-termism and its approach reflects executives' attempts to maximize quarterly market value, demonstrating a shareholder's return on investment—an approach that can comes at the cost of a company's long-term performance. For ESG to integrate into company performance, a shift away from short-termism is a prerequisite.

Core to this discussion is the question of how the capital markets and its experts turn to research that validates the causal relationship between good ESG practices and company performance.

Thomas Van Dyck, founder and chairman of the As You Sow Foundation, and his team engage with companies through shareholder action.

"There is a wide body of research and empirical evidence that supports the view that firms with better ESG ratings experience higher credit ratings and lower cost of debt," he said. "This is due to their being better equipped to manage risks that directly impact their business activities in the short, medium and long term."

In fact, investment portfolios comprised of companies with better ESG ratings display substantially less downside risk greater than 200 basis points. (Hoepner et al., 2011).

If good ESG makes a difference, how do analysts present the case well enough that institutional investors demonstrate their investment preferences? And, if institutional investors show favor by investing in these companies, analysts will need to demonstrate that good ESG creates long-term value worthy of a higher ranking—and attention from mainstream investors.

According to Van Dyck, "Increasingly, we are seeing analysts outside of the traditional ESG/Sustainability analysts take notice of ESG issues for several reasons, including:

- ESG criteria helps assess the quality of management teams in which asset managers are investing.
- ESG criteria helps to assess risk, efficiency, sustainability and productivity of management teams.
- Demand for ESG investing is increasing among wealth creators, wealth inheritors and institutional investors. ***U.S. SIF's Report on US Sustainable, Responsible and Impact Investing Trends 2014*** showed that this style of investing assets has expanded 76 percent in two years from $3.74 trillion in 2012 to $6.57 trillion.

As Sonia Gupta, Manager Sustainability Disclosure and Corporate Social Responsibility at Suncor Energy, explained, "ESG issues are, and have always been, central to value creation in business, as they are inherent to risk management, reputation management and compliance considerations. However, when it comes to effectively targeting and talking about these key issues, we are just now scratching the surface."

Replacing Regulatory Risk with Market Drivers

Regulatory risk is one reason why the discussion on ESG integration is gaining momentum.

According to Marjella Alma, CEO of start-up eRevalue, "Companies, specifically banks and financial institutions, have to start paying attention to ESG considerations largely due to compliance and regulatory risk. The obstacle lies in how to integrate ESG into short-term performance assessments of companies."

For this to happen, Alma emphasized the need for readily available data that can be plotted against other benchmarks, in particular, traditional performance data, earnings and other highly quantified performance metrics. Although there is a challenge with historical data needed to document ESG impact on company value, ESG considerations are no stranger to history. ESG failures have triggered events that have brought down many a fine company.

The first driver for assigning value, therefore, relates to a better understanding of the relationship between ESG and share value.

According to Wim Bartels, Global Head of Sustainability Reporting & Assurance for KPMG, he has seen a number of instances already where ESG-related incidents have impacted the value of companies.

"For example, the Deep Water Horizon safety incident or the Bangladesh drama," he said. "The second driver for assigning value will come from value losses by investors due to additional significant ESG events. Finally, the increasing linkage that companies build between ESG and their corporate strategy, including measurable progress, will assist capital markets to quantitatively incorporate the risks and opportunities into their valuation models."

Others argue that ESG integration is already factored into analyst reports and considered in assessment of company performance outlook—they are simply not identified as such.

Robert McCormick, Chief Policy Officer of Glass Lewis & Co., said that the challenge for ESG integration is "more semantic since some ESG aspects are likely already part of the risk management plan."

Boards are looking at ESG considerations consistently. If incorporated into the enterprise risk management plan, the down-side of ESG shortfalls will be identified and managed against properly.

"If there is an environmental blow up at a company, the damage would be categorized as an operational deficiency," he explained.

Institutional shareholders may hold this company accountable when assessing risk and opportunity, in this instance, as an ESG risk.

An ESG Data Gap

ESG specialists consistently refer to "materiality" as the cause, or at least an existing obstacle, to gathering and validating data needed to make the case to Wall Street.

In lay terms, risks and opportunities taken by companies are considered material if they influence company performance.

To achieve performance, companies allocate capital to opportunities with the intention of creating profits or mitigating risks. The activities undertaken through the employment of capital are material if they are integrated into the overall intended performance plan of a company.

"ESG risks and opportunities are, to a large degree, dependent on the business the company is in and its geographic locations," Van Dyck said. "That is to say, ESG key performance indicators, referred to as KPIs, for a bank are very different from those for an automobile manufacturer. Similarly, a Japanese carmaker faces ESG challenges a German carmaker does not and vice versa."

Some argue that the process of identifying materiality and KPIs has not yet been professionalized when compared to the degree that companies define other risks.

Bartels said, "The process quickly runs the risk of becoming vague and dependent on only a few (sustainability) people who are not always managers responsible for company performance."

But not all activities are fully quantifiable.

"…Market analysts are operating with a data deficit when attempting to extrapolate some specific areas of ESG performance during their assessment of a public company for investors," Glass Lewis' McCormick said. "Governance can be kind of philosophical. For example, evidence is mixed that independent board members result in better boards and company performance. Boards may support high levels of board independence, but may not have specific evidence that a certain level of board independence will improve performance at their company. They may consider the benefits of adding independent board members because it is valued by shareholders who invest capital in their company."

The process of assessing company materiality of risks and opportunities diminishes the efficacy of ESG due diligence.

"In many companies, the relationships between ESG and the company's value are not explicitly and consistently identified and reviewed as part of a materiality process," he said. "As a result, aspects less material to the value of the company can become part of the set of relevant ESG risks and opportunities—which diminishes the value of the whole materiality assessment."

The Need for Stakeholders to Ask

ESG proponents argue that the value-add exists, but is rarely asked about by shareholders and other stakeholders. As a result, ESG often remains a side bar discussion between regulators or staff, many of whom are working to integrate practice throughout their company's operation.

Without integrating ESG factors into stakeholder engagements (and ongoing discussions between stakeholders and companies), the value of ESG integration will not translate into tangible terms for company analysts and raters.

Alma said the discussion on ESG should not be limited to a policy level, but should be practice-focused.

"If companies are engaged regularly in dialogue with stakeholders, the integration of ESG would move down to the department level as an operational practice," she said. "This would require companies to keep up on benchmarks and related topics that are competitor-focused and would motivate companies to meet stakeholder demands."

In addition, how companies define the value-add of embedding ESG into company risk taking matters.

"ESG integration reduces costs and risks, as well as increases revenue. It supports company reputation and stipulates the values of the company to employees, thus leading to a more stable company," KPMG's Bartels said. "Above all, it drives innovation through the identification of these areas and the targets that are linked to the ESG risks and opportunities as part of the embedding process."

If shareholders began to ask more questions about ESG, the discussion would move forward very quickly, creating a class of companies recognized for outstanding performance. To get to this, McCormick suggested that ESG factors become part of the company strategic plan.

“Embedding ESG issues into the larger mosaic of data that guides decision-making by our Senior Management and investors helps us to create consistent value for the communities we serve,” Gupta said.

Alma said ESG factors are “core to value” and should be spoken of on a one-to-one basis in the company.

“For example, topics such as water and energy should be addressed individually, instead of under the umbrella of sustainability,” she said.

Asset Managers Can Move the Needle

A powerful constituency worth courting in the quest for ESG integration is the large asset management firms, who because of their role in vetting investments for their clients, could drive attention to ESG integration.

“If large asset managers continue to sign on to GRI reporting standards, companies will be asked to demonstrate their ESG plans in response to shareholder requests. Shareholder inquiries into company ESG drive change,” McCormick said “Asset managers are beginning to ask questions about ESG in evaluating whether to purchase a stock. This unfolding practice indicates a reshaping of investor consideration of ESG in creating and sustaining long-term value.”

Alma agreed.

“These questions should change to incorporate ESG performance into the due diligence process, as the ‘new normal’ in business involves ESG considerations,” she said.

Market analysts are driven by results and performance and are likely to consider the value add on these bases.

Bartels said, “Companies will incorporate ESG factors once they see the results from these in terms of reputations, revenues and net profit.”

Bridging the ESG Data Gap

Back to quantifiable data and the technologies that need to collect it, analyze it and validate it. For investors to begin to ask the right questions about ESG and value creation, they need quantifiable verification of performance relating to ESG practices.

“ESG-related innovations are primarily found in three areas: data collection, reporting and education,” Van Dyck said. “The second is increasing awareness and understanding among ESG professionals regarding how to synchronize sustainability and business strategies.”

Integrated reporting is a recent innovation now driving the need to eliminate the data gap.

“In terms of disclosure and reporting, integrated reporting and the framework for it, developed by the IIRC, lays out a model for companies to report value they deliver to shareholders on the basis of a comprehensive overview and analysis of the capitals they exploit to maximize such value,” Bartels said.

Software technology will enable companies to move corporate reporting off of the sidelines and into company operations.

“Software solutions are being developed and implemented to further professionalize and harmonize reporting processes, for identification of risks as well as for data,” Bartels added. “These enable companies to manage ESG performance in a structured and professional way and to communicate the quality of the output to shareholders.”

Gupta agreed. “New technological innovations are expected to enable more quick and easy tracking of ESG issues in a very real-time way. As such, we will be better able to align our long-term vision with our short-term goals and effectively communicate this process to our stakeholders,” she said.

However, some argue that technology has not been fully embraced by sustainability executives and that there is room for significant improvement in the technology itself.

“Sustainability has not yet embraced technology, which can provide a means or a strategy to properly use and apply what we learn from the ESG data produced by companies,” Alma said. “Companies, regulators and stakeholders should have the ability to access, analyze and use data instantaneously – something that we are aiming to facilitate at eRevalue.”

She added that an example of this is the accounting profession.

“Many firms argue that data is up to par, but data sets vary too much, are too qualitative and don’t align,” she said. “As a result, market analysts lack the tools to properly segregate data needed for critical analysis and verification of company performance.”

Genuine Integration of ESG

Challenges lie ahead for companies seeking to properly document the value of ESG integration.

Embedding ESG into company operations requires a comprehensive approach to be successful.

The strategy should start with defining a clear business case for all involved, including the vested interests of business units, company entities and managers at all levels.

“This approach would consist of a clear vision, incorporation in processes and procedures and a change of culture within the company and amongst employees. Clear data points and related targets should be set to steer, monitor and track progress against ambition,” Bartels said.

He warns, however, that ambition is one thing, while realized performance is another.

“The simple exercise of collecting and reporting data doesn’t seem so easy, due to a lack of understanding of the data points and the procedures employed to collect and analyze them,” he said.

Once it is understood what data are necessary and how they are defined, it often requires time to grasp, incorporate decision-making and drive results. Culture matters—and remains the most important challenge.

Specifically, companies are challenged to create a culture receptive to incorporating ESG values. “A company requires resilience and a lot of repetition of messaging before all functions and layers within an organization fully commit to ESG,” Bartels said. As a result, some companies use ESG integration as a PR exercise.

There is a lot of push to get boards involved.

“Once they are, management starts to think differently about ESG integration. Once middle management is brought into the strategy and expected to deliver actionable results, then integration will have been achieved,” said Alma.

From Traders to Analysts

Bloomberg recently added a slide deck on its system that will serve as a step forward in educating and informing trader of ESG-related performance data.

However, currently market analysts play a very small role in educating investors on value-related correlations between ESG and stock price.

“Getting data in front of traders is one step, as company reporters look for positive correlations between ESG data sets and the performance of company shares,” Alma said.

Bartels said that “Increasingly, the relevance of ESG risks and opportunities is receiving attention by market analysts. They’re starting to request data to support decision-making.”

For the market analysts that do assess ESG performance, the focus is undoubtedly on optimizing the risk-return characteristics of their portfolio.

“The key challenge is how to integrate these factors into a company’s valuation. This process is still in its infancy but a few interesting trends have emerged. Essentially, the role of market analysts in assessing ESG performance is to: (1) discover, gather and verify ESG Key Performance Indicators (KPIs) that drive financial performance, (2) evaluate company’s ability to manage ESG KPIs, and (3) integrate that data into their products and services,” Van Dyck said.

Favorable Ratings

There is a shift towards applying the principle of materiality to existing ratings, by sector and away from a one-size-fits-all model. This is changing how rankings may ultimately be reshaped to include ESG factors.

Considering favorable ratings could start with comparing value, reputation and actual conduct of those companies who come out with less favorable analyst rankings.

“Equity and credit markets have an opportunity to begin to identify key material ESG risks—by sector and company—and assess whether a company’s response is appropriate,” Bartels said.

“Market analysts will need to figure out how to define the ‘G’ (governance) in ESG and how it is material to a specific company’s assessment of risk and opportunity,” Alma said.

Monitoring value development will impact how companies are ranked as good corporate citizens.

“This will lower risk premium for equity or interest rates for credit terms,” Bartels said.

A New Set of Outliers

If the capital markets trend-setters are successful in developing data on ESG performance, it could have a significant impact on how companies are ranked by institutional investors. If so, companies that do not incorporate ESG into company performance stand the chance of becoming a new class of outliers.

Van Dyck argues that companies managing their ESG performance will ultimately lead to an “improved bottom line.”

“For example, reduced facilities costs, and environmental impact through energy efficiency, water conservation, and waste diversion; increased employee productivity and welfare through health benefits and programs that optimize work-life balance; improved brand strength and reputation through being a good corporate citizen; superior strategy, planning, implementation and decision-making capabilities through leadership and management for the long-term; risk reduction and improved social outcomes through holding suppliers to international labor and human rights standards” he said. “Better corporate governance also helps—including more diversified boards that include women and underrepresented groups. Furthermore, CEO compensation that is tied to long-term performance metrics.”

Van Dyck added that he thinks shareholders more often are engaging the board of directors of companies about various ESG factors, from environment to social to governance.

“For environmental aspects, factors may be coal fly ash management and disclosure, and carbon risk associated with a company’s business operation,” he said. “For social aspects, there’s disclosure and transparency of political contributions. For governance, CEO pay versus longer term company performance and versus lowest paid workers; adding diversity to the board; separating chairman and CEO positions, and for really problematic companies, running and replacing board of directors.”

Reporting ESG to investors will not eliminate ESG-related risk. It would, however, report how a company plans to approach and manage this risk.

“As a result, it could determine a company’s competitive position, business approach and level of attractiveness to institutional investors,” Bartels said.

For instance, “Laggards or companies that are either not adopting or only cautiously adopting sustainability initiatives will find themselves trying to catch up to their sector peers who are more quickly embracing ESG practices. Sector leaders are largely seeing more than just profitability, cost cutting, and risk management as key benefits of robust plans,” Van Dyck said. “There are a range of other drivers that leaders believe support their strategies. These include increased margins or market share, greater potential for innovation in their business models and processes and access to new markets.”

Companies that don’t embed ESG may run a higher risk of related incidents. This can, in turn, influence how institutional shareholders consider their value.

One example of this involves fund manager Cerberus Capital Management L.P., which was scrutinized by the California State Teachers Retirement System (CalSTRS) for owning a gun manufacturer, Freedom Group. This manufacturer produced firearms used in the 2012 Sandy Hook Elementary School shooting. CalSTRS, one of the largest investors in Cerberus, raised questions about the merits of the holding. Soon thereafter, Cerberus was pressured to divest its interest in the gun manufacturer. Two years later, Cerberus has yet to do so, failing to follow through on a plan to allow groups such as CalSTRS to exit their deal without selling other investments in Cerberus funds.

Bartels said these incidents “make it less stable for capital markets and less attractive for future employees, thereby creating the chance for significant decline in company value.”

Alma agreed, emphasizing stakeholder value.

“Companies that are creating stakeholder value—not just shareholder value—will be the more sustained performers. Companies that are mission driven, included. Other companies will need to adapt to this shift,” she said.

McCormick sums up by suggesting that, “Some companies will see short-term growth, but will be penalized in the long term.”

http://www.forbes.com/sites/christopherskroupa/2015/01/08/maybe-wall-street-favors-the-public-company-as-a-good-corporate-citizen/6/