ESG adds significant value for companies

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Positive financial performance in isolation and at a cost to society and the environment was the thinking of the 20th century. It was the error of corporate leaders to do so based on the premise of the primacy of the shareholder. By the end of the 20th century it led to ecological overshoot namely the use of natural assets by companies faster than nature was regenerating them.

Studies have now shown that financial performance must be accompanied with quality governance, environmental stewardship and good social responsibility.

The letters ESG have taken on a whole new meaning in the investment world and in the activities of companies around the world. ESG funds are growing faster than any of the other funds.

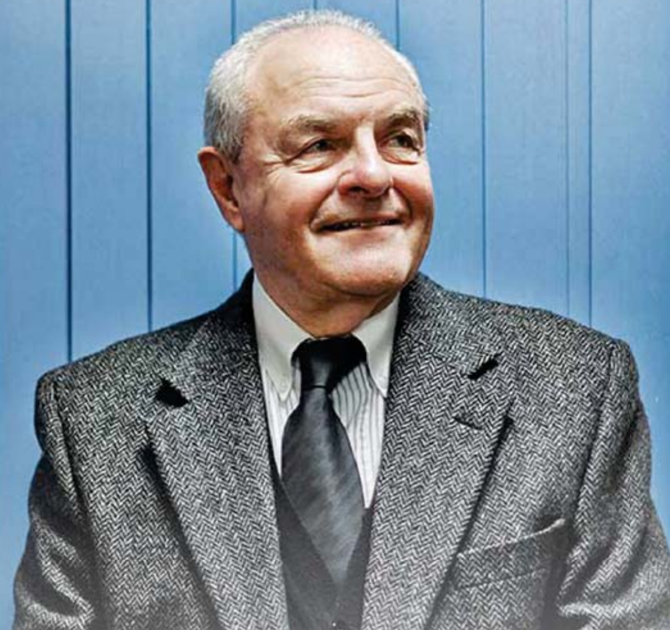
Recent research has shown that diligent sustainability business practices do lead to an enhanced bottom line performance. The increase in bottom line performance, however, is an outcome of this value creation process which has replaced the seeking of profit at any cost.

Because of the resource constrained world in which we now live, with population still increasing, the critical issue is no longer how much money has a company made but how has it made its money? What impact has its activities had on the three critical dimensions for sustainable development namely the economy, society and the environment? Asset owners and managers should ask the question how much sustainable return is the company generating rather than simply how much return on investment is being generated.

In 2013 Accenture conducted a survey of over a thousand CEOs in 103 countries and 27 industries. 80% of those CEOs viewed long term sustainability value creation as a means to gain competitive advantages over their competitors. Their research also demonstrated that it made good business sense for companies to implement sustainable management practices with regard to ESG issues. In other words companies can "do well while doing good," a term used by David Vogel in a CSR context. Further, today a company must not only be but must be seen to be a good corporate citizen. That is one making a product or rendering a service in a way that has a less adverse impact or better still a positive impact on the environment and society. Such an approach has led to competitive advantages as shown in a study done by Hart in 1997. It makes sense for a board to learn and understand who their major stakeholders are and what are their needs, interests and expectations for the company? With an agenda item of stakeholder relationships the board attains an informed oversight over management's proposal otherwise the oversight is blind.

In a study done by Arabesque together with the University of Oxford, environmental factors in the acronym ESG include biodiversity and land use; carbon emissions; climate change risks; energy usage; raw materials sourcing; regulatory and legal risk; supply chain management; waste and recycling; water management and weather events. The social factors include, inter alia, community relations; customer relations; diversity issues; employee relations; health and safety; human capital management; human rights; responsible marketing; research and development; and union relationships.

Under governance the question is whether the governance practiced by the company is a mindless tick-box one or is it mindful and outcomes based? What is the



board structure and diversity? Are there clouds of corruption over the company or any of its directors and/or senior management? Are its compensation schemes linked to variable remuneration so that executives are incentivized for positive impacts on the environment and society as well as increasing the monetary bottom line? Are reports transparent and in clear, concise and understandable language? Only with the latter can the collective mind of a board discharge its duty of accountability.

BP's deep water oil spill in 2010 is a great example of how environmental risks have a huge adverse impact on the financial situation of a company. BP suffered not only financially but hugely from a reputational point of view. The Financial Times estimated that the clean-up costs alone would amount to some US$90 billion. BP share price lost 50%.

Both PwC and Deloitte have completed surveys which show that sustainability is emerging as a market driver with the potential to grow profit and present opportunities for value creation.

In the six capital approach of the IIRC Framework human capital is one of the resources used by organisations in their activities to produce their product or render their service. Without human capital, companies cannot deliver products or render services.

There are good examples of how adverse impacts on human capital can destroy reputation and company wealth. The first was the Guardian article on slavery in the Thailand shrimp industry which started supermarket chains avoiding the purchase of shrimp from Thailand. The other is the textile factory collapse in Bangladesh in 2013 when it was realised that the sale of clothing in so-called warehouse style stores in developed economies at a cheaper price than competitors was achieved as a result of human rights abuses in Bangladesh factories. This resulted in the boycott of certain retail stores. An adverse dealing with human capital results in reputational loss.

Social responsibility issues or adverse impacts on the environment also raise the cost of capital to organisations. Numerous studies have shown that adverse impacts of how the company makes its money on society and the environment increases the cost of capital. Positive impacts reduce the cost of capital. For this reason alone it makes good business sense to practice value creation in a sustainable manner.

Governance became a grudge compliance. It also became a mindless tick-box exercise of complying with certain rules. In consequence the King Committee asked the question: What are the outcomes which a stakeholder will see which will lead them to the reasonable inference that the particular organisation has been practising quality governance?

After input from members of the committee, practitioners and numerous outside academics, it was concluded that there were four outcomes which, if an organisation achieved them, the reasonable probability is that stakeholders would conclude that the organisation has been practising quality governance. The four outcomes are:

1. Value creation in a sustainable manner:

2. Adequate and effective controls with informed oversight by a board:
3. A community's trust and confidence in the organisation with legitimacy of operations:
4. An ethical culture with effective leadership.

If the board as a collective is making a business judgment call it should test the proposed decision by asking what impact it would have on any one or more of these four outcomes. If the impact will be adverse, the board should apply its mind further before making its business judgment call.

Research from Harvard and Wharton has shown that a focus by corporate leaders on the long term health of a company as opposed to the short term wealth of shareholders leads in the longer term to the company outperforming companies still focusing on the primacy of the shareholders.

The price of shares on some of the Stock Exchanges of the world have shown that companies practising value creation in a sustainable manner tend to outperform their less sustainable counterparts by 4.8% annually. This was established in a study by Prof. Eccles and Serafeim.

Arabesque and the University of Oxford in a review of studies since 2013 has shown that:

- Value creation in a sustainable manner is one of the most significant trends in financial markets:
- 90% of the studies on the cost of capital show that value creation in a sustainable manner lowers the cost of capital to companies:
- 88% of the research showed that good ESG practices result in better operational performance of companies:
- 80% of the studies showed that stock prices increase and are influenced by a company practising value creation in a sustainable manner:
- Based on economic impact it is shown that it is in the best interests of stakeholders that a board incorporates sustainability considerations into their decision making process:
- Civil society is having an influence today through social media on a company's impacts on the environment and society in making its product or rendering its service.

The asset manager has a duty today, as per regulation in some countries such as South Africa to not only do a financial audit of the company in which the trust is going to invest its ultimate beneficiary's money in the equity of that company, but also to do an ESG audit. This is underscored by the pronouncements by Larry Fink of Blackrock over the last few years in his letters to CEOs in the EU and America and also by the stakeholder approach as to how a company should be governed, for example by Airbnb. Further, the American Business Roundtable has now acknowledged that boards should take account of the needs, interests and expectations of all stakeholders. The megatrend of ESG in the WEF's Consistent Reporting of Sustainable Value Creation and in the Accountancy Europe report reinforces the need for integrated thinking and doing an integrated report. The informed board must extract from the report the material matter and the challenges and circumstances facing the company and put them in clear, concise and understandable language so that the user can make an informed assessment of the present state of play in the company and its outlook short, medium and long term.

Helen Keller, that famous blind woman, said there is something worse than being blind and that is having sight but no vision. We see today that ESG has a huge influence on the performance of companies and how they are perceived by their internal and external stakeholders.

This has changed the due diligence of companies in the A and M world. A board would not today be discharging its duty of care if only financial due diligence of a company to be acquired was done.

The world is not what it used to be.

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