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Impact Investing

Making a Better Business Case for ESG

Without clearer insight into the financial benefits of corporate sustainability efforts, they may never be scaled up in the face of climate change, COVID-19, inequality, and many other perceived or real challenges to a company's bottom line.

By Tensie Whelan | Aug. 17, 2020

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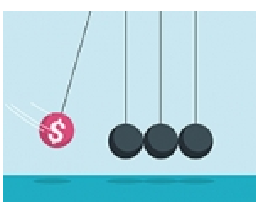
As COVID-19 kills and sickens millions of people around the world, it is also stress testing many institutions and cultural norms, among them companies and their compact with society. It's an extraordinary challenge joining many already connected deeply to the business world, from economic inequality to racial injustice to climate change.

When questioned about their role in responding to deep-rooted problems facing all of society, companies often indicate that they can't afford to invest in environmental protection, strong employee compensation, or other elements of a social issue because they must return sufficient profits to shareholders.



Impact Investing Today and Tomorrow

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Based on research that I and my colleagues undertook at the Center for Sustainable Business (CSB) at New York University Stern School of Business, I contend that embedding environmental, social, and governance (ESG) concerns into business strategies is not only good for making money, but also essential to customer allegiance and protecting against the rising number of major threats to social stability, vibrancy, and inclusiveness that makes a healthy business possible in the first place.

However, scholars and finance professionals need to create a much clearer understanding of the business case for ESG (also referred to as sustainability), as we at the Center for Sustainable Business have begun to do with our Return on Sustainability Investment (ROSI) methodology. Without this insight, corporations will not scale up their investments in sustainability in the face of climate change, COVID-19, inequality, and many other perceived or real challenges to their bottom lines. And investors need more and better information to feel confident that a corporation focusing on its ESG performance can also meet its fiduciary duties.

Building a clear ESG business case for corporations and investors won't be easy. Here are some of the most pressing barriers:

- **There is too much diversity in self-reporting.** Corporations are self-reporting using very different ESG metrics. They generally do so without audits to determine the accuracy of the data. As a result, validating or comparing performance is difficult.
- **ESG ratings done by organizations outside companies lack standardization.** Third-party ESG data providers and raters, much like companies evaluating themselves, use different data and different rating systems, leading to wildly differing assessments.
- **Reporting ESG metrics does not equate to using smart ESG strategies.** The ESG data we do have may not be the type we want. We need to understand the results of *good* ESG strategies and executions, rather than any.
- **Non-financial ESG metrics are reported as completely divorced from financial metrics**. Very few companies are tracking the return on their ESG investments or efforts in their accounting systems. Thus, there are virtually no connections being made between accounting data and sustainability investments.
- **Intangible company value isn't properly tracked.** Accounting itself is an inadequate tool for ESG measurement because it is poor at monetizing intangibles, which typically make up 84 percent of a company's value today and include many sustainability benefits, such as brand reputation and risk mitigation.

Before exploring how we can improve business case arguments for ESG, it's worth looking at where previous efforts to understand the relationship between financial performance and ESG have struggled.

Early corporate research often failed to distinguish traditional corporate social responsibility (CSR) efforts, such as philanthropy, from embedded sustainability, which describes ESG practices that are tightly woven into corporate strategy. The distinction is important—financial performance of embedded sustainability outperforms CSR due to its focus on material ESG factors, and more recent research has demonstrated that stock market outperformance depends on companies focusing on ESG factors that have a material impact on their business (such as waste reduction in auto manufacturing). In addition, there is insufficient research on the management strategies or practices that cause improved performance. The cumulative effect of these flawed approaches? Executive leaders find it difficult to understand the sustainable management levers that improve financial performance.

Research on the performance of sustainable investing has been complicated by different investment strategies having different performance profiles. For example, using negative screens (avoiding investment in industries, such as tobacco or weapons, that work against certain values or social goals) may depress performance because it reduces the diversity of a portfolio. On the other hand, portfolios that removed coal for ESG considerations are performing very well right now. Another strategy, ESG integration—which accounts for ESG factors along with financial ones when valuing a company—tends to have better financial performance than concessionary impact investing (in which an investor accepts lower financial returns in exchange for greater societal impact). Research has conflated these strategies, making it difficult to understand the financial impacts of ESG for the investor.

Despite these research challenges, a 2015 meta-analysis of roughly 2,000 studies found positive correlations between good ESG performance, stock price, cost of capital, and operational achievements, encouraging us and others to continue to investigate the topic.

The Way Forward

In the past few years, several frameworks have been developed to better integrate ESG data and financial analysis and reporting. The UN's Value Driver Model was the first. Pirelli Tire and other companies used it to better understand the financial impacts of their sustainability strategies. The Coalition for Inclusive Capitalism partnered with Ernst and Young on the Embankment Project, which developed accounting strategies for a few sustainability-linked drivers of financial performance, such as employee productivity and retention. Several boutique consulting firms, including Impact ROI, Valutus, Sustainability Advantage, and ALO Advisors (which has worked with CSB), have also developed frameworks.

At CSB, we developed ROSI based on academic literature, our work with private equity firms and major corporations in agribusiness, automotive, pharmaceuticals, utilities, apparel, retail, and other industries. ROSI identifies the factors that—when sustainability is embedded in a company's strategy and practice—can drive better financial performance. They include operational efficiency, risk mitigation, innovation, increased sales, and employee retention and productivity, and others. Though many forces can influence these factors, we are finding that sustainability is the core component of the next wave of best management practices that can improve business performance.

Without ROSI, companies may miss the financial impact of their sustainability efforts. For example, we found that one apparel company's sustainability investments had a 5 percent positive contribution to labor costs. Before ROSI, the company did not consider tracking the connection between sustainability and the factor of employee retention and productivity.

The link between ESG practices and financial results has clear implications for corporate decision-making. Take companies like McDonald's and Carrefour. They have committed to ensuring their supply chain does not cause deforestation, but the cost of doing so may make them reluctant to ask their suppliers to make the same promises and implement sustainable agriculture standards.

However, our research shows that the deforestation-free practices reduce operational risk, which can be monetized as avoided cost. Additionally, the sustainable agriculture practices increased profitability for ranchers nearly seven-fold per kilogram of beef. How? It was a combination of operational efficiencies (reduced agrichemicals) and innovations (such as sustainability efforts enabling an increase from two heads of cattle per hectare to 10). Altogether, they led to better quality meat, lower costs, and higher revenues. It makes a compelling case for enacting supply chain sustainability improvements.

Sustainability practices also improve companies' ability to monetize intangibles, which is critical to assessing returns on future investments. For example, the CSB team worked with a Canadian utility that was deciding whether to stop using coal earlier than mandated by law. With ROSI's help, the company determined that doing so would lower its cost of capital, saving them $276,000 CAD ($207,000 USD) annually. This factor and others led them to proceed with exiting coal earlier than legally required, and the company's stock price increased following the decision.

Surviving and Thriving

Beyond improving financial performance, investing in sustainability may be about a company's basic survival amid changing consumer preferences. For instance, we found that the total milk category (in dollar sales) declined by 10 percent from 2015 to 2019, while sales of sustainability marketed alternatives (organic, non-GMO, or plant-based options) grew by approximately four percent. In 2019, more than half of all milk dollar sales were marketed as sustainable. However, America's biggest conventional milk producer, Dean Foods, apparently failed to respond to the trend, recently declaring bankruptcy.

Corporate leaders and investors tend to track sustainability efforts in terms of non-financial metrics, often missing how good ESG practices eventually connect to the bottom line by improving the management of a business. As a result, some companies might be undervalued because their sustainability strategy isn't appreciated. And some companies might be able to become more valuable than they are—if they implemented a sustainability strategy.

In both cases, information about sustainability opportunities and practices is highly material to investors. Our research shows that C-Suite leaders share a consensus on what constitutes material sustainability strategies in their sector. In the automotive industry, for example, CSB found agreement around 18 strategies, ranging from waste reduction to product innovation. In the apparel sector, we found more than a dozen strategies, including zero-waste supply chains and transparency about the source of materials. For the retail beef supply chain (such as beef produced and sold by international retail brands in Brazil), we found 18 strategies, including innovative agricultural practices and sustainability branding.

But to fully and accurately assess the financial impact of sustainability efforts, investors and managers must follow through to examine not just the strategy, but also how a strategy was implemented and the benefits that ensued. Those positive outcomes are what companies must begin to monetize and report. In the automotive sector, for example, the recycling of paints and solvents represents a way to execute a waste reduction strategy. Doing so saves a company money otherwise spent on raw materials and the disposal of toxic waste. It can also sell leftover recycled paint and solvent. One automotive firm found that improvements in waste reduction annually contributed $285 million to earnings before interest and taxes (EBIT).

ROSI and tools like it can help chief financial officers (CFOs) set up accounting systems that track the ROI of sustainability efforts across divisions at their outset. Intangibles, such as risk mitigation, and tangibles, such as increased sales, are both included in the calculations. With this information, CFOs and CEOs can work together to embed sustainability into the core of their business strategy and communications.

Investors armed with ROSI understand more clearly that sustainability is a good management practice, not just a box to tick off on a disclosure form. It will help ensure they evaluate companies on exactly how they implement high-quality sustainability strategies within their industry and track the financial outcomes—tangible and intangible—of doing so.

Companies' failure or success in achieving ESG goals affects everyone. Consumers, employees, governments, citizens, and investors all have a stake as crises multiply. Companies can help solve looming global problems while creating value for shareholders, if they and investors embed sustainability into the core of their business strategy and track, properly monetize, and report the intangible and tangible benefits of ESG investments. Those that don't are avoiding their responsibility to respond to pressing social issues and they may be failing to perform their fiduciary duty. They may even be headed toward extinction as their customers abandon them for firms that not only have a strategy for facing the future, but act upon it.

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