Walden Asset Management

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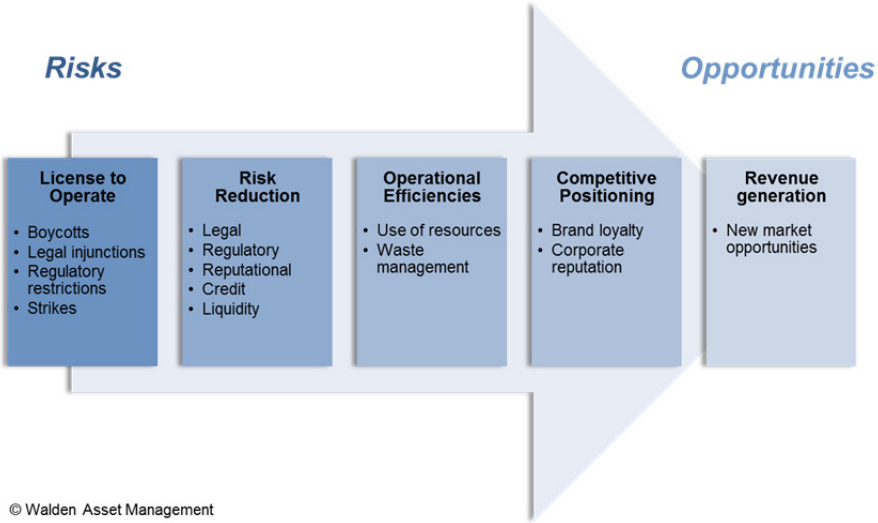
The Business Case for Integrating ESG Factors

Environmental, social and governance (ESG) factors can have a material impact on long-term business prospects. Climate risk is a case in point. A 2010 report commissioned by the U.N. Principles for Responsible Investment (PRI) and the U.N. Environmental Programme Finance Initiative found that global environmental damage caused by human activity has totaled $6.6 trillion, equivalent to 11 percent of global GDP in 2008. The world's top 3,000 public companies reportedly contributed to one-third of that damage, and might face increased operating costs through higher insurance premiums, taxes, input prices, and clean-up costs.

At the same time investors are increasingly asking for ESG information to better assess business risks and opportunities. As of August 2014, the U.N. PRI had more than 1,200 signatories with over $45 trillion of assets under management. These members seek ESG information from companies to analyze fully the risks and opportunities associated with existing and potential investments.

As part of its investment analysis, Walden considers a spectrum of financial outcomes that are associated with ESG factors. This spectrum incorporates five broad areas that range from generally detrimental outcomes to those that are substantively beneficial: license to operate, risk reduction, operational efficiencies, competitive positioning and revenue generation.

Figure: Spectrum of Financial Outcomes Related to ESG Factors



Spectrum of Financial Outcomes

License to Operate

Any corporation's success depends on a broad range of stakeholders. The corporate "license to operate" may be effectively revoked by a consumer boycott, labor strike, community action, regulatory intervention, legal injunction or some other stakeholder intervention. For example, the stock of blood-testing products maker Immucor slid 14 percent on June 26, 2009, when the U.S. Food and Drug Administration issued a notice of intent to revoke its license for two blood tests. Asarco, Owens Corning and W.R. Grace and dozens of other firms facing asbestos-related claims have gone bankrupt. After Operation PUSH launched a boycott of Nike in 1990, in order to promote employment opportunities for African Americans, a Gallup survey found that "31 percent of the public were aware of the boycott, [and] 20 percent were planning to buy fewer Nike products."

Risk Reduction

Corporate activities may generate a variety of ESG risks requiring mitigation. Companies that are actively evaluating and managing ESG factors are likely to avoid major controversies and be better prepared for events that could have a direct business impact. These risks include legal, regulatory, liquidity, credit, reputational or others that could be discontinuous and materially costly to the firm.

There are countless examples of material losses resulting from inadequate management of ESG risks. In June 2010, BP established a $20 billion trust fund to assure reparations for the infamous Macondo oil well spill in the Gulf of Mexico. Two months later, BP agreed with the U.S. Occupational Safety and Health Administration (OSHA) to pay a $50 million penalty for failing to abate safety concerns identified by OSHA following the Texas City refinery explosion of 2005, and to spend at least $500 million on safety upgrades.

The costs of discrimination, as another example, also appear to be rising. Novartis Pharmaceuticals settled a $175 million gender discrimination verdict in U.S. district court in early 2011, and an appeals court

upheld in June 2011 a $187 million class action suit against Wal-Mart for wage and hour discrimination.

ESG risks can also lead to increased financing costs. A 2010 study by the European Centre for Corporate Engagement found that the credit spreads (yields relative to U.S. Treasuries of comparable maturities) of borrowing firms is influenced by legal, reputation and regulatory risks associated with environmental incidents.

No firm is immune to the prospect of future carbon regulations or the physical impacts of climate change. A company that is already monitoring its carbon emissions and setting reduction goals will be better equipped to adapt to carbon regulation or other initiatives to put a price on carbon pollution.

Operational Efficiencies

Companies can reduce operating costs by leveraging capital and human assets. For example, efficiencies in the use of natural resources can often result in significant cost savings. Hewlett-Packard reported that by consolidating more than 85 internal IT data centers into 6 new data centers, the firm reduced its tech budget in half, reducing electricity use by 60 percent per year, and saving $1 billion per year.

Costco offers a comparable example in employer relations. By offering above-market wages and benefits, the retailer experiences a lower turnover rate than peers, such as Wal-Mart. This is important because lower turnover results in lower training costs. One report estimates that turnover costs one and a half times an employee's salary (The Saratoga Institute).

Compensation and benefits are one element of employer relations. A study in the Academy of Management Journal found that "organizations with a greater range of work-family policies have higher levels of organizational performance, market performance, and profit-sales growth." And, University of Pennsylvania Wharton School assistant professor Alex Edmans found that, in general, "[e]mployee satisfaction is positively related to corporate performance."

Integrated energy firm Royal Dutch Shell offers a counterexample in efficient governance. Until July 2005 the firm had operated under two separate boards of directors, an alleged contributing factor to its previous overstatement of its petroleum reserves.

Competitive Brand Positioning and Reputation

Sustainable corporate policies or practices can serve to enhance a firm's overall brand and improve competitiveness. According to Accenture, "in 2008, 91 percent of consumers said they had bought a product or service from a company they trusted, whereas 77 percent had refused to buy a product or service from a distrusted company." Additionally, major customers of some companies are increasingly seeking better sustainability practices and transparency from their suppliers. Large companies such as 3M, Apple, Ford, Intel, Microsoft, and Wal-Mart require suppliers to undergo training, commit to audits, and increase disclosure on ESG performance. Many corporations select suppliers based on their efforts to minimize negative ESG impacts and demonstrate sustainable business practices.

Moreover, reputation matters to more than just customers. As concluded by the Great Place to Work Institute, organizations with reputations as good employers tend to attract high quality staff, directly correlating to productivity. A 2013 Bain & Company study found that "companies with highly engaged workers grow revenues two and a half times as much as those with low engagement levels. And…employees increasingly view their company's sustainability agenda as a critical factor in engagement."

Revenue Generation

A company's success depends ultimately on growth. In recognizing the ability of a particular product or service to provide a more sustainable outcome relative to peers, companies can boost financial prospects directly through new market opportunities. Steve Reinemund, predecessor to Indra Nooyi as CEO of PepsiCo, argued, that diversity not only promoted better decision making, but also credited one percentage point of its 8 percent growth in 2004 to the (increasing) diversity of its employees. PepsiCo cited guacamole-flavored Doritos, Gatorade Xtremo, Mountain Dew Red, and a wasabi-flavored snack.

Products and services that maximize the efficient use of resources may provide their customers substantial cost savings and boost their own top lines. Examples of companies that enable resource conservation include Commercial Metals, which engages in scrap steel recycling; and Watts Water Technologies, which makes water safety and water flow control products such as backflow preventers, and water pressure regulators, which enhance water conservation.

Focus on the Long-Term

Given the associated spectrum of financial outcomes, an appreciation of material ESG factors over a long-term horizon is integral to a sustainable business model. Executives and investors who measure, manage and disclose their policies and performance on ESG factors may have greater insight on this key dimension of overall company performance.

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