Financial Incentives for Improved Sustainability Performance

The Business Case and the Sustainability Dividend

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Key Questions

- Is it in a company's financial interest to improve its environmental and social performance?
- Do financial markets recognise and reward such improvements?
- What are the barriers?
- What is needed to address the barriers?

The Business Case

- Theoretical case
- Case studies of companies
- Multi-company statistical studies
  - Accounting returns
  - Financial market performance

Cost Advantages of Sustainability

- Clean technologies are more efficient
- Recycling, reduces raw materials cost
- Good working conditions mean higher productivity and few disputes
- Being prepared for regulatory change
- Reduced risk of compensation and damage suits
- Reduced cost of capital and insurance premiums
- Reduced transactions costs

Market Advantages of Sustainability

- Access environmentally sensitive markets
- Secure higher prices for products
- Retain existing markets as they become more sustainability sensitive
- First mover advantages
- Investment in the “survival economy”

Reputation Advantages

- Less risk of consumer boycotts
- Licence to Operate
  - Good relationships with regulators
  - Good relationships with community
- Motivating factor for employees
- "Insurance value" – more supportive responses from stakeholders if there is a problem
- Investor perceptions

The Business Case Theory

Cost Advantages- Highly relevant to mining

Market advantages – only relevant for niche products eg diamonds

Reputation advantages - Most relevant for:

- Community relations
- Ability to attract employees

Case Studies

Useful as illustration of potential benefits of addressing sustainability

BUT:

- Potential rather than actuals
- Incomplete costs and benefits
- Cherry-picking
- No positive mining case studies – only negative ones

Linking Financial and Environmental Performance

Positive Linkage (Hart and Ahuja 1996)

- Emissions efficiency against ROS, ROA and ROE

Negative Linkage (Jaggi and Freedman 1992)

- Emissions efficiency against net income, ROA, cashflow/equity ratio

No Positive Linkage but No Penalty (Cohen et al 1997)

- 8 environmental variables eg superfund sites, fines against ROA and ROE

No Significant Linkage (Louche 1998)

- CO_2, Energy use, water use and waste against ROA, ROE, and earnings per share

The Link with CSR

Positive Linkage (Verschoor 1998)

- Financial performance rankings for companies with or without codes of ethics

Partially Positive Linkage (Berman et al 1999; Waddock and Graves 1997)

- KLD rankings against ROA

No linkage (Aupperle et al 1985)

- CEO orientation to CSR against ROA

Financial performance leading CSR (Preston and O' Bannon 1997)

- Fortune corporate reputation rankings against ROA, ROE, and ROI

Shortcomings

- Limited set of sustainability issues
- Conflicting results
- Mainly in the US and of US operations
- Limited evidence for external impacts eg environment
- Direction of causation unclear
- Not very relevant to mining challenges eg overseas operations

Do Financial Markets Reward Sustainability Performance?

Surveys of financial institutions

- More interest in commercial lending than asset management
- More interest in risks rather than opportunities

Statistical studies of links between sustainability performance and financial market indicators

- Cost of capital studies
- Event studies
- Longer-term studies
- Hidden value/hidden cost studies

Cost of Capital Studies

Environmental Performance and Systematic Risk

- TRI emissions and environmental management system (Feldman et al 1997)
- Superfund liability (Garber and Hammit 1997)
- Evidence stronger for large companies

Reputation and Perceived Risk

- Fortune AMAC reputation rankings (Srivastava et al 1997)
- AMAC mainly driven by financial variables

Event Studies

- Strong evidence for US that environmental events affect company market value
- Also affects value of other companies
- Less conclusive outside of US eg Canada
- Social events less well-studied
  - studies mainly on product recalls and law violation and not on “external” social issues

Implications of the Event Studies

- Investor response influenced by the context eg regulatory system
- Not clear whether decline in market value reflect losses incurred by the companies
- Does market reaction come too late?
- Will companies with systematic approaches to sustainability be rewarded?

Studies of “Long”-Term Impact

- 4 studies show evidence of a long-term link
- Emphasis on reputation and intangible asset value
- Strengths:
  - One examines standards for non-US operations
- Main weaknesses:
  - 3 address environment only
  - Direction of causation unclear

Hidden Value/Hidden Cost

- Most studies not in public domain
- One published study (WRI Repetto and Austin 2000)
  - Forward-looking scenario approach
  - Assess company exposure to environmental risk
  - Differences between companies not reflected in their financial statements
  - Evidence of hidden costs
  - Financial analysts can benefit from addressing environmental issues

What are the Barriers?

- According to surveys of financial institutions:
  - Lack of comparable data
  - Difficulty to translate sustainability issues into financial terms
  - Perception that environmental issues are not material to profitability

Translating Sustainability Issues into Financial Terms

- Not just a case of lack of information
- Forward-looking approach needed
- Subjectivity of assessing risks
- provide a methodology
- But the mining sector is more challenging
- Scenarios of society's expectations rather than just regulatory change

Demonstrating That Sustainability Issues Are Material

- Needs more than better methods or data
- Empirical studies of the business case are not conclusive
- Address factors that drive the business case:
  – regulation
  – reputation

The Role of Regulation

- Many studies of the business case imply regulatory action
  - Response of investors to environmental events depends on the nature of the regulatory system
  - WRI scenarios focus on regulatory change
  - Concerns about reputation relate to increased attention from the regulatory authority
- The business case depends on the regulatory system and is not a substitute

The Role of Reputation

- Important where regulation is weak
- But why? - Can't expect consumer reaction
- Investor reaction only if:
  - Other stakeholders likely to react
  - Reputation loss is contagious
- Financial institutions may have closer consumer connection than mining sector
- Regulations on disclosure affect extent of reputation contagion

Conclusions

- Financial institutions have an important role in leveraging change in the mining sector
- Don’t rely too much on the business case
- Need to create the right conditions
  - Improvements in reporting necessary but not sufficient
  - More effective enforcement of:
    - environmental and social regulation
    - Company disclosure on risk management
  - Greater transparency