B. Business Impact

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ESCP Impact Paper No 2021-23-EN

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Abstract

The aim of this article is to analyse briefly the potential effect of corporate sustainability practices on firms' profitability and shareholder's wealth, in an attempt to address the question if shareholders should be afraid of sustainability in firms.

As a conclusion, shareholders shouldn't be afraid of sustainability initiatives in firms as corporate profit-making and implementation of sustainability strategies are not incompatible goals, but can in fact be complementary. The reflection offered in this article draws the conclusion that sustainability in firms is not a threat to the shareholder's wealth, when in some circumstances and market conditions it can even be enhanced. In addition, the orientation toward long term SRI investing, i.e. towards seeking the targeting of instruments issued by firms with robust sustainability practices, brings an effective alignment between the creation of the long term financial return for investors/ shareholders and the broader objectives of society. Also from this perspective, shareholders shouldn't be afraid of corporate sustainability practices, but rather actively support these in their firms.

Keywords: Sustainability strategy, shareholder's wealth, profit

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Should Shareholders Be Afraid of Sustainability Practices in Firms?

The general term of "corporate sustainability" as used in this article refers to a broad palate of initiatives that firms choose to implement in response to environmental emergencies and to support sustainable socio-economic development objectives. The initiatives aimed at the reinforcing of the Corporate Social Responsibility for business to be more socially accountable are classified in this article as part of this broad category of "corporate sustainability initiatives". The term "corporate sustainability" was also used in one of the most influential global initiatives for business - the United Nations Global Compact Initiative. Another term used in this article - "Sustainable, Responsible and Impact Investing" (SRI), as defined by The US Forum for Sustainable and Responsible Investment, "considers Environmental, Social, and Corporate Governance criteria to generate long-term competitive financial returns and positive social impact". SRI is considered as the broadest, the most general, and all-inclusive category of investment instruments linked to sustainability and social responsibility and issued by firms, governments and other private and public institutions, operating either in "for profit" or "nonprofit" schemes.

The aim of this article is to briefly analyse the potential effect of sustainability initiatives on firms' profitability and shareholder's wealth, in an attempt of addressing the question: if shareholders should be afraid of sustainability in firms.

Sustainability in firms and corporate financial performance

Profit generation / profit increase in firms is of high importance as it is the source of income for its shareholders, materialised in a form of dividend payments. As in a free-enterprise system an increase of profits is one of the most important objectives, an analysis of the effects of corporate sustainability on corporate financial performance deserves close attention. Corporate sustainability initiatives can affect corporate profits through either a change in the sales revenue and/or in the costs patterns.
When it is clear that certain sustainability initiatives could result in higher amounts of incurred costs, especially in the short run, the link between sustainability and sales revenue is more complex. Some of the examples of the cost-intensive sustainability initiatives can include a possible use of more expensive ecological materials in the process of production, possibly more expensive biodegradable packaging, extensive capital investment in the factors of production designed to reduce the emission of greenhouse gas emissions or in systems of production programmed to reduce pollution, etc.
Establishing a direct link between corporate sustainability initiatives in firms and revenues of these companies is, as an example, to find evidence that customers buy goods and services from sustainable companies as they appreciate their efforts towards sustainability. The motivations of the customers / consumers to explicitly make a choice of buying or of increasing their purchases from sustainable firms can vary and can be systematised on a scale from personal values and beliefs (ethical factors) to pure material/tangible factors.
Another way of looking at the relationship between corporate sustainability initiatives and firm revenues (via the channel of consumers buying patterns) is that sometimes the efforts of firms towards sustainability result in their customers' loyalty, with an assumption that otherwise their customers would increasingly seek to buy from their (more sustainable) competitors. This would support the claim, that the implementation of sustainability strategies in firms can be a way of preventing the company seeing cuts in their sales and a way of maintaining their market position/market share. The research carried out by Deloitte (2020) into the changing patterns of consumer buying behaviour revealed *the growing*

influence of sustainability. This study demonstrated that 2 out of 3 analysed consumers have reduced their usage of single-use plastics (this is the most common course of action consumers take in being more sustainable), 43% of consumers are already actively choosing brands due to their environmental values and 34% of consumers choose brands based on their ethical credentials. According to Deloitte, consumers of all ages are showing more sustainable consumer patterns compared with the previous studies but the "Millennials" seem to be the most engaged.

It is clear that the effect of sustainability initiatives in firms on their profitability depend on a variety of factors; the nature of the sustainability initiatives, market/industry factors, income and level of economic development of a country, cultural factors, ethical factors, etc. The effect can be also different in the short-run compared with the long-run. As it concerns sustainability, it is often expected that an increase in short-run costs is compensated in a form of new opportunities/savings/benefits in the long term.
Over 2000 empirical studies and several review studies aimed at confirming the existence of a relationship between environmental, social, and governance (ESG) factors[1] and corporate financial performance, have been carried out since 1970s. Interestingly, one of the most comprehensive review studies, combining the findings of about 2200 individual studies, demonstrated that about 90% of studies found a non-negative relationship between ESG and corporate performance – a large majority of studies reported some positive findings (Friede, Busch, Bassen, 2015). Another meta-study categorizing over 190 different analyses found a significant correlation between diligent sustainability business practices and economic performance: 88% of reviewed studies revealed that firms with robust sustainability practices demonstrate "*better operational performance, which ultimately translates into cashflows"* (Viehs, Clark, Feiner, 2014). The report demonstrated that corporate sustainability and profitability are not incompatible but in fact complementary goals. With the results of another broadly cited the integrative, quantitative study yielding a total sample size of 33,878 observations from 52 different studies and suggesting that "*corporate virtue in the form of social responsibility and, to a lesser extent, environmental responsibility is likely to pay off*" (Orlitzky, Schmidt, Rynes, 2003), it is therefore a reasonable claim in this article, that corporate sustainability strategies do not harm corporate financial performance, especially in the long run, when in some cases it can enhance it.

Sustainability in firm's and shareholder's wealth

The modern theory of the firm reflects on companies listed on a stock exchange and owned by many shareholders. It assumes that the main objective of the firm and its corporate executives is to maximise the shareholder's wealth in the long run. It is important to stress that the long-term perspective is predominant in this approach as it is recognised that at times the maximisation of profits in the short-run can be harmful to the profitability of firms in the long run. The objective of the shareholder's wealth maximisation is achieved when the market value of the company (firm's market capitalisation) increases in the long run at an expected annual rate.

Theoretically, under certain assumptions, in which the hypothesis of the efficiency of capital markets, the market value of a company (market price of firm's stock times the number of outstanding shares) closely reflects the company's fundamental value (generated on the product and factor markets, i.e. market of goods and services and market of factors of production), which in turn is a function of profitability of the business. A short reflection on the link between sustainability in firms and profit creation was offered in this article, with a

[1] Looking at the environmental, social and governance factors in firms is often considered the most practical way of approaching "corporate sustainability".

conclusion that sustainability in firms does not necessarily compromise the corporate profit, when in some circumstances it can even enhance it, especially in the long run. In general, an increase in profits translates into an increase in the firm's fundamental value. From this perspective we could claim that sustainability in firms is not a threat to shareholders' wealth, when in some circumstances it can even be enhanced.

Independently of the above, even if theory suggests that the price of stocks should closely reflect the firm's fundamental value, in practice, due to a different channel via which the price of stocks is formed, the market value and the fundamental value can differ even over a long period of time. When the market value exceeds the value of the fundamentals in firms, the stocks are considered to be "over-valued". Theoretically in such situations we would expect the prices of the over-valued stocks to decrease over time to allow convergence with the firm's fundamental value, but in practice it happens that certain individual stocks, industries or whole segments of instruments on the stock markets bring a higher increase in stock prices (market valuation) than other stocks, industries or segments of instruments. In the last decade it has been the case for the segment of instruments classified as Sustainable, Responsible and Impact (SRI) Investing in comparison with conventional forms of investment instruments in the same asset classes. The market for SRI Investing has demonstrated an exponential growth over the last decade, in several markets on average, exceeding the growth of the whole market within the same asset classes. The SRI segment has been characterized by a strong and dynamically growing demand for SRI investing instruments, accompanied by a stable but less dynamic growth of supply of SRI investing instruments, as a result bringing in an increase in the market prices of these instruments (an increase in the market value of businesses that enter within the scope of interest of SRI investors). It does show that there is a demand on the capital markets for the instruments of the firms' sustainable profile, which is the reason that shareholders should not be excessively afraid of sustainability in their firms! One of the previously mentioned meta-studies confirmed the claim that "*prudent sustainability practices have a positive influence on investment performance*" (Viehs, Clark, Feiner, 2014).

It appears that the increased interest of investors in SRI Investing instruments is expected to accelerate in the next years! The recent investment survey by BlackRock (2020), based on responses from 425 investors in 27 countries representing US$25 trillion in assets under management, revealed that "*investors are planning to double their sustainable assets under management in the next 5 years*". According to the Global Sustainable Investment Alliance, the proportion of SRI Investment relative to all assets under management (AUM) increased from a very low level 10 years ago to approximately one third in the USA, and close to half in Europe, while Australia and New Zealand had the highest proportion of SRI investment assets relative to total AUM – 63% in 2018.

If this tendency were to be maintained over a long time, this would suggest that corporate sustainability practices could even be regarded as a potential source of value creation through the channel of capital markets. This accords with the results of a second-level review of 60 review studies on the environmental, social and governance (ESG) and corporate financial performance relation, combining altogether approximately 3700 different sources (Friede, Busch, Bassen, 2015), bringing reassurances to the investors / shareholders of the firms engaged in sustainability practices[2]. According to this review study, ESG outperformance opportunities exist in many areas of the market but in

[2] There is some evidence in the literature of the contrary perception of investors, possibly biased due to findings of numerous portfolio studies, demonstrating, on average, a neutral or mixed effect of corporate sustainability practices on financial performance of investment portfolios. This is because of the various systematic and idiosyncratic risks in portfolios and, in the case of mutual funds, by implementation costs. Still there is more than 2100 other empiric studies (in particular company-focused) that suggest a positive ESG relation (Friede, Busch, Bassen, 2015).

particular in North America, the Emerging Markets, and in nonequity asset classes.

The above reflections allow the conclusion that the orientation toward long term SRI investing, i.e. towards seeking to target the instruments issued by firms with robust sustainability practices, brings an effective alignment between creation of the long term financial return for investors/ shareholders as well as the broader objectives of society. From this perspective, shareholders should not be afraid of corporate sustainability practices, but rather actively support them in their firms.

Corporate sustainability as normal business practice now

According to Friedman (1970) business in a "free-enterprise" should be conducted in accordance with the shareholders' objectives, while conforming to the "basic rules of the society, both those embodied in ***law*** and those embodied in ***ethical custom***". It is possible to interpret this as everything which becomes the "basic rule of society", is a part of the legal requirements or a part of the "ethical custom" that can be considered as a normal business practice in a free-enterprise, private-property system even for the strong promoters of the shareholder business models.

Over the past decades, along with the new theoretical propositions of the Stakeholder Approach, the legal framework and ethical custom within the area of sustainability have significantly evolved, making it an integral part of the new ethical, social and corporate order. The United Nations and other international organisations were the most engaged in promoting corporate sustainability through their global initiatives, as for example, the UN-backed Principles for Responsible Investment (2006), Carbon Disclosure Standards Board (2007), Sustainability Accounting Standards Board (2011), Corporate Human Rights Benchmark (2013), UN Sustainable Development Goals (2015), Task Force on Climate Related Financial Disclosures (2017). As mentioned before, the United Nations Global Compact Initiative (2000) is listed as one of the most influential initiatives on corporate sustainability, with corporate signatories aligning to the 10 principles in the areas of human rights, labour, environment and anti-corruption found throughout the world.
Governments in numerous countries joined the international organisations with their own version of corporate sustainability initiatives. One of the examples is PACTE – Action Plan for Business Growth and Transformation in France (*Plan d'Action pour la Croissance et la Transformation des Entreprises*), aimed at promoting the fairness of business to all the stakeholders, among other objectives. It announced changes to the Civil Code in order to "assert their social and environmental role and provide them with a true *raison d'etre*"[3]. Another example is the change to the UK Companies Act (2006), where Section 172 now gives some recognition to ESG issues and by extension to sustainability[4], as well as to the UK Corporate Governance Code. The most recent version of the Code (2018) emphasises: "To succeed in the long-term, directors and the companies they lead need to build and maintain successful relationships with a wide range of stakeholders. These relationships will be successful and enduring if they are based on respect, trust and mutual benefit. Accordingly, a company's culture should promote integrity and openness, value diversity and be responsive to the views of shareholders and wider stakeholders."

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[3] PACTE, the Action Plan for Business Growth and Transformation (2019), https://www.gouvernement.fr/en/pacte-the-action-plan-for-business-growth-and-transformation, accessed on April 30, 2021.

[4] Section172(1) of the Companies Act 2006 provides that "a director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to: (a)the likely consequences of any decision in the long term, (b)the interests of the company's employees, (c)the need to foster the company's business relationships with suppliers, customers and others, (d)the impact of the company's operations on the community and the environment, (e)the desirability of the company maintaining a reputation for high standards of business conduct, and (f)the need to act fairly as between members of the company."

Finally, corporate sustainability has also gained support of business leaders. To this end, in 2019 the Business Roundtable moved away from shareholder primacy by issuing a new Statement with a commitment to all stakeholders – customers, employees, suppliers, communities and shareholders! 181 CEOs of big corporations became signatories in this BRT's initiative.

These examples are testimony to the changes in business philosophy and practice over last few decades and even if there is still a longstanding debate of what should be a firm's objective in a private property system and whether corporate sustainability in firms matches these objectives, it is likely that corporate sustainability trends will further accelerate in the future.

Additionally, a dynamic growth of the market for Sustainable, Responsible and Impact Investing might in part be an indication of a shift in shareholder ethical standards, making shareholders fully accept the necessity for certain contributions from firms in the form of sustainability initiatives. That way we can consider corporate sustainability practices as being a natural part of normal business practice. Following international organizations, governments, and influential business associations, these initiatives have also recently benefited from the support of the biggest asset managers such as Blackrock, State Street, and Vanguard.

Conclusion

In conclusion, shareholders should not be afraid of corporate sustainability practices as corporate financial performance and engagement in sustainability practices are not incompatible goals. Every firm is different, operates in different industries and countries (with differently operating legal systems), has shareholders and other stakeholders with different needs, motivations, preferences, values, and all these differences discourage excessive generalisations when assessing the effect of corporate sustainability practices on firms and on their shareholders. However, a reflection offered up in this article countenances the conclusion, that firms financial performance and shareholder's wealth should not suffer as an effect of it, especially in the long-run. The valuations of the SRI Investing instruments over the last decade, including a very difficult one for the markets over the period of Covid-19, showed that these instruments performed well and in some segments even better than the whole market in the same asset classes. Whether it is because the conscience of the shareholders / investors on the capital markets has progressed towards putting themselves in the voluntary position of contributing to a good cause / sustainability objectives or whether it is because they were able to capitalize on the opportunities corporate sustainability practices can bring to firms and its shareholders, as previously mentioned, on average, over the last decade, the wealth of the shareholders of the businesses involved in sustainability initiatives did not suffer. Indeed, the contrary was true over this 10 year period - the market valuations of SRI Investing instruments were on average higher than the valuations of the conventional instruments from the same industries / in the same asset classes.

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