



Innovating for Sustainability

“The Role of Capital Markets in Sustainable Capitalism”

Presentation at KCM International Conference

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What is the problem?

-Externalities

⇒ *Environmental crisis*

-Inclusive growth and wealth

⇒ *Social crisis*

-Trust in business

⇒ *Governance crisis*



What is the problem?

-Risk Taking

-Zero Sum Game

-Pressure on Companies to Deliver Performance in the Short-term



About Sustainable Capitalism

*Systematic integration of environmental, social and governance issues
in corporate strategy and operations and in the capital allocation
process of investors*



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Whose Behavior Needs to Change?

Time period	Sales (\$B) of the top 1,000 firms	Employees (M) of the top 1,000 firms	GDP (current US\$B) of OECD members	Population of 15-64 of OECD members	Top 1,000 firms' sales as % of OECD GDP	Top 1,000 firms' employees as % of OECD working population
1980	2,638.10	20.9	8,547	629	30.90%	3.33%
1990	7,126.30	31.4	18,079	702	39.40%	4.47%
2000	15,821.30	49.9	26,162	767	60.50%	6.51%
2010	31,196.30	66.8	42,809	825	72.90%	8.11%

Source: Worldscope; World Federation of Exchanges, <http://www.world-exchanges.org/statistics/annual/2010/equity-markets/domestic-market-capitalization>, accessed January 2012, Global Financial Data, accessed January 2012.



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And How?

There are many mechanisms:

- **Regulation**
- **Reporting**
- **NGO activity**

But I will concentrate today on the role of capital markets



Investor Interest in ESG Data

Environmental	Hits	Social	Hits	Governance	Hits
GHG Scope 1	1,520,488	Fair Remuneration Policy	470,056	% Independent Directors	899,148
GHG Scope 2	1,067,085	Number of Employees - CSR	457,108	Size of the Board	735,853
Total GHG Emissions	920,170	% Women in Management	377,441	Number of Independent Directors	651,913
GHG Scope 3	890,932	Human Rights Policy	375,018	Board Meeting Attendance %	540,427
Direct CO2 Emissions	781,569	Equal Opportunity Policy	337,508	Number of Board Meetings for the Year	519,099
Verification Type	645,330	Employee Turnover %	333,798	CEO Duality	508,482
UN Global Compact Signatory	606,998	Fatalities - Total	324,744	% Women on Board	504,207
Total CO2 Emissions	583,403	Health and Safety Policy	319,579	GRI Criteria Compliance	438,164
Total Energy Consumption	458,246	Community Spending	312,945	Business Ethics Policy	405,987
Total Waste	449,561	Employee CSR Training	284,881	Board Average Age	316,748
Environmental Fines	418,969	Training Policy	245,300	Audit Committee Meetings	277,291
Climate Change Policy	355,335	Lost Time Incident Rate	221,128	Exec Comp Linked to ESG	228,768
CO2 Intensity	351,164	Training Spending per Employee	215,694	Board Duration	197,785
Waste Reduction Policy	343,554	Lost Time from Accidents	205,452	Political Donations	113,259
Emissions Reduction Initiatives	341,817	% Women in Workforce	202,884	Political Donations/Profit Before Tax	81,097

Source: "Market Interest in Nonfinancial Information," Eccles, Krzus, and Serafeim, 2011



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ESG integration makes sense

for investors:

-firms with better ESG performance have better financial performance

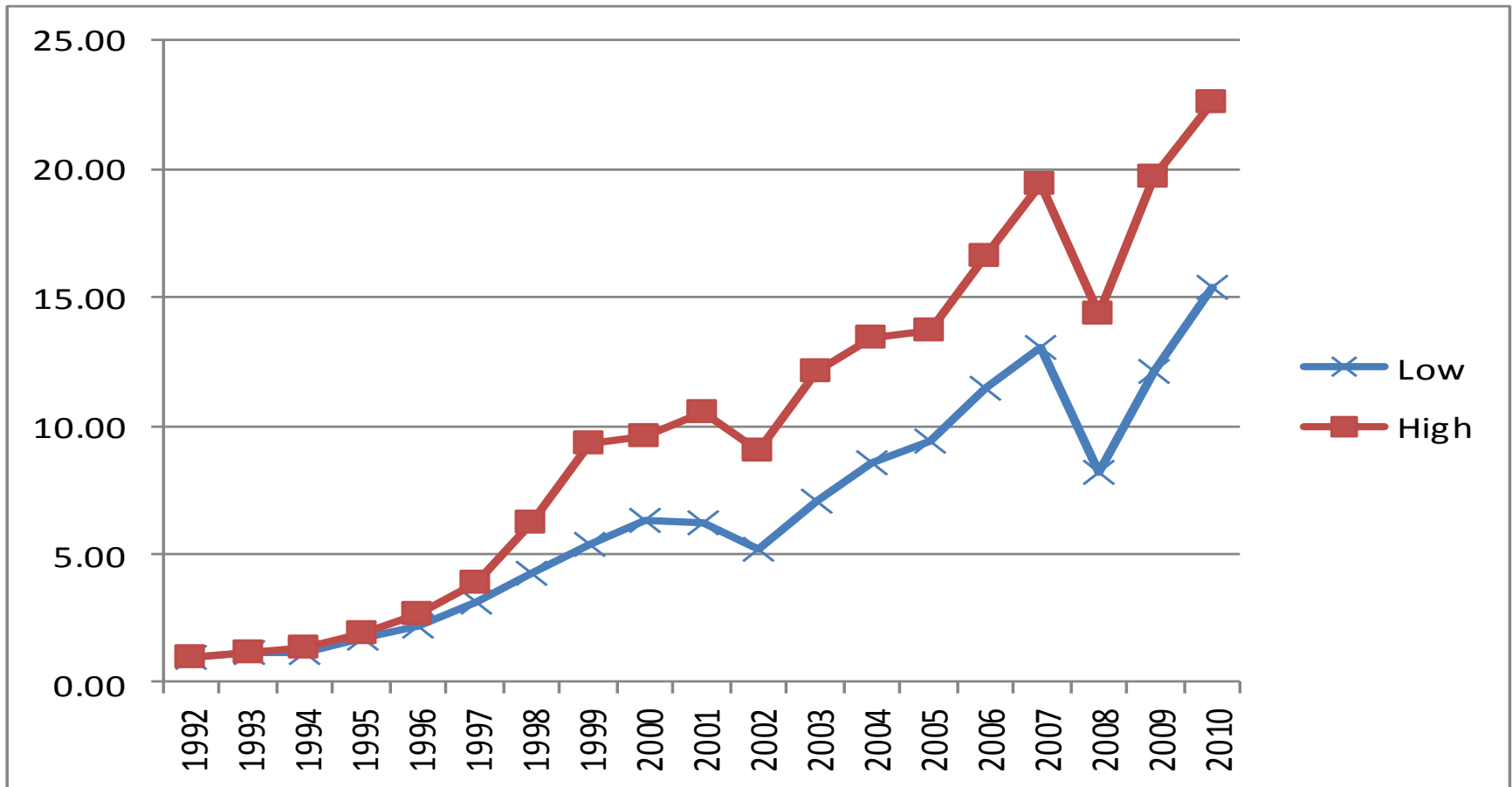
in the long-term

for society:

-creates incentives for corporations to improve their ESG performance



Long-term Financial Performance



Source: "The Consequences of a Culture of Sustainability on Corporate Behavior and Performance," Eccles, Ioannou, and Serafeim, 2011



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Incorporating ESG performance in Prices

Estimating the market premium for good ESG performance:

MTB = f(ESG, ROE, Size, CAPX, Leverage, R&D, Industry, Country, Year)

Environmental	\$	53
Social	\$	26
Governance	\$	110
Sum	\$	189

All else equal, for a firm with BVE \$1 billion, improved ESG performance from the bottom to the median score is associated with an increase in market valuation of \$189 million



More Evidence: Capital Markets

Better ESG performance leads to better access to finance and lower capital constraints through

- 1. ESG disclosure and transparency**
- 2. Stakeholder Engagement**

Source: “Corporate Social Responsibility and Access to Finance,” Cheng, Ioannou, and Serafeim, 2012



Employees are more engaged when:

- 1. their work is more connected to sustainability goals and**
 - 2. they feel that they can have more impact towards the achievement of better sustainability performance**
- **Senior executives overweight the importance of factor 1 and underweight the importance of factor 2 relative to lower level employees**

Source: Serafeim (2012), ongoing research, data from a large multinational chemicals company



More Evidence: Product Markets

Customer loyalty and satisfaction is higher when customers view the company's sustainability efforts more positively

This effect

- 1. exists after holding constant customer satisfaction from service delivered**
- 2. is more pronounced for the most profitable customers**
- 3. is more pronounced for the least loyal customers**

Source: Serafeim (2012), ongoing research, data from a large hotel and casino operator company



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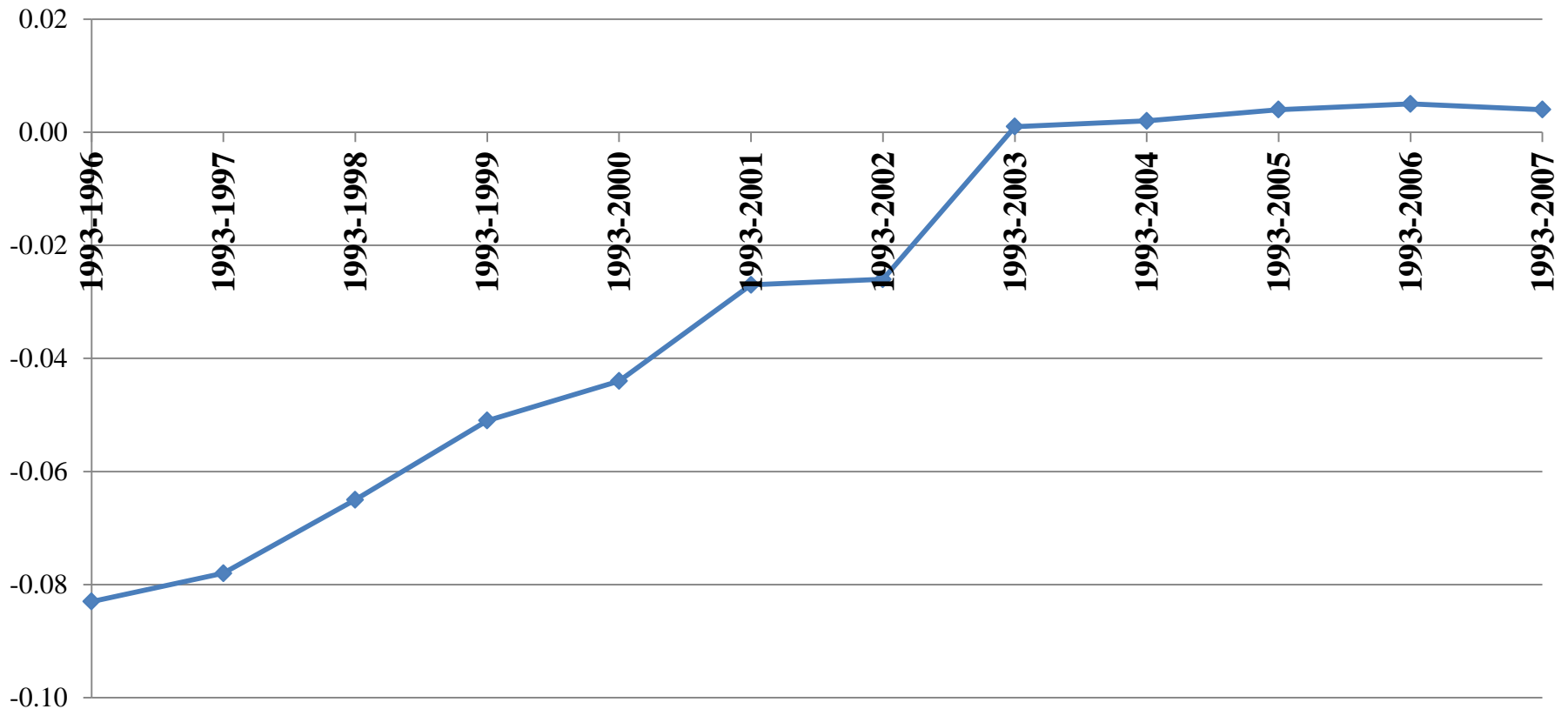
Barriers to Change

1. **Dogmatic Beliefs**
2. **Fiduciary Duties**
3. **Short-termism**



Sell-side Analysts: Changing Beliefs

Estimated Relation between ESG Performance and Investment Recommendation



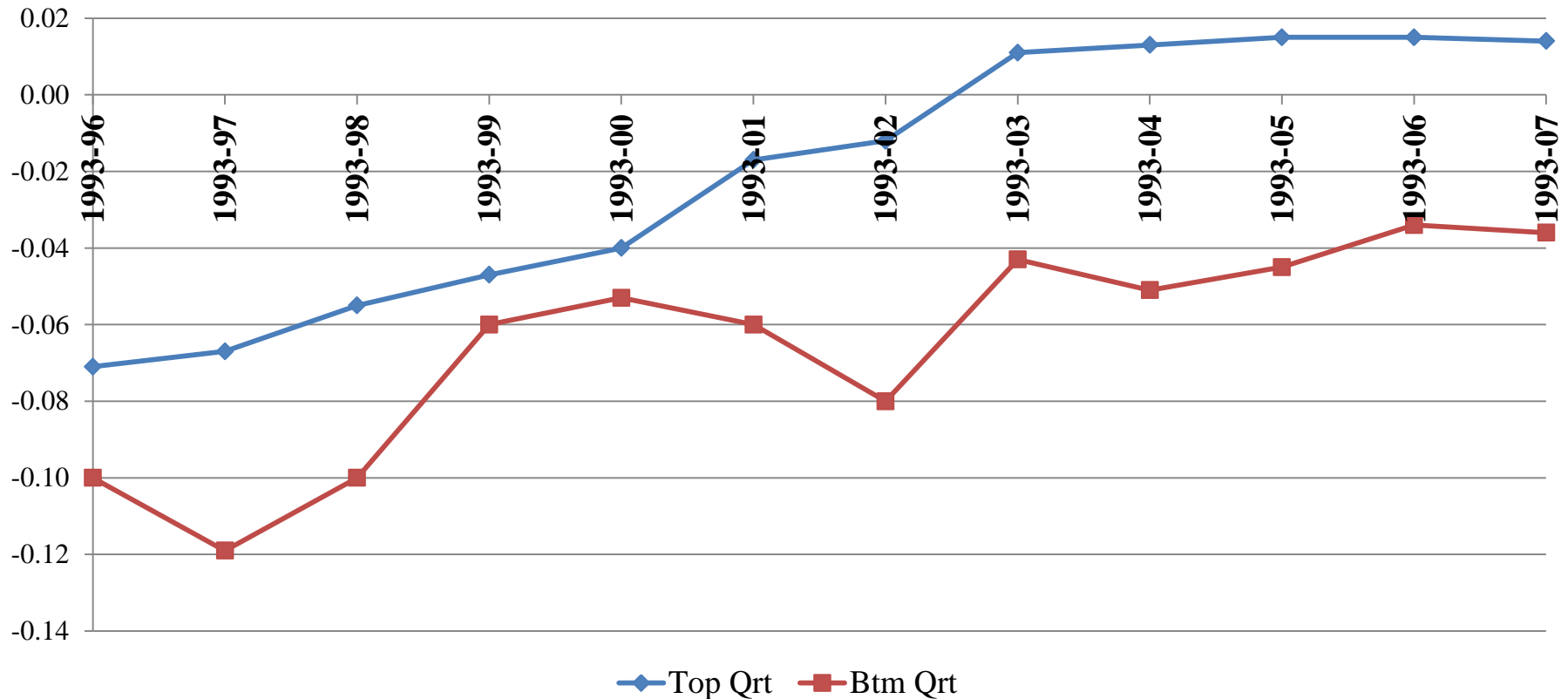
Source: "The Impact of Corporate Social Responsibility on Investment Recommendations", Ioannou and Serafeim, 2011.



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Sell-side Analysts: Who Changes Beliefs

Estimated Relation between ESG Performance and Investment Recommendation
for Analysts with Much vs. Little Firm-specific Experience



Source: "The Impact of Corporate Social Responsibility on Investment Recommendations", Ioannou and Serafeim, 2011.



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Fiduciary Duty

- **“Board directors should put shareholders first”**
- **Recognize that this is an ideology. It is not consistent with the law**
- **In most jurisdictions directors duty is to the corporation and the law gives them considerable flexibility to allocate resources as they choose**



“The market is short-term oriented”

❖ My response: do something about it!

Attracting long-term investors through reporting and communication

Firms have more long-term oriented investor base when they:

- 1. disclose more long-term information during their conference calls**
- 2. practice integrated reporting**

Sources:

Brochet, Loumioti, and Serafeim (2012), Short-termism, investor clientele and firm risk

Serafeim (2012), ongoing work



Forces Expediting Adoption of IR

- **Regulatory forces driving integrated reporting**
 - **Required for the 400+ companies listed on the Johannesburg Stock Exchange.**
 - **Grenelle II makes it required in France for all companies with >500 employees**
 - **CSR reporting required in China, Denmark, Norway, and Sweden**
 - **EU considering mandatory ESG reporting**
 - **Further support obtained through “Paragraph 47” of the [outcome document](#) from Rio+20**



Forces Expediting Adoption of IR

- **Market forces driving integrated reporting**
 - Growing assets by Socially Responsible Investment funds and increased interest by mainstream investment funds
 - [Sustainable Stock Exchanges Initiative](#)
 - [Corporate Sustainability Reporting Coalition](#)
 - [“Friends of Paragraph 47”](#) (Brazil, Denmark, France, and South Africa)
 - Bloomberg has integrated ESG data into its basic subscription service
 - Customers including sustainability issues in RFPs
 - Employees and other stakeholders increasingly interested in a company’s sustainability performance



State of Play by Country

Rank	Country	Environmental score	Rank	Country	Social score
1	UNITED KINGDOM	54.5	1	UNITED KINGDOM	48.2
2	FRANCE	54.3	2	BRAZIL	48.0
3	DENMARK	46.2	3	GERMANY	46.8
4	SWEDEN	45.5	4	SWEDEN	45.5
5	FINLAND	44.4	5	FRANCE	42.9
6	PORTUGAL	44.4	6	FINLAND	33.3
7	BRAZIL	40.0	7	SOUTH AFRICA	30.8
8	RUSSIAN FEDERATION	33.3	8	ITALY	29.2
9	GERMANY	29.8	9	DENMARK	23.1
10	LUXEMBOURG	25.0	10	BELGIUM	16.7
11	SOUTH AFRICA	23.1	11	IRELAND	11.1
12	NETHERLANDS	9.1	12	SPAIN	6.7
13	SWITZERLAND	8.1	13	NETHERLANDS	6.1
14	SPAIN	6.7	14	LUXEMBOURG	0.0
15	BELGIUM	-5.6	15	MALAYSIA	0.0
16	ITALY	-8.3	16	SINGAPORE	-4.3
17	IRELAND	-11.1	17	SWITZERLAND	-5.4
18	MEXICO	-12.5	18	MEXICO	-12.5
19	GREECE	-18.2	19	HONG KONG	-17.1
20	AUSTRALIA	-19.7	20	AUSTRIA	-22.2
21	JAPAN	-20.0	21	INDIA	-26.3
22	SINGAPORE	-21.7	22	CHINA	-26.7
23	AUSTRIA	-22.2	23	AUSTRALIA	-33.3
24	INDIA	-31.6	24	JAPAN	-39.0
25	HONG KONG	-31.7	25	GREECE	-45.5
26	CANADA	-46.2	26	CANADA	-49.5
27	CHINA	-53.3	27	COLOMBIA	-50.0
28	KOREA (SOUTH)	-59.0	28	KOREA (SOUTH)	-64.6
29	UNITED STATES	-79.0	29	UNITED STATES	-81.1



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Country-specific Strategies

Environmental

		<i>Integrated Reporting by Companies</i>	
		Low	High
<i>Investor Interest</i>	High	Canada	Denmark
		Greece	UK
		India	Germany
		Japan	Spain
		Singapore	Switzerland
		United States	
	Low	Australia	Brazil
		Belgium	Finland
		China	France
		Hong Kong	Netherlands
		Italy	South Africa
		South Korea	Sweden

Social

		<i>Integrated Reporting by Companies</i>	
		Low	High
<i>Investor Interest</i>	High	Canada	UK
		Greece	Germany
		India	Italy
		Japan	Spain
		Singapore	
		Switzerland	
		United States	
	Low	Australia	Belgium
		China	Brazil
		Hong Kong	Denmark
		Netherlands	Finland
		South Korea	France
			South Africa
			Sweden

Source: Eccles and Serafeim (2011). "The Role of the Board in Accelerating the Adoption of Integrated Reporting."



Designing Institutions to Overcome Barriers

- I. Sustainability as a competitive advantage**
 - i. Improving both financial and ESG performance through process, product and business model innovations**
- II. Improving sustainability information through integrated reporting**
 - i. International Integrated Reporting Committee (IIRC)**
 - ii. Sustainability Accounting Standards Board (SASB)**
- III. Improving the quality of sustainability ratings**
 - i. Global Initiative for Sustainability Ratings (GISR)**
- IV. Mobilizing investors to develop knowledge and commit to ESG integration**
 - i. United Nations Principles for Responsible Investment (UNPRI)**

