

Valuing ESG issues – a survey of investors

Stephanie Maier

What financial value do investors attach to ESG issues?

A survey conducted by EIRIS in late 2006 analysed the responses from over 40 mainstream and socially responsible asset managers, pension and church funds around the world.

Investors indicated that:

- Financially significant ESG issues affect over 50% of the FTSE All World Developed index by value
- In the 'top 10' sectors over 90% of investors surveyed believed that ESG issues would have some impact on the companies' value over the short to medium term (3-5 years); over a third considered the financial impact to affect over 10% of the value of companies; and around 10% considered over 25% of value to be at risk
- Energy and utility companies are most affected by ESG issues

Focus on sectors

Financially significant ESG issues affect over 50% of FTSE All World Developed index

Investors identified the 15 sectors where environmental, social and governance (ESG) issues have the most significant financial impact (see chart below). These 15 sectors represent over 50% of the total market capitalisation of the FTSE All World Developed index.

When questioned on the financial impact of ESG issues in a number of sectors, investors clearly identified the 'top 10' sectors affected:

- Oil & gas producers
- Gas, water & multi-utilities
- Electricity
- Automobiles & parts
- Forestry & paper
- Chemicals
- Mining
- Food producers
- Construction & materials
- Travel & leisure

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Energy and utility companies are most affected by ESG issues

Investors consider ESG issues to have the greatest impact in the oil & gas producers, gas, water & multi-utilities and electricity sectors.

Most (over 60%) of investors surveyed believed that ESG issues would impact over 10% of the value of these companies in the next three to five years in these sectors.

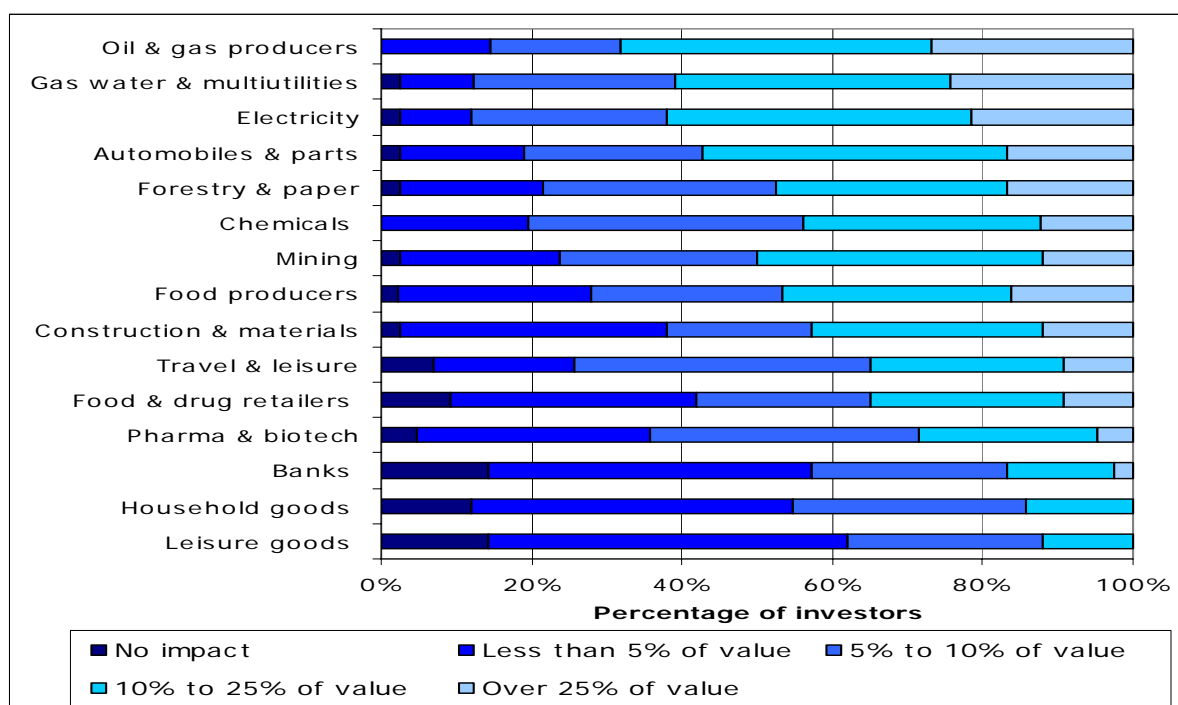
A quarter of investors believed that ESG issues impacted over 25% of the value of the oil & gas sector.

The first step to bring about changes in ESG issues is identifying and managing risks. The next step now is to identify and seize (financial) opportunities. I think that in the current environment these changes can be catalyzed and I see an important role for the SRI community in this.

Terence Berkleef - ABN AMRO Asset Management, Netherlands

Value of companies at risk

This chart illustrates the proportion of value investors consider to be at risk from ESG issues for the 15 sectors most impacted by ESG.



For sector descriptions see Notes section (at end of briefing)

Themes

Investors ranked the top five ESG issues for each of these 15 sectors, revealing some interesting themes and trends. Across sectors five themes emerged and are described below.

1. Climate change

Climate change emerged as the key issue (ranked top) for the automobile, airline, electricity and forestry & paper sectors and as a significant issue (ranked second) for a further two sectors – oil & gas and mining. Overall, investors ranked climate change as one of the five most financially significant ESG issues for nine of the 'top 10' sectors.

Investors, governments and society are increasingly concerned with the environmental and economic impact of climate change. Investors are concerned with the implications for companies operating within a carbon constrained economy. The related business opportunities and risks vary between sectors. For example, in the automobile sector the focus is on fuel economy and alternative technologies whereas the focus is on energy intensity for sectors such as forestry & paper. To better understand companies' impacts and management approach, investors are seeking improved disclosure on this issue through initiatives such as the Carbon Disclosure Project (www.cdproject.net).

Climate change is likely to significantly impact returns, particularly if global carbon trading becomes a significant factor. As awareness of ethical practices increases, there could be significant shareholder or consumer demand for alteration of current policies.

Tim Macready - Christian Super, Australia (pension scheme)

2. Environmental degradation

In the mining and oil & gas sectors environmental degradation, including waste, air and water emissions and biodiversity impact, was ranked first beating climate change as the ESG issue with the greatest potential financial impact. Environmental degradation was ranked second for the chemicals and construction & materials sectors. In the travel and leisure sector, the impact of tourism on biodiversity and other natural resources was also identified as a financially significant ESG issue (ranked second). It is clear that investors continue to be concerned with how companies manage the environmental risks and impacts of their operations.

Degradation of natural resources such as fresh and marine water, land, forests, reduced biodiversity and the pollution of the atmosphere remain significant global issues. While in some regions such as Europe and North America the state of the environment has stabilised or improved, in other regions such as in developing countries the environment continues to deteriorate (Global Environmental Outlook 3, UNEP). Regardless of location, the impact from companies' operations continues to represent a key issue for governments, societies and investors.

3. Product safety & liability

Investors identified product safety (including issues surrounding food contamination, genetically modified (GM) foods and food additives) as the top issues for the food producer and food & drug retailer sectors. Product liability and product safety standards were also identified as the top issue for

the leisure goods and pharmaceuticals & biotechnology sectors.

The financial impact of product recalls and related litigation can be significant. Direct costs include regulatory fines, out-of-court settlements and the cost of product recalls. However it is often the damage to company and/ or brand reputation that has the larger and longer term impact.

4. Chemicals of concerns in products

Investors identified this as a key issue (ranked top) for the chemicals and household goods sectors and as a significant issue (ranked second) for the leisure goods sector. These sectors include products such as cleaning products and consumer electronic products.

Growing scientific evidence linking man-made chemicals to environmental and health risks has fuelled widespread public concern over chemicals in the environment and has led to mounting pressure on producers to implement strategies to improve the safety and sustainability of their products.

New European chemicals legislation on the registration, evaluation and authorisation of chemicals (REACH) and numerous international initiatives to address chemicals management contribute to the potential financial impact of this issue on the value of companies in affected sectors.

5. Single-sector issues

The EIRIS survey also revealed a number of sector specific issues that

scored highly for potential financial impact.

In the banking sector customer policy was ranked top which includes issues such as consumer debt, high interest rates and charges, and product miss-selling, all of which have received significant coverage in the press and may prompt additional regulation.

'Sustainable construction practices' was ranked as the top issue in the construction sector. There are a number of drivers for change in the construction industry including the need for energy conservation measures, land use regulations and urban planning policies, waste reduction opportunities, resource conservation strategies and the proliferation of environmental technologies. Companies integrating these issues into the design and construction process stand to maximize the opportunities available.

In the gas, water & multi-utilities sector investors identified security of supply as the issue with the most potential financial impact (ranked top). This issue was ranked only third in the electricity sector, behind climate change and nuclear power.

The future

As initiatives such as the UNEP Principles for Responsible Investment (www.unpri.org) gain support socially responsible and mainstream investors alike acknowledge the affect that environmental, social and corporate governance (ESG) issues have on the performance of investment portfolios in the long-term. Factoring these issues into the investment process can further the dual aims of improving financial return and better aligning investors' objectives with the broader objectives

of companies' wider stakeholders (e.g. employees, regulators and local communities).

Notes

Sector descriptions

- Chemicals - includes both commodity and specialty chemicals
- Construction & materials - includes building materials and fixtures e.g. cement and other aggregates wooden beams etc heavy construction for commercial buildings and infrastructure and for the purposes of this survey house builders
- Food & drug retailers - includes supermarkets
- Household goods - includes domestic appliances furnishings and cleaning products
- Leisure goods - includes consumer electronics, recreation products and toys
- Travel & leisure - includes airlines hotels and travel and tourism services but excludes gambling and restaurants and bars for the purposes of this survey

Risk briefings

Additional briefings are available on ESG risks facing specific sectors – including 'Obesity concerns in the food and beverage industry', 'Beyond REACH – chemical safety and sustainability concerns' and 'Project finance: a sustainable future?'.

To obtain copies or for information on how EIRIS research can assist the investor to better integrate extra-financial environmental, social and governance issues please email clients@eiris.org or visit www.eiris.org.

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