



THE BUSINESS CASE FOR ESG

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INTRODUCTION

Recently there has been increased debate among corporate managers, boards of directors, and institutional investors around how best to incorporate ESG (environmental, social, governance) factors into strategic and investment decision-making processes. Central to this discussion is the premise that both companies and investors have become too short-term oriented in their investment horizon, leading to decisions that increase near-term reported profits at the expense of the long-term sustainability of those profits. The costs of those decisions are assumed to manifest themselves as externalities, borne by members of the workforce or society at large.¹

Prominent investors such as Larry Fink at BlackRock adopt this viewpoint:

To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate. Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth.²

Similarly, Martin Lipton of law firm Wachtell, Lipton, Rosen & Katz has urged corporate clients to adopt what he calls “The New Paradigm,” a more stakeholder-centric orientation that emphasizes a long-term investment horizon:

In essence, the New Paradigm recalibrates the relationship between public corporations and their major institutional investors and conceives of corporate governance as a collaboration among corporations, shareholders, and other stakeholders working together to achieve long-term value and resist short-termism.³

Evaluating claims such as these on a national or macro-level would require an accurate measurement of the time horizons of business managers today and the degree to which, if any, they

ignore or underestimate long-term environmental or social costs in the pursuit of near-term profits.⁴

Boards can improve their analysis of ESG risks and opportunities at a practical level by considering how long-term investors integrate ESG factors into their decision-making process. To do so, we examine a framework informed by the experience of ValueAct Capital. ValueAct is a long-term investor that aims to work constructively with portfolio company management teams and boards in a variety of ways, including at times having a ValueAct representative serve on the board.

BROAD INTEGRATION OF ESG FACTORS

In many ways, a focus on the durability of earnings and downside risk inherently incorporates many concepts commonly associated with ESG. To that end, ValueAct has also adopted an approach to evaluate ESG-related factors as part of its decision-making process and has deepened engagement with its portfolio companies around these issues. It does so because analysis of ESG factors can:

- Provide an effective risk-management framework
- Provide a new lens for strategy development and growth opportunities
- Address the demands of stakeholders such as customers, employees, and investors

As such, ValueAct generally incorporates ESG factors into its process by identifying relevant stakeholders and factors, isolating and evaluating potential risks, and supporting companies as they invest in their businesses to increase returns.

IDENTIFYING RELEVANT FACTORS

The first step is to map the ecosystem of stakeholders associated with the company and analyze their interests (i.e., their incentives, values, viewpoints, etc.). These stakeholders typically include customers, suppliers, employees, regulators, the general public (including environmental impact), shareholders, and competitors. Once this ecosystem is mapped, it is easier to understand which

ESG factors are most relevant to a particular company. Certain factors, such as governance and human capital, might be applicable broadly while others, such as environmental footprint, might be more limited.

As an example of this process, ValueAct created an ecosystem map as part of its diligence of the private student loan industry, including the leading provider Sallie Mae (see Exhibit 1). The map identifies students and their parents, colleges and their financial aid officers, government regulators, U.S. taxpayers, and shareholders as key stakeholders and summarizes the goals of each.

ISOLATING AND EVALUATING POTENTIAL RISKS

Once the relevant factors have been identified, one can evaluate and quantify (to the extent possible) the company's position and associated risk in each area. The active engagement of an investor with a significant stake and long-term perspective can elevate a company's discussion of risk at the C-suite and board level, encourage corporate investment to mitigate risk if needed (even at the expense of near-term profit), and provide support for the management team as it justifies its decisions to the broader investment community.

In the example of the student loan industry above, the federal government is an important focal point given its dual role as lender and policy maker. This suggests several questions:

- Can private student loans provide better value to students than federal programs?
- How might policy changes impact the competitive dynamic between private and federal programs?
- What impact do various sources of student loans have on both school and student outcomes?

In attempting to answer these questions from an investor's perspective, ValueAct was better able to evaluate how private student loan providers could play a positive role in any higher education policy focused on access, quality, and affordability, and therefore serve as an important part of the long-term solution to fund higher education.

INVESTING TO INCREASE RETURNS

Beyond risk reduction, ESG factor analysis can lead to the identification of investments or activities by the company that increase long-term returns. For example, a company's investment in a more sustainable supply chain can deepen relationships with customers (thereby promoting volume growth and premium pricing), attract talent to the organization, and perhaps reduce

costs. In the private student loan ecosystem, investments behind improving student outcomes can significantly reduce default risk while also improving the brand in the eyes of customers, employees, and regulators. These positive effects can build on one another and create a powerful flywheel effect. To identify and capitalize on opportunities such as these, senior business leadership must consider material ESG factors as core inputs into their strategy development.

BEYOND ESG: INVESTING BEHIND BUSINESS MODELS AND TRANSITIONS INTEGRAL TO SOLVING GLOBAL PROBLEMS

Integration of ESG-related factors is broadly applicable across all companies. In ValueAct's experience, there is also an opportunity for institutional investors to identify and invest behind companies where sustainability is at the center of the investment thesis, or whose business models are core to the ultimate solution for specific environmental and social problems (increasingly referred to as "impact investing"). These global problems can include carbon emissions, waste recovery, access to education, affordability of healthcare, and biodiversity loss, to name a few.

Below we explore two of those problems—carbon emissions and access to education—and provide an example of companies that are transitioning their business models to address these problems.

CARBON EMISSIONS

Electricity production accounts for over a quarter (27.5 percent) of greenhouse gas emissions in the United States.⁵ Approximately 64 percent of electricity production comes from fossil fuels such as coal and natural gas, 19 percent from nuclear, and 17 percent from renewables such as wind and solar.⁶ Renewables have steadily gained share as they have become more cost competitive with fossil fuels in certain geographies. Increased investment can accelerate this transition and pull forward the benefits from a climate change perspective.

Global power company AES has a 38-year history of owning and operating contracted generating capacity to utilities around the world. By early 2018, AES was addressing the environmental cost of its reliance on coal as an energy source and was in the process of repositioning its portfolio to renewable sources. The company subsequently made a series of changes to accelerate the transition of its business model. In early 2018, AES announced a broad reorganization, including asset divestitures primarily related to coal plants. The company also committed to a target of decreasing reliance on coal from 41 percent of supply in 2015 to 29 percent by 2020.⁷ It publicly set a carbon intensity reduction

target of 70 percent by 2030.⁸ Through joint ventures with Siemens and others, it built capacity for energy storage and development of renewables. In November 2018, the company voluntarily released a Climate Scenario Report, claiming to be the first U.S. publicly listed energy-related business to do so in accordance with guidelines set by the Task Force for Climate-related Financial Disclosures (TCFD). The company also modified its mission statement to emphasize its commitment to transformation to: “Improve lives by accelerating a safer and greener energy future.”

These actions appear to have had a number of ripple effects. According to AES, the updated mission statement galvanized the company’s culture, helping it to attract talent, increase workforce productivity, and further innovation. The company also received recognition from external parties for its reporting efforts.⁹ Shareholders who had pressured the company to conduct a climate-change risk assessment voluntarily withdrew their proxy resolution, and according to AES, some foreign and domestic investors, who previously would not invest in AES because of its exposure to coal, made new investments. During this time of investment in a less carbon intensive business, the company’s price-to-earnings multiple expanded from approximately 9x in January 2018 to 14x by March 2019, and its stock price outpaced industry indexes (see Exhibit 2).

ACCESS TO EDUCATION

Higher education is a critical determinant of future wages, with college graduates earnings approximately 80 percent more per year than those with only a high school degree. The cost of college education, however, has been rising significantly for many years, and student loans become the fastest-growing category of consumer debt, rising to \$1.6 trillion by the end of 2018. Addressing the problems of access and affordability while maintaining quality offers substantial potential benefits for U.S. citizens and the economy.

The for-profit education industry has long had the potential to provide this solution by offering a less expensive educational experience focused on occupational training. By and large, however, the industry had not achieved this objective. By the early 2010s, poor student outcomes and high student loan default rates led to regulatory scrutiny. The federal government began to enforce punitive performance requirements and cut off funding to those institutions whose graduates could not find well-paying jobs. These actions led to the collapse of several companies in the industry, such as ITT Educational and Corinthian Colleges. Meanwhile, the survivors experienced precipitous declines in revenue and profits. In the case of Strategic Education (formerly

Strayer Education), one of the largest for-profit education companies in the United States whose history dates back to 1892, operating margins, which exceeded 35 percent prior to the change, fell into the teens. The company’s stock price declined from a high of \$254 in April 2010 to a low of \$34 in December 2013 (see Exhibit 3).

Since mid-2015, Strategic Education made a series of changes to reposition itself for durable growth, based on a business model that contributes to positive societal change. The company reduced tuition rates to increase affordability.¹⁰ It made investment in machine learning and artificial intelligence to lower its costs and improve student outcomes, passing on the savings as lower tuition.¹¹ It also increased its efforts to measure student outcomes and take the learnings to foster continuous innovation in the education experience. Recently, it merged with Capella University—an online graduate school education company—to build scale and further its competency-based learning. Strategic Education has also expanded non-degree educational offerings for employed workforce members, with corporate partnerships representing approximately a quarter of enrollment and growing.¹²

Subsequently, student experience and retention improved, leading to higher unit economics. Operating margins and profits increased. In 2018 alone, enrollment at Strayer University increased by 8 percent to nearly 48,000 students while the continuation rate and number of students completing the requirements for graduation also rose.¹³ Importantly, the company has positioned itself as a contributor to positive social outcomes by improving education and training for students and adults at lower cost.

INCORPORATING STAKEHOLDER CONCERNS

The examples of AES and Strategic Education illustrate how some companies can benefit from a foundational shift in their business model to explicitly address stakeholder concerns, leading to more sustainable long-term economics. In some cases, it requires that management and the board be amenable to collaborating with stakeholders to determine how to achieve those changes or with a significant shareholder to champion this decision among the broader shareholder base. Ultimately, certain incumbents whose industry faces significant environmental or social challenges can create value and generate returns by more centrally focusing on addressing those challenges.

WHY THIS MATTERS

1. The examples included in this Closer Look involve companies that appear to have a long-term investment horizon and are willing to bear the cost of an up-front investment in order to

- increase long-term value. How prevalent are companies with a long-term perspective? How many companies miss long-term opportunities because they are excessively focused on short-term profits? If many, what does this say about the quality of corporate governance and board oversight in companies today?
2. This Closer Look offers two case studies of companies transitioning “beyond ESG” to solve global problems. Both are traditional businesses whose executives and board members recast their business models to try to solve environmental and/or social problems and improve long-term profit opportunities. How widespread are such opportunities? Can every company achieve such a transition and do so profitably? If not, what factors determine whether a company has such an opportunity?
 3. The approach described in this Closer Look suggests that opportunities exist for investors to earn competitive risk-adjusted returns with a favorable ESG focus. How large is this opportunity? How does this compare to the total universe of publicly traded companies? ■

¹ An externality is the cost of a commercial activity that is not incorporated in the cost of goods or services provided and is borne by third parties.

² BlackRock, “Larry Fink’s 2018 Letter to CEOs: A Sense of Purpose,” available at: <https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter>.

³ Implicit in this argument is the practical consideration that by embracing broad stakeholder objectives corporations can forestall costs, such as those due to regulations that politicians will impose on them to satisfy the demands of their constituents. See Martin Lipton, Steven A. Rosenblum, Sabastian V. Niles, Sara J. Lewis, and Kisho Watanabe, in collaboration with Michael Drexler, “The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth,” World Economic Forum (September 2016).

⁴ For example, it would require an accurate measure of the extent to which short-termism is actually prevalent in corporate decision making today, the time horizon of institutional investors (perhaps as a proxy the stock market) and the impact this has on corporate decision making, the extent to which corporate managers take into account (or ignore) the needs of employee and non-employee stakeholders, the cost (or benefit) of including stakeholder considerations in decision making, and the reduction in financial returns (if any) that investment professionals are willing to accept in pursuit of ESG objectives. Some research finds that companies that embrace ESG principles perform better, although the results are mixed. Lins, Servaes, and Tamayo (2017) find that during the financial crisis, high-ESG firms experienced greater returns, profitability, growth, and sales per employee relative to low-ESG firms. Deng, Kang, and Low (2013) look at value creation from mergers, showing that high-ESG acquiring firms experience significantly more positive returns from acquisitions than low-ESG firms. Ferrell, Liang, and Renneboog (2016) provide evidence that well-governed firms that suffer less from agency concerns engage more in ESG activities, and that a positive relation exists between ESG and firm value. However, Margolis, Elfenbein, and Walsh (2011) find, in a meta-analysis of 251 studies from 1972 to 2007, that the “overall average effect [of ESG...] across all studies is

statistically significant, but on an absolute basis it is small.” For a review of the research literature, including these papers, see David F. Larcker and Brian Tayan, “Environmental, Social, and Governance Activities: Research Spotlight,” Stanford Quick Guide Series (March 2019), available at: <https://www.gsb.stanford.edu/faculty-research/publications/environmental-social-governance-activities>.

⁵ It is the second-largest source after transportation (29 percent). See U.S. Environmental Protection Agency (2019), Inventory of U.S. Greenhouse Gas Emissions and Sinks: 1990-2017.

⁶ U.S. Energy Information Administration (EIA), “U.S. Electricity Generation by Source, Amount, and Share of Total in 2018,” accessed April 2019.

⁷ AES, Fourth Quarter & Full Year 2017 Financial Review (February 2018).

⁸ Base year 2016. AES, Climate Scenario Report (November 2018).

⁹ Ceres press release, “New Disclosure Report from Major Global Power Company Highlights Shift Toward New Low-Carbon Investments,” (November 13, 2018).

¹⁰ Jeff Clabaugh, “Strayer Cuts Tuition by as much as 40 percent,” *Washington Business Journal* (November 22, 2013).

¹¹ Ari Chanen, “Using Artificial Intelligence and Machine Learning to Improve Student Success,” posted on LinkedIn (January 2, 2018).

¹² “4Q18 Strategic Education Inc Earnings Call,” CQFD Disclosure (March 1, 2019).

¹³ Strategic Education, 2018 Annual Report.

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The Stanford Closer Look Series is dedicated to the memory of our colleague Nicholas Donatiello.

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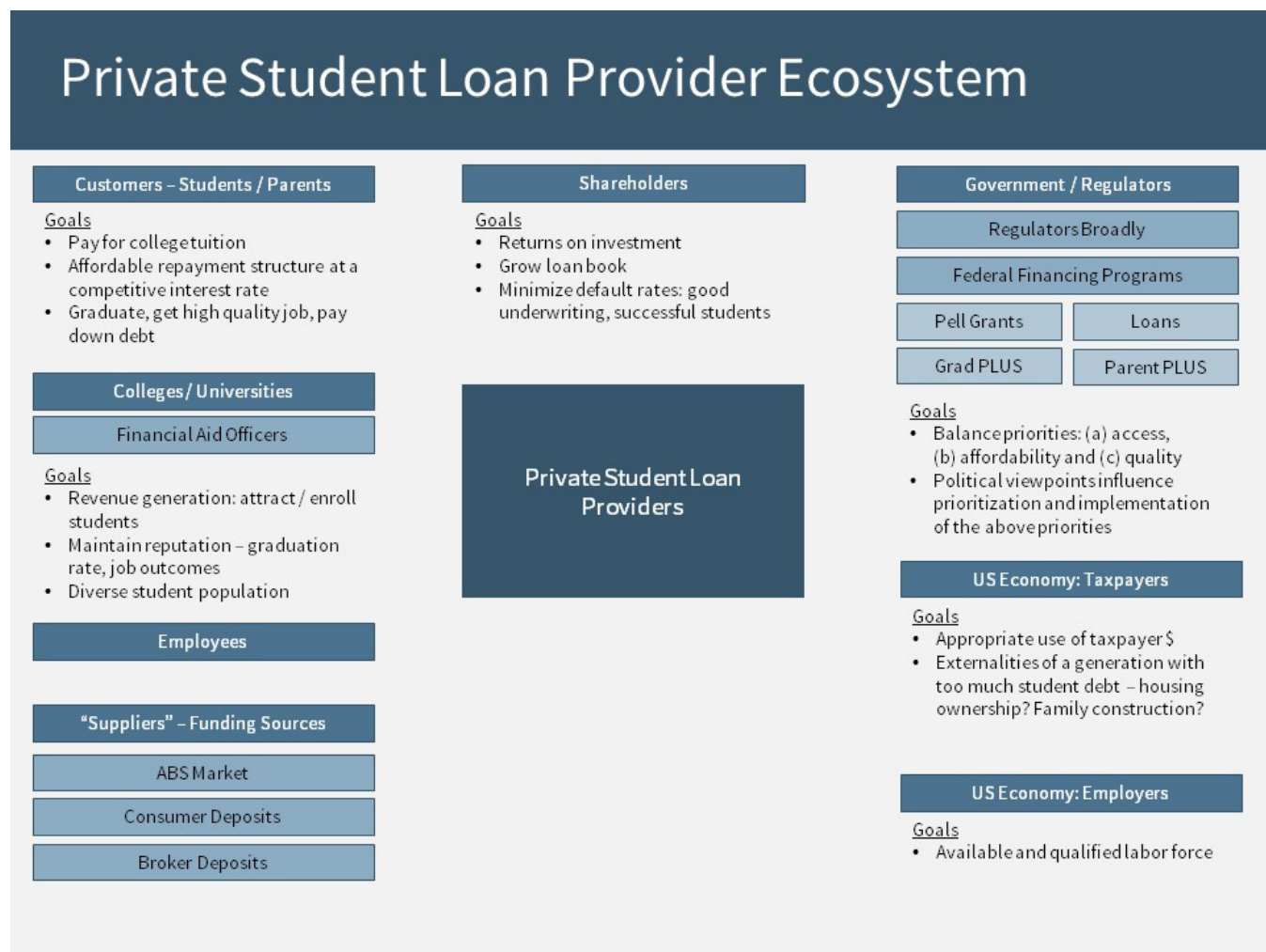
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EXHIBIT 1 — PRIVATE STUDENT LOAN ECOSYSTEM



Source: ValueAct Capital.

EXHIBIT 2 — AES STOCK PRICE AND MILESTONES

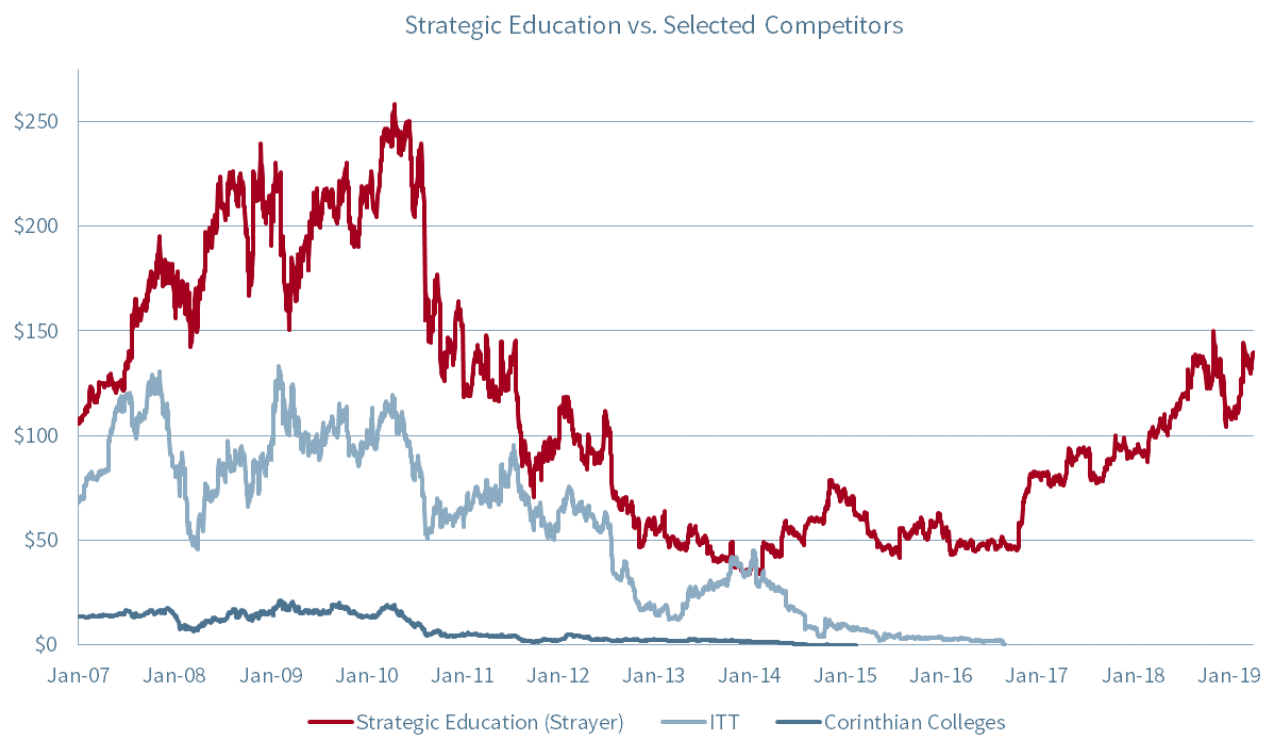


1. AES announces investments in energy storage.
2. ValueAct announces investment in AES; joins the board of directors.
3. AES announces cost reduction efforts; carbon intensity reduction target of 50% by 2030.
4. AES commits to adopting recommendations of Task Force on Climate-Related Financial Disclosure.
5. Shareholders voluntarily withdraw resolution requiring climate-risk assessment.
6. AES changes mission statement.
7. AES increases carbon intensity reduction target to 50% by 2022 and 70% by 2030.

Note: The price of VPU is indexed to September 1, 2017. P/E refers to NTM (next 12 months) price-to-earnings ratio.

Source: CapitalIQ.

EXHIBIT 3 — STRATEGIC EDUCATION STOCK PRICE VS. SELECTED COMPETITORS



Source: Center for Research in Security Prices (CRSP) and Yahoo! Finance.