Radnor View

ESG approaches for positive share price movements

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Within the space of only a couple of years, ESG has established itself as an alternative lens through which investors can assess a company's performance. Companies that have yet to define and adopt a clear ESG strategy or embed such a strategy in the fabric of their business are missing out on a potential valuation premium. There is also the nature and motivation of the investor to take into account. This latest Radnor View explores the importance of **ESG materiality** and **the nature of one's share register** on valuation.

Until recently, there was a question mark over whether integrating ESG considerations resulted in better price performance or not. However, retrospective studies are now proving '**abnormal' positive returns for those companies demonstrating strong ESG credentials**, as well as overwhelming appetite for environmentally and socially responsible investing more generally. From our investor engagement work, we know that investors are increasingly keen to integrate ESG as a new assessment tool when making investment decisions. This Radnor View addresses the critical steps a company should take for their ESG strategy and message to land on the right side of an investor's decision making process.

Firstly, we should acknowledge that companies are diverse, with differentiated strategies and at various stages of development. There is no one size fits all when it comes to ESG. However, we believe that two themes underpin successful ESG messaging regardless of company size and maturity. Firstly, an effective and rewarding ESG strategy is predicated on **efficiency**, i.e., a strategy that allocates resources for measures that generate the most value. Secondly, we believe **authenticity** is critical i.e., how genuine are your claims. Taken together, a company's ESG message should not only satisfy these two conditions, but also be clear and succinct enough to capture quickly the attention of ESG-minded investors.

For some companies, there might be an attraction in just wearing the new Emperor's ESG clothes and sit back to enjoy a short term ESG halo effect without actually seeking to embed sustainable practices within their businesses. However, in an environment where investors are coming under material pressure to justify their own portfolio holdings through an ESG lens, such an approach is fraught with risk.

For us, a successful and meaningful ESG journey starts with some **relatively simple steps** which can deliver positive investor outcomes whilst allowing time to further develop a deeper and more cohesive ESG strategy and framework.

So, what do these simple steps look like?

1) Materiality – focusing on ESG issues most relevant for your sector

SASB's Materiality Matrix, made up of issues likely to affect business according to industry sectors, e.g., journalistic integrity and IP protection are issues more likely to affect a company operating in the media sector than a hospitality company. Utilising this matrix allows companies and investors alike to easily identify the most material ESG issues relating to a specific industry. One research portfolio, constructed of companies with positive performance on material issues (as defined by SASB) resulted in positive price movements between c.3-8% annualised[1]. This outperformance persisted even in 'sin' companies (alcohol, gambling and tobacco).

Conversely, many studies have demonstrated that policies based on non-material issues result in little to no impact on share price. Additionally, resource allocations to non-material issues are seen as an unnecessary agency cost and can be judged unfavourably by investors. In fact, in a 2018 study, it was found that firms with *good* performance on material issues, but poor performance on *non-material* issues outperformed those with good performance on both. Indicating that the best ESG strategy is one that is efficient and focuses solely on material issues – even at the expense of non-material ones[2]. Ultimately, such a focus on materiality signals to investors that a company has a deep understanding of ESG and how they are focusing their attentions on value-generating opportunities.

Focusing on SASB's material issues within one's sector is a strong starting point. Investors often use progress against these **material issues as a differentiating factor between two similar potential investment operating within the same sector.**

2) Intelligent share register assessment– Knowing what your shareholders want

Understanding the nature of your share-register, particularly whether the company wishes to attract long term vs shorter term/transient investors, is crucial for any company looking to bolster their ESG agenda. Distinguishing between the two is critical as their interests and motivations can be polarised. Moreover, analysing the investment style and importance of ESG to shareholders is key. With this information to hand, it becomes far easier to make informed decisions on where to focus one's ESG efforts. **The worst possible thing is the misallocation of resources for ESG measures that will not be appealing to the type of investor your company is targeting.**

We recognise that every share register looks different and so companies have different needs when it comes to investor attraction and retention. At Radnor, we believe a rigorous approach to investor targeting is critical to successful investor outcomes.

Investors with a shorter-term focus, as a general rule, will tend to be more responsive to headlines and sentiment as opposed to looking through to a longer term outcome. This type of investor is much more likely to decrease their holding or divest completely at what first appears to be negative ESG headlines.

Since short-term investors tend to look for an attractive market value (as opposed to valuing the fundamentals), they are also more likely to be against large scale ESG projects that take several years for the benefit to become apparent. Their ESG focus may be classed as more 'superficial' and / or 'short-termist'.

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[1] Serafim, G., (2018), "Public Sentiment and the Price of Corporate Sustainability", Financial Analyst Journal 76(2), p. 26-46, < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3265502>

[2] Ibid, 2018

However, for those companies targeting a supportive long-term investor base, implementing ESG policies that may take longer to roll out but will result in positive fundamental changes should be the core ESG strategy. Longer term institutional investors are more prepared to see through minor blips in progress, provided that adequate communication is maintained with all relevant stakeholders. Such transparent and robust reporting is linked with lower propensity for share price declines[3], since socially responsible firms behave more responsibly and are less likely to conceal bad news (a must for long term investors). Such investors are firmly of the view that good ESG leads to good returns.

Conclusion

The combination of knowing your investor base and a focus on materiality can deliver an effective, initial ESG strategy implementation. Taking these initial steps can ensure that any company is able to capture the value of positive ESG investor sentiment, even though the longer term ESG framework may not have been fully fleshed out.

A streamlined and efficient ESG strategy will be the best use of a company's resources and signal to investors that efforts will result in positive material changes to the business. The ability outperform peers on the very issues investors study will only yield positive investor attraction.

Radnor is well placed to help companies undertake their share register analysis, discern the investor type and recommend the necessary ESG areas companies should focus on, in order to reap as much value for a company's efforts. Understanding the mindset and motivations of your shareholders inevitably leads to a supportive and 'sticky' register.

[3] Kim, Y., Li, H., Li, S., (2014), "Corporate social responsibility and stock price crash risk", Journal of Banking & Finance 43, p. 1-13, < https://www.sciencedirect.com/science/article/abs/pii/S0378426614000764>