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Valuation of Investments from a Sustainability Perspective

THEME III

SUSANNE ARVIDSSON
MARITA BLOMKVIST

Speakers and moderator in the theme

INVITED SPEAKERS:

LARS HASSEL, Professor, Umeå School of Business and Economics, Umeå University. He will present research evidence concerning equity valuation from a sustainability perspective.

KARIN SVENSSON, Advisor for private sector cooperation, SIDA. She will talk about the shift in paradigm of the importance of sustainable leadership for sustainable finance. She will address this shift in the context of a sustainable future.

PETER LUNDKVIST, Chairman of the Ethical Council of the Swedish National Pension Funds. Peter is invited to talk about the funding strategy in one area of the Swedish national pension system, AP3. He will discuss how sustainable businesses often have higher returns and lower risk.

ÅKE IVERFELDT, Executive Director at Mistra, a Swedish governmental research foundation that supports research on the strategic importance for a good living environment. He will present his views on developing sustainability assets management in a global economy.

JOHAN HENNINGSSON, PhD, Head of Sustainability at the Swedish Export Credit Corporation (SEK). His presentation will focus on sustainability risks in credit decision-making.

HENRIK SUNDSTRÖM, VP for Group Sustainability Affairs at Electrolux. He will share his experiences from being included in sustainability indexes.

INVITED MODERATOR:

ANITA LINDBERG, Chairman of the Swedish Forum for Sustainable Investments and ESG Analyst at Alfred Berg.

Summary of the presentations

LARS HASSEL: (Keynote address) Equity valuation from a sustainability perspective – Research evidence

Hassel has a long-standing research interest in how sustainability has created value. He began his presentation by concluding that over these years, much has happened in the area of sustainability. This academic topic shows a long-term development related to responsibility on the financial market.

In his research, Hassel has focused on three strategies for sustainability-reporting information (SRI). The first strategy *Best-in-class Environmental, Social, Governance (ESG) portfolios*, focuses on ESG measures or indicators of corporate performance against ESG criteria. Using this strategy, the investor will select the best ranked ESG companies. Many studies find that sustainable business practices add economic value to assets at firm level. Also, as sustainability creates value, this value is priced; therefore, this value may not necessarily result in higher returns at portfolio level. To sum up, the market has learned that many companies create value that does not necessarily result in higher returns. A challenge for future research is to explain whether the market will continue to overlook the benefits of ESG, and if this will result in a mispricing on the market.

The second strategy is *'sin Industry' or shunned stock portfolios*. Empirical studies have demonstrated that many investors do not follow the best-in-class strategy. Instead, investors appear to be willing to bear the reputation risk involved in investing in these more questionable companies in order to earn a return premium. New evidence shows that this strategy can also be explained by asset pricing factors such as profitability and investment. Hassel stressed that it is a challenge to learn more about the relation between investors' strategies for sustainability-reporting information and asset-pricing factors.

The third strategy, *Engagement as SRI strategy*, relates to engagement as a private dialogue between investors and a company. Today this is often referred to as stakeholder engagement and dialogue. A few studies in the US have examined firm-engagement targets. These studies show that investor targets for engagement focus mostly on governance risk and reputation risk. Successful engagements improve reputation and financial performance. On the other hand, studies of Nordic investors' behaviour show different target engagement. Here engagement seems to derive from an incident or corporate scandal. Research shows that information related to an incident or corporate scandal have resulted in negative ESG scores.

Even though successful engagements improve ESG performance and also transparency, it has no financial effects. There is a need for future research in order to learn more about private dialogue between investors and companies.

The conclusion from Hassel is that companies place stakeholders' ESG issues high on the agenda, given that investors cannot neglect stakeholders' ESG management. Economic logic teaches us that increased attention to value-relevant ESG information makes potential 'miss pricing' short lived. In this respect, transparency is fundamental. Hassel ends his presentation by emphasizing that we now have quite strong evidence that companies that perform well in the ESG area also have higher market values. It will be a challenge for both the academic community and practitioners to follow how the market will react on sustainability reports in the future.

KARIN SVENSSON: The importance of sustainable leadership for sustainable finance and a sustainable future

In her presentation, Svensson focused on the shift in paradigm towards a more sustainable future and on the importance of sustainable leadership for establishing sustainable finance. She took her departure in the new roadmap towards Agenda 2030 and the UN's 17 Sustainable Development Goals (SDGs). Although she argued that these goals might be set far too high, she emphasized that it would be even worse to set them too low. This indicates a major challenge for organizations in the future as well as a potential for future research. In the process of meeting these goals, Svensson explained that the key actors involved are investors and the private sector. The private sector creates 90 per cent of all sustainable jobs, and this is vital in the transformation towards more sustainable organizations. The role of so-called development actors, among them Sida, is to catalyse other actors to make change towards sustainability. She highlighted that this new role links well to SDG no. 17 'Partnerships for the goal'. For Sida, this task has been manifested in the establishment of partnerships, collaboration and cooperation arrangements.

Svensson pointed to the Swedish Leadership for Sustainable Development network that was founded in 2013 and is coordinated by Sida. According to Svensson, the network does not focus on all SDGs but has identified those on which the network can make a positive impact. When it comes to investors as key actors, Svensson argued that they influence through corporate-governance engagement. Here, Svensson pointed to Swedish Investors for Sustainable Development (SIDS), an investor network that invites other organisations to act together. To enable relevant actions, the investor network works with communication and inspiration, as well as learning, exchange of experiences and initiatives. In various types of partnerships, Sida has also focused on gender issues. She stressed that it is vital for organisations to collaborate in networks in order to face the challenges related to working with sustainability.

In the later part of her presentation, Svensson identified impact investing as an international trend in sustainable development. Investors can assess the investment potential tied to the 17 SDGs. Sustainable finance and sustainable investments are important, but to achieve efficient and sustainable decisions, Svensson suggested that we need transparent and relevant information. In this context, she emphasized the key role played by reporting. According to Svensson, we are approaching a time when an agreement can be reached on a common framework for reporting. Achieving such a common reporting framework agreement is crucial. Great work has already been done. Today, we have SDG indicators for states and reporting initiatives for private sectors, such as the SASB (Sustainable Accounting Standard Board – a US-based system) and GRI/UN (Global Reporting Initiative/Global Compact). Svensson argued that it seems like GRI is now analyzing goals and targets, a developing that will have an impact on the common reporting language.

Svensson closed her presentation by raising two questions to the audience: What is your goal? And what impact do you want to focus on?

PETER LUNDKVIST: Higher returns and lower risk in credit decisions

Peter Lundkvist centered his presentation on AP3 strategies. First, he gave an overview of the Swedish national pension system, of which AP3 is one component. This system was formed 15 years ago. This portfolio is global and diversified. Since its establishment, AP3's capital has grown, and the return has been either on or above target. The investment rule set by the parliament is that 30 per cent of the portfolio should be placed in private equity. Lundkvist argued that it is here we find most sustainable investments. This is a bit problematic, since we cannot ourselves change this proportion. In order to focus more on sustainable investments, they could make a request to parliament for a change in AP3's investment rules.

When addressing the importance of sustainability, Lundkvist pointed out that AP3 do care, but the premium is high. AP3 has been involved in ethics and climate for many years. In 2006, they were early adopters of the UN Global Compact, and in 2007 the Ethical Council was founded. Investments in clean tech and green bonds started as early as 2008. Stakeholders began to demand investments in sustainable ESG factors several years ago. In 2011, AP3 started to integrate ESG indicators into their valuations, and today these indicators are fully integrated.

Lundkvist stressed the importance of return on investments, and this is always first priority. However, AP3 also looks into sustainability as a core value and serves as a goal. There are different types of portfolios, with different strategies for approaching sustainability depending on the nature and profile of ownership. One important part of value creation, according to Lundkvist, is active stewardship. This means that there is an effective dialogue between the board and the management team.

In order to safeguard sustainability, AP3 screens the investment incentives with various tools and also classifies the companies according to. Lundkvist states that it is important for the investors to incorporate both the importance of sustainability goals and the importance of return on investments.

Lundkvist concluded his presentation by presenting the AP3 Sustainability targets for 2018. Four targets are set; (i) Carbon footprint, (ii) Green bonds, (iii) Sustainability investments and (iv) Green building. To reach these targets, AP3 has developed a careful strategy. Lundkvist added that AP3 supports the SDGs. In one of his final slides, he showed how AP3 'ticks the boxes' when it comes to the SDGs. Materiality is vital. It means that each actor should focus on those goals where they can make the most positive impact or minimize its negative impact. Thus, AP3 has ticked all the goals, but those that are ticked have clear descriptions of how AP3 is working to meet these goals.

Finally, Lundkvist concluded what AP3 has learned from working with sustainability. He highlights some key takeaways. For example, today they have a more holistic perspective on sustainability and assess all the different risk classes. Another key learning is engagement with companies. Lundkvist pointed out that AP3 has a dialogue with 300 companies each year. Here they can make a significant change towards a more sustainable development. He closed his presentation by stating that a major challenge for the future is that sustainability should be integrated *into* the investment process.

ÅKE IVERFELDT: Developing sustainable assets management in a global economy

Iverfeldt has worked as financier since in the 1990s. He argued that sustainability then was an 'alibi'. Now, we see a completely different picture. He started his presentation with an overview of the Mistra Foundation. Mistra was established in 1994 with money from the Swedish Government. Its purpose was to fund world-class research of strategic importance for the environment, contributing to quality of life, solving key environmental problems and achieving sustainable development. Mistra started early with environmental investments and according to Iverfeldt, has done pretty well in managing the capital on the stock market.

In 2003, they started to manage Mistra with a sustainable goal. According to Iverfeldt, Mistra then started to question what sustainability really meant. He humbly admitted that they are still asking themselves what sustainability *is* and if they are integrating the right things. Mistra has several selection criteria for both the portfolios, funds and management. This includes, e.g. active management and leaders in sustainable investments. Iverfeldt emphasized that Mistra will increase their engagements with a strong international focus. One important criterion in this engagement

is competence, and another is trust. Iverfeldt emphasized that every action Mistra has taken ends up in trust. 'If our investments or funds are bad, then Mistra is bad', concluded Iverfeldt.

Finally, Iverfeldt presented the 'Toolbox for knowledge-based dialogue with asset managers'. He explained that when Mistra discusses sustainable investments with managers, they use the values in the Toolbox as a frame. Among these values are transparency, dialogue and SDGs. Iverfeldt ended his presentation by underscoring that Mistra has always acted and will continue to act as a platform for ideas on sustainable investments, taking a systematic approach to all asset classes. This process is based on a continuous dialogue with partners. A challenge is to understand how the SDGs fit in the dialogue and how they can be integrated.

JOHAN HENNINGSSON: Assessing sustainability risks in credit decisions

Henningsson has a background as financial-market investor. He holds a PhD in finance and now works at the state-owned Swedish Export Credit Corporation (SEK) with the task of integrating sustainable finance. He started his presentation by asking 'What is sustainable finance?' His own answer is that it is all about integrating and mobilizing capital for sustainable investments. Lending is different from investments. In lending, you want your money back (and also with some interest). He highlighted two problems. First, banks do not know how to interpret climate risks. Second, even though they now identify sustainability risks, they do not integrate them in their models.

SEK works with financing Swedish export, and Henningsson noted that as a bank, SEK has a key role in sustainable lending. Being a bank means that SEK is highly regulated. Risks are carefully integrated into calculations and regulations. Sustainability risks are risks that the bank identifies as negatively affecting the environment, the climate or people. Henningsson elaborated that until last year, SEK had been very confused when defining sustainability. Now, sustainability risks are defined as risks that directly or indirectly can threaten our capital and/or threaten the environment, the climate or people. Henningsson also pointed out climate risks that bring with them potentially profound implications for financial stability and the importance of these risks for assessing long-term risk. Banks must include climate impact in their risk profiles. However, this has yet to be done, according to Henningsson. Taken together, it will be a challenge to follow how investors include long-term factors such as climate in their future calculations.

At the end of his presentation, Henningsson stressed that if we want to be able to assess sustainability risks in the future, the development of quantitative measures is fundamental. Regulators and rating agencies will be the main actors in the process of establishing a new regime of corporate-climate information.

HENRIK SUNDSTRÖM: Experiences from being included in sustainability indexes

Sundström shared his experiences from Electrolux, which has been included in sustainability indexes for many years. He admitted that they cannot say whether this will remain a priority in the future. He raised the question 'Does the inclusion in sustainability indexes bring value to the company or not?'

Sundström began his presentation by introducing the company's sustainability framework, defined as 'For Better'. This framework focuses on how the company administers its products, operations and society. The first area is defined as 'Better solutions' and refers to improvements in product performance and efficiency. The second area, 'Better operations', denotes respect for human rights and ethical principles. The third area, called 'Better society', involves tasks such as improvements in the supply-chain. Sundström stressed that Electrolux makes an assessment of which rating institutes with whom they choose to engage. He then presented how they prepare their Robesco Sustainability Report. This work involves a coordinator working full time for a month, with the additional support of 25 other staff. Their work starts in April, when Robesco presents the areas to be included in the report, and ends in December with the final analysis. Many companies give up on ratings and indexes, considering the work to involve too many resources. Another problem is that you get very little feedback from the rating agencies. To obtain information, you need to pay for it. We do not pay. However, this information could be used for benchmarking purposes.

Overall, Sundström thinks that ratings are good, although he admitted that they do not know how much 'value' it adds to be included in these indexes. Do the financial markets use the indexes? Is this information used in the valuation of a company? Sundström continued his presentation by explaining that the main driver for Electrolux to participate in ratings and indexes is not the potential impact it will have on investors and their investment decisions. Instead, they use the ratings results to develop the sustainable agenda for the company. In this context, the ratings and indexes play an important role by providing relevant input, not least in terms of materiality. Hereby, an effective sustainability agenda can be developed that demonstrates sustainability leadership for their shareholders.

Panel discussion and dialogue with the audience

In the panel discussion, Anita Lindberg from the Swedish Forum for Sustainable Investments raised questions about the available data, the paradigm shift, how investors work with climate and stakeholder engagement.

The first question focused on available data. Hassel pointed out that data quality has improved considerably. Today, there is available corporate data over time. This is important, since academic research is based upon historical data. With longitudinal corporate data, we can understand the historical development in the company and then try to build trends and scenarios into the future.

On the question of paradigm shift, Svensson stressed that she believed that a paradigm shift is taking place regarding the importance of sustainable leadership for sustainable finance. Iverfeldt thought that ratings can be driven in different ways. The challenge is to deal with all the available information you can value and how you interpret values. He added that you have to push for better data as well as new information. Finally, he pointed out that sustainability is for him a process. SDG is also a process.

The third question in the panel discussion focused on investors' work related to climate. Lundkvist pointed out that there is a political risk, since investors work with long term decisions. Lundkvist hoped to see activists focus more on social and environmental risks and not only governance risks. Henningsson argued that if we want to change investment behaviours in society, we need to motivate capitalists to make more sustainable investments. He saw a need to push for changes by new regulations. In addition, Iverfeldt and Svensson agreed on the importance of climate. As laudable initiatives, they mentioned climate law and Blue Bond.

The panel discussed the importance of stakeholder engagement. All the speakers agreed that it is vital to engage in an active, on-going dialogue with their main stakeholders. Stakeholder-identification analysis was also raised as a challenging area.

A person from the audience brought up the absence of the Carbon Disclosure Project (CDP) in the panel. This person also agreed with Hassel's question about what is integrated reporting. Hassel continued the discussion, saying that we are starting to see integrated reporting at the firm level. How this integrated reporting is used among investors, however, remains unclear. What are we doing when we integrate? He claimed that there is too little research on integrated reporting. Lundkvist finished

the discussion, pointing out that integrating sustainability in businesses and in the valuation process is both a challenge and a learning process.

The audience continued to focus on integrated reporting. It was argued that there is a need for case studies, where researchers go into the firms and examine if and how sustainability has been integrated into companies. Another question from the audience focused on how firms prioritize the SDGs. Iverfeldt explained that at Mistra, they focus on all SDGs but in different ways. Lundkvist seconded this point.

Summing up: Challenges and future knowledge needs

The key challenges and future knowledge-needs covered in this session include:

- The scattered reporting landscape, including a mix of voluntary frameworks, guidelines and standards, adds to a complexity for the actors on the financial markets when it comes to understanding, assessing and comparing information related to corporate sustainability performance;
- The lack of clear definitions of sustainability and sustainability risks needs to be addressed promptly;
- Establish a generally accepted reporting framework that integrates both non-financial and financial information;
- Establishing routines for how to integrate sustainability aspects into the corporate valuation process;
- Establish how the SDGs can be integrated into the corporate-valuation process from both an impact and risk perspective;
- Developing quantitative measures of sustainability (KPIs) that will be optimal for assessing and comparing sustainability performance between companies and industries;
- Determining the relation between 'sustainable' companies and their corporate risk and rate of return;
- Consider how regulation can assist in the process of integrating sustainability into the routines and processes on the financial markets;
- Prioritize active stewardship and continuous dialogue between investors and management teams in the quest for safeguarding sustainability perspectives.

Suggestions for interdisciplinary projects

The interest in valuation of investments from a sustainability perspective has increased during recent decades among management teams, actors on the financial markets and researchers. This tendency was strongly manifested in the presentations and discussions on this theme. It was also clear from the discussions that there are several challenges related to integrating sustainability with financial-market perspectives. These challenges need to be given research attention. As pointed out earlier in this Conference Report, there is a need to unpack the conceptual ambiguity related to sustainability. In doing so, it is vital to include both performance and risk perspectives.

A challenge for future research is to develop valuation models that can effectively integrate sustainability perspectives. To accomplish this task, a more direct research focus is needed in order to establish quantitative measures of sustainability performance that are value-relevant, credible and comparable between companies and industries. Determining sustainability performance is vital from both a management and financial-market perspective. Considering the multidimensional nature of sustainability (e.g. environmental, social and economic), these studies need to adopt interdisciplinary and multidimensional approaches. In future studies, we need to focus not only on sustainability *performance* but on sustainability *risks*. Research resources need to be directed towards establishing which kind of sustainability risks are present in companies. How should these sustainability risks be categorized? How do they relate to existing corporate risks and how should they be assessed and integrated in risk management programmes and valuation models?

There appears to be a consensus among the speakers about the *value* of being sustainable. However, the ongoing debate on whether there is a positive, negative or non-existing relationship between sustainability performance and economic performance has not been resolved. We need studies aimed at determining the longitudinal relation between being a 'sustainable' company, corporate risk and rate of return. Pursuing such studies will enable us to build models for future scenarios incorporating different levels corporate sustainability.

