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Pillar G In ESG And Investment Decision Making Process

ESG & Sustainability Transformation

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Of the three E-S-G factors, Governance (G) is the factor most commonly considered by traditional investment analysts. A 2017 CFA Institute ESG survey found that 67% of global respondents considered Governance in their investment analysis and decision-making (up from 64% in 2014), ahead of Environmental (E) and Social (S) factors (both at 54%). In the EMEA region, the number of analysts indicating that they considered Governance was 74%.

The preference for Governance is justified. Academic research shows that of the three E-S-G factors, Governance has the clearest link to financial performance. Friede, Busch, and Bassen's 2015 meta-analysis of ESG and financial performance notes that:

• 62% of the studies they reviewed found a positive correlation between Governance and corporate financial performance; and

• 58% of the Environmental studies and 55% of the Social studies found a similar correlation.

Similarly, in mid-2016, a UK investment management organisation estimated that companies with good or improving governance tended to outperform companies with poor or deteriorating governance by an average of 30 basis points per month over the previous seven years. Environmental and Social factors also appear to guide investors towards better-performing companies and away from poor-performing ones, but the dispersion in performance is about half as large.

Good governance is fundamental to corporate performance, both in terms of creating long-term shareholder value and creating wider prosperity for society and all its stakeholders. If a company provides good governance, it is more likely to approach environmental and social issues with a sound, long-term mindset and thus avoid significant risks, or manage effectively and seize the opportunities associated with them. Governance failures can be devastating to shareholders and other capital providers. The description of board failures in the case of Enron (where the company's market value fell from $60 billion in December 2000 to zero in October 2001) is seen in the following excerpt from the Special Commission Report:

The oversight of related-party transactions by Enron's board of directors and management failed for a number of reasons. As a threshold issue, in our opinion, the very concept of Related Party Transactions at this level with the CFO was flawed. The board had put in place numerous controls, but the controls were inadequate and were not fully implemented. Certain senior members of management failed to exercise adequate oversight and failed to respond adequately when issues arose that required a robust response. The board assigned the Audit and Compliance Committee an extensive mandate to review the transactions, but the committee performed only cursory reviews. The board was denied material information that could have prompted action, but the board also failed to fully appreciate the significance of certain specific information that came before it. Enron's external auditors were said to have examined Enron's internal controls but failed to identify or bring to the Audit Committee deficiencies in their implementation.

Governance matters because the wrong people – or not enough of the right people – around the board table are less likely to make the best decisions, leading to significant

value erosion and failure to address key risks, including environmental and social issues. And if the interests of management and shareholders are not aligned, there is also a risk of value erosion for stakeholders more generally.

Companies with poor governance therefore risk destroying value or at least adding less value than they otherwise would have. These issues are as true for private companies as they are for public companies: Governance, good or bad, is not exclusive to public companies or the exclusive concern of listed equity investors. Governance is also an issue in private equity investments and infrastructure vehicles (including public finance initiatives), where value can be easily lost. The foundation for understanding good governance — accountability and alignment, with Governance, at its heart, about people (enabling the board to have the right mix of skills and experience and a range of perspectives in the boardroom) — can be applied to any situation.

Some would argue that governance is less of an issue in private equity investments because investors are directly represented on the board, and the same is often true in many infrastructure vehicles. While this reduces the risk of miscommunication and lack of feedback, it does not in itself eliminate all governance risks. Indeed, given the highly indebted nature of many such investments, the margin for error is not always large, and so failure can be rapid when it occurs, often overwhelming even more nimble governance structures. Certainly, as the following case studies (of Theranos, Uber, and WeWork) demonstrate, there are significant risks to consider from governance failures in private companies.

Case Studies:

Theranos Board of Directors

In 2014, around the time Theranos raised money from private investors at a valuation that confirmed it was — at least temporarily — a so-called unicorn (a private company valued at more than $1 billion), the company that claimed to be reinventing blood testing with proprietary technology, had the following board of directors:

• Elizabeth Holmes, 30 — founder, CEO, and chair

• Sunny Balwani, 48 — president and COO (former software engineer)

• Riley Bechtel, 62 — chairman of the board of construction company Bechtel Group

• William Frist, 62 — former heart and lung transplant surgeon before becoming a U.S. senator

• Henry Kissinger, 90 — former U.S. Secretary of State

• Richard Kovacevich, 70 — former CEO of Wells Fargo

• James Mattis, 63 — retired U.S. Marine Corps general retired

• Sam Nunn, 75 - former US Senator and Chairman of the Senate Armed Services Committee

• William Perry, 86 - former US Secretary of Defense

• Gary Roughead, 61 - retired US Navy Admiral

• George Shultz, 93 - former US Secretary of State

Overseeing a company that innovates blood testing technology is therefore a board whose non-executive directors are all male, mostly with military or foreign service backgrounds rather than medical or scientific experience, and with an average age of 73 (excluding the two executive directors). There are more former secretaries of state in their 90s on the board than those with medical training. None have any expertise, or even basic experience, in blood testing.

The level of oversight provided by the board and its activities has always been limited, and its influence is further hampered by the company's dual-class share structure, which sees the founders hold 99% of the voting rights. In addition, the board appears to have met infrequently, and some directors have poor attendance rates. All of this suggests that the board has not been as effective as it could be. Perhaps that is not surprising. Wall Street Journal investigative reporter John Carreyrou, in his seminal report on the Theranos story, Bad Blood, noted that Elizabeth Holmes told a job interviewer at the company in 2011: "The board is just a bunch of placeholders. I make all the decisions here."

Ultimately, all $700 million invested in the company was lost (along with a largely theoretical valuation of $10 billion) when it was revealed that the company had falsified test results and misled investors about the nature and effectiveness of its technology.

Uber, công ty công nghệ mạng lưới giao thông, cảm thấy có nghĩa vụ phải thay đổi các hoạt động Quản trị của mình sau một loạt các vụ bê bối gây thiệt hại đang ảnh hưởng đến sự tăng trưởng của nó. Trách nhiệm của CEO sáng lập đã được phân bổ lại, quyền biểu quyết ưu đãi được điều chỉnh và tính độc lập của HĐQT được tăng cường.

In retrospect, many of the red flags on the Theranos board indicate that something was amiss—at the very least, the board could have been better designed to effectively oversee an early-stage, high-risk technology company with unproven leadership. The red flags on other boards may be less obvious, but the two key questions investors will always need to ask are:

a) Is there the right mix of skills and experience, and enough of the right skills and experience, to properly oversee the next stage of the company's development? If there are obvious gaps, investors need to consider how those gaps can best be filled.

b) Are there the right dynamics around the board table to allow the views of appropriately skilled board members to be heard? This question is about behaviors, which are certainly harder to determine from the outside; however, there are often signs that the board dynamics are not as effective as they could be.

Theranos is not the only unicorn to face governance challenges that have impacted its valuation.

Uber, the transportation network technology company, felt compelled to overhaul its governance practices after a series of damaging scandals that were hampering its growth. The founding CEO's responsibilities were redistributed, preferential voting rights were adjusted, and the independence of the board was strengthened.

In 2019, WeWork was forced to abandon its initial public offering (IPO) plans—and its valuation fell sharply from its projected market capitalization when it listed—as investors balked at the company's approach to a number of governance issues, including the founding CEO's dominant decision-making position (which would persist even after his death, when his wife was given the power to select a successor) and the arrangements with the CEO.

While these governance issues were resolved in the later stages of the planned IPO, they were enough to raise broader questions in investors' minds, including significant questions about its business model and the lack of a clear path to profitability. In a Financial Times article about the company's collapse, a financial advisor who was particularly insightful about corporate governance and the CEO's management style said, "How do you go from being successful by not listening to being successful by listening?"

Few corporate governance failures have been as devastatingly value-destroying as Theranos and WeWork, and few boards have been as lacking in diversity and relevant skill sets as Theranos' board. There is good evidence in the academic literature of the beneficial effects of diversity. A 2003 study by Carter, Simkins, and Simpson of Fortune 1000 companies found a statistically significant positive relationship between the presence of women or minorities on boards and firm value, as measured by the Tobin question (a valuation measure based on the ratio of a company's market value to the replacement cost of its assets). A 2017 study by Bernile, Bhagwat, and Yonker concluded that board diversity reduces stock return volatility (consistent with diversity acting as a governance mechanism) and that companies with diverse boards tend to adopt more stable and resilient policies (consistent with less idiosyncratic board decisions). Additionally, while diverse boards are less financially risky, "this behavior does not translate into actual risk-taking activities," with diverse boards investing more in research and development (R&D). Overall, their research found that greater heterogeneity among directors on boards leads to higher returns and higher firm valuations.

Governance failures lead to fines and additional liabilities, as well as litigation and other costs. Revenues fall as confidence erodes and customers boycott the company or buy from competitors, and profits fall as additional costs are imposed to mitigate future risks. All of these effects are detrimental to stock prices. Management analysis should be a core component of valuation practice.

Integrating Governance into the Investment and Stewardship Process:

Different fund managers integrate Governance elements into their investment decision-making in different ways. For many, it is a threshold assessment – a formal minimum criterion to consider before they consider an investment at any price. Often it is referred to as management quality, although despite the name, it is never simply an assessment of the CEO and CFO but of the entire Governance team and structure that oversees the company and (hopefully) drives the success of the business.

For others, it is a risk assessment tool, which may represent a level of confidence in future earnings or the multiple at which those earnings are placed in the valuation, or it may be reflected less in full financial models and more in a simple level of confidence in the valuation range or investment thesis.

If corporate governance analysis is specifically built into valuation models, this is often done by recognizing negative governance characteristics by adding a risk premium to the cost of capital or increasing the discount rate applied. Others see poor governance as an opportunity to engage and invest—the logic being that governance can be improved through active dialogue with management and proxy voting, so that past underperformance, for which the company is currently priced in the market, is reversed and valuation can be enhanced by stronger performance and expectations of more positive future performance, which benefits investors.

Many elements of Governance lend themselves to stewardship dialogue with companies, not least because many of these issues will be addressed directly on the agenda of the Annual General Meeting (AGM). Investors will have an obligation to take a stand on these issues (which is why, for many investors, Governance has a longer legacy than Environmental and Social issues in ESG – not least because in many markets the obligation to consider positive voting decisions is well established). In most markets, investors will be faced with voting decisions on at least the following on an annual AGM:

- Adoption of the Report and Accounts;
- Appointment of the board of directors;
- Appointment of auditors, and possibly their fees; and
- Executive remuneration.

There is therefore a natural, at least annual, incentive to engage on these issues – although investors increasingly prefer to avoid the nitty gritty of all such discussions during the AGM season (which is largely April to June in the Northern Hemisphere (e.g. Vietnam), July in Japan and September to November in the Southern Hemisphere). To avoid this, dialogue is held throughout the year, with the conclusions reached in the dialogue reflected in the AGM voting.

To date, although many may view corporate governance as a particular issue for listed equity investments, in reality many investments across asset classes are embedded in corporate structures in one form or another. Therefore, corporate governance concerns will be relevant to a wide range of investments, including, for example, fixed income (e.g. bonds), private equity, real estate and infrastructure.

Our aim in this article is to discuss corporate governance at a level where its relevance across this broad range of asset classes is clear and the analysis can be applied and adapted as appropriate.

However, there is one asset class where the G pillar of E-S-G will always have a very different meaning. In the sovereign debt sector, including local government debt, G stands for Governance and the strength of the government and its institutions, the rule of law approach and the General Business Environment (including issues such as competition and anti-corruption). In practice, the concern is to ensure that the economy can prosper through Good Governance, so that sovereign debt obligations can continue to be met. ESG-minded investors are increasingly integrating analysis of these issues into their broader financial analysis of sovereign debt.

To learn more about ESG and sustainability-related models, please contact **YTT Consulting**!