Missing Metrics that Matter to Investors: How Companies Can Develop ESG Financial Value Creation Metrics

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Abstract

Investment in companies that leverage superior environmental, social, and governance (ESG) performance to enhance financial results would increase if mainstream investors could discern whether companies' ESG strategies help, hurt, or have minimal impact on financial performance. We propose ESG value creation metrics that indicate the impacts of a company's ESG strategy on line items in its financial statements, and thus the strategy's impacts on earnings, cash flow, and value. By clarifying the causal connection between a company's ESG and financial performance, ESG value creation metrics provide investors, senior executives, directors, and other decisionmakers with better information about how much value a company's ESG strategy creates. We also propose a three-step process through which companies can design an effective ESG strategy and value creation metrics.

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Introduction

Environmental, social, and governance (ESG) investing has become an important strategic concern among investors, corporate executives, and boards. While formal estimates vary, the size of the ESG investment market probably falls between three and 22 percent of assets under management (Lubin & Esty, 2014; Lubin & Krosinsky, 2013; Voorhes & Humphreys, 2017). This figure depends on the definition of ESG that is used (see Eccles & Kastrapeli, 2017 for a typology of ESG investing definitions). Growing investor demand and changes in client demographics suggest greater future attention to ESG. In a recent survey, 85% of professional asset managers who considered ESG in their investment analysis and portfolio construction had done so in response to client demand (Voorhes & Humphreys, 2017). Millennials, who are twice as likely to seek investments consistent with their environmental and social values (Morgan Stanley, 2017), will fuel the ESG investing market as they age and accumulate wealth.

As the ESG investment market has grown, the focus has shifted away from investors who screen companies to align with their moral values, even at the expense of potential returns, and toward investors seeking ESG-conscious investments that don't sacrifice financial returns. Between 2014 and 2016, investments that explicitly considered ESG opportunities and risks in their decision-making process grew by 23% per year, while investments that merely screened on ESG criteria declined by 20% per year (Global Sustainable Investment Alliance, 2017). The future is one in which investors will increasingly allocate capital toward companies that demonstrate strong ESG practices linked to increased financial returns.

Professional investors have already begun to adjust to these trends and many indicate that they intend to in the future. While only 16% of North American institutional asset managers have a specific ESG allocation, 52% expected ESG considerations to become a bigger investment priority within the next three years, according to a 2016 study by the asset management firm AB (Giuliano, 2016). When asked what would accelerate their consideration of ESG factors, 68% wanted a "demonstrated link between ESG and financial performance." In other words, the dearth of quality information about causal connections between ESG and financial performance is restricting both the flow of capital into companies that leverage ESG activities to increase their value and the rate of ESG investment growth.

There appears to be no shortage of data measuring companies' ESG performance. An industry of NGOs and commercial data services produces an array of measures across a range of ESG domains (Esty & Cort, 2017). Governance metrics address how the company's board oversees management, strategy, and risk, as well as management's control over the business and relationships with its stakeholders. For the most part, traditional social and environmental metrics are designed to measure the societal value – beyond economic growth and jobs – that companies produce. However, traditional ESG metrics are less useful for investors whose primary need is to determine if a company's ESG performance increases, decreases, or has minimal impact on its current and future financial performance. Although companies' senior executives are in the best position to evaluate the strategic importance of ESG activities and produce credible metrics that indicate their connection to financial performance, few are currently doing so. A 2017 global study indicates that 92% of investors "want companies to identify and report on the material ESG issues they believe affect financial performance" (Eccles & Kastrapeli, 2017).

We propose guidelines to help companies design financially relevant ESG metrics; that is, a small number of meaningful measures that signal to investors how a company's ESG strategy affects its financial performance. From this foundation, investors can evaluate opportunities and compare companies. By clarifying the causal connection between a company's ESG strategy and its financial performance, ESG value creation metrics serve to improve the efficiency of resource flows. They provide investors, senior executives, board members, and other decision-makers with better information about how much value a company's ESG practices create. By bringing ESG metrics to the attention of senior executives and directors, and by integrating expertise from across and beyond the company to define accretive ESG strategies, the metrics development process may reveal new pathways to enhance financial performance.

The Need for ESG Value Creation Metrics

Companies' ESG strategies have the potential to improve or harm their financial performance depending on factors like management quality and strategy and operational, industry, and institutional context (Esty & Cort, 2017; Khan, Serafeim, & Yoon, 2016). Some academic research finds that ESG performance is positively correlated with financial performance, perhaps through superior management skills (Orlitzky, Schmidt, & Rynes, 2003) or more proactive risk management (Godfrey, Merrill, & Hansen, 2009). Anecdotally, research shows cases where companies strategically leverage their ESG performance to increase financial returns (see Reinhardt, 2000). More recent research suggests that companies' superior ESG performance can generate financial value under certain circumstances, but a host of confounding factors prevents clear conclusions (Endrikat, Guenther, & Hoppe, 2014). Of course, stronger ESG performance does not always produce financial results, and recent investment industry studies have shown little to no difference in risk-weighted returns between ESG-weighted and traditional portfolios (O'Brien, Liao, & Campagna, 2017).

A Brief History of ESG Metrics

ESG metrics have proliferated over the past several decades (Eccles, Serafeim, & Krzus, 2011). ESG measures gained international prominence in the 1960s and 1970s, as NGOs and social activists highlighted perceived corporate ESG failures. This raised awareness of social and environmental issues and pressured companies to improve performance in these areas. To protect their reputations, some companies reacted by putting in place ESG activities that addressed activist concerns, providing ESG metrics to signal performance improvements. As interest grew among NGOs, activists, and even governments, companies expanded the scope of their ESG activities and metrics.

Over time, some mainstream investors began to perceive that better ESG performance signals lower-risk investments (Ioannou & Serafeim, 2015). Some company executives also realized that applying an ESG lens across their operations and industry value chains could help them identify and capture value. Investment advisory organizations began to produce more comprehensive ESG metrics for the mainstream investor community. These wide-ranging ESG measures were, and are, constructed from many sources, including corporate disclosures, government data, media reports, NGO analyses, and correspondence with company management. Meanwhile, more companies have been producing their own ESG reports, increasingly guided by standardization initiatives such as the Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), and International Integrated Reporting Council (IIRC). These initiatives seek to improve comparability of traditional ESG factors across firms and identify which have the greatest financial impact within industries. On the whole, however, today's metrics were designed to measure externalities – the impact of companies' ESG activities on society at large.

The Current Landscape

How mainstream investors currently use ESG metrics reflects this history. For the most part, ESG activities are perceived as a way to protect company value. Mainstream investors have primarily used ESG metrics as indicators of risk, highlighting governance weaknesses and the potential environmental and social controversies that can arise from governance failures (Khan et al., 2016). Because they were not designed to measure financial value, ESG metrics have proven ill-suited to helping investors discern the financial impact of companies' ESG performance (Esty & Cort, 2017).

Absent compelling evidence to the contrary, many investors are skeptical of the potential value and strategic importance of companies' ESG activities, which appear peripheral to core business operations and strategy. Meanwhile, the costs of a company's ESG practices are often readily apparent to outside observers; potential financial benefits tend to be less obvious. The result is that investors who primarily seek to maximize financial returns, but would consider ESG performance if they could, face a situation akin to a "lemons market" (Akerlof, 1970): the seller is more informed about the quality of a product than potential buyers. Without credible verification of the seller's claims on the attributes that matter to the buyer, the buyer is reluctant to make a purchase, fearing that the product touted as high-quality is in fact low-quality. Likewise, when investors cannot distinguish which companies use their ESG practices to create value, they are unable to incorporate a company's ESG performance into their investment decision-making processes. Thus, investors who would prefer to invest in ESG-conscious companies, all other things equal, are unable to do so because they cannot discern if ESG practices will help, hurt, or have minimal impact on their financial performance.

A Solution in Better Data

Better data can solve this lemons-market problem. Certificates of authenticity allow antique collectors to purchase with greater confidence; taster ratings help wine enthusiasts anticipate the quality of a bottle before they buy. In the same way, credible metrics that reflect how a company's ESG activities contribute to financial value can help mainstream investors identify those companies that fall within their investment mandates. Such metrics can unlock pent-up investor demand for ESG-conscious investments that do not sacrifice, and indeed increase, financial performance.

Mainstream investors want ESG metrics suited to investment decision-making purposes. To be useful to investors, metrics must be specific to the company under consideration and present a causal, predictive, and transparent connection between ESG performance and financial performance. Thus, they must be carefully attuned to measure what matters within the context of each company's unique business strategy, customer value proposition, industry and market dynamics, competitive positioning, and core competencies. Finally, metrics must move towards standardization and be amenable to integration into investors' proprietary analytical models to allow comparison across companies and within companies over time. What companies need is better guidance on how to produce credible ESG metrics that investors can use.

ESG Value Creation Metrics

To help investors identify companies executing ESG strategies that create financial and broader societal value, we propose an investor-oriented conceptual framework and methodology for producing company-specific ESG value creation metrics. As the name implies, ESG value creation metrics measure the contribution of a company's ESG strategy to its financial value; they identify the causal links between ESG and financial performance.

Investors can use ESG value creation metrics to evaluate which companies are executing ESG strategies that enhance financial performance, while companies can use them to more credibly communicate the financial value of their ESG strategies. Finally, the process of designing these metrics helps guide senior executives toward a more strategic approach to ESG value creation; it provides them with practical tools to set goals, define the combined ESG and business initiatives required to achieve them, and monitor and manage their companies' ESG and financial performance.

To be useful to the investment community, the measures we propose are grounded in the terminology, tools, and processes used by asset managers in their decision making, particularly those routinely used when analyzing companies' standard financial statements. This means focusing ESG metrics around activities that impact earnings (Lubin & Esty, 2014; Lubin & Krosinsky, 2013) and cash flow. In some cases, value-creating activities have a clear and direct causal link to earnings and cash flows. For example, an increase in sales generated by acquiring new customers is captured directly by the revenue line of the financial statements. In other cases, the mechanism by which an activity drives value is less direct and more difficult to measure. In labor-intensive industries, the energy and commitment employees bring to their work can be an important labor-cost driver, even if causal effects on value may not appear on the surface to be directly linked to financial results. Implementing a system of metrics for both the direct and indirect drivers of value can make cash flow forecasts more precise and allow senior executives to forecast the financial impact of new activities whose value might otherwise be difficult to evaluate. Robert Kaplan and David Norton's *Balanced Scorecard* (1996) presents a comprehensive and systematic strategy for identifying value drivers, implementing programs to improve them, and establishing metrics to track and manage them for success.

ESG value creation metrics track how a company's ESG strategy impacts drivers of cash flows, in particular by measuring the associated direct and indirect impact on revenue and cost. A company's ability to generate financial returns from its ESG strategy hinges on how well it advances the company's strategic and financial objectives. For example, a U.S. based food-products company whose growth strategy revolves around penetrating the European food service market may choose a non-GMO sourcing strategy to help it grow revenue. This same strategy of procuring potentially higher cost non-GMO ingredients may be revenue neutral for a company with a growth strategy focused on emerging markets, and therefore detrimental to cash flow and value creation.

Tracking direct and indirect indicators that contribute to financial returns over time is particularly useful for demonstrating causal impacts. When properly designed and implemented, these ESG value creation metrics can be used to quantify the impact of the of a company's ESG strategy on its intrinsic value.

We propose a three-step process for designing value creation metrics around those activities that maximize the strategic and financial returns of ESG investments. This process can be incorporated into ongoing business strategy, financial planning and reporting, and performance management processes. Required for implementation are: senior executive leadership with the strategic perspective and stature to execute company-wide initiatives; a cross-functional team that integrates a range of financial and operating experience; and the necessary oversight required for material information disclosures. Inputs to this process must come from across the company because ESG value may be generated in multiple areas of the business. Input should also come from outside the company because identification of some ESG value creation opportunities require perspectives from beyond the company.

Step 1: Identifying Company ESG Strategy As a Source of Value Creation

The first step is to develop an ESG strategy that identifies value creating opportunities, upside potential, and downside risks across the entirety of the company's operations and industry value chain (Lubin & Krosinsky, 2013). An effective ESG value creation strategy articulates the prioritized set of integrated ESG and core business activities, tailored to the company's unique business objectives and circumstances, that have the greatest potential to increase value through revenue growth, sustained cost reduction, and increased productivity (Lubin & Esty, 2014). The ESG strategy then lays out specific goals and milestones, along with the interlinked ESG and business initiatives, timeline, and responsibilities required to achieve them. An ESG strategy to expand sales per customer, increase customer retention, and capture price premia for differentiated goods may focus on environmental and social attributes that matter most to current and potential customers. In manufacturing industries, an ESG strategy that increases value through procurement cost-savings may favor ESG activities that increase efficiency and reduce waste. In service industries, an ESG strategy focused on energy efficiency in office buildings may have minimal financial impact.

Step 2: Quantifying Operational Value Outcomes

The second step follows processes similar to those that corporate finance departments use to allocate capital, corporate strategy departments use to evaluate new businesses, and some investors use to value companies. It also may serve as a mechanism to identify the granular components of ESG value that map to emerging SASB guidelines (SASB, 2017) and the United Nations Principles of Responsible Investing investor communications toolkit (Lubin & Krosinsky, 2013).

The process identifies the direct and indirect mechanisms by which the major initiatives encompassed by a company's ESG strategy create financial value. It pinpoints the pathway by which each initiative moves a driver of cash flow, and then measures that change. This process systematically identifies the impact on each line item of the forecasted financial statements that, in aggregate, drive operating cash flows and intrinsic value, starting with revenue and moving through the income statement, balance sheet, and statement of cash flows. The process of developing ESG value creation metrics can identify new or under-recognized sources of value and enable deeper insight into risk management. The measures may also be subjected to best practice quantitative and qualitative scenario planning and sensitivity testing to estimate potentially material upside and downside risks to earnings, cash flows, and value.

ESG value creation metrics must be measureable in practice and mindful of implementation factors, such as possible process and information technology changes, employee time, and expense. In some cases, proxy measures may be more practical. While time-series metrics are often helpful for estimating cause and effect, surveys and qualitative data, from focus groups say, can also provide predictive value.

A few simple examples can illustrate how ESG value creation metrics connect to companies' financial statements at the operational level:

- A company looking to increase revenue might target consumers who consider ESG performance as a purchasing differentiator. A direct revenue metric for this strategy might assess the size and amount of ESG-conscious customer purchases before and after a sustained marketing and brand-building effort. Indirect metrics could assess these customers' attitudes toward the company and their purchasing plans.
- Another ESG strategy could look to lower the cost of goods sold by improving visibility, control, and collaboration within a supply chain. Measurement of lower input costs would be relatively straightforward.

- Finally, an ESG strategy might reduce selling, general, and administrative expenses by encouraging video conferencing to reduce greenhouse gas emissions. A metric for this program could assess employee travel and entertainment expenses for company meetings.

Step 3: Selecting ESG Value Creation Metrics

The third step is for senior executives to identify and sum up the value indicated by all operating level ESG metrics; evaluate the ESG strategy's aggregate effect on financial performance; and decide which small number of meaningful metrics, if any, to disclose. These few metrics should aim to convey the overall impact of the company's ESG strategy on financial performance and health, such as those that signal the contribution of ESG to revenue growth rate and margin expansion (Lubin & Esty, 2014; Lubin & Krosinsky, 2013) and the primary initiatives that drive that impact. While these factors differ between industries and by company, metrics should be built up in a granular manner and designed with an eye toward standardization and comparability. Finally, the selected metrics should be structured to fit the company's senior executive responsibilities, governance obligations, and the legal ramifications of disclosure.

ESG value creation metrics can help improve forecasts for financial statement line items and provide additional perspective on the health of the company. Because these adjustments flow through to financial ratios such as gross, operating, and net income margins, earnings growth rates, and return on capital employed, they can help investors differentiate a company that has implemented a value creating ESG strategy from comparable companies that haven't.

To illustrate ESG value creation metrics, and our framework for developing them, we describe how a major retail clothing company may construct them. The company seeks to increase financial performance primarily by acquiring new customers and reducing high employee turnover. Its ESG strategy advances these goals with an initiative designed to increase workforce engagement and simultaneously equip employees to attract new customers. The initiative provides opportunities for employees to participate in ESG activities carefully selected to resonate most with the company's customers and employees, such as ensuring ethical working conditions in the supply chain, using environmentally friendly raw materials, and promoting workplace recycling.

The company designs the employee engagement program to produce two main causal pathways to financial value. First, it seeks to increase revenue by attracting customers who prefer to purchase from ESG-conscious companies. Employees who personally participate in the company's ESG programs are likely to demonstrate conviction in the company's ESG accomplishments, and thus convey credibility to potential customers. Second, encouraging employees to participate in workplace activities that align with their own values and having coworkers, managers, and senior executives participate along with them is expected to improve employees' pride in and commitment to their company. More engaged employees can lower labor costs through improved recruitment, retention, and productivity (Harter, Schmidt, & Hayes, 2002). This is particularly valuable in an industry with high labor costs and turnover rates.

Table 1 illustrates a potential approach to measure the value created by some elements of the clothing retailer's employee engagement initiative. The first column provides examples of line items from the company's profit and loss statement that drive earnings and cash. In practice, these can be broken into more specific line items, such as costs of labor or talent acquisition. The second and third columns represent the driver of the financial line item that the ESG strategy changes, and the mechanisms that cause that change. The last column provides potential ESG value creation metrics that the clothing retailer could implement at the operational level for its ESG workforce engagement initiative. Note the intent of this proposed class of value creation metrics is to complement metrics that capture the broader societal benefits of the company's ESG initiatives. (While such benefits can be important, approaches to measuring and reporting them have been developed elsewhere, as discussed above).

Table 1: Operational ESG Value Creation Metrics at a Clothing Retailer

Driver of increased earnings, cash flow and value	**Driver of financial statement line item**	**ESG causal impact on driver of financial statement line item**	**Operational ESG value creation metrics**
Increased revenue	Increased number of customers	Increased customer awareness of company's ESG leadership Increased front-line sales personnel promoting company's ESG accomplishments	Number of new customers citing company's ESG leadership for making purchase (customer surveys) Frequency and level of employee comfort discussing company's ESG accomplishments with potential customers (employee surveys)
Reduced costs	Reduced cost of employee turnover	Reduced turnover rate of ESG engaged workforce	ESG-engaged employee turnover rate versus average (employee surveys) Level of workforce pride, commitment to company, and job satisfaction due to company's ESG performance (employee surveys)

Evaluating the company's operational level metrics can help the company identify if, where, and how its ESG strategy creates value. It may choose to disclose a small number of higher-order metrics to guide investor communications, such as those that signal ESG-driven increases in operating profit margins and revenue growth (Lubin & Esty, 2014; Lubin & Krosinsky, 2013). In the case above, measures may indicate a sustained reduction in employee turnover within two to three years, which could have meaningful financial impact in an industry characterized by high turnover rates. They may also indicate competitive advantage in attracting customers, particularly millennials, who are critical to the financial performance and health of most retailers.

Conclusion

ESG value creation metrics provide evidence of the causal pathways through which companies' ESG strategies impact their financial performance. While existing metrics indicate performance along dimensions with no explicit link to financial outcomes, ESG value creation metrics are company-specific, driven by company strategy, and causally indicate future financial performance. These metrics are more credible to investors and thus help solve the lemons-market problem between investors and companies.

ESG value creation metrics are based on standard measurement approaches for showing the direct and indirect causal connections between companies' strategic programs and important cash flow drivers. Companies develop these metrics through established strategic planning processes with executive management and board oversight. ESG value creation metrics are functionally similar to other data that investors use to evaluate investment options, enabling ready integration into proprietary analytical models. Armed with ESG value creation metrics, investors can unlock capital resources otherwise sitting on the sidelines by incorporating companies' ESG strategies and associated financial impacts into their investment evaluation processes. In other words, for mainstream investors, the process for evaluating investments along ESG criteria will start to look like the process for evaluating investments along most other criteria.

Along with ESG value creation metrics, the strategic planning process for developing them can be valuable for companies. Fostering investor interest and attention in ESG as a value driver elevates ESG performance to a matter of strategic importance among senior executives and directors. Companies are more likely to systematically identify and potentially uncover unexpected sources of value. These metrics can improve the efficiency of resource flows by providing investors and senior executives better information about value created by companies' ESG strategies. In the end, by identifying the financial returns of an ESG strategy, ESG value creation metrics help investors and companies maximize both ESG and financial performance.

Mainstream investors have an important opportunity to do well by doing good. By engaging with management around ESG value creation metrics, investors encourage management to take a more strategic approach to ESG; investors, meanwhile, are able to make more informed decisions on allocating capital to those companies that are poised to produce both financial and broader societal value. And, for society at large, ESG value creation metrics, and the process for constructing them, serve to help the investor and business community expand economic prosperity, enhance corporate governance and increase positive environmental and social externalities.

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