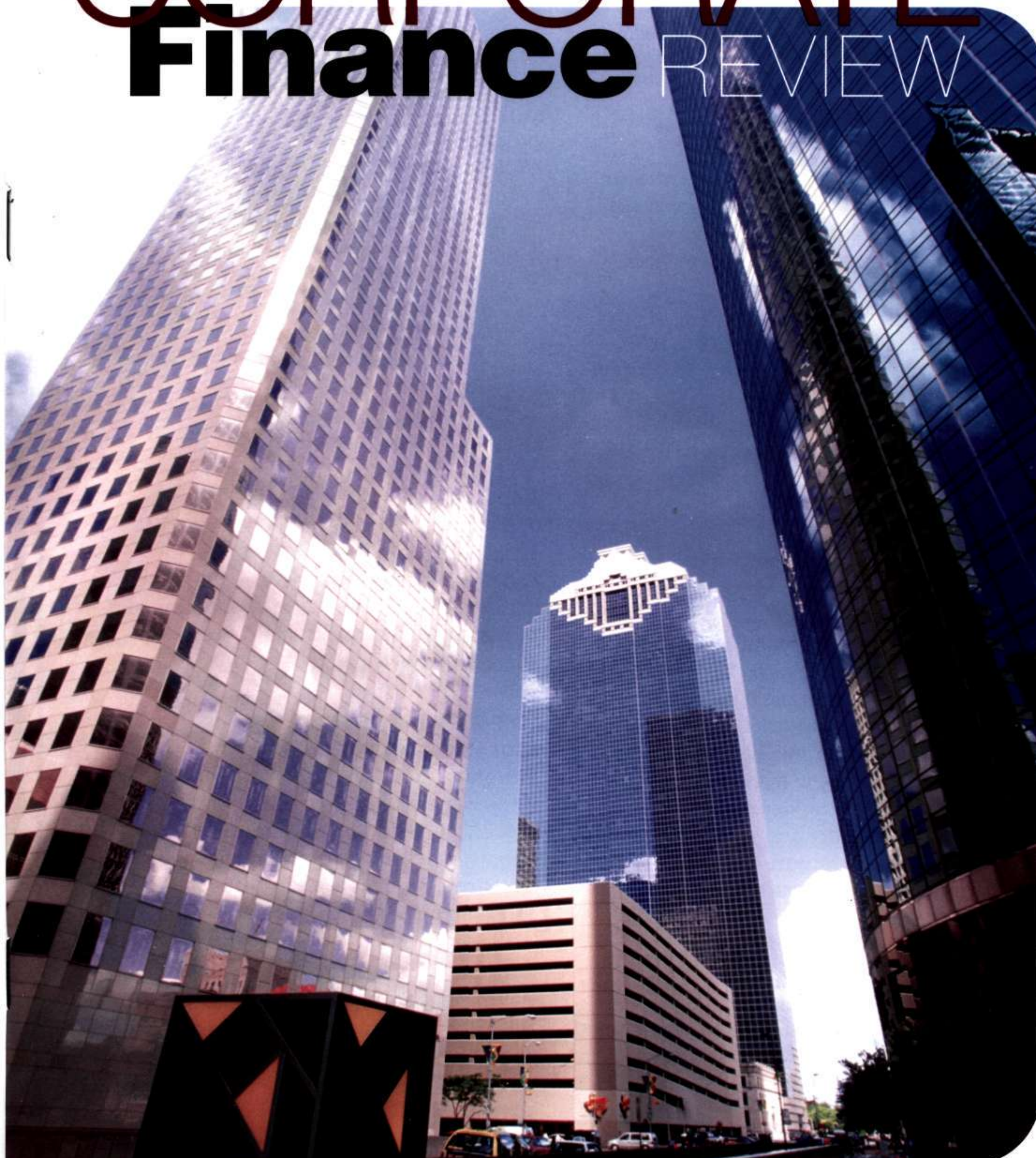
CORPORATE Finance REVIEW

September October 2007



Governance Failures:
Lessons From Recent Mergers and Acquisitions

The Importance of Environmental, Social, and Governance Factors

Corporate Portfolio Management: Capital Allocation From a Risk-Return Perspective

CORPORATE Finance REVIEW

CORPORATE FINANCE REVIEW (ISSN 1089-327X) is published bimonthly by Warren, Gorham & Lamont, Division of Thomson Tax & Accounting (TTA), 395 Hudson Street, New York, NY 10014. Subscriptions: $250.00 a year in the United States; $280.00 a year elsewhere. For subscription information, call 1 (800) 950-1216; for customer service call 1 (800) 431-9025. Foreign callers (who cannot use our toll-free numbers) should call (914) 749-5000 or fax (914) 749-5300. We encourage readers to offer comments or suggestions to improve the usefulness of future issues. Contact Scott Gates, Editor, TTA, 395 Hudson Street, New York NY 10014; (212) 337-4129.

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YOUR COMPANY'S ESG—ENVIRONMENTAL, SOCIAL, AND GOVERNANCE FACTORS ARE MATTERING MORE NOW TO INSTITUTIONAL INVESTORS

The financial executive's daily conversations are studded with abbreviations and acronyms—CEO, CFO, ROI, SEC, FASB, PCAOB, LBO, CDO, ROE, and many more. Add this to your collection: ESG. Chances are an increasing number of the investors and financial analysts on the buy-side who analyze your firm are considering or actually measuring your organization's ESG along with other factors in their buy-sell-hold decision making. It's also likely they are sharing vital ESG information about your firm with other capital-market players; if they are not, a growing army of shareholder and nonshareholder advocates certainly is spreading the word (good and bad) about your company. Coalitions of investors representing hundreds of billions of dollars in holdings have zeroed in on ESG. And it won't be long before major financial and business media begin reporting regularly on corporate ESG standings.

The definitions of ESG include the key metrics of a firm's nonfinancial performance, the many important intangibles that help make up market valuation beyond traditional financials and other quantifiable information. A company's ESG profile will include a range of executive and workforce behaviors; the track record of corporate and product/brand reputation; nature of compliance with local and national laws and the growing list of industry and sector codes of accepted behavior; the manner in which the company is governed by its board and managers; responsiveness to stakeholders; disclosure and transparency; and other elements relating to Environmental, Social, and Governance factors important to investors.

New form of American populism—but global this time

This new form of American populism is in part a definable, broad global effort to rein in corporate power, which is now firmly entrenched in boards or C-suites, along with the abuse of this power that is perceived as being damaging to the enterprise and its valuation. This "modern progressivism" includes investors' efforts to seek out investment opportunities where positive ESG factors signal future growth and to screen *in* and screen *out* companies from institutional portfolios based on various ESG criteria.

The Modern Corporation and Private Property, by Adolph Berle and Gardiner Means—the prescient analysis of the spread of the publicly held American company, written back in 1932—predicted that the benefits of power would eventually accrue mostly to the professional managers, not the shareholders. Shareowner advocates see today's abuse of power and executive privilege as something that must be dramatically pruned back to restore balance between the issuer and the enterprise's partial owners.

Progressivism redux

In some ways this twenty-first century movement resembles the great populist awakening of the last years of the nineteenth century and first decade of the twen-

HENRY"HANK" BOERNER is chairman of the Governance & Accountability Institute, Inc. (www.accountability-central.com). He recently retired from the global management consulting practice of Rowan & Blewitt, a member company of the Interpublic Group of Companies (NYSE: IPG). Mr. Boerner can be reached at hboerner@accountability-central.com.

tieth century, the start of the era's progressive movement. At the time, this movement comprised newly organized labor unions and their rank and file, immigrants, small-town merchants, and western ranchers and farmers (the majority of the United States workforce was still agrarian), all of whom organized against the "robber baron" monopolists and trusts of the era. The big corporate interests (headed by Rockefeller, Carnegie et al.) controlled the markets for oil, steel, rubber, ores, railroads, utilities, and so on. Market dominance was the way to assure future prospects for the corporate enterprise. Presidents Theodore Roosevelt and William Howard Taft, the first trustbusters, led the progressive movement to rein in and push back corporate power. There are no equivalents on the national scene today in the United States.

Today, fiduciaries, financial representatives, and social/economic justice advocates are mounting the campaigns and defining many of the parameters of ESG for Corporate America and Wall Street. Even mainstream mutual funds have been joining either the governance reform movement or social investment movement. Are these bold assertions on our part? Let's explore some powerful signals that this grassroots movement is creating new dynamics for corporate issuers in the capital markets. Corporations that respond to or meet the new demands of the marketplace appear to be in line for the investment winner's circle in the months and years ahead. But what influence do ESG factors have on shareholder value?

The assertions of Goldman Sachs

Goldman Sachs unveiled an extensive analysis of companies and sectors at the United Nations Global Compact Leaders Summit (July 2007).[1] The report included new analytical tools for picking tomorrow's capital market winners and offered a short list of mostly large-cap companies that are leaders in environmental, social, and governance policies and are leading the pack in share-price performance—by an average premium of 25%. They are also outpacing their own sectors.

Goldman Sachs researchers looked at 120 corporate ESG leaders in five mature, large-cap industries — energy, metals and mining, food and beverage, pharmaceuticals, and EU media—and found that in four of the sectors in which it published comprehensive reports in 2006-2007, certain companies outperformed the MSCI World Index by an average of 25% since August 2005; nearly three-quarters of companies on the watch list also outperformed their industry peers.

Note, however, that two other "ethical indices" that are widely used do not reflect these results: Both the FTSE4Good and Dow Jones Sustainability Index underperformed the market. Goldman Sachs points out that its proprietary research included reviews for many other factors such as competitive advantage over peers and a range of key traditional financial metrics. The investment bank's researchers also point out that socially responsible investing on its own, such as represented in the stocks in these indices, will not necessarily create greater returns than the market. There are regional differences as well in corporate behaviors and characteristics in the companies analyzed.

Introducing GS Sustain at UN summit. The GS investment bankers publicly introduced their GS Sustain focus list (of companies) at the UN summit; this initial list brings together a range of separate GS analyses of aspects of long-term "sustainability" in corporate performance. Goldman Sachs will try to identify competitive advantages in mature industries (such as steel and mining) as well as winners in emerging industries as these "evolve in response to a rapidly changing, globalizing world."[2]

Key factors for the financial executive to consider: Goldman Sachs believes that globalization and a shifting political landscape— combined with significant changes in populations, continuing urbanization, resource utilization, climate change (no matter the causes, it is here), and employee and consumer attitudes—are creating more change and more challenge for corporate managers.

The GS research effort began in 2003 in response to an invitation from a group of investors forming the Asset Management Working Group of the UN Environmental Program Finance Initiative, which represents

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GOLDMAN SACHS'S NEW ANALYTICAL TOOLS AND FOCUS LIST WILL BE USED TO PICK LONG-RUN WINNERS AND SEEK OUT EMERGENT INDUSTRIES AS CAPITAL IS ALLOCATED.

over 160 institutions with $8 billion assets. The institutional investors asked the investment bankers to identify environmental and social issues likely to be material for company competitiveness in the global energy business and to quantify the potential impact on stock price. Out of this evolved the firm's proprietary ESG framework.

The issuer and the operating environment. Consider this: Goldman Sachs's framework "reflects the fact that all companies have to interact with the four pillars of: the economy in general, their industry, society and the environment."[3] In their ESG research, Goldman Sachs factors in the following:

- A company's governance and various social issues with regard to its board and corporate leadership, workforce, and treatment of stakeholders.
- Adherence to the ten principles of the UN Global Compact[4] (including human rights, labor standards, anti-corruption, protection of the environment); 2,900 companies in 100+ countries have signed the compact.
- The company's financial performance (a range of traditional metrics).

Combined, these factors create a "good overall proxy for the management quality of companies relative to their peers and, as such, gives insight as to their ability to succeed on a sustainable basis."[5] In brief, the companies included in the GS Sustain list could be the ones to invest in for the long haul—they may be future "sustainability" winners in a crowded global field of potential investments as national boundaries continue to disappear for institutional investors.[6]

Picking winners on ESG factors. Goldman Sachs's investment bankers state that the trends now clearly identified in its landmark report will only intensify, making it "imperative that investors pinpoint sustained competitive positioning and the emergence of new entrants."[7] Capital allocation is entering a new phase if Goldman Sachs's assertions hold true. The new analytical tools and focus list will be used to pick long-run winners and seek out emergent industries as capital is allocated.

Small-cap firms are an important part of GS Sustain; the researchers identified four key areas in which there is good news for the investor:

- Alternative energy sources;
- Environmental technologies;
- Biotechnology; and
- Nutritionals.

There are forty-four companies in the initial focus list; twenty-one are large, established firms and twenty-three are emerging companies (with ratings of buy or neutral, or not rated yet). Sixty four percent are EU issuers; 25% are US; and the rest of the globe makes up 11%. The upside potential of the list appears to be about 15%.

The companies were selected for the focus list based on the key factors of cash, industry themes, and ESG. In all, says Goldman Sachs, its ESG framework uses twenty to twenty-five objective and quantifiable indicators for each sector; two-thirds of these are universal across sectors and one-third are sector-specific.[8] All corporate governance and leadership indicators are universal; stakeholder indicators are sector-specific. Each indicator is scored on a scale of 1 (worst) through 5 (best), with data coming from the issuer (70% or more response rate). Disclosure affects performance across all categories, although this varies by country and region.

The researchers say their analysis is "quantitative and consistent, but not exhaustive or prescriptive," because ESG cannot capture the full impact of the company/sector on society.[9] Most difficult to measure is a company's track record on human rights, quality of recruitment and training, management of local waste, water management, and biodiversity.

Finally, in case the above seems otherworldly, or beyond your everyday understanding of what the market now values, the GS researchers state clearly that valuation is not changing and that "cash return spreads and valuation over the past 15 years have been highly correlated, and portfolios constructed on this basis have consistently outperformed. The market rewards competitive advantage with premium valuations."[10]

As the socially responsible investment community has expanded and SRI mutual funds attract more investors, there has been a growing debate on the value of ESG factors in picking stock and shaping portfolios or investment policies. We can expect that the 179-page Goldman Sachs analysis and the availability of the GS Sustain focus list will generate more recognition of and respect for ESG factors in investment decision making—and position Goldman Sachs for leadership among investment banks as global experts in factoring ESG into corporate valuations. •

NOTES

1 "Introducing GS Sustain," published by Goldman Sachs, June 22, 2007. Available at http://www.unglobalcompact.org/docs/summit2007/gs_esg_embargoed_until030707pdf.pdf.

2 Ibid., page 1.

3 Ibid., page 5.

4 The UN Global Compact's ten principles are outlined at http://www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/index.html.

5 Op. cit. at note 1, page 5.

6 All of the methodologies used and resulting matrices and conclusions are spelled out in the report. Please see the following article discussing GS's report for more details: "Groundbreaking Studies by the United Nations, Goldman Sachs and McKinsey & Company Show Benefits of Corporate Responsibility," United Nations Global Compact, July 5, 2007: available at http://www.unglobalcompact.org/NewsAndEvents/news_archives/2007_07_05d.html.

7 Op. cit. at note 1, page 1.

8 Ibid., page 38.

9 Ibid.

10 Ibid., page 1.