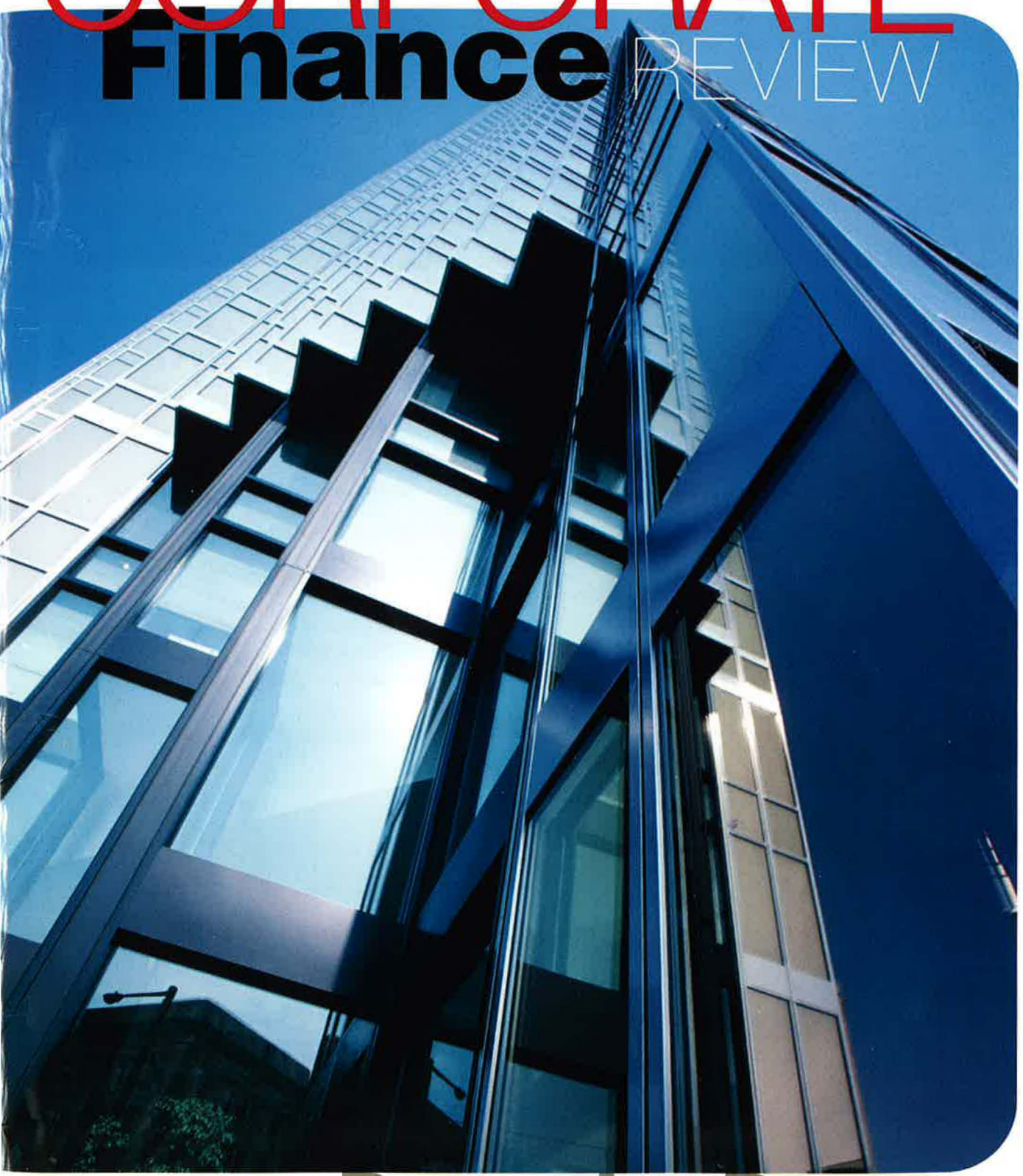
November
December
2012

CORPORATE Finance REVIEW



Borrowing Power

Profiting from Uncertainty

Reporting Market Intangibles

Increasing Workloads and Staff Underinvestment

CORPORATE Finance REVIEW

Contributing Editors

Marianne M. Jennings
Professor of Legal and Ethical Studies
Arizona State University

Hank Boerner
Chairman
Governance & Accountability Institute

Pablo Triana
Professor and Strategist
ESADE Business School
Barcelona – Madrid

Editorial Staff

Editor-in-Chief
Morgen Witzel
mail@morgenwitzel.com

Senior Director, Financial Reporting and Management Publications
Bruce Safford

Editor
Jack Nestor
jack_nestor@technicaeditorial.com

Desktop Artist
Anthony Kibort

Advertising Sales Director
Terry Storholm
WG&L Journals Advertising
610 Opperman Drive
Eagan, MN 55123
phone: (800) 322-3192
fax: (651) 687-7374
e-mail: terry.storholm@thomsonreuters.com

Reprints
Lont & Overkamp
(973) 942-5716

Editorial Advisory Board

Ivan E. Brick
Professor of Finance
Co-Director, New Jersey Center for Research in Financial Services
Graduate School of Management
Rutgers University

Marianne M. Jennings
Professor of Legal and Ethical Studies
Former Director, Lincoln Center for Applied Ethics
College of Business
Arizona State University

Yong H. Kim
Professor of Finance
College of Business Administration
University of Cincinnati

Prakash Deo
Associate Professor of Finance
University of Houston–Downtown

George J. Papaioannou
Professor of Finance
Co-Director, Merrill Lynch Center for the Study of Financial Services and Markets
Frank G. Zarb School of Business
Hofstra University

Nickolaos G. Travlos
Associate Professor of Finance
Carroll School of Management
Boston College and
University of Pireaus, Greece

Samuel C. Weaver
Associate Professor of Finance
Faculty of Finance and Law
Lehigh University

John Jahera
Colonial Bank Distinguished Professor
Department of Finance
College of Business
Auburn University

Francois Mallette
Vice President
L.E.K. Consulting

Stanley Block
Professor of Finance
M.J. Neeley School of Business
Texas Christian University

Deborah Pretty
Principal
Oxford Metrica

CORPORATE FINANCE REVIEW (ISSN 1089-327X) is published bimonthly by Warren, Gorham & Lamont, Division of Thomson Reuters, 195 Broadway, New York, NY 10007. Subscriptions: $315.00 a year. 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, Thomson Reuters, 195 Broadway, New York, NY 10007; (212) 337-4129.

Editorial Offices: Thomson Reuters 195 Broadway, New York, NY 10007. All editorial correspondence and manuscripts should be sent to this address. While the utmost care will be given material submitted, we cannot accept responsibility for unsolicited manuscripts. **Web: http://ria.thomson.com/financialreporting/.**

Copyright © 2012 Thomson Reuters. All rights reserved. No part of this journal may be reproduced in any form—by microfilm, xerography, or otherwise—or incorporated into any information retrieval system without the written permission of the copyright owner. Requests to reproduce material contained in this publication should be addressed to Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 750-4744. Requests to publish material or to incorporate material into computerized databases or any other electronic format, or for other than individual or internal distribution, should be addressed to Thomson Reuters, 195 Broadway, New York, NY 10007, 1 (800)431-9025.

Postmaster: Send address changes to CORPORATE FINANCE REVIEW, Thomson Reuters, 117 East Stevens Avenue, Valhalla, NY 10595.

THOMSON REUTERS

HANK BOERNER

THE CORPORATE ESG BEAUTY CONTEST CONTINUES: RECENT DEVELOPMENTS IN RESEARCH AND ANALYSIS

In these pages in recent months, we have called attention to the continued — and at times, quite dramatic — rise in the importance of corporate environmental management, or excellence or controversy in social or societal and corporate governance issues (ESG) as a comprehensive framework or systematic approach for financial analysts and asset managers to evaluate companies for portfolio decision-making. For a growing number of large asset owners, the ESG evaluation has become a proxy for the quality of board and management.

As a reminder for the reader, in terms of nomenclature, we see this trend played out in the terminology used by ESG proponents and investment professionals to define the approach:

- *Triple Bottom Line (TBL)*: This is a focus on the importance of, in this order, *People, Planet, Profit*, which dramatically shapes the analyst or investor approach to the traditional bottom line — a responsibility that is in the province of the corporate financial manager. The TBL or "3BL" approach reflects growing investor concerns about climate change and the presumed consequence of global warming (and thus, for example, greater intensity of natural disasters and the impact of these on corporate finances).
- *Economic, Environmental, Social (EES) performance factors*: These are at the heart of the Global Reporting Initiative (GRI) framework; EES performance, governance, and other disclosures by companies are expected and even demanded by investors. (The GRI framework is used by more than half of the companies in the benchmark S&P 500 index for their ESG/sustainability reporting; slightly less than half do not report.)
- *Sustainable & Responsible Investment (SRI)*: Starting out as "socially responsible investing," with relatively few adherents to the movement three decades ago, SRI today is a major factor in the U.S. capital markets. According to the last survey, which is in the process of being updated, SRI accounts for more than $3 trillion of the $15–16 trillion assets under management (AUM) in the U.S. That's one-in-eight dollars.
- *Sustainable Investing*: SRI is shortening to a more mainstream *Sustainable Investing*, as championed by Erika Karp, head of UBS Global Sector Research, for example. Watch this term; it has the potential to be more widely accepted in mainstream investment circles, especially as the global teams inside UBS and other major financial houses become more familiar with the concept.[1]
- *Impact Investing*: An emerging concept, it means using the AUM to have a defined impact with consideration of not just risk and return, but also the ESG effects. Assets could be investment in a company, a pool, or fund, or even directly in a community. We are seeing this discussed in endowment, foundation, and public employee retirement systems circles.

In our close monitoring of ESG from investor and corporate viewpoints, we see

HANK BOERNER *is chairman of the Governance & Accountability Institute, a research and consulting organization focused on issue management related to corporate ESG and sustainability performance and disclosure. He is a former head of communications for the New York Stock Exchange. In November 2012, he was named for the second time to the list of "people to watch in corporate governance" by the National Association of Corporate Directors (NACD).*

a continuing consolidation of the approaches described, so that ESG and sustainability (and for many companies, responsibility) are evolving as the most preferred terms, with various combinations used (sustainable investing is an example).

The practical and pragmatic for CFOs

The question raised here is: How does all of this affect the responsibilities, duties, strategies, day-to-day operations, and decisions on public disclosure for the corporate financial officer? After all, the common statement often made in conference settings where ESG is the topic is, "Analysts and our top 20 investors are not asking about this, so how important is it?" Does ESG matter to the finance professional?

Focus for the financial manager

To help answer the questions, consider these recent developments that directly or indirectly affect the finance manager.

GMI Ratings. GMI Ratings (formerly known as Governance Metrics International) is one of the world's leading corporate governance rating organizations, coming to prominence after passage of Sarbanes–Oxley legislation. Thousands of public companies are covered by their ratings systems; asset managers are prime users. GMI Ratings is the company that emerged with the merger of three predecessor companies (The Corporate Library, which focused on boards, and Audit Integrity, focused on the accounting practices of companies). GMI, "building on the pioneering legacy of predecessors... is expanding the portfolio of analytical tools for the study of issuer risk and corporate character...."[2]

One of these analytic tools is the "Global LeaderBoard" (GLB), an online research and data visualization to map relationships between corporations and corporate board members. This works at the individual, organization, industry, and regional levels. Specific example: Wells Fargo & Company — the tool provides GMI Ratings clients (mostly investors with significant representation among insurers focused on risk assessment) with graphic representation of the bank's close ties with a very wide range of industries, such as two active interlocks (Chevron and Target) and second-level links with Disney, McDonald's, Protective Life, and The Southern Company. GLB maps and analyzes the complex relationship patterns among 370,000 global board members, 270,000 executive associated with 70,000 entities.[3]

The tool helps investors screen directors' backgrounds using multiple criteria (education, experience, board relationships, multiple board service, compensation, "degrees of separation," potential conflicts, and other factors). This, GMI states, is a tool for analysts, asset owners, their managers, D&O insurers, and auditors — and corporate issuers — to better understand director networks and potential impact on "governance practices and corporate performance."[4]

The GMI Ratings compliance toolbox includes close tracking of many corporate ESG performance factors and certain ESG characteristics of companies.

Other third-party raters and rankers. MSCI is a major analytical and investment research organization; among its activities, MSCI creates and manages dozens of specialized indexes that track corporate ESG performance that institutions favor for their portfolio management. (MSCI now includes the former Institutional Shareholder Services/ISS, a pioneer in corporate management evaluation and ratings.) The development of the company's "ESG Dashboard" was a major step forward to quantify ESG performance for investors and fiduciaries.

Recently MSCI announced that its ESG research and analysis is now integrated on FactSet, a subscription service that integrates financial information, analytic applications, and client service in offerings to the global investment community. (The company was founded in 1978, trades on the NYSE, and has been included in *Fortune* magazine's Top 100 Best Companies to Work For.) FactSet now carries MSCI ESG data and ratings. There are three ways that investors can look at public companies:

- MSCI ESG Tangible Value Investment (IVA): ratings and analysis of

THE COMMON STATEMENT OFTEN MADE IN CONFERENCE SETTINGS WHERE ESG IS THE TOPIC IS, "ANALYSTS AND OUR TOP 20 INVESTORS ARE NOT ASKING ABOUT THIS, SO HOW IMPORTANT IS IT?"

corporate management of environmental and social factors "that can reveal ESG-driven" investment risks not captured by traditional financial analysis;

- MSCI ESG Impact Monitor: ratings and analysis of "ESG controversies" (and the list of these is constantly expanding thanks to globalization and technology advances); also, violations of the "norm" for such frameworks as the UN Global Compact, which many companies now have pledged to uphold; and
- MSCI ESG Business Involvement Screening Research: As ESG issues in focus expand, this allows investors to screen out companies — and their subsidiaries — involved in high-risk countries (e.g., Sudan, Iran) and such activities as tobacco or weapons manufacturing that might violate certain religious or faith-based mandates.

In announcing the expansion of services for FactSet, its vice president, Patrick Locke, said this will "help meet the growing demand of asset managers and institutional investors to integrate ESG information."

WAL-MART STORES, INC. WILL ADD $150 MILLION TO THE BOTTOM LINE THIS YEAR FROM VARIOUS SUSTAINABILITY INITIATIVES SUCH AS SOLAR AND WIND ENERGY PRODUCTION PROJECTS, INSTALLATION OF FUEL CELLS, AND PROGRESS TOWARD ITS "ZERO WASTE" GOAL.

ESG — effective corporate response

Against this background, we offer the examples of two prominent U.S. companies; their issues are included in many indexes and benchmarks. Both issuers announced pragmatic ESG initiatives with real top and bottom line effects.

Wal-Mart Stores, Inc. will add $150 million to the bottom line this year from various sustainability initiatives such as solar and wind energy production projects (there are 180 renewable projects underway), installation of fuel cells, and progress toward its "zero waste" goal (2025).

At its October annual meeting for investors, Wal-Mart said these impacts are in addition to the $231 million saved last year in its waste reduction and recycling efforts. This is a practical approach; all landfill waste from U.S. stores and Sam's Club locations is on track to achieve "zero" level by 2025. Plastic shopping bag waste was cut by about 3.1 billion bags in 2011 — a 35 percent reduction for the goal set in the 2007 baseline efforts to achieve by year 2025. There are interim steps; the retailer beat its goal for 2013 reduction of shopping bag waste of 33 percent.[5]

Walt Disney Company will drop the use of paper from "endangered" sources; all paper used by the company and its subsidiaries connected to destruction of endangered forests and animals will be eliminated. That includes illegally harvested forest woods; "High-Value Conservation Area" wood (such as old-growth forests); areas where paper fiber is harvested in violation of internationally accepted instruments to protect the rights of indigenous peoples; and from areas converted to plantations and other uses from natural forests since 1994.

This is a significant change from current practice; it means that Asia Pulp & Paper and Asia Pacific Resources International Holdings (third-largest paper producer globally) can no longer count on Disney business. And Disney pledged to reduce paper consumption overall, including increasing the recovery of paper and packaging for recycling (such as packaging for the company's popular toy lines and children's books). The Disney commitment applies through its entire global supply chain and covers the theme parks, resorts, cruise ships, and the 3,700 licensees that use Disney characters.

The decision will affect the operations of 25,000 factories in the more than 100 countries that produce Disney product — 10,000-plus in China alone. The action was taken in collaboration with the Rainforest Action Network (RAN), a nongovernmental organization (NGO) that identifies regions with poor forest management practices and where there are high rates of deforestation.[6]

Disney joins a growing list of U.S. publishing houses that have worked with RAN to reach "forestry commitments," including Harcourt, Macmillan, Random House, Simon & Schuster, and others. Supplier reaction? In May 2012, Asia Pulp & Paper (APP) announced it would

suspend natural forest clearances on its pulpwood plantations in Indonesia (a high-value forest). All APP supply chain partners will have until December 2014 to comply with its guidelines.

Real, practical impacts for companies

In practical terms, think of the challenges posed by these commitments, with real — not "intangible" — impacts on both top and bottom lines for the companies involved. And think of the impact throughout the supply chains of the two companies; it's estimated that Wal-Mart has upwards of 100,000 suppliers. In the case of the large competitors to Wal-Mart and Disney, think of the peer pressure to be exerted by these dramatic moves and the impact of large-, mid- and small-cap companies in the supply network. And, most important in the context of ESG, think of the favorable impressions made on such third-party organizations as MSCI and GMI Ratings — and the thousands of asset managers that they touch with their ratings and recommendations.

Governance still matters — as the "G" in ESG

Finally, even after presenting the above facts, we can expect that there will be some senior corporate managers who will ask for more defining affirmation that ESG and sustainability matter to investors. Consider this: The nonprofit Investor Responsibility Research Center Institute (IRRCI) and the ISS unit of MSCI have a new study out — "Controlled Companies in the Standard & Poor's 1500: A Ten Year Performance and Risk Review." The researchers found that "controlled companies," those with multiple classes of shares, underperformed over the long term as compared with companies with dispersed ownerships. Investors generally don't like multiple classes of shares and governance structures.

Companies with these characteristics have been increasing over the past decade (there are 114 in the S&P 1500; tech entrepreneurs favor the approach). These companies generally have uneven voting rights, and a few dozen have one class of voting stock. The study found that these structures contributed to volatility, material weaknesses, more interrelated transactions, and less responsiveness to investors. IRRIC and ISS did note that controlled companies with single voting rights more closely resemble non-controlled firms.[7]

For the past year, a team at Governance & Accountability Institute working with third-party raters and rankers has been comparing the capital market performance and reputational and perception aspects of the S&P 500 index constituents that do disclose and report on their ESG performance with the companies that do not (slightly less than half of the index companies). The results will be presented as a continuation of this commentary in the January–February 2013 issue of CORPORATE FINANCE REVIEW. ■

NOTES

[1] Author conversation with Erika Karp, October 2012. Her comments in the November 2012 "UBS Global Portfolio Manager's Spotlight": "In the 'Sustainable Trends' weekly report from Julie Hudson and our ESG Strategy team, the happenings of the past month *'strengthen the argument for systems resilience to shocks.'* We would apply this statement not just to the climate [note this was the week Hurricane Sandy struck New York City] but also to other broad areas of *environmental, social and governance factors in the capital market*s." For these views see "Investing in Diversity" at http://www.wallstreetweek.com/guest-post-investing-in-diversity-painful-but-profitable/.

[2] GMI Ratings announcement, November 10, 2010 — "How to Enhance Your ESG and Stewardship Capabilities," in announcing tools for extra-financial financial research.

[3] *Ibid.*

[4] Wal-Mart Stores, Inc. statement, October 12, 2012 at annual investor conference.

[5] *Ibid.*

[6] Walt Disney Company announcement, October 2012.

[7] IRRC and ISS webinar on new report, "Controlled Companies in the S&O 1500: A Ten Year Performance and Risk Review," October 8, 2012.