

# **A Sustainable Environment: Our Obligation to Protect God's Gift**

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## **How Can Sustainability Improve a Company's Value?**

There is no question that the vast majority of CEOs of major corporations believe that sustainability is a critical component of the company's strategy. However, at the same time these companies are challenged to actually implement the sustainability strategy. The resistance to move forward is usually the result of placing emphasis on the financial performance of the company. It is important for the CEOs to understand that sustainability consists of three major components: environmental integrity, social equity and economic viability. Institutional investors usually refer to environmental accountability, social responsibility and corporate governance collectively as ESG. Many use the terms "sustainability" and "ESG" interchangeably. In any event, there is no question that sustainability enhances the financial performance of the company. But how does one know?

When a company develops a sustainability strategy, it usually requires some investment to implement it. The company then analyzes the action to determine whether the return on the investment is appropriate. It is critical for the company to have a good understanding of the potential of the sustainability initiative so the investment is made with some assurance. One financial measure that can be employed to determine the impact of the sustainability strategy is the shareholder value (SHV) of the company. The SHV of a company can be based on several different drivers like growth, business model risk, leverage, but here we will only consider ESG. A key financial metric affecting the SHV is the cost of capital. One way to determine an expected SHV for a company is the net present value of the stream of future earnings. The key metric in this calculation, however, is the cost of capital, or discount rate. So how does the cost of capital relate to a sustainability initiative?

Since sustainability can be enhanced through many different activities, how can the financial performance be attributed to any one or more of these activities? This is one of the reasons investors or corporate executives ignore the contribution by ESG. What is needed is a methodology to relate a company's cost of capital to its ESG performance. The cost of capital was obtained from a widely-recognized investment research company that calculates company-specific implicit discount rates to measure the value of about 40,000 public companies worldwide. Research efforts have used this data base along with 120 policy and performance variables for 2,800 firms reported by IW Financial. For each firm, IW Financial can provide a value for each of the 120 ESG variables that can be a numeric value or a binary value, like "yes" or "no". Applying statistical analysis of the combined data can provide a mechanism to determine the relationship between ESG performance ratings and the discount rate.

It has been determined that the ESG variables can have a different impact on the various industries. When assessing a specific company, the analysis should be performed on 20 – 30 different companies in the same industry. The financial research company's data can provide the discount rate for each of the companies in that selected industry. By conducting the statistical analysis on each company for the 120 ESG variables, one can determine which of these ESG variables actually has a positive or negative impact on the discount rate. By examining the ESG variable, it is important to note both a correlation and a causation. Now it is possible to determine which of the 120 ESG variables, if any, actually have an impact on the company's discount rate and therefore the shareholder value. A company can then determine which sustainability initiatives will actually enhance the company environmentally and socially while actually improving the financial performance. Consequently, the company can make more effective investment decisions and not be accused of "green washing".