Calvert Institute for Responsible Investing

When sustainable practices yield sustainable profits: The path to a strategic edge

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- As growing numbers of companies embrace sustainability practices, the question of whether those efforts can provide a competitive edge through strategic differentiation becomes increasingly important.
- A recent research study of about 3,800 companies across 65 industries finds that sustainability practices have converged across companies within most industries, as policies that started out as differentiated become common.
- The study concludes that systematically understanding which practices are becoming common and which are differentiated can provide important insights into corporate strategy and building a persistent strategic advantage.
- The study finds that differentiated sustainability practices — but not common practices — were associated with higher return on capital. However, both strategic and common sustainability practices correlated with higher valuation multiples (price-to-book ratios).

This paper draws from the results in Ioannou, Ioannis and Serafeim, George, 2019, "Corporate Sustainability: A Strategy?" Working Paper 19-065, Harvard Business School. One of the authors, George Serafeim, conducts joint research with Calvert aimed at enhancing public education and knowledge related to Responsible Investing and business practices; he receives compensation for this work.

In recent years, a growing number of companies have embraced sustainability practices – efforts that strive to align corporate operations with the demand for better performance on environmental, social and governance (ESG) factors. Indeed, a 2017 report by KPMG found that 93% of the largest 250 companies globally issue a corporate sustainability report, and 78% of them include sustainability information in audited financial statements.

But while corporate sustainability practices are becoming firmly entrenched, we are still in the early stages of exploring the long-term implications of this trend. There are numerous questions that are of significant relevance to companies, investors and other stakeholders. For example:

- Can corporate sustainability practices provide strategic differentiation that leads to superior financial results?
- If so, will that advantage erode as competitors converge on similar sustainability practices?
- To what extent has such convergence taken place?
- Alternatively, do sustainability initiatives constitute common practices – compulsory moves that ensure corporate survival, but don't necessarily enhance performance?

This study documents the convergence of sustainability practices within many industries. Our overarching thesis is that by understanding the causes and extent of convergence in a given industry, we can determine which sustainability practices are most likely to also provide a sustainable competitive edge.

Sizing up convergence

This paper is based on an analysis of MSCI ESG ratings of about 3,800 companies from 2012 to 2017. The dataset is limited to companies that appear in the MSCI ratings across all years, so the results are not compromised by inconsistencies in the universe.

MSCI ESG ratings range from 1 (worst) to 10 (best) based on a company's exposure to "key issues" such as climate change, natural capital, environmental opportunities and human capital. MSCI estimates how well the company manages risk or seizes opportunities for each key issue, and weights the ratings according to the issue's materiality in each industry.

Exhibit A compares the distribution of MSCI ESG ratings in 2017 with those in 2012, and it is evident that the range has narrowed over that period. It shows that within most industries, sustainability practices have converged over that period. In 2012, the mean MSCI ESG rating across industries was 4.53, with a standard deviation of 1.32. While the mean increased modestly to 4.71 in 2017, the standard deviation narrowed significantly to 0.90.

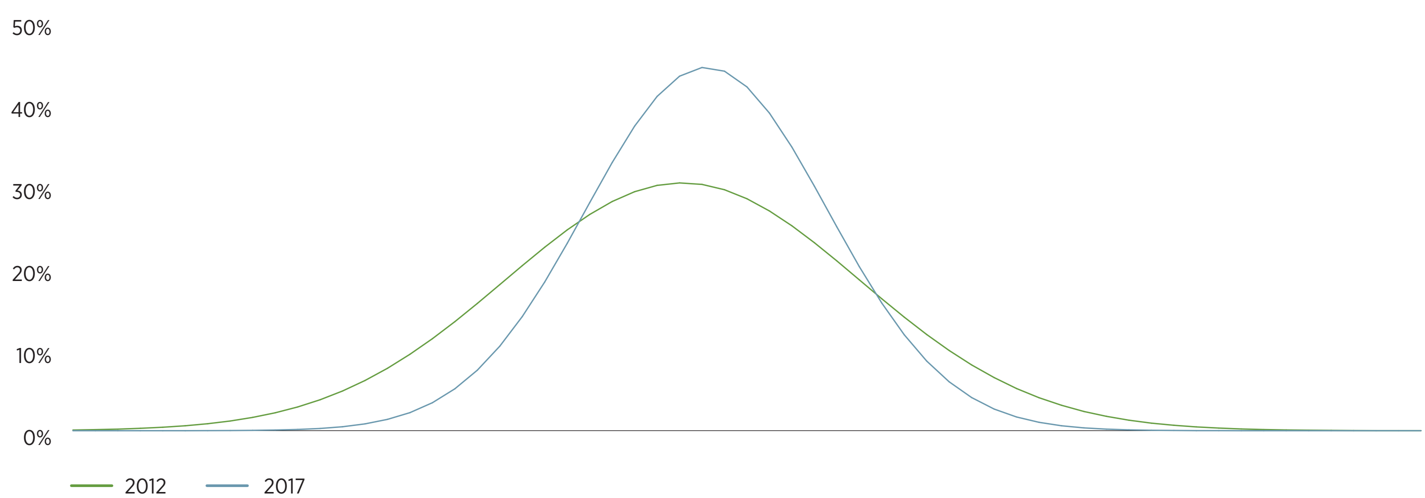
This finding implies that, on average, companies adopted an increasingly similar set of sustainability practices, raising the possibility that they are becoming common practices. As such, those practices are less likely to serve as strategic differentiators, and more likely to be survival necessities.

To better understand the degree of convergence within various industries, we used the coefficient of variation (CV) – the standard deviation divided by the mean – for each sustainability practice. We established the degree of convergence by comparing CVs in 2017 versus the CVs in 2012 using the CV ratio – the 2017 level over 2012, multiplied by 100; in this formulation, no convergence equals 100.

Exhibit A

Shrinking standard deviations mean converging sustainability practices.

Distribution of sustainability scores in 2012 and 2017



Source: Ioannou, Ioannis and Serafeim, George, 2019, "Corporate Sustainability: A Strategy?" Working Paper 19-065, Harvard Business School.

How coefficients of variation vary

We computed CV ratios for the 65 industry ESG categories used by MSCI, and the lowest CV ratio belonged to biotechnology, at 34.4, meaning sustainability practices converged two-thirds of the way to exactly the same. Only two industries exhibited divergence of sustainable practices: automobiles, and integrated oil & gas, which had CV ratios of 137.4 and 101.0, respectively. Within the MSCI universe, 53 industries had a CV of 80% or lower, confirming that convergence of sustainability practices is indeed widespread.

We also analyzed the data to determine the factors that drove the degree of convergence within industries. The biggest single factor was the presence of a market leader within the industry, one which we defined as in the top quartile in 2012 in terms of both market capitalization and sustainability practices.

The other variables that increased convergence were environmental materiality and social materiality, which represent the weights of those issues within industries, as determined by MSCI. We found the impact to be stronger for environmental materiality.

In contrast, governance materiality did not correspond to an increase in convergence. Throughout most of the 1990s and 2000s, investors and regulators placed pressure on companies to adopt best governance practices. Thus, we believe much convergence on corporate governance codes had already taken place prior to 2012, the start of our study period.

Distinguishing strategic from common

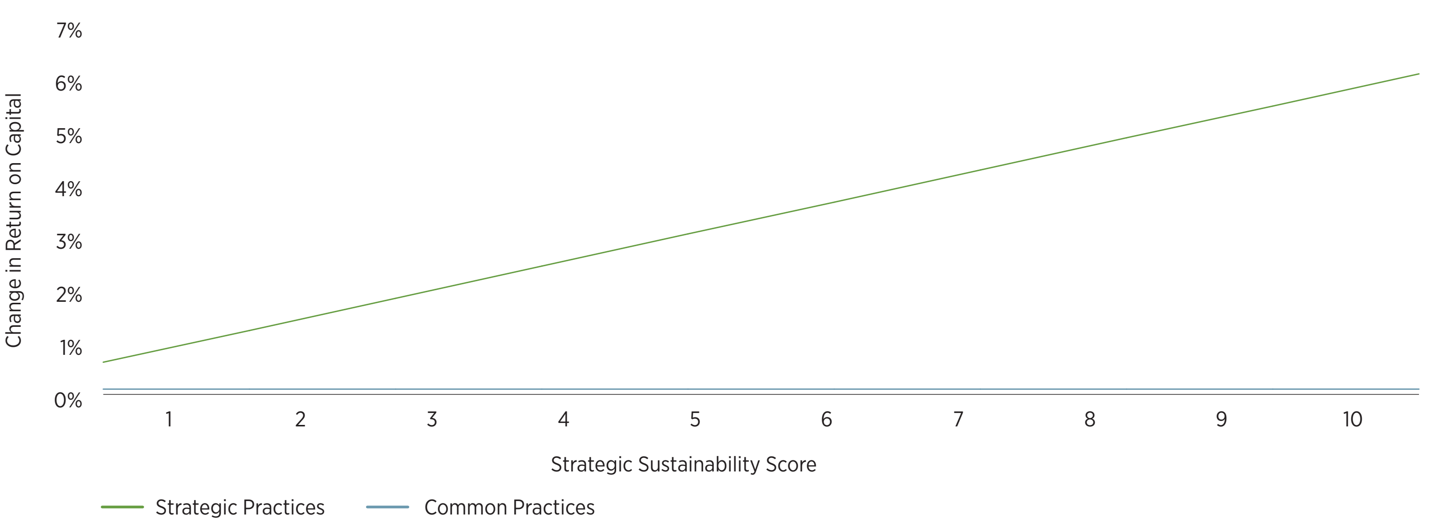
Recall that our thesis suggests that the less vulnerable a sustainability practice is to the forces of convergence, the more likely it is to provide a strategic advantage. To distinguish strategic from common practices in our dataset, we considered it to be common if it converged by 10% or more – i.e., strategic practices are those with a CV ratio in 2017 of 90% or higher. This calculation was made at the industry-issue level and not at the industry level.

Drilling deeper at the issue level in the MSCI data revealed substantial variation even within themes. For example, we observe very low frequency of convergence on data privacy, water stress, human capital development and product carbon footprint issues. In contrast, we observed high frequency of convergence in green building opportunities, clean tech opportunities, labor-related supply chain, and employee health and safety issues. For example, the CV ratio for data privacy was 124%, while packing and material waste was 71%. Moreover, while in one industry an issue can be common, in another industry the same issue can be differentiated.

Given that we set the threshold for "strategic" to be a CV ratio of 90 or higher, this resulted in about 75% of industry sustainability practices being classified as common and the rest as differentiated.

Exhibit B

As strategic sustainability scores grew, so did profits.



Source: Ioannou, Ioannis and Serafeim, George, 2019, "Corporate Sustainability: A Strategy?" Working Paper 19-065, Harvard Business School.

Strategic sustainable profits

We analyzed the relationship between strategic practices, as defined earlier, and return on capital (ROC), and found a positive association that was significant both statistically and economically. A two-point increase in the strategy practice variable was associated with about a 1.2% greater ROC, where the average ROC for the sample was 8.3% (Exhibit B). The same regression found that the relationship between common practices and ROC was statistically insignificant.

Because some of the change in ROC might be attributed to laggard firms catching up with the industry averages for sustainability practices, the analysis controls for this effect and the relationship remains significant as shown. Our results found that persistent leaders – those that remained ahead of the industry average throughout the sample period – gained the most in terms of increased ROC. The same held true for common practices, though here, the results are not statistically significant.

This confirms our expectation that sustainability practices least susceptible to convergence are the ones conveying strategic competitive advantages. Within our sample, convergence occurred least frequently on human capital management and most frequently on environmental opportunities.

Just as intriguing is the relationship between sustainability practices and price-to-book ratio (Exhibit C). In this case, however, the association was positive and significant for both strategic and common practices. A two-point increase in the strategic practice variable was associated with about a 7% greater price-to-book ratio and about 5.5% for common practices.

These findings are consistent with the ROC data, and also demonstrate that strategic sustainability practices enhance perceptions about a company's future growth and/or risk, given that price-to-book is a forward-looking valuation measure of investor expectations. The fact that common practices also lead to higher valuations may reflect investor approval of the willingness of a company to comply with emerging industry standards, thereby reducing political and regulatory risk.

A sustained trend

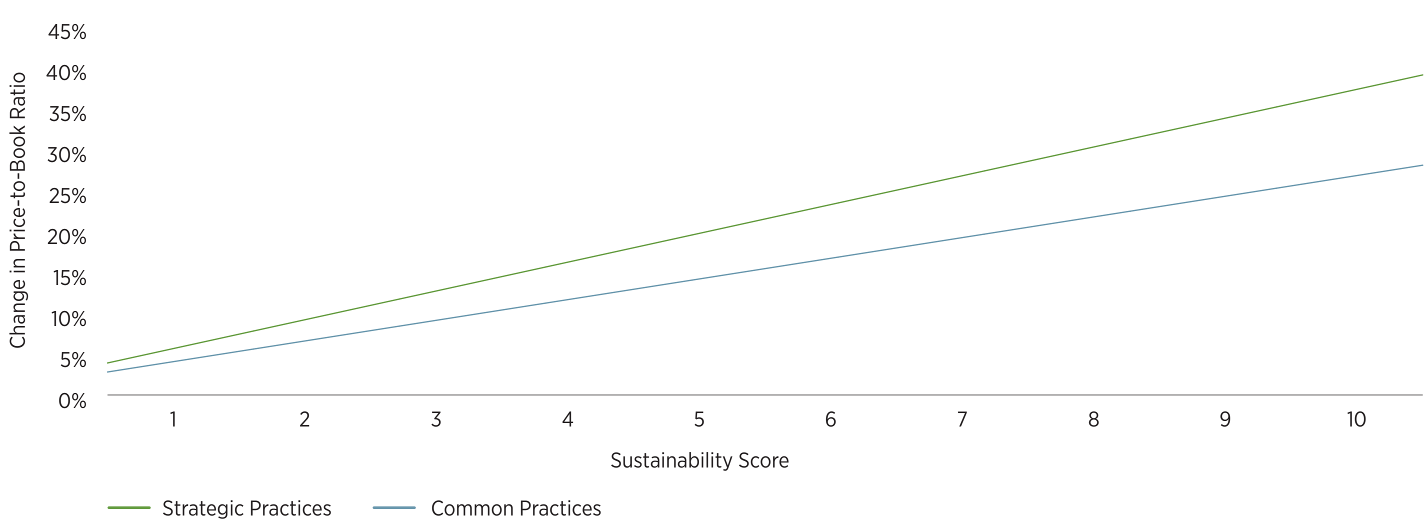
The adoption of sustainability practices by companies is a major trend that shows no sign of slowing down. With the foundation of this research, it may be fruitful for future work to explore:

- The conditions that are conducive to the persistence or convergence of sustainability practices.
- Why some sustainability practices develop into common ones over time.
- The role of corporate decision makers in developing and implementing sustainability practices.

We believe that the distinction between strategic and common practices is key for managers, investors and other stakeholders, and that understanding the related dynamics will be an important component of sustainable investing. The report that follows outlines how Calvert Research and Management (Calvert) seeks to identify strategic sustainable practices that drive long-term profitability.

Exhibit C

Both strategic and common sustainability practices correlated with higher valuations.



Source: Ioannou, Ioannis and Serafeim, George, 2019, "Corporate Sustainability: A Strategy?" Working Paper 19-065, Harvard Business School.

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George Serafeim is Charles M. Williams Professor of Business Administration at Harvard Business School. He has presented his research in over 60 countries around the world and ranks among the top 20 most popular authors out of over 12,000 business authors on the Social Science Research Network.

Professor Serafeim's research focuses on measuring, driving and communicating corporate performance and social impact. His work is widely cited and has been published in the most prestigious academic and practitioner journals, such as The Accounting Review, Strategic Management Journal, Journal of Accounting and Economics, Journal of Finance, Organization Science, Journal of Accounting Research, Management Science, and Harvard Business Review. His research is regularly cited in the media, including The New York Times, Bloomberg, Financial Times, The Wall Street Journal, The Economist and The Washington Post.

Professor Serafeim has served in several not-for-profit organizations including the board of directors of the High Meadows Institute, the working group of the Coalition for Inclusive Capitalism and the Standards Council of the Sustainability Accounting Standards Board. He has expertise in professional services firms as the co-founder of KKS Advisors, focusing on integrating material sustainability issues in business strategy and investment decisions. He serves on the steering committee of the Athens Stock Exchange. He was appointed to the first-ever decarbonization advisory panel by the New York State Governor and Comptroller to protect the state's pension fund from climate change risks and identify sustainable opportunities. He has been recognized by Barron's as "one of the most influential people in ESG investing."

Important Additional Information and Disclosures

Source of all data: Ioannou, Ioannis and Serafeim, George, "Corporate Sustainability: A Strategy?" Working Paper 19-065, Harvard Business School, as of September 2019.

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About Calvert Institute

The Calvert Institute for Responsible Investing is a division of Calvert Research and Management created for the purpose of driving positive change through research, education and action on behalf of investors, corporations and policy-makers.

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