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Sustainability and financial performance: the chicken or the egg dilemma

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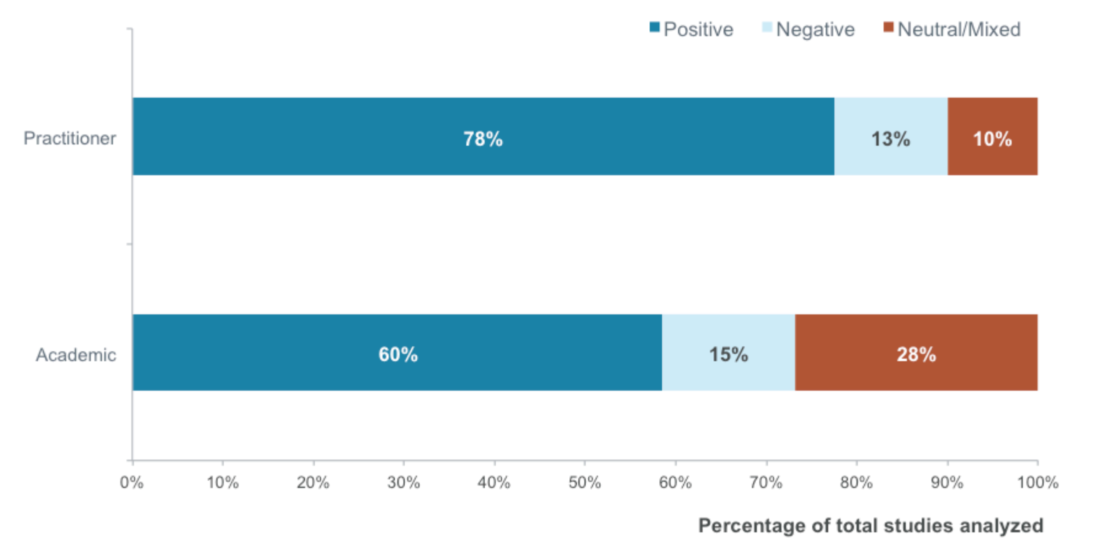
Sustainability and financial performance: the chicken or the egg dilemma

There is a clear link between corporate sustainability and financial results, but which one is the trigger? Well, the link can actually run both ways.

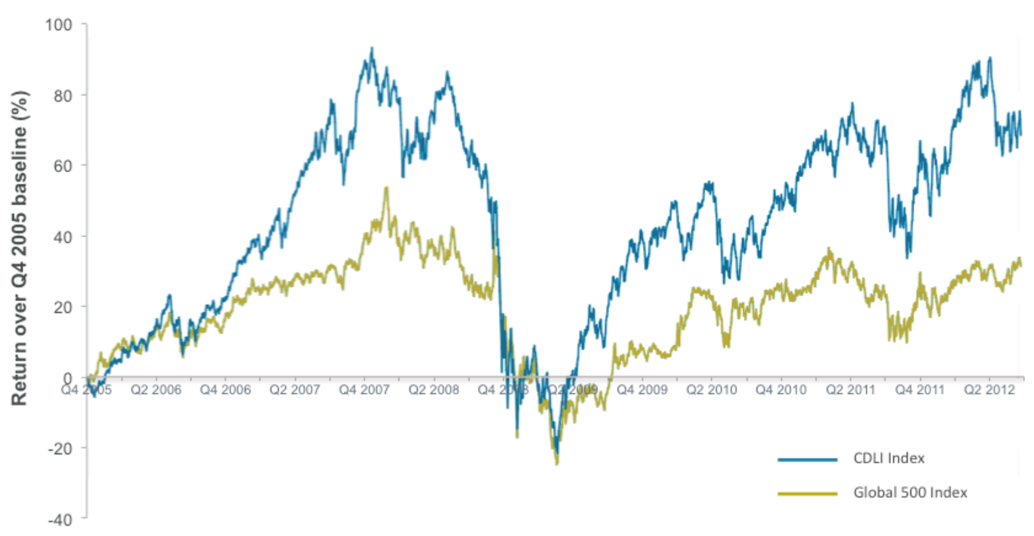
Little doubt remains about the correlation between improved sustainability practices and better financial results: Exhibit 1 compiles the results of close to 160 research papers, most of which found a positive correlation between these two benefits. But which one is the trigger? In other words, do better sustainability practices lead to improved financial results, or does the availability of funds lead to increased investments in sustainability? In this article we explore the issue of causality between sustainability and financial performance, and what it means for various stakeholders.

The relationship between sustainability and financial performance is a complex one. To begin with, there is not a standard metric for measuring sustainability, since it covers a broad number of socio-economic and environmental issues. Financial performance, although narrower in scope, can also be measured in different ways, from share price to profits. Even after selecting concrete



Source: Network for Business Sustainability

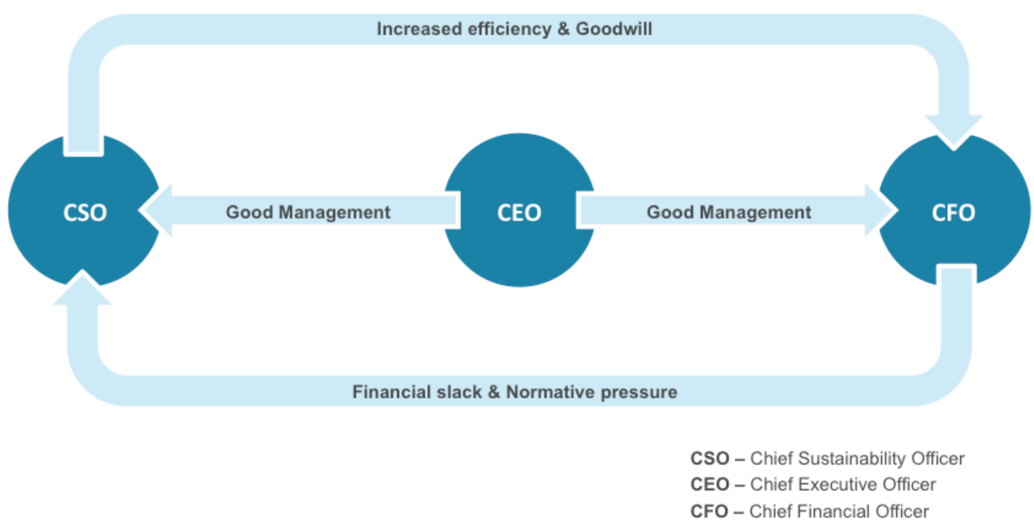
***Exhibit 1** – Results of 159 studies from 1972 to 2008, analyzing the correlation between*



Source: Carbon Disclosure Project

***Exhibit 2** – Stock market returns of the CDLI and Global 500 indexes (2005-2012)*

metrics and identifying a clear correlation, one question remains: is that correlation causal? Take Exhibit 2, for instance, which compares the stock performance of companies in the CDLI (Carbon Disclosure Leadership Index) with the Global 500 Index. The CDLI includes Siemens, Coca-Cola, Microsoft and many other industry leaders with an above-average stock performance that is likely the result of several best practices, some directly related to sustainability, others not.



Source: Adapted from *The reciprocal and non-linear relationship of sustainability and financial performance*

***Exhibit 3** – Suggested virtuous cycle of good management, sustainable practices and increased financial performance*

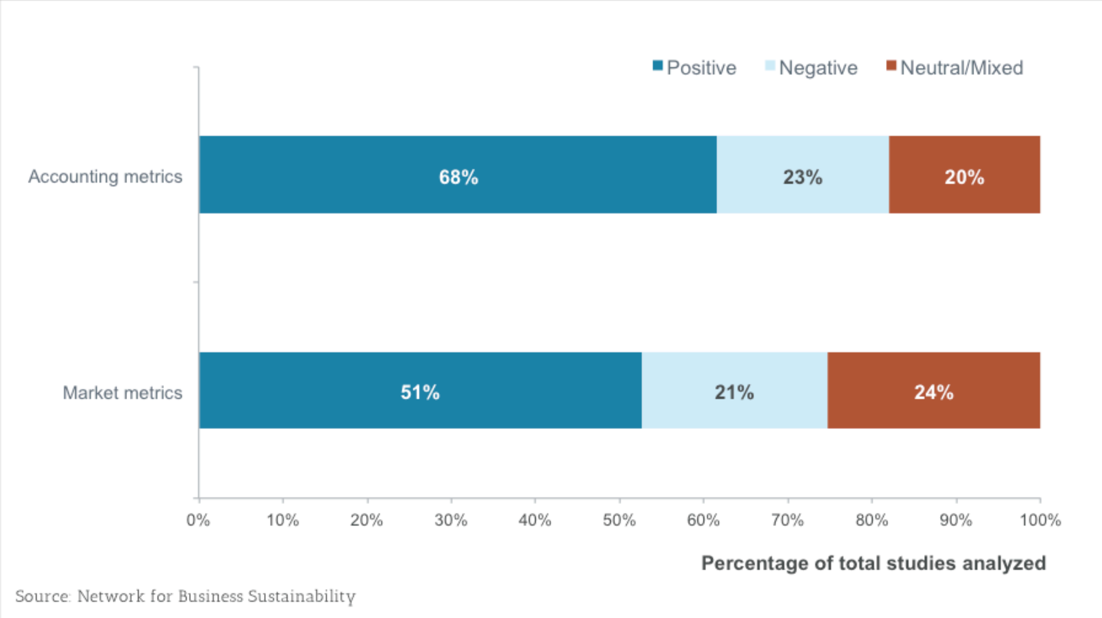


***Exhibit 4** – Results of 159 studies from 1972 to 2008, analyzing the correlation between sustainability and accounting/market metrics*

Recent studies have shed some light onto this issue, suggesting that both sustainable practices and solid financial performance stem from good management, causing a virtuous cycle: actions to increase sustainability trigger good financial performance, which allows for additional investments in sustainability, which again improves financial performance (Exhibit 3).

So it looks to be a "chicken or the egg" sort of dilemma. Does it matter what is the chicken and what is the egg? If you are a prospective employee looking for the best company to work for, it probably doesn't. But if you are an investor, a senior manager or a policy maker, it can indeed matter:

Employees: You can have the cake and eat it too

For a job seeker or employee, a company that is both sustainable and financially strong is a keeper, irrespectively of what is the driver and what is the result. Companies with stronger financials are more likely to provide attractive remuneration packages, and offer better job security. Sustainable companies often provide better working environments and clearer career development paths.

Investors: Look at mediating metrics

For an investor however, it is key to understand if enhanced sustainability practices are an indicator of future strong financials, or merely the result of past financial slack. This often involves identifying a more direct link between the two factors: as supported by Exhibit 4, it is more likely to find a correlation between sustainability and accounting metrics than between sustainability and market metrics. For instance, efficiency improvements to the manufacturing process of a pharmaceutical company will have a more direct impact on the company's operating margin than on its share price, because the latter depends on additional variables.

Furthermore, different sustainability actions can impact accounting metrics differently. For instance, recent research of the Japanese Electronics sector has found a strong causal link between environmental costs and revenues, but not between environmental costs and profits. Whenever possible, it is therefore preferable to drill down further, looking for correlations between sustainability and mediating metrics such as energy consumption, process efficiency or waste production.

For Venture Capital (VC) and Private Equity (PE) investors, a complementary strategy might be to analyze the relationship between sustainability and innovation. A study from Deloitte (Exhibit 5) has found that sustainability leaders are 4 to 6 times more likely to become top innovators. Likelihood increases with time, reinforcing that sustainability is indeed one of the pillars of innovation. Incidentally, the reverse – top

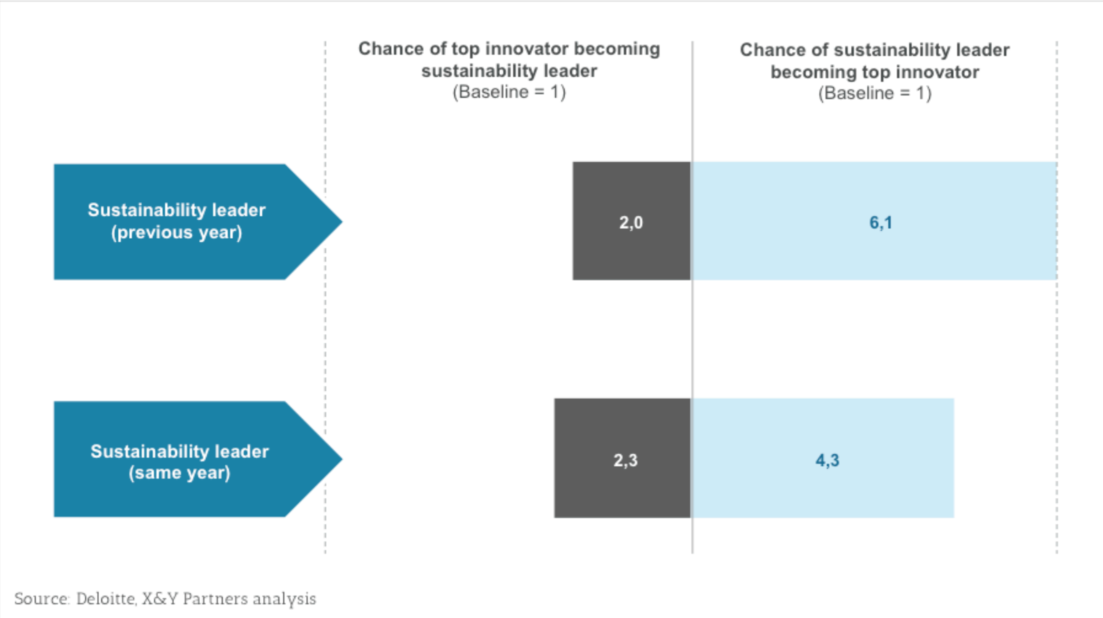
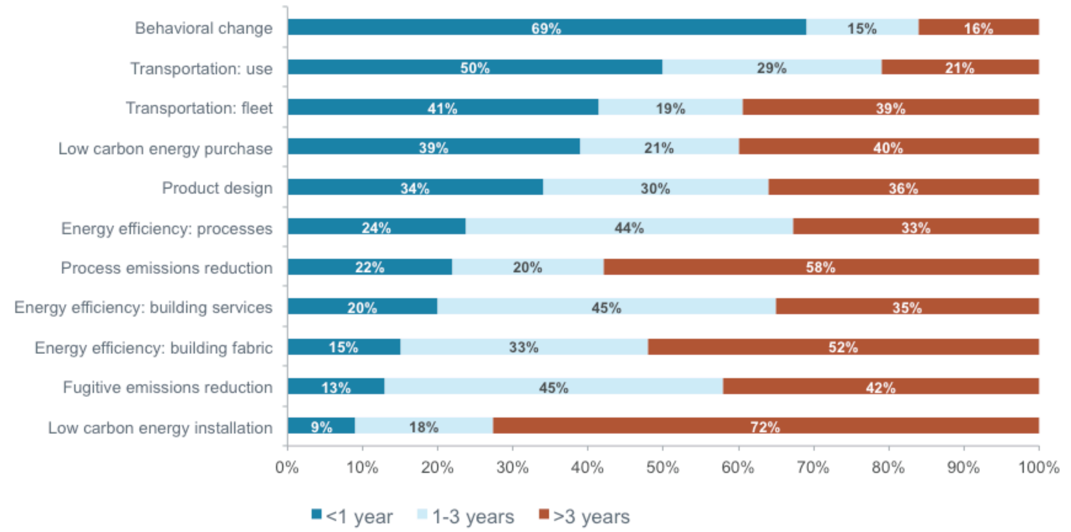


***Exhibit 5** – Bi-directional correlation between sustainability and innovation*



Source: Carbon Disclosure Project,

***Exhibit 6** – Payback period for sustainability initiatives, as reported in 2012 by members of the Carbon Disclosure Project*

innovators becoming sustainability leaders – also happens, but is less prevalent.

Senior Management: Investing in sustainability will not solve broader financial problems

The argument made in Exhibit 3 can be mirrored: bad management can lead both to misguided investments in sustainability and to poor financial results. This suggests that sustainable investments are not a silver bullet for bad financial performance, and can even worsen matters. Furthermore, as discussed in a previous article, sustainable investments need to be individually analyzed from both an economical and a sustainability standpoint, in order to strike a good balance between these two factors. The actions described in Exhibit 6, for instance, are all environmentally beneficial but have very different payback periods.

Policy Makers: Minimum sustainability requirements are valuable but should not be overwhelming

From a legislative perspective, minimum sustainability requirements can be valuable, forcing inattentive companies to look into the benefits of sustainability. However, these policies should not be overwhelming, as to not risk overburdening financially distressed companies with additional investments. It can also be argued that very strict sustainability requirements are unnecessary, as the market itself will push for a higher level of conformity. The World Business Council for Sustainable Development (WBCSD), for instance, includes close to 200 global members and 1500 regional members. The Carbon Disclosure Project includes more than 500 companies that publicly disclose information about their carbon footprint and reduction targets. Most members of these two voluntary schemes go considerably further than what is mandated by the sustainability requirements in place for the countries they operate on.

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