Insight 01|2014

ROBECOSAM
Sustainability Investing

Focus on financial materiality of sustainability

Recent initiatives such as the Global Reporting Initiative's G4 Sustainability Reporting Guidelines have put a spotlight on the concept of financial materiality of sustainability. While RobecoSAM has always focused on identifying sustainability factors that are likely to have an impact on companies' financial performance, over the past year, the Sustainability Investing Research team has updated its analysis of the materiality of sustainability criteria across all industries. Christopher Greenwald, Co-Head of Sustainability Investing Research explains how RobecoSAM determines the financial relevance of the sustainability criteria that are incorporated into the Corporate Sustainability Assessment.

How do you define financial materiality, and why is this important to you?

We consider any intangible factor that can have an impact on a company's core business value – namely growth, profitability, capital efficiency and risk exposure – to be financially material. Factors such as a company's ability to innovate, attract and retain talent, or anticipate regulatory changes matter from an investor's point of view because they have significant impacts on a company's competitive position and longterm financial performance.

As an asset manager, we have always focused on identifying financially relevant sustainability factors. For this reason, we have put considerable effort into developing and updating our materiality framework so that our analysts focus on those factors that are most relevant to the companies' financial performance. This helps us ensure that we integrate financially material sustainability factors into our investment process in a structured manner. Because these factors are relatively under-researched by most investors, our integration of financially material sustainability factors in the investment process allows us to make unique and better-informed investment decisions for the long-term.

There has been much discussion about the materiality of sustainability in recent months. What makes your framework different?

What sets us apart is that our approach focuses on the intersection between sustainability and business performance. Specifically, we focus on identifying the most important intangible factors that relate to companies' ability to create long-term value. For instance, lowering energy consumption in manufacturing processes results in significant cost-saving opportunities and has a direct impact on a company's bottom line. This focus on the most financially relevant sustainability factors is essential, given our mission to create long-term attractive returns for our clients through Sustainability Investing strategies. However, we have also found that a focus on the link between sustainability and business performance is also a key priority for the leading companies in sustainability, which are working toward much more sophisticated models to understand the pay-offs of their sustainability investments in financial terms.

So how do you determine which information is financially material?

We begin with a top-down industry and mega-trend analysis. For each of the 59 industries we assess, we ask ourselves which are the key sources of value creation for that industry, and which long-term trends are likely to have an impact on these industry drivers. For example, one of the primary value drivers for the IT industry is its user and customer base. Given increasing interconnectedness and the exploding volume of data, an IT company's ability to ensure data privacy is critical to maintaining customer trust.

Once we have identified material factors for each industry, we prioritize them according to their expected magnitude and the likelihood of their impact on growth, profitability, capital efficiency and risk. This results in a materiality matrix for each industry, which maps the relative importance of each material factor against each other and provides us with a visualization of the most important factors for each industry (See Figure 1).

Once the material issues in each industry have been prioritized, our analysis shifts to the company level and focuses on how and to what degree management is addressing these intangible factors that are considered to be most relevant. This allows us to make the investment case for sustainability for individual companies, which in turn ensures that our investment decisions consider long-term company performance.

Essentially, we are determining which companies are most likely to remain competitive in a rapidly changing business environment and are therefore best positioned to continue to create value in a sustainable way.

Although your materiality framework focuses on industry-specific criteria, have you identified any sustainability criteria or factors that are significant across all industries?

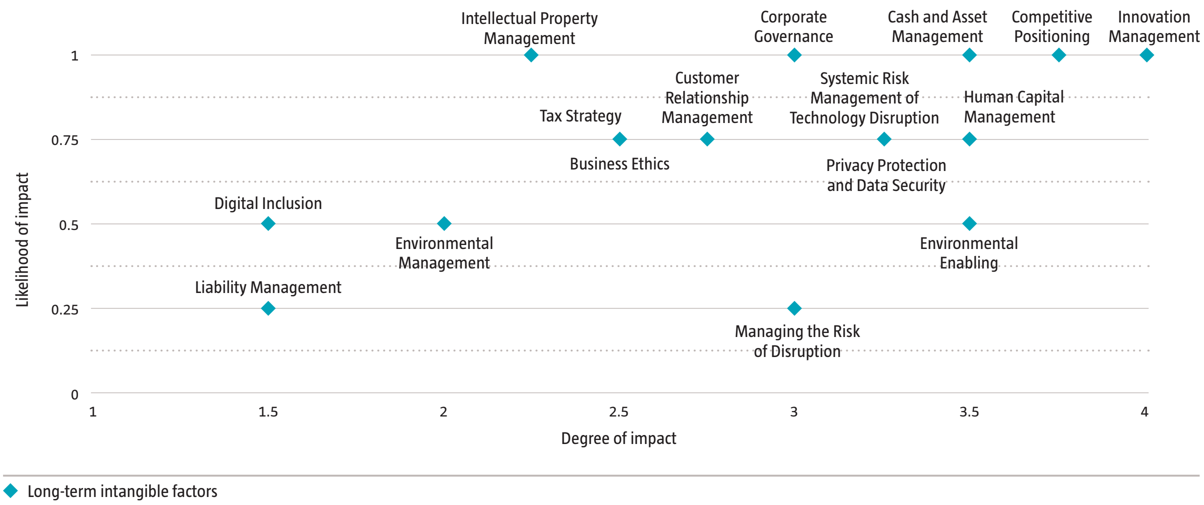
Yes. A variety of sustainability factors are relevant to companies across a wide range of industries. These include innovation management, human capital management, supply chain management, environmental management and corporate governance. But we tailor the questions in these criteria to the specific characteristics of each industry.

Sustainability factors and their financial impacts

We provide three industry examples – one for each dimension – to illustrate the impact of three selected sustainability criteria on the business value drivers for that industry. These examples are by no means exhaustive, and were selected to demonstrate how we make the link between sustainability factors and company costs and revenues.

Tax competition among different tax jurisdictions offers opportunities for multinational companies to optimize their tax spending. Tax optimization can help a multinational beverage company, for instance, to enhance its profitability, which investors appreciate. But the company can also face reputational risks if its tax strategy is perceived to be too aggressive, hurting its brand value and revenues. It can also lead to a poor relationship with the host country, jeopar-

Figure 1: Example of Materiality Matrix: Software industry



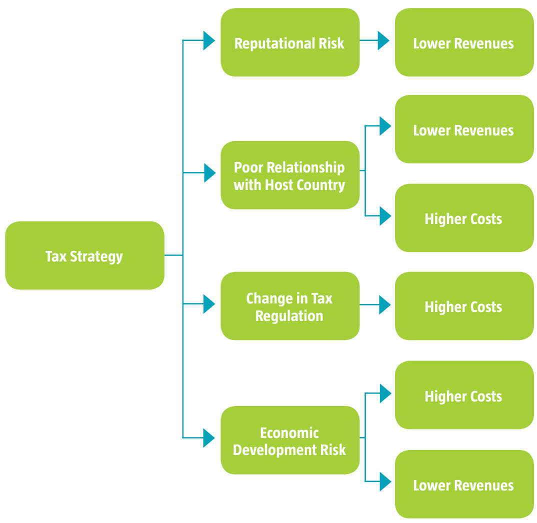
Note: This materiality matrix is provided for illustrative purposes. The materiality matrix for other industries may differ.

Source: RobecoSAM

dizing the company's license to operate or slowing permit approvals to build new factories, leading to higher costs and lower revenues. In addition, a tax strategy that relies too heavily on exploiting tax loopholes is not sustainable in the long-run and may result in higher costs if the government decides to change tax regulations to close these loopholes. Finally, if the company is not paying an appropriate level of local taxes to support economic development, particularly in developing countries, it inhibits the government's ability to invest in basic services for the local population, hurting potential consumers' purchasing power, and ultimately, company revenues.

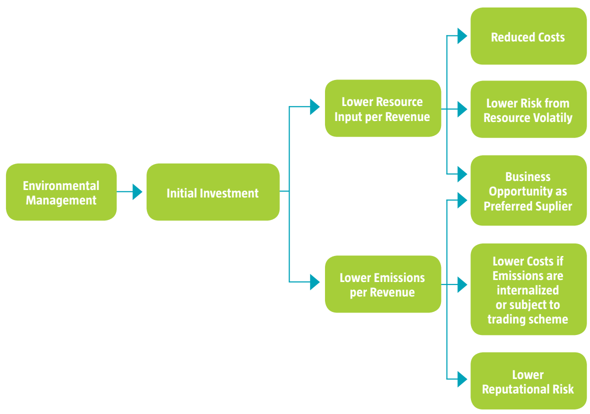
Given the amount of energy required for cement production, the cement industry accounts for 5 % of global CO_2 emissions. Therefore, reducing CO_2 emissions is an important component of an effective environmental management strategy for this resource-intensive industry. One approach, for instance, involves replacing CO_2 emitting coal with renewable energy. Though such a solution typically requires a large initial investment, it can also generate immediate benefits for the company. First, the amount of coal input per revenue generated is reduced, lowering operating costs and reducing the risk of margin volatility caused by changing coal prices. Second, emissions per revenue are reduced. This is particularly important in some regions, such as Europe, where CO_2 emissions are subject to an emissions trading scheme, and therefore have a real monetary value. Finally, a lower emissions profile may help companies generate business opportunities, as cement produced in this manner is considered to be more sustainable.

Industry: Beverages
Dimension: Economic
Sustainability Criterion: Tax Strategy



Source: RobecoSAM

Industry: Construction Materials
Dimension: Environmental
Sustainability Criterion: Environmental

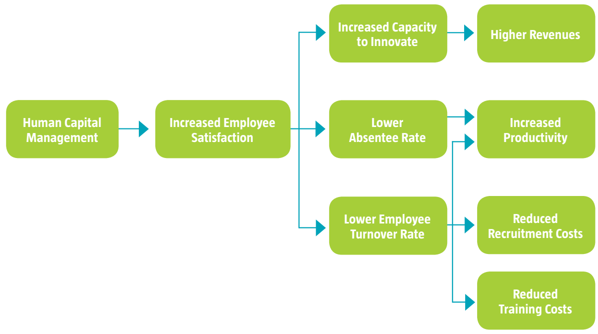


Source: RobecoSAM

For most companies today, employees are their most valuable asset. This is especially true for a knowledge-driven industry such as the pharmaceuticals industry. An advanced human capital management strategy that offers employees opportunities for career advancement, appropriate incentives to perform well, and a fulfilling work environment contributes to employee satisfaction. In turn, a motivated workforce contributes to the company's capacity to innovate, which has a positive impact on revenues. Lower absentee rates also contribute to enhanced productivity, while lower employee turnover leads to lower recruitment and training costs.

Christopher Greenwald
Co-Head of Sustainability Investing Research

Industry: Pharmaceuticals
Dimension: Social, Sustainability Criterion: Human Capital Management



Source: RobecoSAM