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20 Years

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What are the financially material ESG factors in the pharma sector?

Which sustainability criteria are financially material in the pharmaceutical sector? How do we evaluate pharma companies on ESG factors? RobecoSAM Sustainability Research Analyst Jacob Messina and Robeco Healthcare Analyst Stijn Vanacker explain how RobecoSAM determines financial materiality of sustainability factors, and how this information is integrated into financial analysis.

Financial materiality matters

ESG information is an important element in the investment processes of the Robeco Group's investment strategies. RobecoSAM's dedicated Sustainability Investing Research analysts (SI analysts) analyze over 90 ESG factors and assess how companies perform on these factors. They then work closely with equity and fixed income analysts throughout the organization to integrate this ESG analysis into their investment cases for individual companies.

What does financial materiality mean?

Not all ESG information is created equally in the eyes of the investor. RobecoSAM considers any factor that can have a significant impact on a company's core business value drivers – namely growth, profitability, capital efficiency and risk exposure – to be financially material. Thus, our SI analysts first determine which information is "material" for their sectors.

Why is it important?

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 a significant impact on a company's competitive position and long-term financial performance. As these factors are relatively under-researched, our integration of financially material sustainability factors into our investment processes allows us to make unique and better-informed investment decisions for the long term.

Company performance on material ESG factors is integrated into financial analysis

Our SI analysts have regular consultations with Robeco's equity analysts. They prepare the ESG analysis for the investment cases of the individual companies. To this end, the SI analysts begin with a top-down industry and mega-trend analysis. For each of the 59 industries we assess, we determine the key sources of value creation for that industry, and which long-term trends are likely to have an impact.

Once we have identified the 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 illustrates the most important sustainability factors for each industry.

Quantifying the impact of material ESG information on equity valuations

Once the material issues in each industry have been prioritized, our analysis shifts to the company level and we assess the company's performance on these factors. These company-specific analyses are included in the investment cases of the financial analysts, who quantify the impact of these scores on their valuation of the stock in question.

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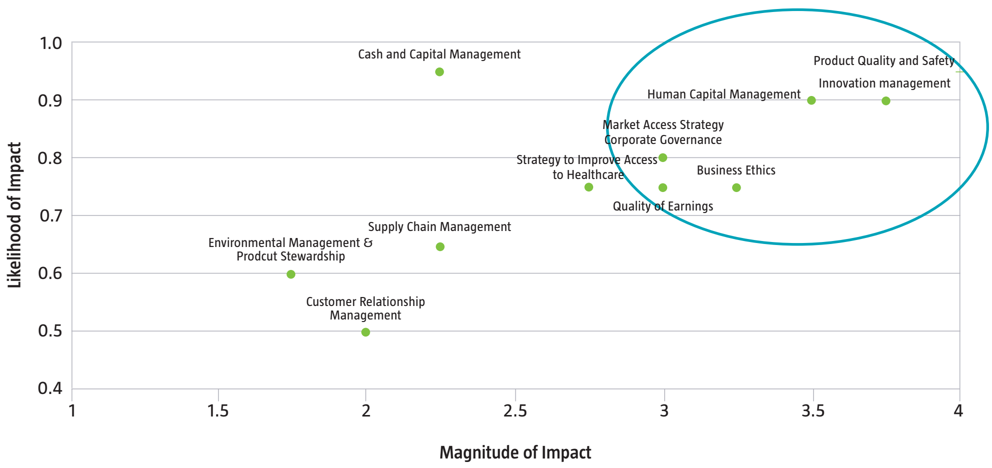
The evolving pharma landscape

Healthcare spending is soaring throughout the world. Aging populations, the ensuing increase in chronic diseases and growing access to healthcare in emerging markets have driven healthcare expenditures to unsustainable levels, and there is no relief in sight. Governments are increasingly looking for ways to slow the growth in health spending, and are introducing major healthcare system reforms to better align incentives for providers of products and services. The

Figure 1: Likelihood and magnitude of impact per factor for the pharma industry

Source: RobecoSAM



key word is value-based healthcare, or simply put, the delivery of the best outcomes to patients at the lowest cost.

Solutions coming from the pharmaceutical companies include personalized treatments and specialty therapies. The latter are the main driver of growth, especially in oncology and auto-immune diseases. Pharma companies increasingly focus on targeted acquisitions, selling non-core assets and mature products. Mergers & acquisitions (M&A) are nearly as important as research & development, especially for the large companies that are clearly focused on leveraging their development experience and launch capabilities. Over the past ten years, M&A activity in European large cap pharma companies accounted for USD 300 billion, against USD 390 billion for R&D.[1] Partnerships have also become critical, with agreements covering every aspect of the business from research to clinical trials to marketing.

Which are the most material ESG factors in the pharma industry?

With a view on industry trends, competitive dynamics, and critical success factors for the industry, the analyst evaluates the importance of various long-term intangibles. Figure 1 illustrates the result of this process for the pharma industry. As the factors in the upper right-hand corner have the largest impact and are most likely to have an impact, we focus our sustainability analysis on these financially material factors.

The most material factors in the pharma industry are:
- Product Quality and Safety
- Business Ethics
- Innovation Management
- Human Capital Management, Talent Attraction & Retention
- Quality of Earnings
- Corporate Governance

Analyzing the material factors for each company

A company's performance on these factors is analyzed in a disciplined, almost quantitative manner, leveraging the data collected in the RobecoSAM Corporate Sustainability Assessment as well as other public resources. Below we provide a short description of each factor, as well as examples of concrete variables we look at to assess companies' performance on each factor.

Product Quality and Safety and Business Ethics

Regulators, the public, and the courts have a diminishing tolerance for errors, omissions, and violations. The latter can either have a direct impact on earnings through fines, litigation, or lost income from regulatory actions, or an indirect impact as negative exposure in the press can damage a company´s reputation. Therefore, we carry out a Media & Stakeholder Analysis (MSA) by analyzing all media coverage of the company's involvement and response to environmental, economic and social crisis situations, over the past five years, as highlighted by RepRisk Business Intelligence. In this analysis, we adjust for the size of each company's revenue base, as one would expect a larger company to have a greater absolute number of incidents and related expenses. We are most interested in this adjusted relative performance.

For example, Pfizer is often thought of as having a uniquely poor track record of incurring significant fines and penalties. However, when adjusting for the size of its revenue base, it actually performs in line with several of the other large pharma companies. Thus, we

[1] Goldman Sachs

assign the company a “below average” rating in this area, but not a “worst in class” rating.

Innovation Management
Companies derive a competitive advantage from the consistent development of new products positioned in high growth markets with high barriers-to-entry. R&D needs to be organized efficiently. We look at, among other indicators, the ratio of new product revenues to R&D investment (a measure of R&D productivity), the pipeline, and positioning in specialty versus primary markets.

Human Capital Management, Talent Attraction & Retention
Innovation is driven by highly skilled and educated employees, which are in short supply. Talent retention and satisfaction contribute to all value drivers. Therefore, we look at factors such as employee turnover and employee satisfaction.

Quality of Earnings
The use of "normalized" earnings, i.e. earnings excluding one-time items, has become common practice in the investment community, and often for good reason. However, management has a significant amount of discretion in what they classify as "non-recurring," and in the first place, they are responsible for the events that give rise to these very real expenses, which have a tendency to persist at predictable levels over time. Thus, we compare "normalized" earnings to GAAP earnings, operating cash flow and free cash flow as a reflection of management quality and company performance. We also look at the sustainability of revenues, indicated by product concentration, patent expiries versus the pipeline, or the exposure to the primary market versus the more attractive specialty markets.

Corporate Governance
Good corporate governance is essential given the size of the pharma companies, the complexity of the markets in which they operate and the amount of funds allocated to M&A. We assess a company’s board quality by looking at the board members’ experience, independence, and the diversity of the board, as well as the executive compensation structure. Finally, we review the CEO’s remuneration to determine whether these policies are effective in practice, as a good compensation structure does not always lead to the alignment of pay and performance.

Rating the companies

For each of the material factors, we rate the companies from " ++ " to " -- ", which leads to an overal relative sustainability rating that is used in our actively managed strategies. We do this for highly competitive peer groups, as our goal is to identify competitive advantages even between leading companies. In the case of the pharma sector, we analyzed 15 of the largest US and European pharma companies, many of which perform well in our Corporate Sustainability Assessment and are included in the DJSI Indices.

Table 1 provides three examples of how companies are rated.

Let’s look at the example of Roche, which is "best in class" in the industry. This company is a clear leader in the space, with an excellent innovation record and a strong fundamental position in oncology, driven by the success of its US biotech subsidiary Genentech. The company also has an outstanding track record when it comes to safety, quality, and corruption, reflecting a culture of superior business ethics throughout the organization.

We do acknowledge that its corporate governance structure poses a minor risk, but one that we see as having historically contributed to the company’s long-term focus and outperformance. Roche’s leading scores in almost all categories mean that it has a sustained competitive advantage.

Integration of the sustainability assessment into financial analysis

Having determined the factors that are material for the sector and having evaluated the relevant companies on these factors, the SI analyst recommends impacts on the business value drivers of the company. For example, for Roche the SI analyst suggests that the company will likely be able to generate above market growth rates, sustainable profitability above peers, and at a slightly lower risk. The

Table 1: Sustainability ratings

Company	Ticker	MSA	Innovation	Human Capital Management	Quality of Earnings	Corporate Governance	Overall Relative Sustainability Rating
AstraZeneca	AZN	-	--	--	-	=	-
Johnson & Johnson	JNJ	-	=	=	=	=	=
Roche	ROG	++	++	+	++	=	++

Source: Bloomberg, RobecoSAM

financial analysts throughout the Robeco Group then integrate these views into their analysis of the stock, translating the associated competitive advantages and disadvantages into adjustments to value driver assumptions in valuation models.

Continuing with the example of Roche, the company's competitive advantages are visible in the field of oncology, where Roche dominates the domain. We expect its long term innovation edge over competitors to lead to higher pipeline success rates and stronger sustainable revenue growth. In one analyst's model, this equated to CHF 17, or 6 % of the company's fair value.

Conclusion

Many financial analysts do not analyze and quantify the impact of ESG factors as they feel this is too subjective. We disagree: with the combined knowledge and insights of SI analysts and financial analysts, we can make better informed decisions. Paying attention to ESG information enables the financial analyst to look at the company from a different perspective and think carefully: how would this company perform without this competitive edge or disadvantage? Quantifying the impact of ESG factors can be done and is a valuable exercise as it ensures critical thinking and analysis that go beyond consensus views.

Read more about ESG Integration at the Robeco Group:
C. Greenwald, "From Theory to Practice: Integrating Sustainability into Financial Valuation", RobecoSAM, The Sustainability Yearbook 2015.
http://yearbook.robecosam.com/from-theory-to-practice.html

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