CAN SUSTAINABILITY REPORTING REDUCE FINANCING COSTS?

By Philipp Mueller

More and more investors are aligning capital allocation to wider goals of financial stability and sustainable development. The view that investment strategies should create a positive impact for both business and society is now widely accepted. Corporate disclosure on sustainability issues such as climate change, human rights, governance and social well-being has increased significantly since the launch of the Global Reporting Initiative (GRI) in 2000. GRI helps businesses and governments worldwide to understand and communicate their impact on critical sustainability issues.

Today, 75% of the world's largest corporations use GRI standards. In the United States, 90% of the S&P 500 companies have published a sustainability report in 2019, a significant increase from the 20% observed in 2012, and much can be attributed to an increased investor demand. The same is true for the Netherlands, where 23 out of the 25 companies listed in the AEX Index have a dedicated sustainability report, either as a separate report or as part of their annual report.

Overall, the market for sustainability reporting is maturing and quality is improving continuously. New techniques based on machine learning can unlock valuable insights and offer ways to apply sustainability data in addition to conventional financial reporting. Initially viewed as a 'necessary evil', disclosing sustainability information is now a vital element of corporate reporting. For corporations that have a relatively good sustainability performance, reporting can be a key differentiator. But could sustainability reporting reduce financing costs for companies?

Different studies have illustrated that less information asymmetry through improved disclosure on sustainability performance leads to lower costs of equity capital.

Sustainability disclosure data are becoming increasingly important for asset managers to identify suitable investment opportunities.

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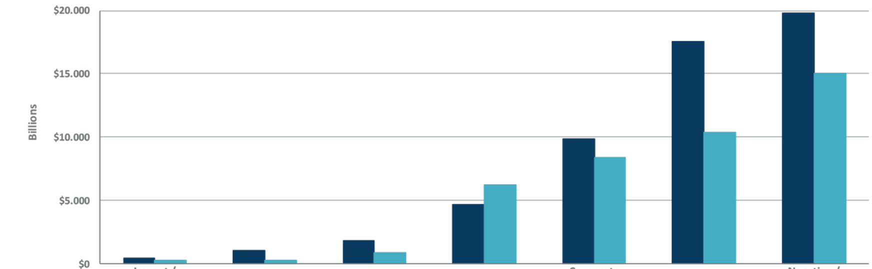
CV

Philipp Mueller is Chief Executive Officer of BlueOrchard, a member of the Schroders Group. As CEO, he leads the executive and extended management team and has executive oversight of the firm's client and business areas, including strategy and resource management. Mueller holds the position of Head of Investment Solutions at BlueOrchard. In this function, he is heading the Global Investment Committee and overseeing the portfolio management and asset allocation of all funds and mandates. Mueller joined BlueOrchard in 2018 from Partners Group, where he worked for ten years in Switzerland and the UK, most recently as Senior Vice President of Investment Solutions. Mueller holds an MBA from ETH Zurich and a Master's degree in Law from the University of Zurich.

Investors feel less need to price in risks when information asymmetry is reduced, leading to a decrease in the cost of capital. Whilst there is no evidence for immediate effects, sustainability reports and integrated reporting can indeed lower the cost of debt and equity in the medium and long term. These effects can be attributed to two main factors. Firstly, the adoption of a more sustainable business model, and secondly, an information asymmetry reduction caused by greater transparency, thus allowing for more informed forecasts by both borrowers and lenders. In short, sustainability disclosure can increase transparency and effective management and thereby enhance the ability of companies to attract long-term capital with better financing conditions.

Figure 1: Global Growth of sustainable investing strategies 2016 - 2018



	Impact / community investing	Sustainability themed investing	Positive / best-in-class screening	Norms-based screening	Corporate engagement and shareholder action	ESG integration	Negative / exclusionary screening
2018	$444,26	$1.017,66	$1.841,87	$4.679,44	$9.834,59	$17.543,81	$19.770,96
2016	$248,47	$276,16	$818,01	$6.195,40	$8.385,17	$10.353,20	$15.063,57
Growth 2016-18	79%	269%	125%	-24%	17%	69%	31%
CAGR	33,7%	92,0%	50,1%	-13,1%	8,3%	30,2%	14,6%

Source: Global Sustainable Investment Alliance (http://www.gsi-alliance.org/wp-content/uploads/2019/06/GSIR_Review2018F.pdf)

With the global SRI market now being worth more than USD 30 trillion, the demand for investable sustainable assets is growing in line. Sustainability disclosure data are becoming increasingly important for asset managers to identify suitable investment opportunities. This may open up financing opportunities for companies scoring high on sustainability performance.

Incorporating sustainability reporting into the investment process also benefits investors. Sustainability reporting leads to additional insights concerning positioning, management, operational efficiency, environmental and other potential risks, ultimately leading to better investment decisions. Recent studies and performance data suggest that integrating sustainable and impact reporting have a particularly positive impact on returns in emerging markets. A comparison of annualized returns since 2012 shows that sustainability-focused debt and equity indexes in emerging markets outperform the standard index, with comparable volatility. This seems not surprising given the relative information inefficiency of emerging markets: the analysis of sustainability reporting provides investors with a set of information that is complementary to traditional financial metrics.

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Good examples in this context are Green and Sustainable Bonds issuances. More and more investment managers develop in-house tools to assess the impact of bond issuances based on the issuer's sustainability reporting and on third party reports. These in-house tools often rely on industry standards set by the International Capital Market Association (ICMA), which has produced the widely accepted Green Bond Principles and Sustainable Bonds Principles.

For example, we developed an impact assessment process with detailed criteria to assess the social and environmental impact of bond issuers and bond issuances. The proprietary analysis tool used for the sustainability assessment assesses impact criteria based on publicly available information. In parallel, our company leverages its regional offices to gather additional and fundamental information on the local market. Other asset managers may apply similar processes, combining the sustainability and financial reporting.
Since frontier and emerging markets represent such a heterogeneous set of markets, local expertise and a detailed understanding of how different risks may impact these markets and relevant companies remain crucial. Successful investors combine detailed, fundamental analysis with local knowledge. Investors who are able to incorporate sustainability reporting into the investment process can benefit from these opportunities in some of the fastest growing markets in the world. So do companies that provide sustainability reporting.

The more a company is able to provide clear and transparent information on both financial and sustainability achievements, the higher it will score in the asset manager evaluation processes and qualify as an investee for the increasing volume of sustainable capital. The increased transparency brought by sustainability reporting broadens the investment universe for asset managers and can reduce investment barriers, especially in emerging markets. «

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