



The value of sustainability ratings

December 18, 2012

Robert Klijn

Founder and ESG specialist

www.fairimpact.nl



Agenda

- Introduction Fair Impact
- Why ESG Research?
- Influence on company behavior
- Which indicators do ESG research providers use?
- Which choices would you make?
- Value of ESG ratings on performance
- Which choices did I make?
- Conclusion



Fair Impact

- Founded in 2010
- Extensive international network
- More than twenty years in financial services industry
- Insight into ESG issues
- Representative of GMI Ratings and RepRisk
- Partnership with Tradinfo for ESG events
- Clients: investors, corporates, stock exchanges, brokers
- Competitors: event organizers, research providers

Why ESG Research?

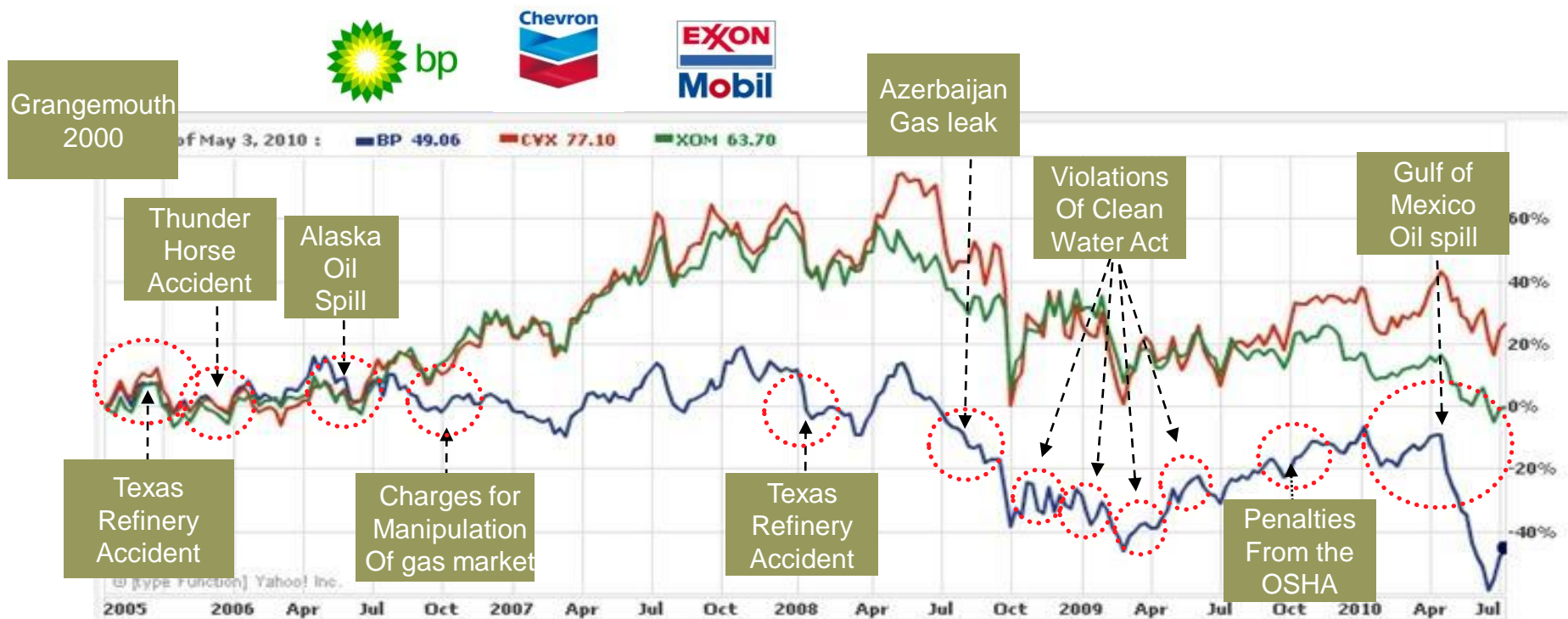
11 fatalities
17 injuries



Latest BP cost estimate \$40 billion
30% share price drop
1-year suspension of dividends



Warning signs prior to the disaster



Source: Yahoofinance.com

Up until April 19 (the day before the Deepwater Horizon explosion), his [BP's] performance was excellent.

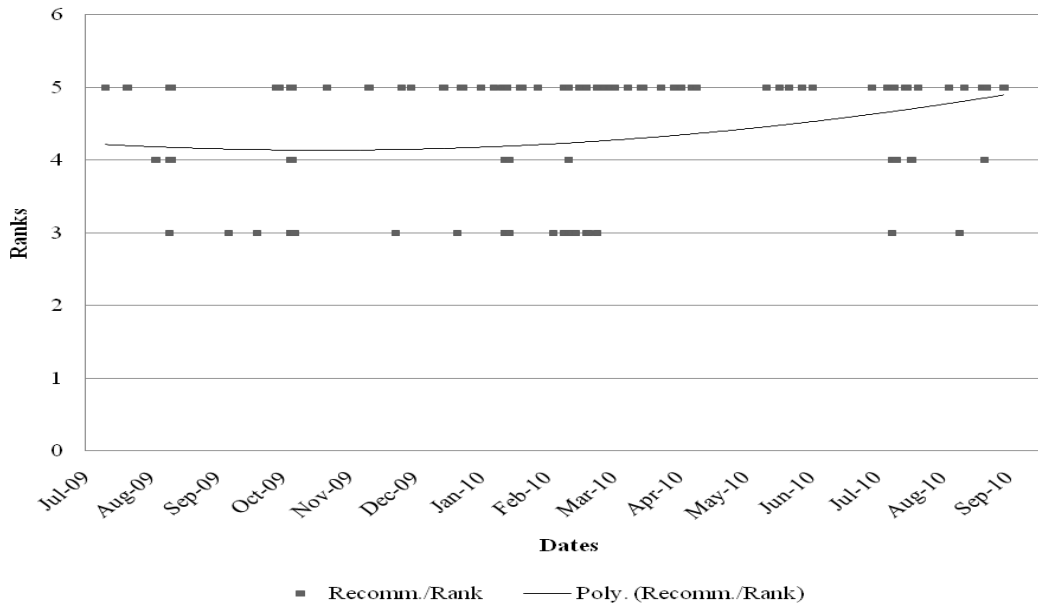
An investor close to BP quoted by The Financial Times, July 25th 2010



Behavioural finance expert: “analysts are biased”

Unicredit: analysts claim that BP has a good operational momentum because of its **“first-mover advantage in cost cutting”**

Recommendations



5 = buy or strong buy recommendations

4 = add, overweight, outperform and accumulate

3 = hold, perform, neutral

2 = reduce, underweight and underperform

1 = sell or strong sell

Source: SHEFRIN Hersh, CERVELLATI Enrico Maria, “BP’s failure to debias: underscoring the importance of behavioral corporate finance”, 21st February 2011



Are asset owners & “buy-side” much better?

Sadly, no!

Only 60% of capital voted at BP's 2010 AGM

57% of votes in favour of chair of safety committee! (Only leaving in 2012!)

Even proxy voting agencies recommended abstain (ISS)
or vote against (Glass Lewis)



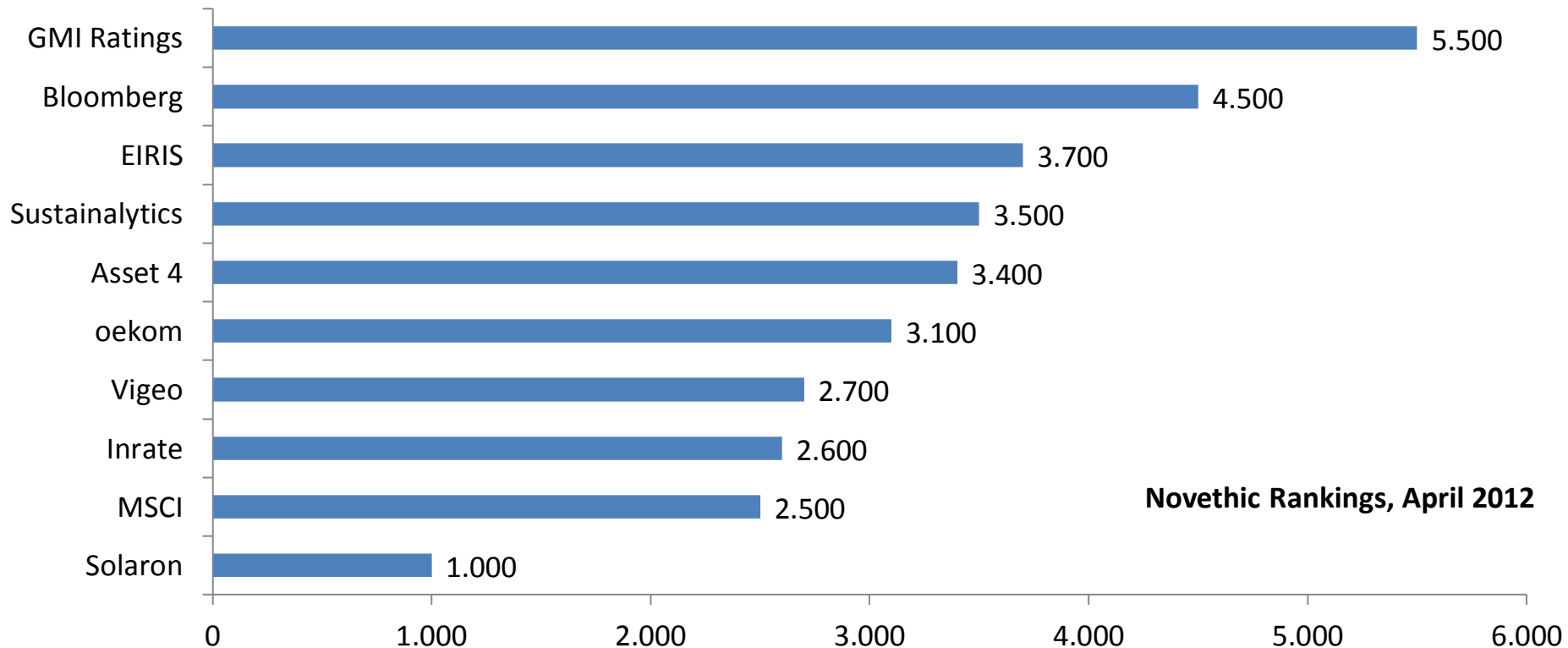
Influence on company behavior

- The CalPERS effect
 - Targeted 139 companies 1987-2007
 - Impact measured: 5-year TSR before and after engagement
 - Pre 5-year TSR: -84% < benchmarks
 - Post 5-year TSR: +15% > benchmarks
- Example: Vedanta Resources has now sustainability framework



Which indicators do ESG research providers use?

Coverage ESG Ratings



GMI Ratings' ESG and AGR Research

Data

- Thousands of data points collected and analyzed
- No cost to issuers
- Uses **publicly-disclosed information**
- Research teams in Portland and New York

Metrics

- 120 ESG metrics
- 50 AGR risk metrics



Red Flags

- Identified as companies with **“outlier” values**

Ratings

- Summary of flagged metrics
- **ESG rating** offers a **long-term view**
- **AGR rating** offers view on **material risk and financial governance concerns**
- Include both Home and Global market grades and reflect industry conditions



Investment Issues Covered and Example Data Points

Governance

- Board Accountability/Effectiveness
- Executive Pay Policy and Oversight
- Ownership Structure
- Takeover Defenses
- Example data point: **Is there at least one non-executive member of the risk committee or the board who has recent expertise in risk management?** Flagged if no.

Social

- Vendor Standards
- Employee Relations
- Bribery and Corruption
- Diversity
- Political Contributions
- Example data point: **Has the company been cited, or pled or found guilty 3 or more times for unfair labor practices within the last 2 years?** Flagged if yes.

Accounting

- Forensic Risks
- Financial Disclosure Issues
- High Risk Events
- Example data point: **Has the company been accused of or settled allegations or charges related to securities or accounting fraud?** Flagged if yes.

Environmental

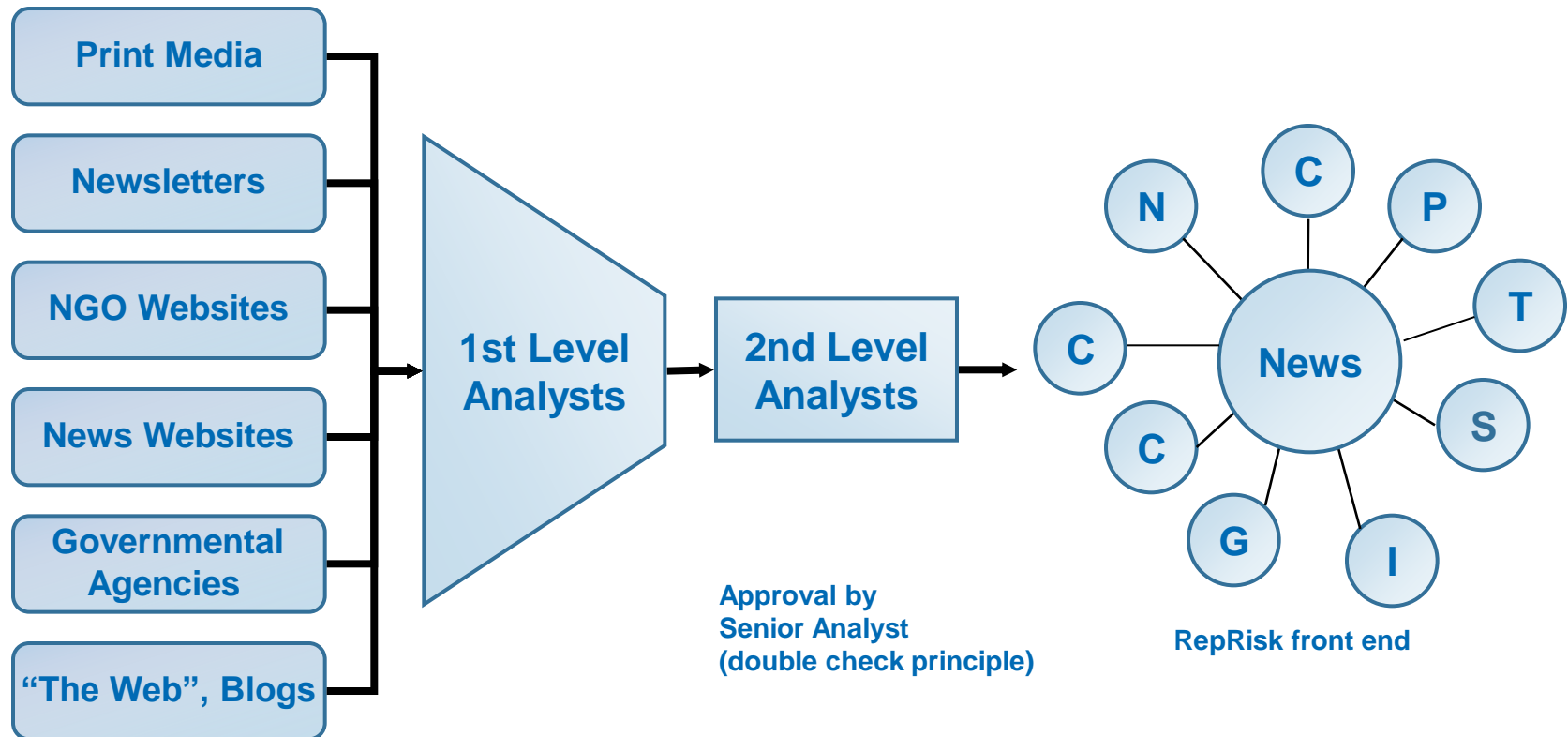
- Climate Change
- Environmental Reporting
- Board-level Governance
- Supply Chain Risk
- Management Systems
- Example data point: **Has the company identified specific environmental impact reduction targets?** Flagged if no.

AGR: Metrics Engine - AGR Taxonomy

- Imposes a logical structure onto all of the data allowing the user to expand from high-level summary information to a detailed chart.

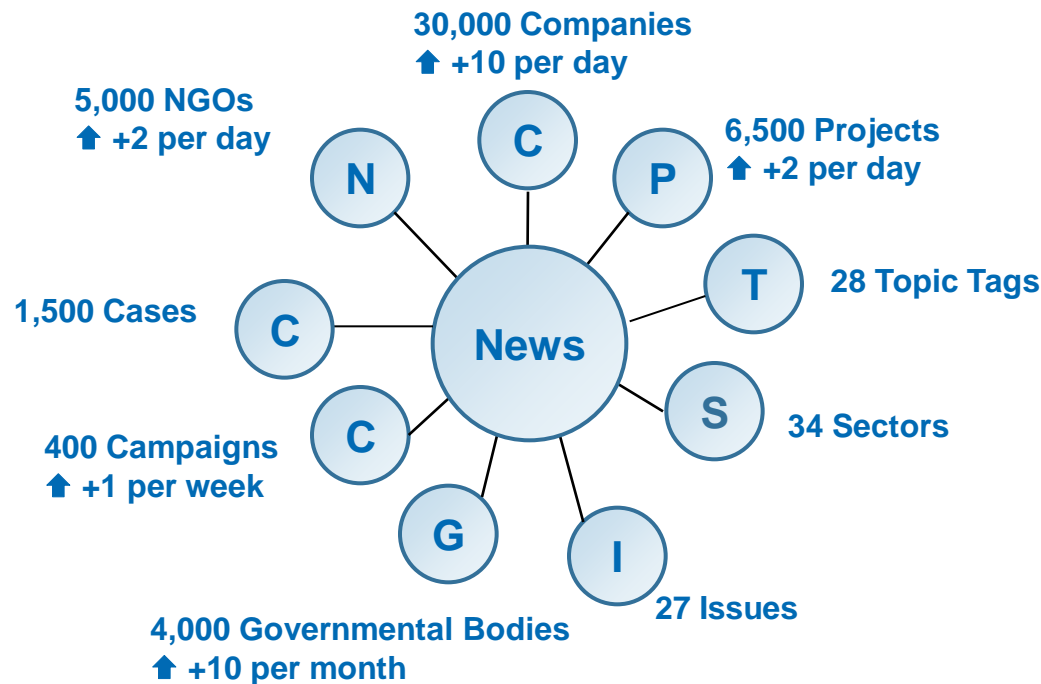
AGR Hierarchy	Current Qtr	Historical Quarters (AGR Percentiles/Red Flags)											
		03/11	12/10	09/10	06/10	03/10	12/09	09/09	06/09	03/09	12/08	09/08	06/08
Risk » Metric » Metric Test	AGR Impact	94	74	48	66	82	82	75	35	32	44	49	76
<input checked="" type="checkbox"/> Corporate Governance Events	58.2%												
<input checked="" type="checkbox"/> High Risk Events	0.0%												
<input checked="" type="checkbox"/> Revenue Recognition	0.0%												
<input checked="" type="checkbox"/> Expense Recognition	41.8%												
<input checked="" type="checkbox"/> Asset-Liability Valuation	0.0%												
<input type="checkbox"/> Expense Recognition	41.8%												
<input checked="" type="checkbox"/> Deferred Income Tax Assets LT/Operating Exp													
<input checked="" type="checkbox"/> Deferred LT Charges/Operating Expense													
<input checked="" type="checkbox"/> Deferred Policy Acquisition Costs/Operating Exp													
<input checked="" type="checkbox"/> Depreciation Expenses/PPE	41.8%												
<input checked="" type="checkbox"/> Insurance: Insurance Reserves over Premiums													
<input checked="" type="checkbox"/> Labor Related Expense/Revenue													
<input checked="" type="checkbox"/> Realized Loss/Operating Expense		--	--	--	--	--	--	--					--
<input checked="" type="checkbox"/> Selling G&A Expenses/Operating Expense													

Global Coverage and Rigid Data Selection



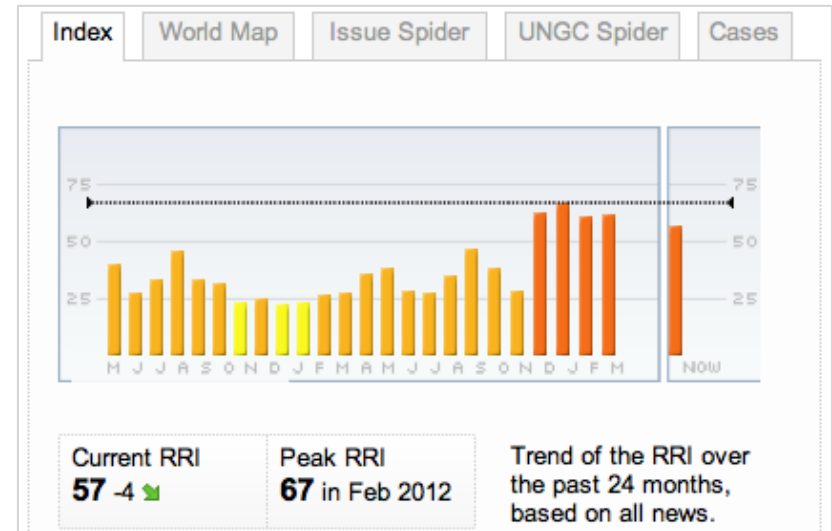
Advanced search algorithms covering Chinese, English, French, German, Japanese, Korean, Portuguese, Russian, Spanish, Danish, Finnish, Swedish and Norwegian sources worldwide

Companies associated with controversial issues in over 180 countries



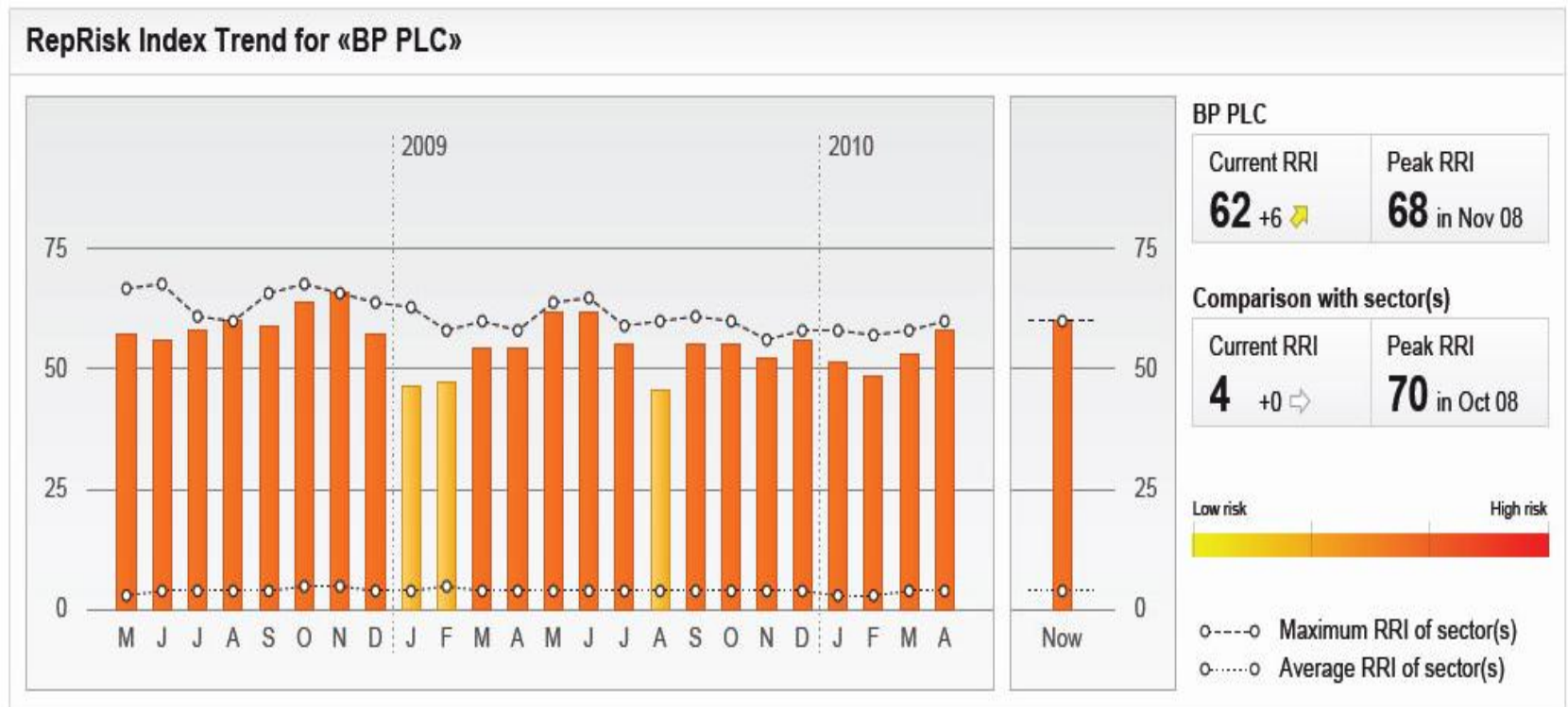
The RepRisk Index (RRI)

- Quantifies the exposure of environmental, social and reputational risks
- Identifies controversial companies to avoid financial, compliance and reputational risks
- Allows comparison to peers and avoidance of controversial investments and risky business relationships
- Calculation based on source, severity and novelty of news as well as frequency and timing of news



BP's risks peaked in 2008 and materialized in 2010

RepRisk Index Analysis of «BP PLC» from May 2008 to April 2010





Users

- Asset managers
- Asset owners
- Banks
- Credit rating agencies
- Insurance companies
- Professional service firms
- Public corporations
- Regulatory agencies
- Stock exchanges
- Universities



Which choices would you make?

- After reading the cases, what are the names of the 5 companies?
- What ESG ratings would you give to the 5 companies?
- What drove the ratings?
- In which order would you place the 5 companies? 1=best, 5=worst

Example case Study: Financial Implosion

Lehman Brothers (2008) Governance and Accounting

What happened? Bankruptcy due to over-exposure to sub-prime mortgages

What was the GMI Ratings ESG rating? D

What drove the rating?

- Exceptionally weak & ineffective board
- Accounting & disclosure issues
- Consistently poor pay/performance link

ESG Rating	Scores
A	96-100
B	76-95
C	26-75
D	6-25
F	1-5



In which order would you place the 5 companies in the cases?

Groups	1	2	3	4	5	6
Order						
1	4	4	4	4	4	4
2	2	1	2	5	1	1
3	1	2	5	2	5	5
4	5	5	3	1	2	2
5	3	3	1	3	3	3

Company 1 News Corporation (2011) Governance

What happened? Scandal leading to significant reputational damage and potential shareholder litigation and regulatory actions

What was the GMI Ratings ESG rating? F. At present still F and Aggressive (21)

What drove the rating?

- Governance organized to benefit a controlling shareholder
- Exceptionally poor pay/performance link
- Questionable related party transactions

What was the RRI rating? Peak September 2011: 59 after sharp increases in March (+17) and July (+20) 2011. Peak April 2012: 76. March 2012 increased from 43 to 63 (+20).



Source: RepRisk AG, www.reprisk.com



Company 2 Sino-Forest Corporation (2011) Accounting

What happened? The China-based timber company was accused of accounting fraud, leading to a loss of 72% of the stock price and the CEO's resignation.

What was the GMI Ratings Risk rating? 1 (of 100, lowest possible), now F

What drove the rating?

- Revenue recognition issues, including Receivables
- Expense recognition: understated, misreported
- Indications of overstating asset valuations
- Questionable board qualifications

What was the RRI rating? Aug 2011 increased from 25 to 35 (+10).
Sept 2011 increased from 35 to 44 (+9). Peak Sept 2011: 44.

Company 3 Tokyo Electric Power Company, TEPCO (2011)

Environmental and Governance

What happened? Environmental damage leads nuclear crisis and \$15B direct loss; massive future cost overhang related to ongoing cleanup and remediation

What was the GMI Ratings ESG rating? D, now: F and aggressive (31)

What drove the rating?

- Ineffective board oversight, including:
- Excessive size
- Large Percentage of Executive Directors
- Three employees on Audit Board



What was the RRI rating? March 2011 increased from 19 to 76 (+57). Peak April 2011: 86.



Source: RepRisk AG, www.reprisk.com

Company 4 General Motors, GM (2009) Social and Accounting

What happened? Bankruptcy, which was identified as a possible outcome by GMI

What was the GMI Ratings ESG rating? D, now C and Very Aggressive (9)

What drove the rating?

- Weak, ineffective board
- Failed internal controls and 404 violations
- Accounting issues, including underfunded pension

Company 5 American International Group, AIG (2008)

Governance and Accounting

What happened? Major loss of value precipitated a liquidity crisis that necessitated the largest government bailout in history

What was the GMI Ratings ESG rating? D, now F and Average (56)

What drove the rating?

- Weak, ineffective board
- Poor pay/performance link
- Accounting irregularities



Value of ESG ratings on performance

ESG

- We find a strong and positive relation between firm-level **corporate governance** and firm valuation and between a company's **social behavior** and firm value." (Ammann, Oesch & Schmid, 2009)
- "A stock portfolio consisting of companies categorized as least risky by [GMI Ratings] sizably **outperformed** the broad benchmark." (QSG, 2010)
- "[ESG Ratings] are statistically significantly related to prior **performance** and to **future returns**..." (Watson & Spellman, 2009)

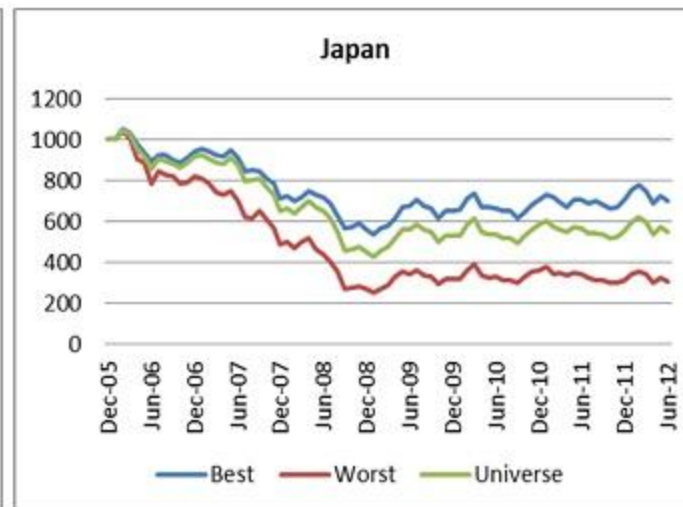
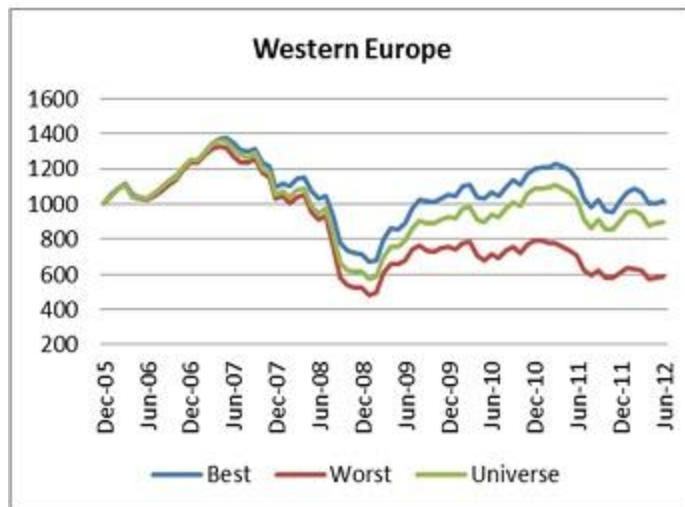
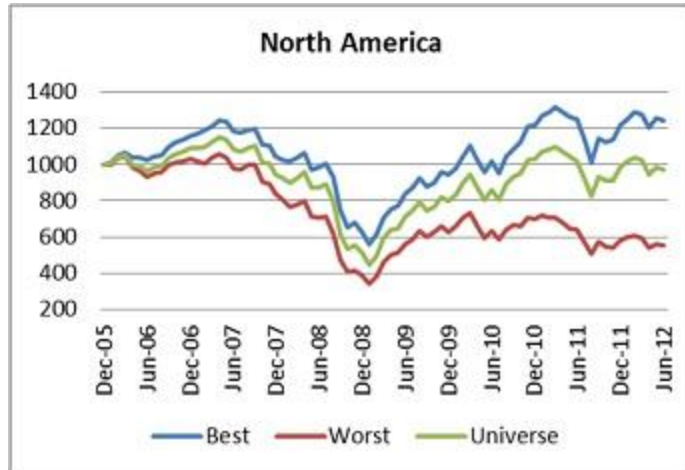
AGR

- "...the commercially developed [Risk Ratings are] **superior to current academic measures** for detecting and predicting accounting irregularities." (Price, Sharp & Wood, 2010)
- "The **accounting component** of the [Risk Ratings] performs better in predicting misreporting leading to restatements, shareholder litigation or an SEC enforcement action." (Correia, 2009)
- "[GMI Ratings] had **solid return** performance as well as having significantly **less volatility** of returns than other research firms." (Fidelity/Investars, 2010)

AGR Global Performance Data



- Between December 2005 and June 2012, a portfolio of companies with top-decile AGR ratings would have outperformed the lowest-decile portfolio by 123% in North America, 74 % in Western Europe, 94% in Asia Pacific (ex. Japan) and 128% in Japan.





Which choices did I make?

- Graduated in Economics in 1991 in Amsterdam with Bert Scholtens
- Account Manager at F. van Lanschot Bankiers
- ...1390 people did not get this job in private banking
- 1994 General Sales at ING Equity Markets, sell-side
- 2000 Specialist Sales for Oil&Gas and Utilities
- 2002 Started SRI&CG Brokerage at ING Equity Markets
- 2008 Client Portfolio Manager at APG, buy-side
- 2010 Sales Mandate at RepRisk
- 2011 Partnership with Tradinfo: RICA conferences
- 2012 Executive Sales, Europe at GMI Ratings



Conclusions

- Sustainability ratings help and alert investors and companies.
- ESG is only the beginning of the search for a more holistic definition of risk. Forensic accounting represents a logical next step in the development of non-traditional measures of issuer risk.
- You can be part of the process to improve sustainability!



Thank you, and please think how you can support this work!

No money but very useful experience / networks for a self starting young researcher...



Network for Sustainable Financial Markets

www.sustainablefinancialmarkets.net

rthamotheram@gmail.com



Preventable
Surprises

www.preventablesurprises.com