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Sustainability issues move from the periphery

Board perspectives

As companies head into the 2017 proxy season, shareholder engagement and environmental, social, and governance (ESG) issues are likely to be high on the agenda for many boards. Indeed, in his latest research, Harvard Business School Professor George Serafeim finds sustainability issues moving from the periphery to the center of corporate thinking.

Board Leadership Center (BLC): *Your latest research looked at investor engagement with companies on ESG issues in the form of shareholder proposals. Why did you choose that topic?*

George Serafeim: In the past, engagements on environmental and social issues tended to be very rare and received very low levels of support, but this has been changing. This past year, such engagements represented the majority of all shareholder proposals, and average votes in support more than doubled to reach more than 20 percent. Boards need to be part of the discussion in order to understand why investors are engaging on such issues, how the company should respond, and how its business model needs to adapt to remain competitive.

We now have strong evidence that ESG issues are significant value drivers and that the strategic importance of different ESG issues varies across industries. At the same time, the role of the private sector in solving big problems, such as climate change and social inequality, is clear. The adoption by world leaders in September 2015 of the Sustainable Development Goals was a formal recognition that, without the private sector, we are not going to make much progress toward a more inclusive and sustainable form of economic development.

As I mentioned, these proposals have received very low levels of support. At the same time, it has been clear for a while now that ESG issues have been gaining importance and redefining the role of the corporation in society. The public is looking at business as a potential solution to the large environmental and social issues we face. This means that many companies could become responsive to such proposals. Indeed, sustainability issues for many companies have been moving from the periphery to the center of business model, and product and process innovation. At the same time, we live in an age of transparency. It is hard for any company to ignore such issues, as corporate impact is easy to publicize, and reputations are hard to repair.

BLC: *Why should boards care about shareholder activism on ESG issues if those proposals don't usually get that much traction in terms of voting support?*

Serafeim: First, average support for such proposals has been increasing. Within the next two years, if the trend continues, a significant percentage will gain majority support or be close to it. The same thing happened with executive compensation and board composition proposals: they started with very low levels of support but gradually gained votes. Second, an increasing number of investors are developing more advanced and sophisticated voting policies. Boards should not be surprised to see some ESG issues becoming must-address issues within industries. These will vary across industries. For example, climate change is an issue for energy companies that face technological and regulatory risk, as well as insurers and real estate companies with exposure to physical risks due to climate change. Retailers and technology companies will increasingly face questions about customer privacy and data security, while access to affordable products and price setting in the context of healthcare companies will likely gather momentum.

But perhaps, more importantly, my research shows that a subset of these proposals provides a useful lens for understanding whether the organization is performing to its full potential and whether management has the right strategy and policies in place. The board can be informed by proposals that are both financially material and advance social impact.

BLC: *How can boards determine which ESG issues are material for their companies? What questions do they need to consider in making that determination?*

Serafeim: A first step could be considering the materiality determination made by the Sustainability Accounting Standards Board. SASB develops industry-by-industry standards that specify which issues are material and the key performance indicators (KPIs) for tracking performance on those issues. So, the board of a pharmaceutical company has access to important analysis for the pharmaceutical industry, while the board of a commercial bank can look at information that is relevant for the banking industry.

Even within the same industry, the materiality of an issue from company to company might differ due to idiosyncrasies in business models and strategy. Boards need a deeper understanding of what matters to employees and customers, as well as shareholders and other stakeholders. Understanding how these stakeholders make choices in a competitive market will go a long way in informing how ESG issues should be addressed and integrated in the operating policies of the organization. For example, relating to employees, many organizations are now realizing that a clearly communicated corporate purpose and a meaningful job create a more productive, effective, and engaged workforce, which could be a unique competitive advantage, but most companies still fail to convince their employees about corporate purpose. Similarly, an increasing percentage of consumers, especially among younger generations, really care about a company's societal impact, and, in some cases, this is reflected in their buying behavior. But many companies still fail to understand how consumer sentiment is shifting and how they can maintain social capital. With an increasing involvement of the board in strategic decision making, there is an opportunity to design better business strategies that create more sustainable economic performance and more positive social impact.

BLC: *What should boards take away from your research?*

Serafeim: Boards should expect to face requests from different shareholders asking them to consider and take action on a diverse set of ESG issues. My research suggests that a subset of those proposals provides some really fantastic ideas in promoting both positive societal impact and business value, ranging from nutrition-related proposals in the retail and food sectors to community relations proposals in the mining sector to climate change proposals in the utilities sector. My research finds that those proposals are associated with subsequent improved performance of the engaged companies on the topic of the proposal, and the market valuation of those companies also improved relative to their competitors.

At the same time, my research also shows that many proposals are financially immaterial. As a result, boards need to exercise professional judgment in how they react to shareholder proposals and the actions they take. They need to understand how the changing societal and environmental context is affecting the viability of their company's business model, including integrating the most important sustainability issues into the business strategy, tracking the right KPIs, incentivizing management using those metrics, and communicating performance improvements to shareholders and other stakeholders.

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