Crisis management and circular investment opportunities

When do circular businesses become recognized as undervalued investment opportunities?

Peter Groznik, MD MSIN and Partner at NorthGrant

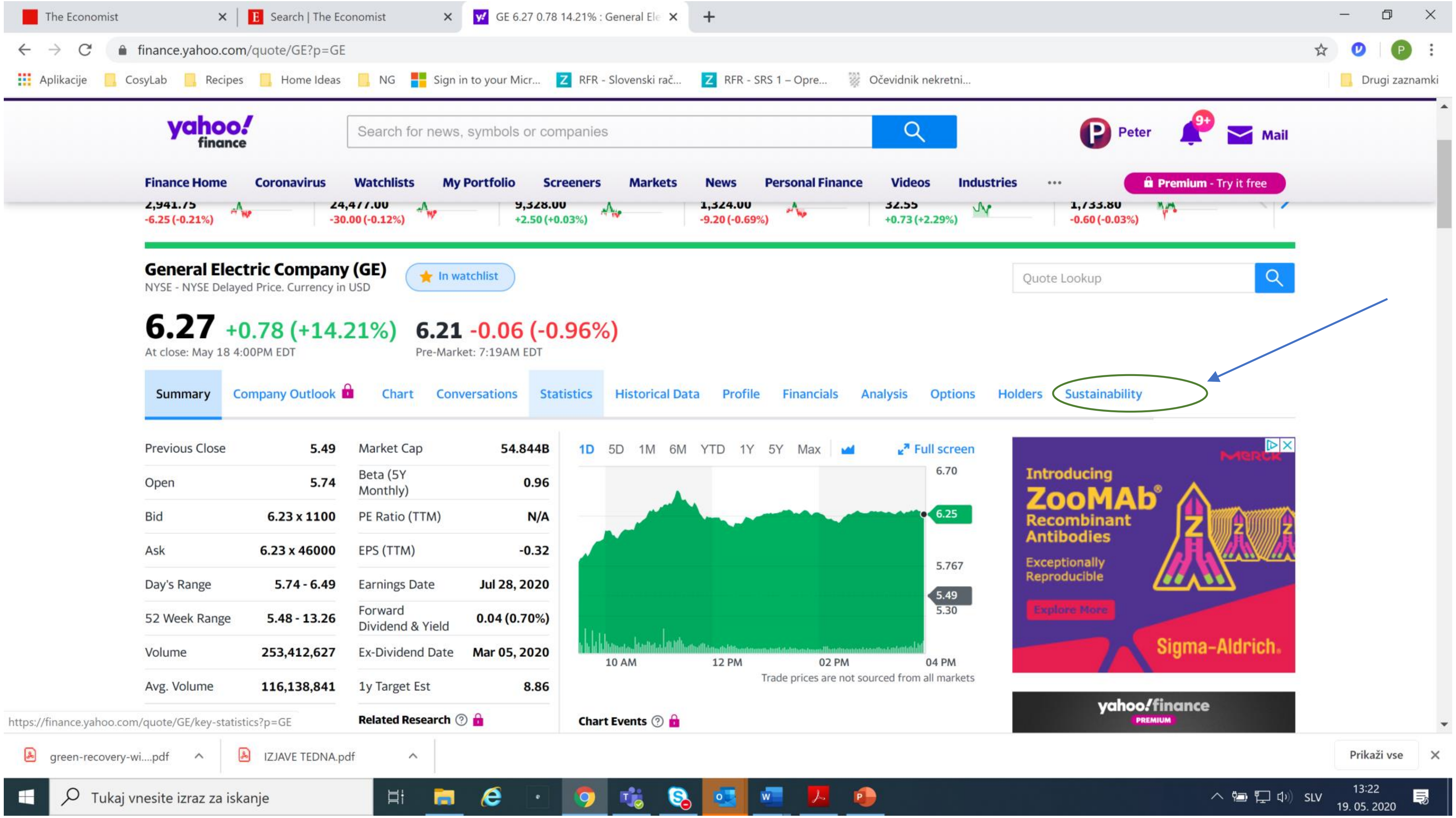
Circular economy

- The concept of circular economy is based on the ability to recover onsite resources that are still circulating (overproduction, waste) instead of importing them from the outside.
- Circular economy means a different approach to production methods. In other words, it goes from a linear process that sees the use of raw materials and the generation of production waste that is thrown away, to a model that regenerates itself, transforming what is commonly considered waste into a resource. A passage that is first and foremost cultural
- Related concept but not the same as Environmental, Social, and Governance (ESG) factors.

Green is the color of money

- Wise corporate leaders believe strongly in sustainability. Even in tough economic times, they adopt sound environmental policies, and understand that “green thinking” can be profitable, both short- and long-term.
- Some misguided executives believe that going green means more expenses. They have it backward. In fact, green companies use fewer resources, which means saving money, for example, by cutting energy use and by reducing waste.
- While a green strategy can call for start-up capital investments, that cost generally leads to substantial long-range savings and often very short paybacks as well (Green Recovery, Andrew S. Winston, 2009)

How sustainable /circular company is, plays a role in investment decisions



Climate change has made ESG a force in investing (The Economist, 7.12.2019)

- Yet love them or hate them, ESG scores are becoming ever more important in the world of investing and capital markets. At least $3trn of institutional assets now track esg scores, and the share is rising quickly.
- Christine Lagarde, the new head of the European Central Bank, thinks the institution should consider using monetary policy and bank supervision to fight climate change—a shift that would involve assessing which firms are dirtier than others. Mark Carney, the governor of the Bank of England, has championed better disclosures by firms on climate change. Chris Hohn, the head of tci, a London-based hedge fund famous for its hard-headed approach, has outlined plans to vote against the directors of companies that fail to reveal their carbon emissions.

Valuation of any business

- The way to think about valuation is: It is a bridge between stories and numbers. (A. Damodaran, 2017)
  - 5-step Process to Valuation
    - Step 1: Develop a narrative for the business you are valuing.
    - Step 2: Test the narrative to see if it is possible, plausible, and probable.
    - Step 3: Convert the narrative into drivers of value.
    - Step 4: Connect the drivers of value to a valuation.
    - Step 5: Keep the feedback loop open

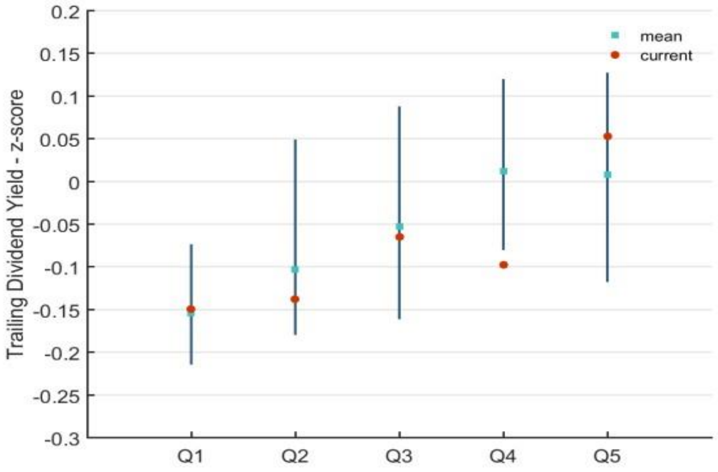
All of the classical finance valuation pillars also apply to circular/sustainable/greener companies

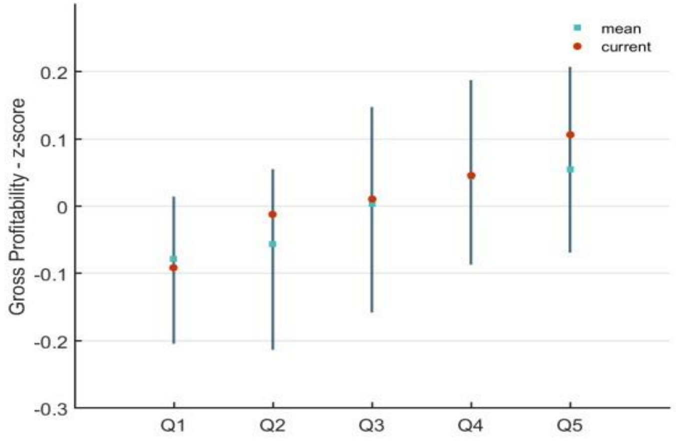
...Free Cash Flows, Dividends, Risks, Growth rates...still matter

CASH-FLOW CHANNEL (Giese, Guido, et al, 2019)

Strong ESG profile → **1. More competitive** → **2. Higher profitability** → **3. Higher dividends**

1. Companies with a strong ESG profile are more competitive than their peers. For instance, this competitive advantage can be due to the more efficient use of resources, better human capital development or better innovation management. In addition to this, high ESG-rated companies are typically better at developing longterm business plans and long-term incentive plans for senior management.
2. High ESG-rated companies use their competitive advantage to generate abnormal returns, which ultimately leads to higher profitability.
3. Higher profitability results in higher dividends.

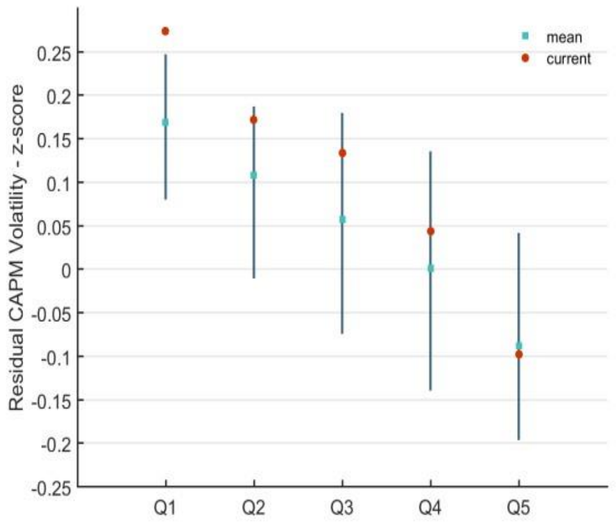




IDIOSYNCRATIC RISK CHANNEL (Giese, Guido, et al, 2019)

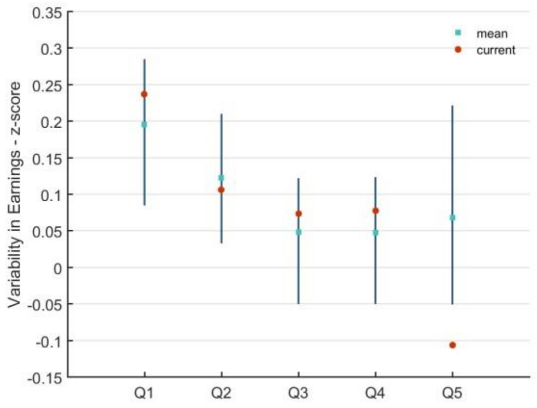
Strong ESG profile → 1. Better risk management → 2. Lower risk of severe incidents → 3. Lower tail risk

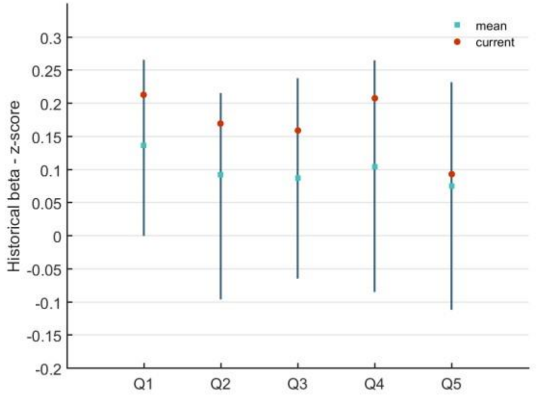
- Companies with strong ESG characteristics typically have above-average risk control and compliance standards across the company and within their supply chain management.
- Due to better risk control standards, high ESG-rated companies suffer less frequently from severe incidents such as fraud, embezzlement, corruption or litigation cases (cf. Hong and Kacperczyk [2009]) that can seriously impact the value of the company and therefore the company's stock price. Hoepner et al. (2013) call this an ''insurance-like protection of firm value against negative events.''
- Less frequent risk incidents ultimately lead to less stock-specific downside or tail risk in the company's stock price.



SYSTEMATIC RISK TRANSMISSION CHANNEL (Giese, Guido, et al, 2019)

1. Companies with a strong ESG profile are less vulnerable to systematic market shocks and therefore show lower systematic risk. For instance, energy- or commodity-efficient companies are less vulnerable to changes in energy or commodity prices than less efficient companies and therefore their share price tends to show less systematic market risk with respect to these risk factors.
2. In a CAPM model framework (cf. Ruefli 1999), the beta of a company has two important functions: First, beta measures the systematic risk exposure of companies (i.e., lower beta means less systematic risk) and second, it translates the equity risk premium into the required rate of return for the individual company. Therefore, lower systematic risk means a company's equity has a lower value for beta and therefore investors require a lower rate of return. Ultimately, this translates into a lower cost of capital for a company.
3. Finally, a lower cost of capital leads directly to the last step of the transmission mechanism: In a DCF model framework, a company with lower cost of capital would have a higher valuation.
4. Investor preferences: Many risk-averse investors and socially conscious investors avoid exposure to low ESG-ranked companies.
5. Information asymmetry: The problem of asymmetric information between companies and their investors is less severe for high ESG-rated companies, since high ESG-rated companies are typically more transparent, in particular with respect to their risk exposures and their risk management and governance standards.

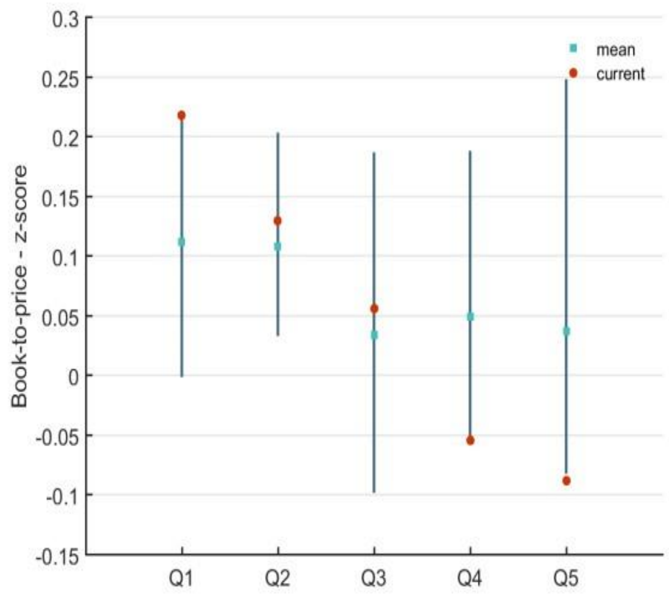


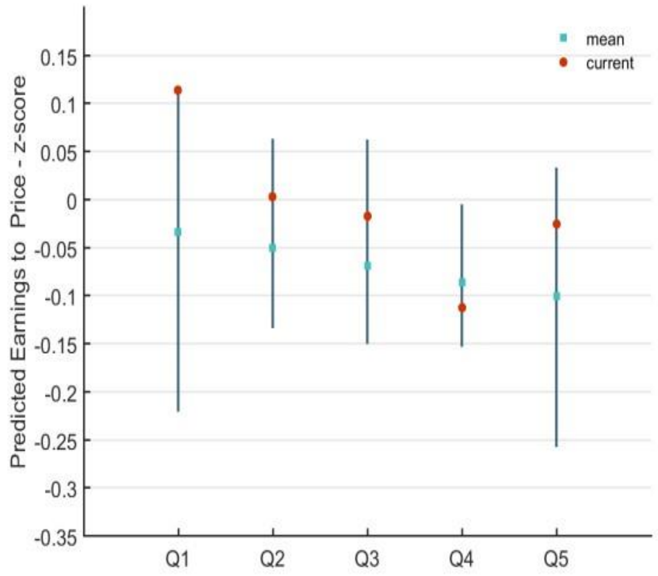


Risks- other studies are coming to similar conclusions

- The corporate social performance (CSP) of organizations is often operationalized and evaluated by the so-called environmental, social, and governance factors (ESG factors)
- On the basis of a large European panel dataset of 8752 firm-year observations covering the period 2002–2014, we find that a higher CSP decreases total and idiosyncratic risk. Looking at the three dimensions of CSP, we show that social performance has a significantly negative effect on all three risk measures. Environmental performance generally decreases idiosyncratic risk, whereas total risk and systematic risk are only affected in environmentally sensitive industries. In contrast, we cannot detect a significant effect of corporate governance performance on firm risk.
- Our findings suggest that a higher CSP and a higher performance regarding the social dimension in particular have the potential to increase firm value through lower firm risk.
- Overall, our evidence fosters the assumption that there is a business case to be made for corporate social responsibility.
- (Impact of ESG factors on firm risk in Europe, Sassent et al 2016)

Higher ESG – higher valuations





Causality or correlation?

- Companies with a rating upgrade demonstrated a relative improvement in their systematic risk profile compared to neutral or downgraded companies
- We observed a relative decrease in beta for companies whose ESG rating improved compared to downgraded companies

Crisis management and communications

- Take care of your people
- Keep an eye on liquidity
- Strengthen the long-term solvency of your business (i.e. going even more circular?)
- In discussions with investors/banks: clearly explain your business model and show how your circularity is contributing to cash flows, risks, growth rates.

- Everything you do should affect either free cash flows/risks/growth rates -if it does not, then don‘t do it.

References

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