Private Engagements on Material ESG Issues

Rob Bauer, Jeroen Derwall, and Colin Tissen (2022)

WPSF Research Seminar
January 18, 2023
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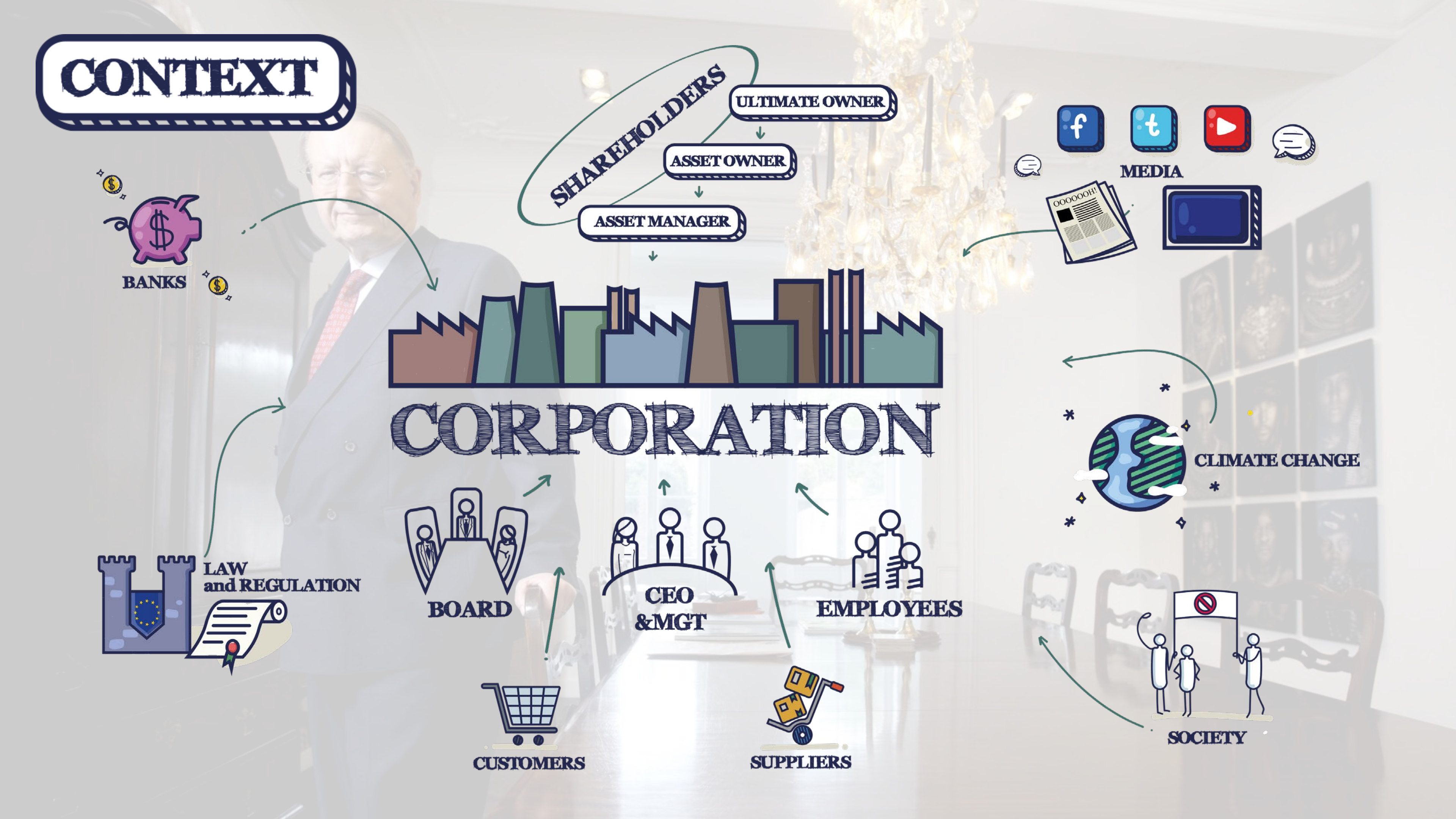
CONTEXT
SHAREHOLDERS
ULTIMATE OWNER
ASSET OWNER
ASSET MANAGER
MEDIA
OOOOOOH!
BANKS
CORPORATION
CLIMATE CHANGE
LAW
and REGULATION
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EMPLOYEES
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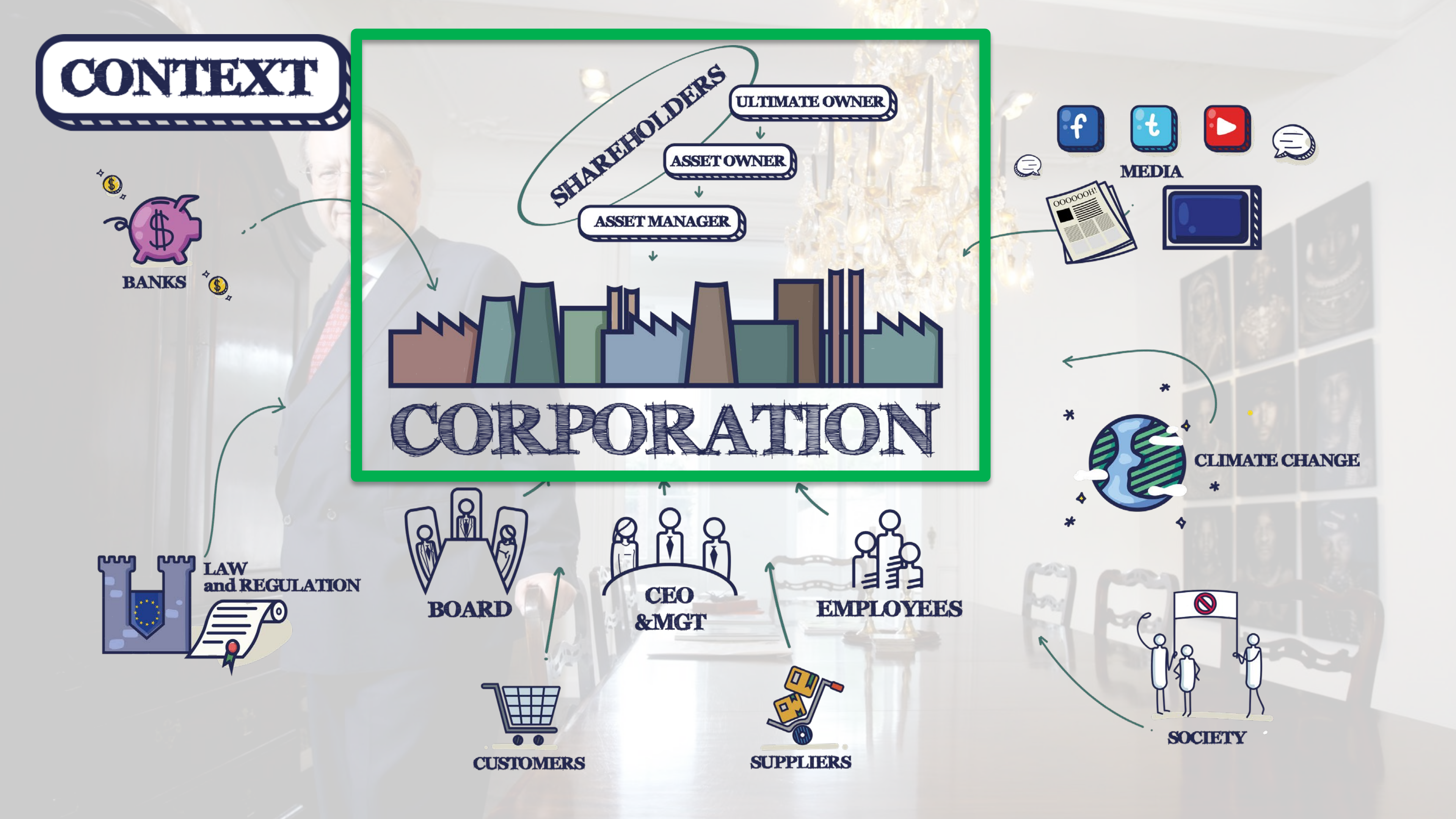

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Divestment versus private engagement

- Divestment may not be very effective in creating "real-world impact" or having access to better financing conditions (Berk and van Binsbergen, 2021).

- Since asset prices increasingly reflect (tangible) material sustainability information and preferences (Pastor et al. 2020), many asset managers and owners consider engagement to be the "panacea" to obtain higher risk-adjusted returns and to create real-world impact with investments.

- Yet, transparency about engagement policies and efforts is low which is related to the nature of this (private) game and to the inherent conflicts of interest, which particularly holds for asset management organizations.

- We know little to nothing about the effectiveness of private engagement.

Investment beliefs (or axioma's?) on engagement…


PRI Principles for Responsible Investment

HOW ESG ENGAGEMENT CREATES VALUE FOR INVESTORS AND COMPANIES

ABP's journey in this topic…

Fossil fuel divestment

One of world's biggest pension funds to stop investing in fossil fuels

ABP says it will no longer invest in sector and will sell €15bn of holdings by first quarter of 2023

Daniel Boffey *in Brussels*

Tue 26 Oct 2021 16.08 BST

An Extinction Rebellion protest outside the APB offices in Amsterdam in September. Photograph: Charles M Vella/SOPA Images/REX/Shutterstock

Belief: Shareholder engagement is an effective tool.

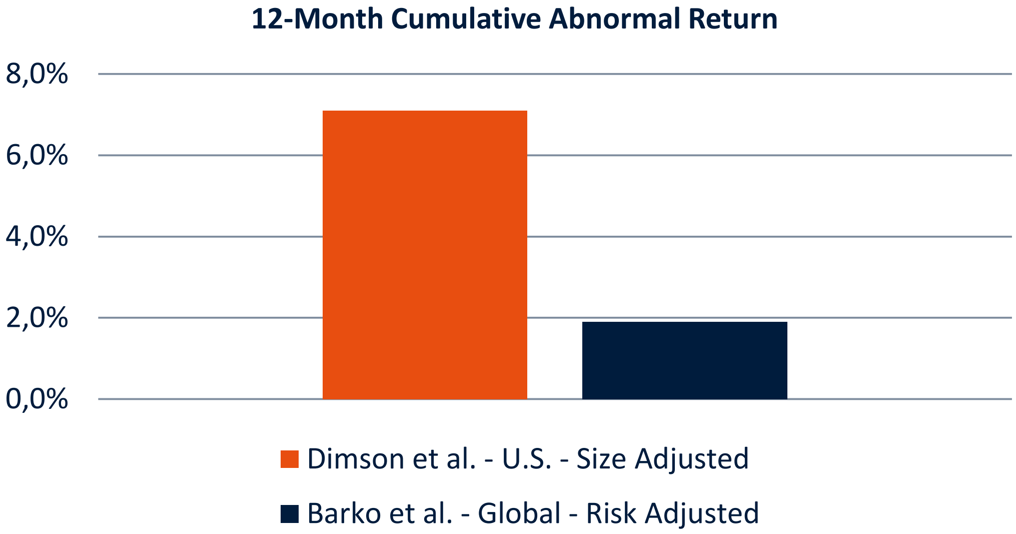
- Shareholder engagement is the most reliable mechanism for **investor impact** (Kölbel, Heeb, Paetzold, and Busch, 2020).
- Shareholder engagement can be effective in reducing the carbon emissions of target companies and improving their ESG scores (Naaraayanan, Sachdeva, and Sharma, 2021; Akey and Appel, 2020; Barko, Cremers, Renneboog, 2021)
- Limited empirical evidence on the **real-world corporate impact** of engagement. We contribute to that literature.

Previous studies on private ESG engagements find positive abnormal returns and improved accounting performance but need an update.

- *"Active Ownership"* → 1999-2009 **U.S. sample**
  - **Positive size-adjusted returns** after successful engagements (+7.1% over the year following engagement) and **improved accounting performance.**

Source: Dimson, Karakas, and Li (2015, p. 3253)

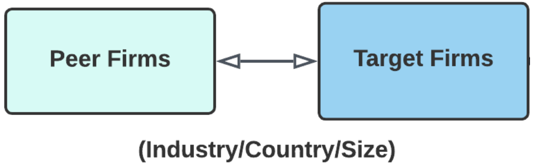
Previous studies on private ESG engagements find differences in the size of abnormal returns following (successful) engagement.



- Our study uses the **largest sample of <u>global</u> private engagements studied to date (2007-2020)**.
- We contribute to previous work by comparing financially material to immaterial engagements.

Dimson, Karakas, and Li (2015) ; Barko, Cremers, and Renneboog (2021)

We examine success drivers and the effects of engagements on the ESG and financial performance of target firms relative to their peers.



BMO Responsible Engagement Overlay (reo®)

- The reo® service has a **global client base of investors,** including pension funds, insurers, asset managers, fiduciary managers, charities, family offices and discretionary managers.

- At the end of 2021, there were 47 clients representing **€1,043bn of assets under engagement.**

- The engagement data contains 25,122 engagements and 4,080 milestones between 2007 and 2020. The data includes, i.a.:
  - *Company name*
  - *Engagement/milestone date*
  - *Engagement activity name (short description)*
  - *Client engagement summary (detailed description)*
  - *Engagement method (letter, email, call, etc.)*
  - *Investor participants and leadership level (>2012)*

We create sequences: engagements on the same topic at the same firm over time.

2019

December 2019

Requested information on the company's soy and sugar exposure, to help us ascertain deforestation risk. Also asked for information around plans to adopt standard environmental commitments or certifications (**mainly target 15.2**)

(Sequence 1) Biodiversity & Land Use
(Sequence 2) Packaging Material & Waste

2020

18 February 2020

Wrote to Investor Relations to outline our expectations on the company's supply chain management and for a deforestation risk assessment. Asked for a commitment to zero deforestation in its tier 1 supply chain (**target 15.2**)

(Sequence 1) Biodiversity & Land Use

19 March 2020

Call with new Sustainability Director and Investor Relations on ESG policies and risks in its agricultural supply chain. Encouraged the company to improve disclosure and transparency on the potential impact (of material risks) on business, strategy and financial planning (**targets 2.4, 12.2, 12.6, 15.2**)

(Sequence 3) Supply Chain Management

11 August 2020

Two Milestones achieved: An improved approach to packaging, including a life cycle assessment of plastic, and guidelines for sustainable farming practices (**targets 2.4 and 12.5**)

(Sequence 2, end) Packaging Material & Waste
(Sequence 3, end) Supply Chain Management

23 November 2020

Follow-up call with Sustainability Director and Investor Relations to discuss progress on ESG risk management, climate change impact, and packaging, among other items (**targets 12.2, 12.6, 13.2**). Intending to follow up in a few months' time

(Sequence 4) Packaging Material & Waste

2021

31 March 2021

Spoke with Sustainability Director on diversity and inclusion initiatives (**targets 5.2, 5.5, 10.2**)

Source: BMO SDG Engagement Global Equity Strategy Impact Report (2021)

Final sample consists of 7,415 engagement sequences (12,727 engagements)

25,122 engagements
4,080 milestones

↓

7,415 sequences
12,727 engagements
1,476 milestones

Constraints:

- We remove engagements/milestones that only relate to AGM votes (public engagements). Note there may still a connection between public and private engagements.
- We do not classify not sufficiently descriptive engagements (i.e., “CSR Meeting”).
- We only keep target firms that are in the MSCI ESG universe (= most significant constraint).

Since there are a lot of engagements in the original data, these constraints do **not affect the power** of our analyses but only **improve their accuracy**.

The sample covers a large variety of ESG issues that differ depending on the framework.

We use SASB for determining materiality.

SASB	
Environment	**2,146**
Environment	807
Ghg Emissions	802
Water & Wastewater Management	209
Ecological Impacts	149
Waste & Hazardous Materials Management	99
Energy Management	70
Air Quality	10
Human Capital	**598**
Employee Health & Safety	259
Labor Practices	223
Employee Engagement, Diversity & Inclusion	116
Social Capital	**687**
Human Rights & Community Relations	219
Data Security	141
Customer Welfare	119
Access & Affordability	66
Product Quality & Safety	65
Selling Practices & Product Labeling	57
Customer Privacy	20
Business Model & Innovation	**1,018**
Supply Chain Management	464
Product Design & Lifecycle Management	335
Business Model Resilience	139
Materials Sourcing & Efficiency	74
Physical Impacts Of Climate Change	6
Leadership & Governance	**693**
Business Ethics	548
Management Of The Legal & Regulatory Environment	121
Critical Incident Risk Management	10
Systemic Risk Management	9
Competitive Behavior	5
Governance (Traditional)	**2,273**
Total	**7,415**

MSCI	
Environment	**2,612**
Carbon Emissions	884
Environment	821
Water Stress	209
Biodiversity & Land Use	150
Raw Material Sourcing	143
Financing Environmental Impact	94
Opportunities In Renewable Energy	76
Product Carbon Footprint	72
Toxic Emissions & Waste	67
Packaging Material & Waste	59
Climate Change Vulnerability	25
Opportunities In Clean Tech	6
Electronic Waste	4
Opportunities In Green Building	2
Social	**1,870**
Labor Management	332
Supply Chain Labor Standards	319
Product Safety & Quality	279
Health & Safety	261
Community Relations	227
Privacy & Data Security	158
Responsible Investment	90
Opportunities In Nutrition & Health	80
Access To Health Care	53
Chemical Safety	29
Controversial Sourcing	23
Human Capital Development	9
Access To Finance	6
Access To Communications	3
Insuring Health & Demographic Risk	1
Governance	**2,933**
Total	**7,415**

We use MSCI for determining materiality and linking engagements to ESG performance.

The SASB/MSCI classification is industry-specific.

Animal Welfare

Food retail / Restaurants

Meat, poultry, and dairy producers

SASB	
Environment	**2,146**
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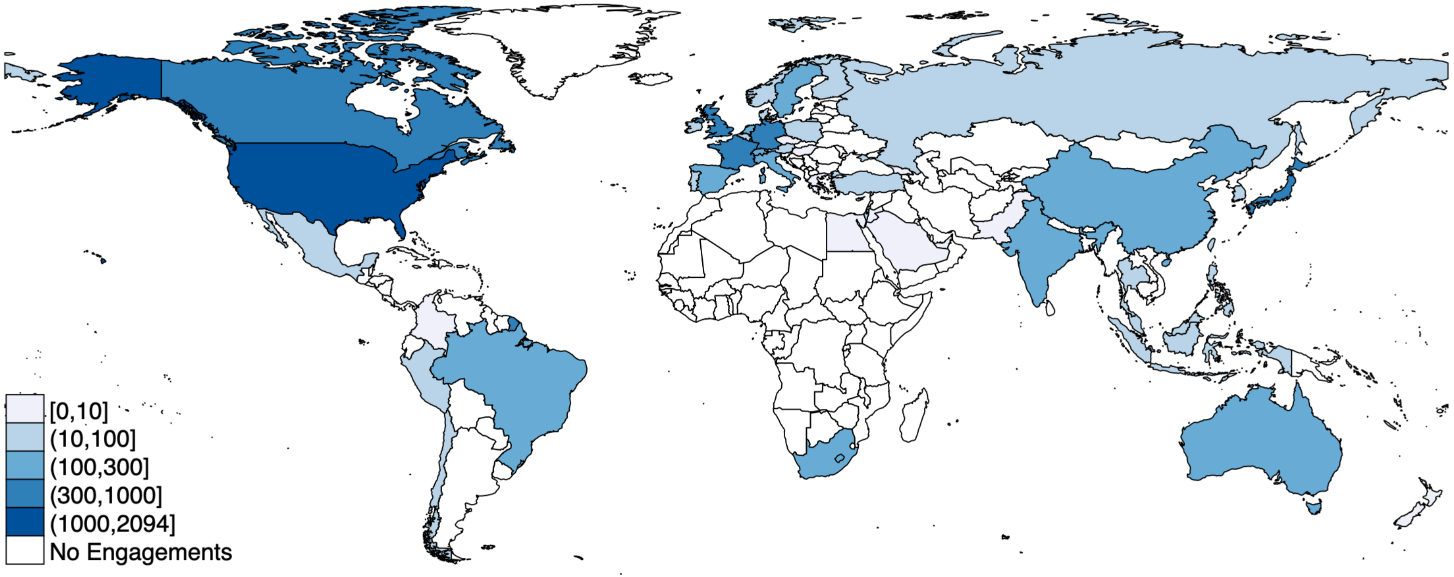
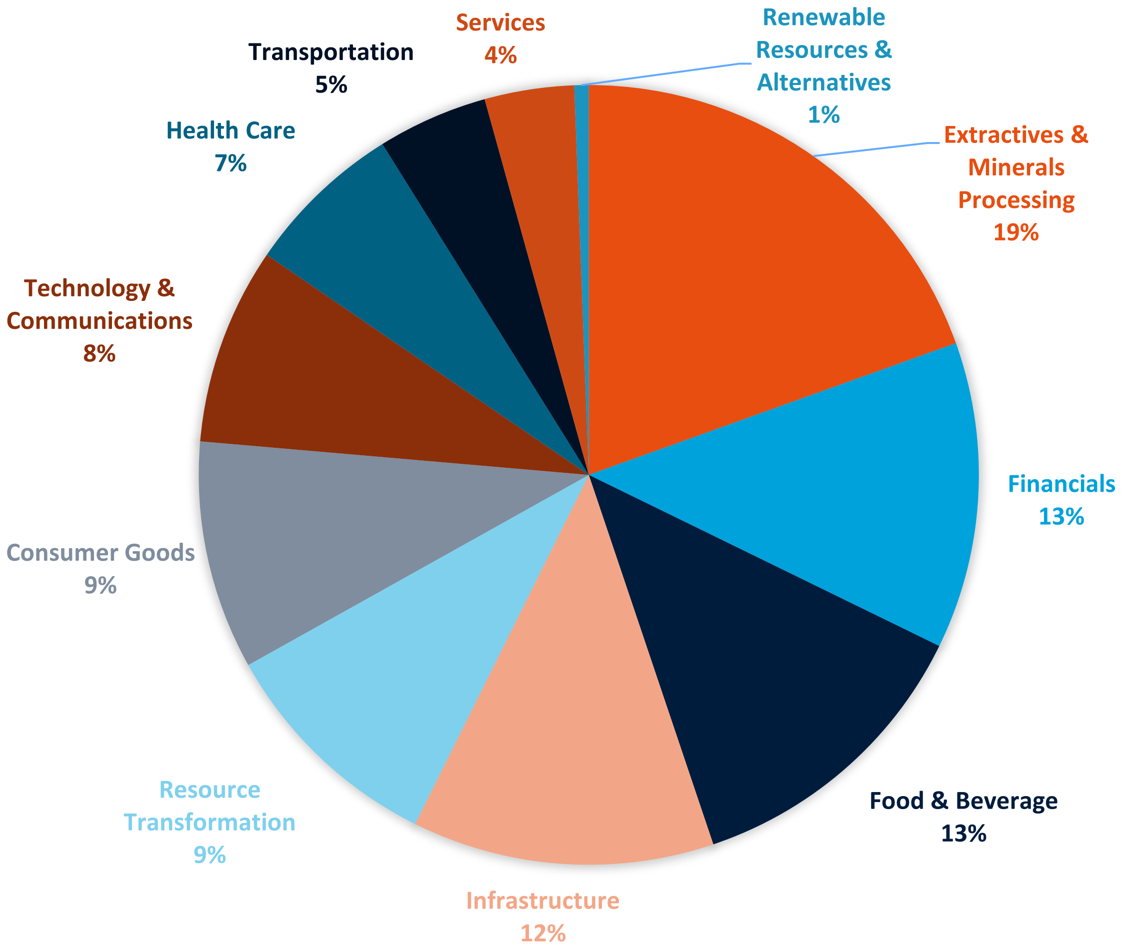
The engagement sample has global diversity but less focus on emerging markets.

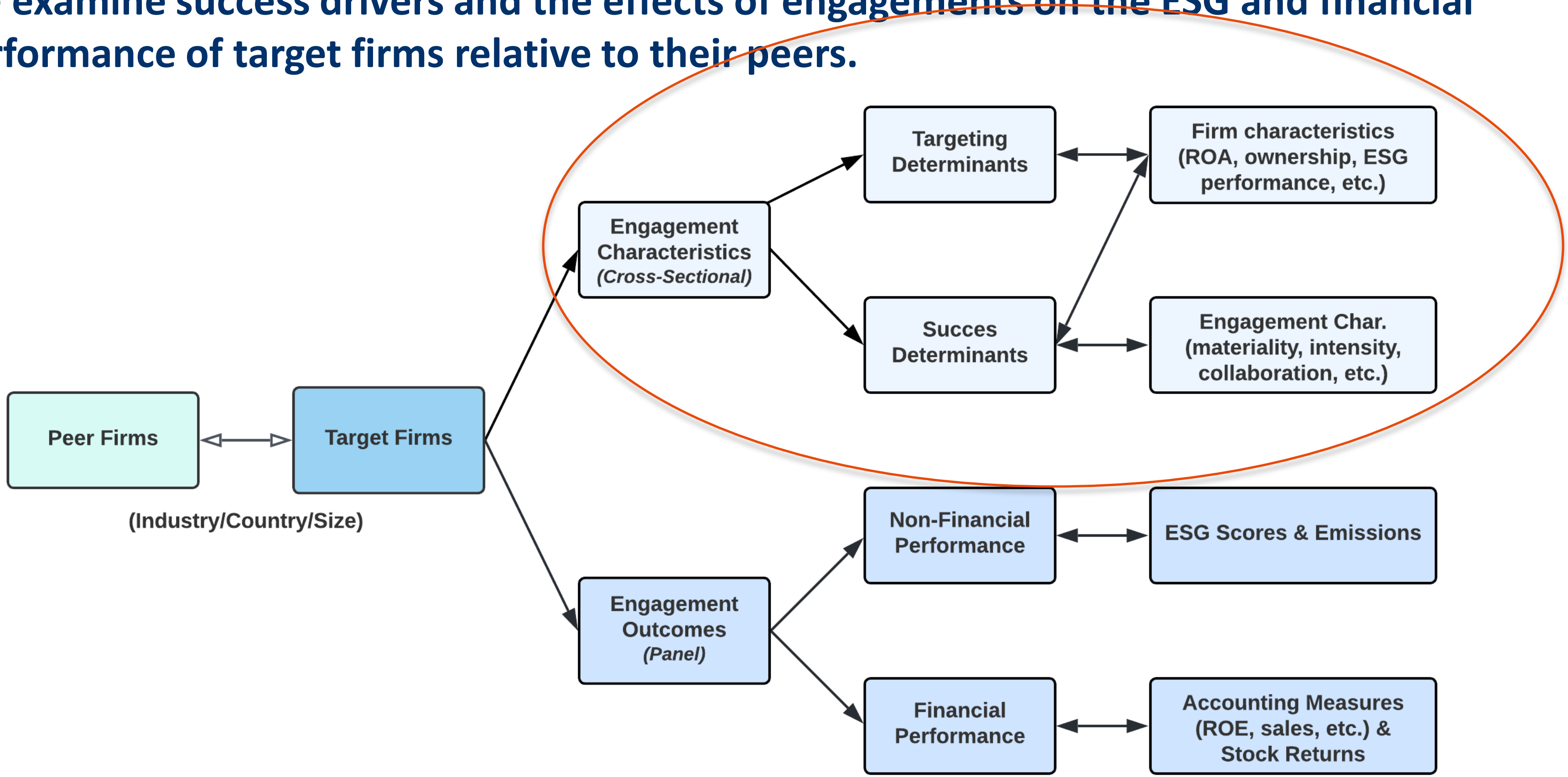


Europe – 38.4%	**North America – 34.40%**	**Asia– 19.83%**
Oceania– 3.73%	**South America – 2.21%**	**Africa – 1.47%**

The engagement sample covers a wide range of industries.



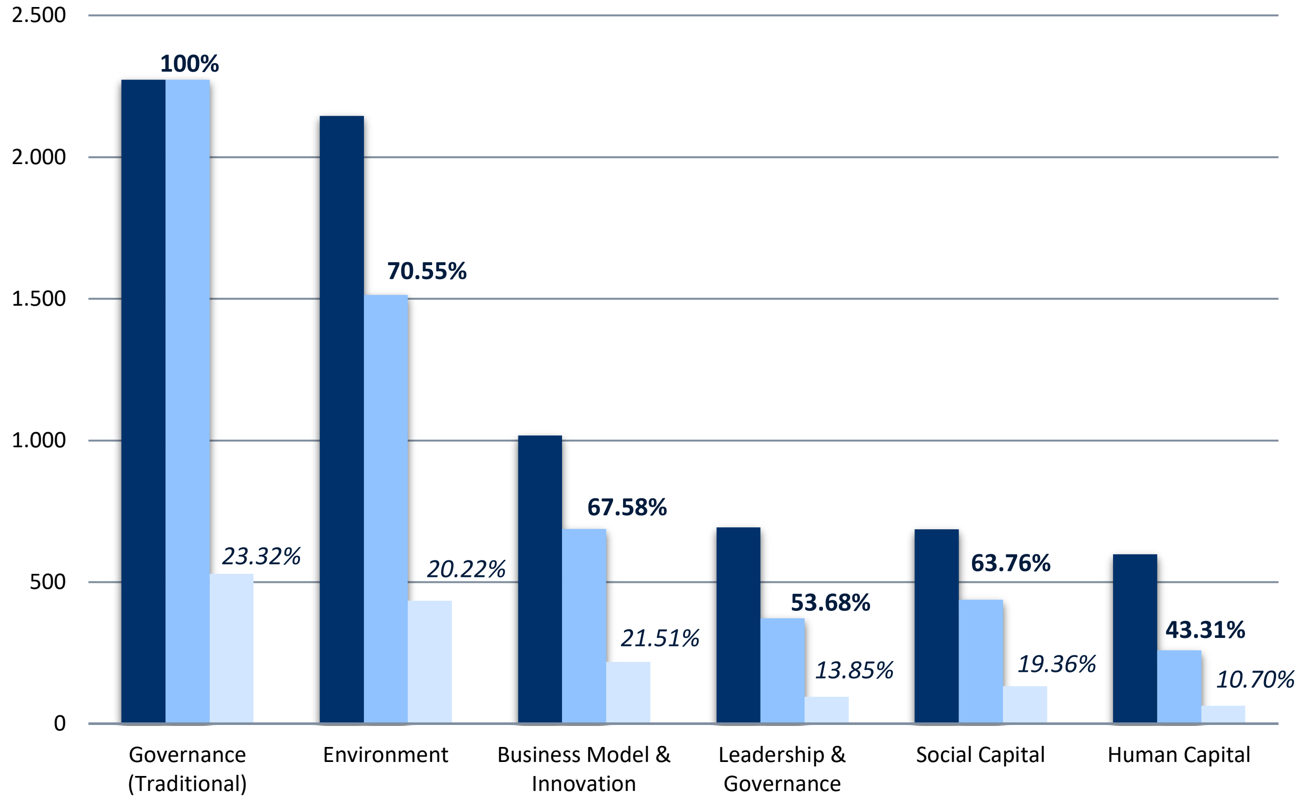
We examine success drivers and the effects of engagements on the ESG and financial performance of target firms relative to their peers.



Which firms are targeted (t-1)?

- Larger firms (compared to peers)
- Firms with higher CO2 emissions, higher CO2 intensity levels
- Firms with lower insider ownership
- No clear difference in ESG score (both leaders and laggards are engaged with) and no clear patterns in accounting performance
- Determinants of success: materiality and intensity (see Appendix for more info)

Nearly 75% of engagements are financially material, and 20% achieve a milestone.



Total:
- **7,415 engagements**
- **74.77% material**
- **19.19% successful**

Engagement success by topic and materiality

Table 3: Engagement Success by Topic and Materiality
The table presents the percentage of successful engagements by topic and SASB/MSCI materiality. The *Dif.* column displays the difference in success rates between material and immaterial engagements in percentage points. The *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively. Statistical significance is based on a t-test of equal means (average success rate). The table does not include an examination of material versus immaterial governance engagements based on the MSCI materiality map because all governance engagements are considered material by MSCI.

		SASB			MSCI		
	Total	**Material**	**Immat.**	**Dif.**	**Material**	**Immat.**	**Dif.**
Environment	21.86%	23.35%	18.21%	5.15%***	21.23%	25.00%	-3.77%*
Governance	20.90%	22.02%	11.96%	10.05%***			
Social	15.61%	17.17%	13.47%	3.71%**	17.36%	11.43%	5.93%***
Total	19.91%	21.52%	15.13%	6.39%***	19.77%	17.43%	2.34%***

Engagements that are material, collaborative, intensive, and contain multiple activities are more likely to succeed.

All differences are statistically significant after controlling for firm- and engagement characteristics.

0% 5% 10% 15% 20% 25% 30% 35% 40% 45% 50%

Probability of success

There are many collaborative engagement initiatives.

Climate Action 100+

IIGCC
The Institutional Investors Group on Climate Change

EUMEDION
CORPORATE GOVERNANCE FORUM

PRI Principles for Responsible Investment

achmea Investment Management
actiam
apg
a.s.r. asset management
MN For PMT
Pensioenfonds Rail & OV
PGGM
VAN LANSCHOT KEMPEN

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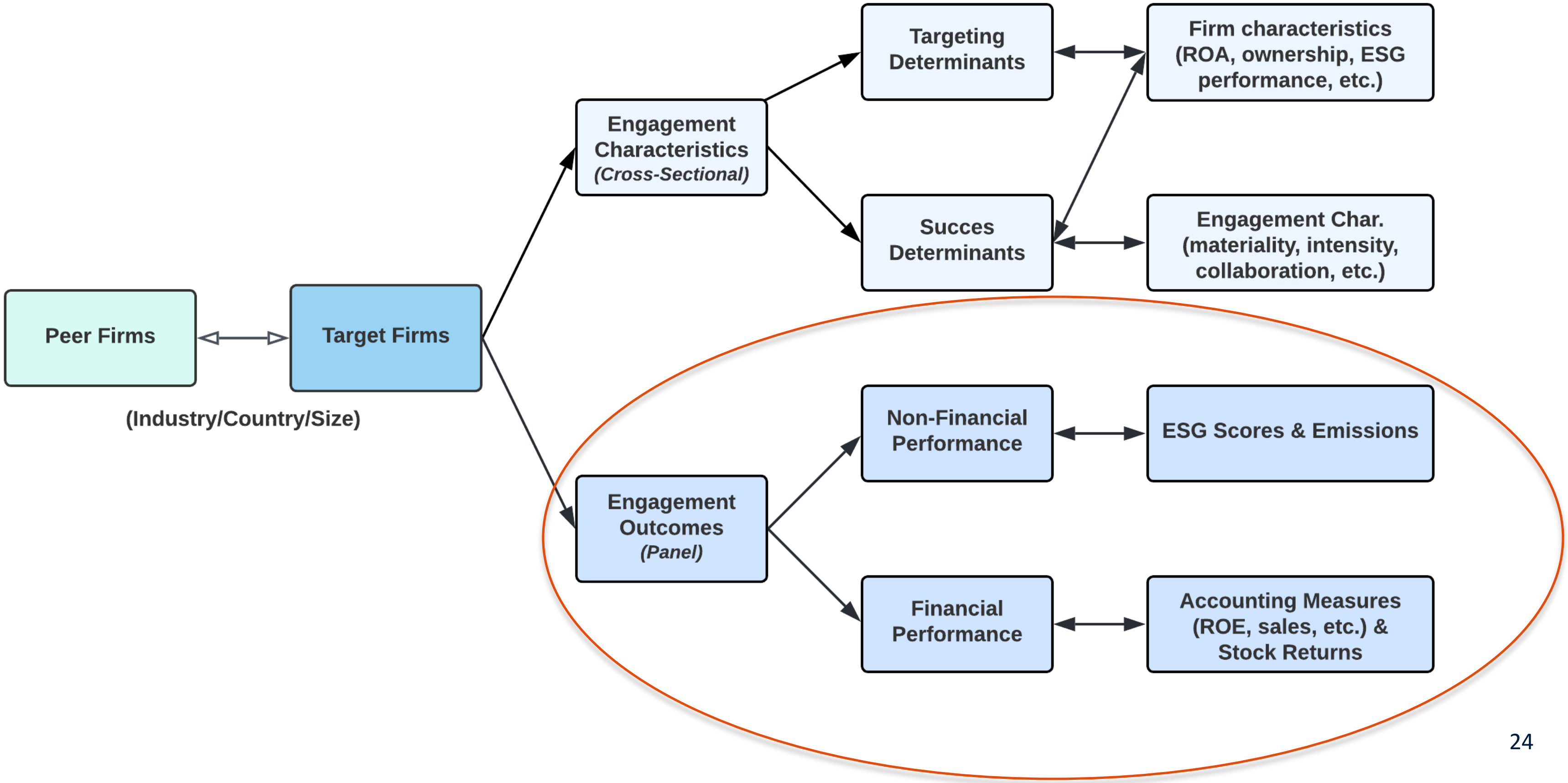
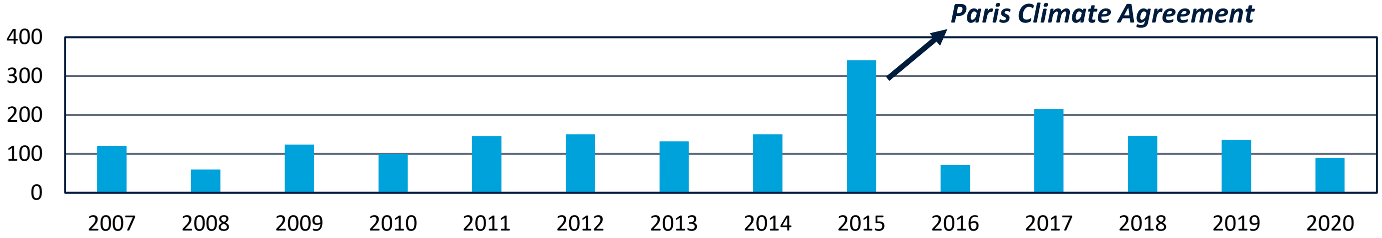


Methodology - Effects of engagements on target firms

$$ESGperformance_{ijt} = \beta_1 After_{ijt} + \beta_2 Target_{ij} \times After_{ijt} + \theta X_{j,t-1} + \Lambda_{F,T} + \epsilon_{i,t}$$

- We measure ESG performance using MSCI's ESG scores and Refinitiv's emissions data (CO_2e and $CO_2e/Sales_{t-1}$)

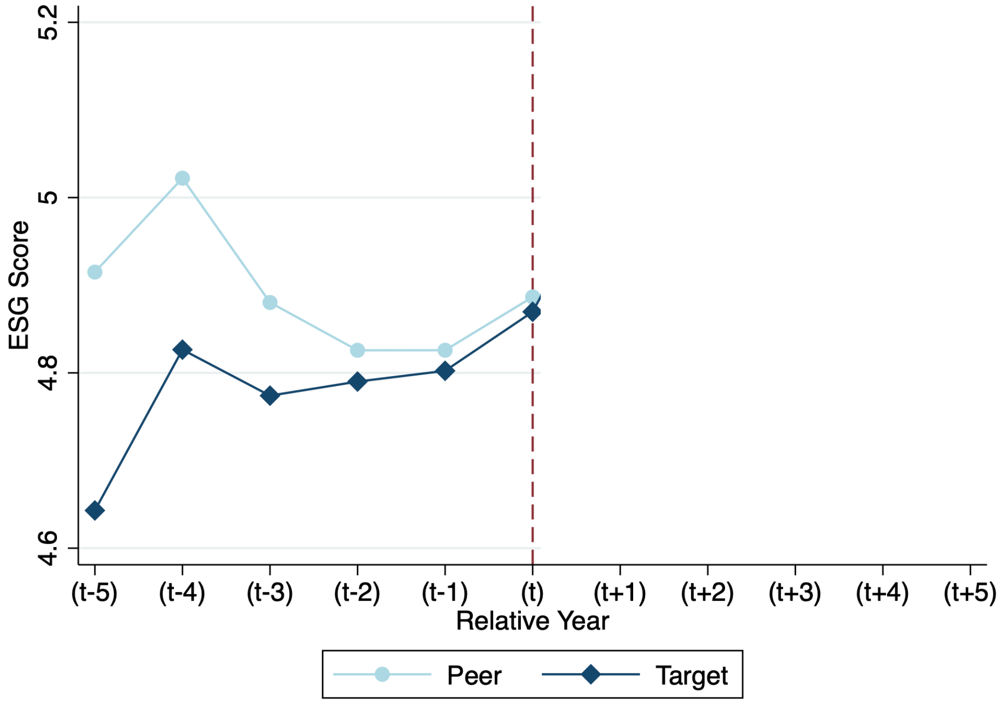
- Firms can be targeted multiple times. However, we **only examine the first time a firm is targeted** by an engagement with multiple contacts on topic *i* (ESG / E / S / G). If a firm does not experience such an engagement, we examine the first one-time engagement on topic *i*.



- *Target* equals 1 for target firms and 0 for peer firms. *After* equals 1 in the years after the first engagement at the target firm. For peer firms, we use the event date of the target firm.

- We keep the **five years before and the five years after** the engagement in our panel (when available). Moreover, we include lagged firm controls, firm fixed effects, and time fixed effects.

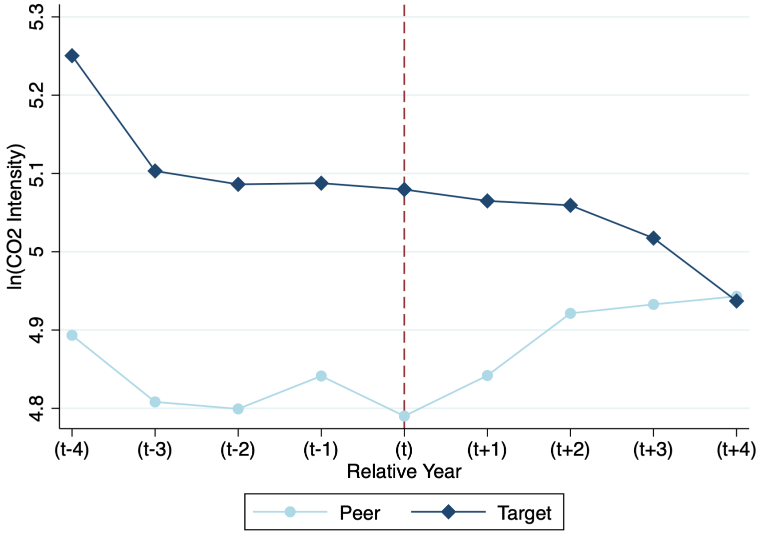
Target and peer firms have similar ESG performance before the engagement. However, target firms improve their ESG performance after the engagement relative to peers.

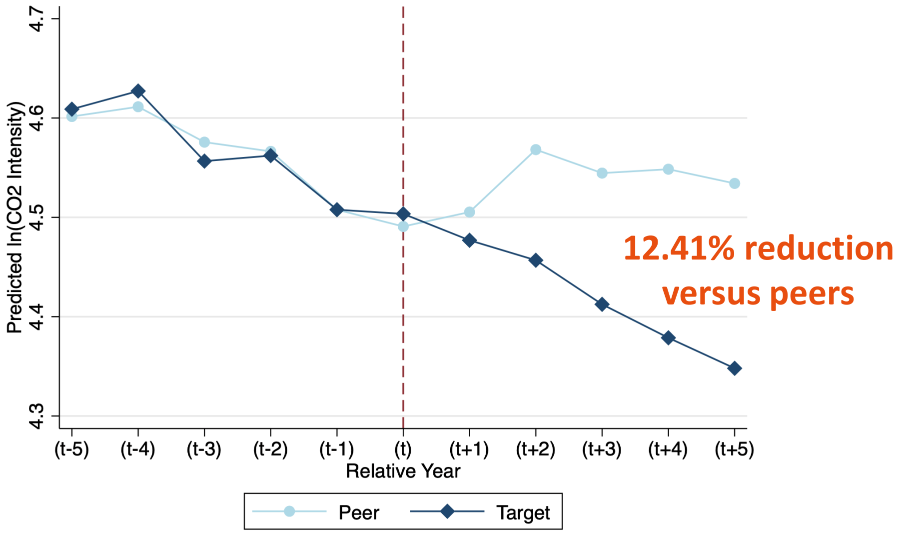


Controlling for firm characteristics, we find the following.

- The overall **MSCI ESG score improves by 3.8%** after the engagement relative to peer firms.
- We find **improvements in the (category-specific) MSCI environmental score**. However, we do not see improvements in the MSCI social and governance scores.
- When using **Refinitiv's** scores, we find positive and significant improvements in the ESG, E, and G scores.

Target firms lower their CO_2 intensity relative to peers after engagement.





ln(CO_2e Intensity)
Balanced panel

How much CO_2 do you emit per dollar of sales?

ln(CO_2e Intensity)
Predicted

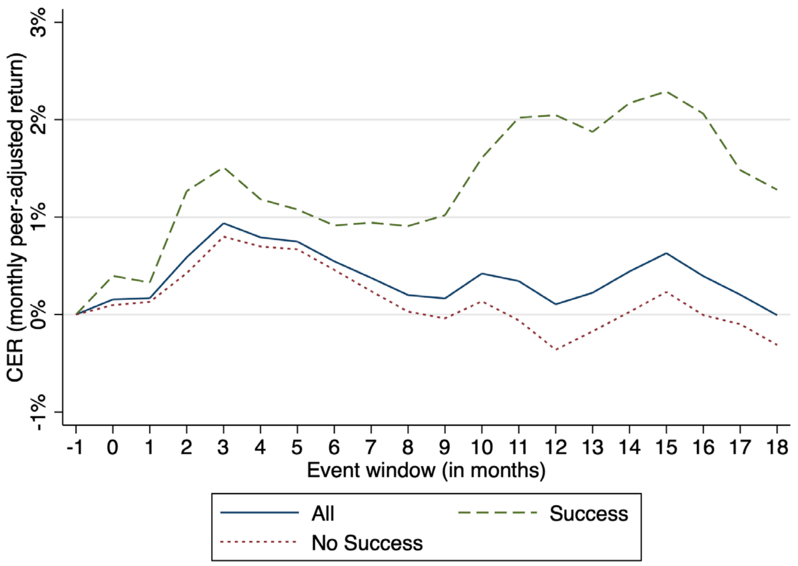
Impact of being targeted on subsequent accounting performance

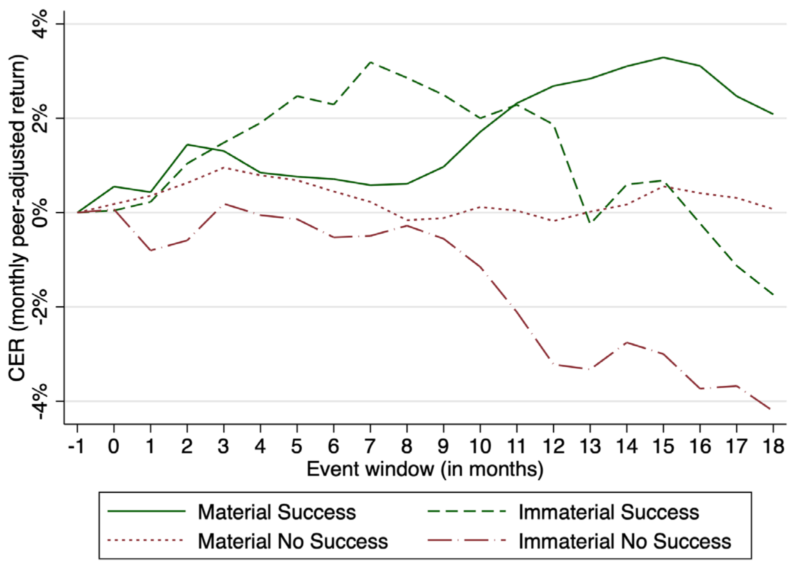
Table 8: The Effect of Being Targeted on Subsequent Firm Accounting Performance

The table displays the effect of being targeted on accounting performance relative to peer firms using a difference-in-differences model. The outcome variables are ROE, ROIC, opex/assets, log(sales), capex/sales, and R&D/sales. *Target* equals one for target firms and zero for peer firms. *After* equals one in all years after the event year (i.e., the first year a firm is targeted). For peer firms, it equals one in all years after the matched target firm's event year. For each firm, we keep the five years before and after the event year. All models include time-varying firm controls and firm and year fixed effects. The *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively. Standard errors are robust..

	(1) ROE	(2) ROIC	(3) Opex/Assets	(4) log(Sales)	(5) Capex/Sales	(6) R&D/Sales
After_{ESG}	-0.734	-0.732***	0.603	-0.024**	0.085	0.508*
	(0.464)	(0.229)	(0.509)	(0.009)	(0.537)	(0.276)
$\text{Target}_{ESG} \times \text{After}_{ESG}$	1.335***	0.772***	-0.648	0.011	0.302	-0.812***
	(0.514)	(0.280)	(0.695)	(0.013)	(0.615)	(0.301)
N	27171	27358	27422	27391	27385	14287
After_{GOV}	-1.406**	-0.726**	1.634***	-0.022*	0.336	0.314
	(0.574)	(0.283)	(0.565)	(0.011)	(0.507)	(0.375)
$\text{Target}_{GOV} \times \text{After}_{GOV}$	1.719***	0.913***	-2.209***	0.018	0.279	-1.000**
	(0.623)	(0.339)	(0.779)	(0.016)	(0.622)	(0.417)
N	19144	19287	19344	19315	19312	9833
After_{SOC}	-1.261	-0.595	1.799	-0.038***	0.625	0.933**
	(0.876)	(0.435)	(1.238)	(0.014)	(0.743)	(0.411)
$\text{Target}_{SOC} \times \text{After}_{SOC}$	2.847***	0.453	-0.477	0.055***	-1.555*	-1.035**
	(0.984)	(0.534)	(1.470)	(0.018)	(0.867)	(0.407)
N	9738	9836	9854	9840	9840	6121
After_{ENV}	-0.862	-0.859**	-1.327*	-0.003	-1.456	-0.219
	(0.648)	(0.368)	(0.735)	(0.014)	(0.911)	(0.192)
$\text{Target}_{ENV} \times \text{After}_{ENV}$	0.158	0.338	-0.495	-0.003	1.649*	0.379*
	(0.677)	(0.401)	(0.986)	(0.018)	(0.924)	(0.201)
N	14617	14713	14745	14727	14724	8272
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes
Year Controls	Yes	Yes	Yes	Yes	Yes	Yes
Firm Controls	Yes	Yes	Yes	Yes	Yes	Yes

Engagements are correlated with financially outperformance versus peers





The targets of successful material engagements significantly outperform their peers by 2.5% over the next 14 months.

Takeaways

- **One-size-fits-all engagements do not seem to work. Instead:**
  - Focus on intensive engagements (calls/meetings) related to material issues.
  - Collaborate with other investors → making these intensive engagements less costly.
- **Financially material engagements** are more likely to be successful.
- Improving engagement effects cannot be done without **measuring them properly**.
  - Take a critical look at the engagement data collection process; sustainability reporting frameworks like SASB or GRI might help.
  - Engagement milestones often contain pledges or targets → track whether firms make real changes and are on their way to meeting their targets.
- Our findings indicate that **engagements are associated with improvements in non-financial performance** and do not come at the expense of financial performance. Furthermore, material engagements correlate with outperformance versus peers.
- **Omitted variable and self-reporting bias**
  - It would be very helpful if the investment industry stores (collaborative) engagement efforts, let them be audited, and shares data with academics…. ("eine heile Welt")

Future projects

- Preferences between institutional asset owners and managers differ markedly (the topics are engaged on, focus on materiality).

- There is also a trend that preferences of ultimate asset owners need to be measured (pension beneficiaries and clients of mutual funds) which may impact engagement topic choice going forward.

- Regulation (e.g., interpretation of fiduciary duty) between jurisdictions (EU versus US) differs substantially; yet capital markets are global.

- Interaction between public (e.g., shareholder proposals) and private engagements might be a fruitful area of future research (although again very reliant on data access).

- What about double materiality…?

Q&A