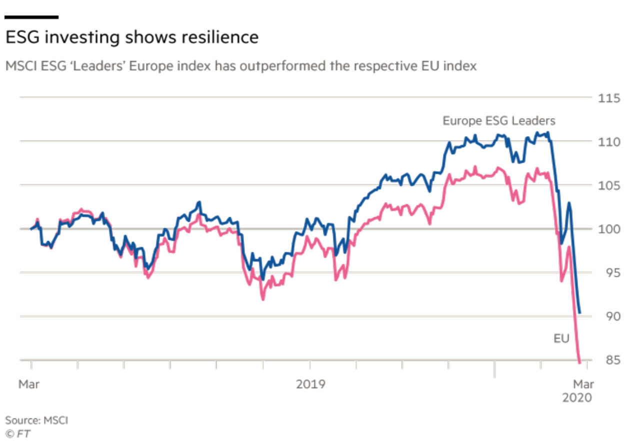
ESG and the Culture Imperative

Millani Inc.

The inclusion of ESG (environmental, social and governance) factors in investing has increased substantially over the past several years, as can be seen from the growth in numbers of signatories to the Principles of Responsible Investment (PRI), and in the increase of flows into ESG funds. There are now almost 3,000[1] signatories to the PRI globally, managing $89 trillion in assets[2], while net flows into open-end and exchange-traded US sustainable funds totaled $20.6 billion in 2019, a fourfold increase from 2018.[3]

What does this mean? Increasingly, mainstream investors are taking ESG factors into consideration in their evaluation and monitoring of potential and existing investments to help inform their investment decisions. This assessment can take the form of evaluating how a company manages their ESG issues through primary and secondary research, or by engaging directly with a company to influence their behavior around ESG issues. Investors are increasingly integrating ESG into their investment processes for multiple reasons, including identifying risks and hidden value. In the current context of the COVID-19 pandemic, ESG funds have been shown to be more resilient in times of volatility, and ESG funds have "withstood the market sell-off better than most others".[4]

Figure 1: ESG investing shows resilience *(4)*



ESG investing shows resilience, Financial Times, March 2020

Culture can be defined as "the expression of those behaviors, expectations and interactions that either allow for or impede the execution of an organization's strategy and the manifestation of its purpose"[5]. Or, as put by Pentti Karkkainen (Board Member of NuVista Energy and Board Chair of AltaGas), culture is simply the "air you breathe" in an organization.[6]

Culture: "The air you breathe"

Pentti Karkkainen, Board Member and Chair *(6)*

Culture is one area of ESG that has been getting much more attention from institutional investors over the past years. In fact, in Millani's study of global institutional investors' shareholder engagement practices, "Culture & Ethics" was found to be in the top 10 of engagement priorities overall, an increase from previous years. What's more, "Board Composition" and "Diversity" were in the second and third positions, with "Risk Management" in fourth place, all strong indicators of a company's culture.[7]

Millani and MNP Consulting held a series of events at the start of 2020 on just this topic, "*ESG and The Culture Imperative*". The sellout events across the country, hosted by ***TMX Group***, were another strong indication of the interest in culture and how it relates to ESG, from both the investor and the corporate perspective.

One reason for this increased interest in culture and how a company is run is the growing acknowledgement that culture is not an intangible afterthought but something that creates real value for an organisation, both from a financial and reputational standpoint.

What's more, as investors, and other financial stakeholders (such as creditors and lenders) attribute more value to culture, more capital will be driven towards companies that demonstrate strong cultural values and behaviors. There is a "tectonic shift" happening in the world of finance, with the focus shifting from traditional finance to sustainable finance.[8]

1. "Signatory directory, UN PRI, 2020. 2. PRI in Numbers, UN PRI Annual Report 2018, 2018. 3. Jon Hale, "Sustainable Fund Flows in 2019 Smash Records", Morningstar, January 10th, 2020. 4. "ESG shines in the crash; legal milestone for ratings", Moral Money, Financial Times, March 16th, 2020. 5."The Culture Imperative", Institute of Corporate Directors, October 2019. 6. Pentti Karkkainen, "ESG and the Culture Imperative", Millani & MNP Consulting panel, February 13th, 2020 (hosted by TMX Group). 7. Trends in Shareholder Engagement, Millani, 2020. 8. "Sustainability: The Tectonic Shift Transforming Investing", BlackRock, 5th March 2020.

Companies, and their leaders, should take advantage of this sea-change by prioritizing management of environmental, social and governance issues, and underlying all these issues, culture.

A strong culture equals resilience

As uncertainty looms over the implications of the COVID-19 pandemic, it is essential that companies are resilient to change. In this time of unprecedented need for adaptability and agile working for all types of organizations, it will likely be companies with strong, ingrained cultures that will be able to withstand volatile situations and external pressures. Employees, customers and stakeholders throughout supply chains will need to be adaptable, and individuals with high levels of "cultural adaptability"[9] may find themselves more adept at dealing with the all the changes that will necessarily come.

What is certain is that the COVID-19 pandemic is a powerful stress-test for all organizations, not only on the financial resilience of a business but also on the strength of its culture and its values.

Culture is a strategic priority

Culture is often seen as something intangible and for that reason, unmanageable and perhaps less of a day-to-day priority. In fact, intangible factors, including talent and culture, are now estimated to make up 52% of a company's market value. For some companies, it can be as high as 90%.[10] Following some recent, well publicized corporate controversies, we know that cultural mismanagement can have lasting impact.

In 2018, Under Armour faced allegations of sexual misconduct, a hostile work environment, and "systematic inequality" towards women; generally, a toxic work culture.[11] Then in 2019, Under Armour announced that they were under federal investigation regarding their accounting practices.[12] This news led to a decrease in share value of almost 20%. The *Wall Street Journal* then brought out a report "detailing allegations that Under Armour 'pushed early shipments' and 'dumped goods at off-price chains' in an effort to boost revenue growth."[13] The founder and CEO stepped down from his position. A toxic culture and questionable business practices meant that Under Armour lost value, affecting investors, employees and suppliers, and its reputation in a very damaging way.

Accordingly, culture, and the strengthening and managing of it, should be firmly in the remit of the Board, to be monitored and managed as a strategic priority. As Boards are becoming aware of the need for a strong culture and ethical working environment, culture is being mentioned more by CEOs during earnings conference calls, illustrating growing awareness of the strategic importance of culture.[14]

To prove the point, in PwC's annual CEO survey, it was found that for the first time in the survey's history, more executives are losing their positions due to unethical behavior rather than for financial reasons. In 2018, the CEOs of Barnes & Noble, CBS and Lululemon all left their positions as a result of violating company policies, unrelated to financial performance. In fact,"39% of the CEOs who left their jobs in 2018 left for reasons related to unethical behavior stemming from allegations of sexual misconduct or ethical lapses connected to things like fraud, bribery and insider trading."[15]

To summarize, Boards and management teams have a responsibility to set the culture of the organisation and have an opportunity to benefit from doing so. The *2018 UK Corporate Governance Code* "promotes the importance of establishing a corporate culture that is aligned with the company purpose, business strategy, promotes integrity and values diversity." [16]

Its second provision is explicit in its prioritization of culture, stating "The Board should assess and monitor culture. Where it is not satisfied that policy, practices or behaviour throughout the business are aligned with the company's purpose, values and strategy, it should seek assurance that management has taken corrective action."[17]

Positively, this already seems to be happening. Research from the Institute of Corporate Directors, as conducted by MNP Consulting Partner Mary Larson, illustrated a real change in perspective from Board members. "Of the 55 Board members we spoke to, many said that it's no longer appropriate to just pay attention to quarterly results. We ought to put […] the measurement of safety, environmental responsibility and making our workplaces places people want to be […] over financial performance."[18] The current pandemic has brought into the spotlight those companies that are prioritizing the health of their employees and their societal responsibility, and those that will need to spend time reprioritizing. Those that take the time to look at their ESG issues and identify risks are likely to see the financial value in the long run. Additionally, they will be better prepared to proactively respond to engagements from investors that are looking closely at how companies are managing their people and operations throughout the crisis.

9. Matthew Corritore, Amir Goldberg, Sameer B. Srivastava, "The New Analytics of Culture", Harvard Business Review, January-February 2020. 10. "The Board's Role in Overseeing Culture", ICGN Viewpoint, ICGN, January 2020. 11. Chavie Lieber, "Under Armour won't let employees expense "adult entertainment", limos, or gambling anymore", Vox, November 7th, 2018. 12. James Ludden, "Under Armour shares are plunging after disclosure of U.S. accounting probe", Fortune, November 4th, 2019. 13. Sheena Butler-Young, "Under Armour under Federal accounting probe: Why investors are suddenly optimistic", Footwear News, November 27th, 2019. 14. "The wrong way to strengthen culture", Harvard Business Review, July-August 2019. 15. Sarah Clayton, "6 signs your corporate culture is a liability", Harvard Business Review, December 5th, 2019. 16. UK Corporate Governance Code, Financial Reporting Council, 2018. 17. UK Corporate Governance Code, Financial Reporting Council, 2018. 18. Mary Larson, ESG and the Culture Imperative, Millani & MNP Consulting panel, February 13th, 2020 (hosted by TMX Group).

Managing culture has many benefits

Why spend precious resources on culture? Not only does culture management lead to increased employee satisfaction, it makes sense from a financial standpoint.

Investors assess culture

A demonstrably good corporate culture may mean increased access to capital. Culture can be an important contributor to the discrepancy between a company's book and market value, and the assessment of it can add a human lens to ESG assessment. At Millani and MNP Consulting's panel, Pentti Karkkainen shared his experience of working in private equity and assessing which companies to invest in. "When looking for investable opportunities we'd evaluate the proposed business plan, projected returns, risk profile, time frame and most importantly the skills and character of the team. In doing the latter we'd do a deep dive on track record and due diligence on the principals. What we tended to find was that successful teams always seemed to have some kind of secret sauce; some intangible characteristic that showed up in how they worked together; how they dealt with adversity; made decisions. This past success more often than not showed up in subsequent success. That secret sauce is culture."[19]

Companies need to be able to effectively communicate their culture to financial stakeholders in order to seize these opportunities. "Culture is becoming a substantial factor in investor assessments of a company's performance. Executive managers and Boards therefore must not only oversee and shape corporate culture: companies must also get better at telling their "culture" story to their investors and other interested stakeholders."[20]

A strong culture supports delivery of ESG targets

As pressure mounts on companies to disclose more transparently and to set targets on ESG issues, such as carbon emissions, responsible water use, and health and safety, the ability to deliver on these goals becomes a strategic priority. An organization will find it easier to deliver on targets if the targets are well-aligned to the values of the company and its employees. Furthermore, having leaders that align with the corporate culture will increase a company's ability to manage environmental and social issues long-term.

If delivering on ESG targets forms part of a company's strategy, it is imperative that the culture supports the strategy. Investors are aware that it can be challenging to accurately measure and report on ESG issues but the consensus (from our *ESG and the Culture Imperative* event) is that investors appreciate organizations making a start on these initiatives and improving, rather than not disclosing material information at all.

Long-term value creation attracts investors

There is a shift from investors looking for long-term value creation, rather than solely looking for short-term returns. *Focusing Capital on the Long Term* (FCLT) is an initiative originated by the Canada Pension Plan Investment Board and McKinsey & Company, and supported by BlackRock, The Dow Chemical Company and Tata Sons. The goal of the organisation is to shift investor focus to a long-term approach, leading to a real shift in capital markets, with commitments from these major players in the financial system illustrating real desire to move investors to a long-term view.

What's more, *The Embankment Project for Inclusive Capitalism* was launched by the Coalition for Inclusive Capitalism, EY, and 30 companies, asset managers and asset owners, with the key goal of identifying and creating new metrics to measure and demonstrate long-term value to financial markets. Their report highlights talent and organizational culture among the key drivers of long-term value.[21]

To seize opportunities and access capital from more sophisticated investors, companies should consider how they can make themselves more attractive in the long run, by focusing on culture.

Culture & ethics as an engagement priority

Millani's research into the growing trend of investor engagement shows that culture is a priority for almost half of institutional investors in the market.[22] 43% of institutional investors in the sample are placing "Culture and Ethics" as one of their engagement priorities, with focus on other culture related indicators such as "Compensation", "Board Composition and Diversity", and "Risk Management" also placing high on the priority list. It's important to add that although culture and ethics are inextricably linked, they are not the same. A company may have a strong written "Code of Ethics", but it may not necessarily translate to a sustainable culture. This comes from the actions and behaviours of employees, management and the Board. An example is Wells Fargo, who famously pushed cross-selling tactics on their employees. The sales targets were so high that salespeople were found to have opened accounts for people who didn't exist and pushed unneeded financial products on vulnerable people.

19. Pentti Karkkainen, ESG and the Culture Imperative, Millani & MNP Consulting panel, February 13th, 2020 (hosted by TMX Group). 20. "The Board's Role in Overseeing Culture", ICGN Viewpoint, ICGN, January 2020. 21. "Embankment Project for Inclusive Capitalism", EY, 2018. 22.Trends in shareholder engagement, Millani, 2020.

A Code of Ethics may have existed, but this didn't automatically translate to the good behavior of managers and employees. The focus on growth and cross-selling and the behaviours that reflected this culture did. "You can talk yourself blue in the face about ethics, as many Wells Fargo managers did, but you can not send employees a clearer signal than their paycheck."[23]

Culture can be measured

As the adage goes, "what gets measured, gets managed". The question must then be asked, how can culture be measured? Moving on from static multiple-choice employee surveys and customer satisfaction calls, artificial intelligence is being implemented to measure cultural data points. One study used data processing techniques to "mine digital traces of culture in electronic communications, such as emails, Slack messages, and Glassdoor reviews".[24] More specifically, they looked at communication style to understand how employees interact online, and if new employees adapt to be like other employees over time, measuring similarity of communication style and how quickly they adapt to the company culture.

Additionally, MIT Sloan Management Review and Glassdoor used machine learning to analyze culture, using a data set of 1.2 million employee reviews on Glassdoor. The tool provides insights on 500 US companies on 9 different cultural values: agility, collaboration, customer, diversity, execution, innovation, integrity, performance, and respect. The study provides insights on the leading companies are in each culture category, for example, Bain & Company ranks highest in "collaboration" while Netflix ranks highest on "execution".

The Barrett Values Centre (BVC) performs an assessment on a company to understand "the amount of energy consumed in doing unproductive or unnecessary work", producing a *Cultural Entropy Score*. The score reveals the degree of dysfunction in an organisation, coming from the "self-serving, fear-based actions and behaviors of leaders, managers, and supervisors".[25] The assessment, as noted by MNP Consulting Partner Mary Larson, is being used to "measure the difference between an individual's own values, what the company says its values are, and how things actually get done. It allows you to figure out if there are cultural problems at any level of the company. The entropy score [can then be linked] to any profit left on the table."[26]

These tools provide a company with the ability to measure and manage culture as a strategic priority. The increasing focus on culture from the investor community means companies will need to familiarize themselves with these tools, in order to effectively integrate them into corporate strategy.

What can the Board do to ensure culture is a strategic priority?

As the *International Corporate Governance Network* put it, "it is likely that many directors don't know what makes their company's culture tick, or that company messaging emphasizes a culture that is significantly at variance with what is actually happening. A Board needs to be, and investors want to be, aware of what the culture really is - including the tangibles and intangibles that construct it."[27]

Once Boards understand the value of culture, additional questions arise. How can Boards truly know the culture of the day-to-day company, and how can the assessment of it be integrated into a Board's remit? Below are a few ways that Boards can understand culture and integrate it.

- Ask the Board to describe the culture and the behaviors that define it. This will quickly show whether the official 'corporate culture' reflects what is happening 'on-the-ground'.
- Include culture and associated metrics at Board meetings, for example, staff turnover, customer complaints, results from employee satisfaction surveys.
- Actively prepare for requests from investors regarding culture. These questions are likely to get harder and more frequent as investors enhance their shareholder engagement strategies.
- Include culture in strategy sessions.
- Find opportunities for Board members to engage with people at all levels of a company. For example, include operational staff in the Health and Safety Committee meeting, or arrange tours of the operation for small groups of the Board. "If you can detect a difference … in what is being said is important and what is being done…or can't get access to people, there's a problem."[28]

23. Mark Pastin, "The surprise ethics lesson of Wells Fargo", Huffpost, 20th January 2017. 24. Matthew Corritore, Amir Goldberg, Sameer B. Srivastava, "The New Analytics of Culture", Harvard Business Review, January-February 2020. 25. The Cultural Entropy Score, Barrett Values Centre, 2020. 26. Mary Larson, ESG and the Culture Imperative, Millani & MNP Consulting panel, February 13th, 2020 (hosted by TMX Group). 27. ICGN, The Board's Role in Overseeing Culture, January 2020. 28. Mary Larson, ESG and the Culture Imperative, Millani & MNP Consulting panel, February 13th, 2020 (hosted by TMX Group).