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PERSPECTIVES

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Impact-Adjusted Return on Investment

A paradigm for decision-making in the 21st century

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Image courtesy of: alchetron.com

Every business and every investor thinks about return on equity or return on capital or return on investment. As decision-making has become more sophisticated, these simple return measures have become more nuanced, leading to the creation of risk-adjusted return on capital and similar measures. Whilst all these have ugly acronyms (RAROC etc), they have had a big impact on improving the sophistication of financial decision-making.

ABC Australia presenter holding a print-out of the original Earth model c 1972

But - and a very important but - these measures pay no attention to two modern-day scarce resources, namely the environment which sustains us, and the societies in which we live. Perhaps this singular focus on financial and economic results once made sense, when capital was in short supply, and economic growth was driving widespread improvements in living standards.

Today, however, we have a massive surfeit of capital, as evidenced by 5,000+ year low interest rates and declining equity risk premiums in many countries around the world. In contrast, we have a huge environmental deficit, as we consume more than a planet's worth of resources every year. The latter translates into climate change, extensive environmental degradation and widespread pollution of our food supply chains. As one simple, shocking statistic, the vast majority of body-weight of mammals on the planet is animals being bread for human consumption. Humans come second, and

everything else a distant third.

For a little context, my background is in finance, science and systems thinking. I've been working in commercial and financial decision-making for over 30 years, both as an investment banker and strategic advisor to leading companies and governments, and also as an entrepreneur. So, I know how financial and strategic sausages are made, and the reality is often ugly.

Over the last few years, interest in ESG, SRI, sustainability - call it what you will, though I will use ESG to cover them all - has exploded. The USA saw net inflows into ESG-related funds of over $50bn in 2020, ten times the level just two years previously. In Europe, ESG-driven ETFs now eclipse all others for new money raised. And many institutional investors now expect at least some component of ESG-screening of investments.

Thus, investment managers are now asking CEOs about ESG at almost every meeting. This is because investment managers are being pressed by underlying investors whose money they manage to take a much more hands-on role in appraising the broader impact of businesses on the environment and society. For now, a lot of this activity is somewhat superficial, though clearly a lot of data is being gathered and this can only be helpful.

As a result, most investment decisions are still driven through a binary filter. This may be as simple as asking whether any particular investment is acceptable from an ESG perspective or not, or it may extend to investors making a thematic choice to invest to address climate change, or habitat destruction, or to promote diversity, equity and inclusion, or to protect our oceans. There is nothing wrong with these approaches per se, but they will be eclipsed by more nuanced metrics in due course.

Right now, more sophisticated companies, shareholders and investors are evaluating the links between action on matters related to sustainability and long-term business and share price performance. This helps to drive maximum benefit from ESG-related strategies and enables companies and investors to assess where they should act first.

As ESG-related activity expands, companies and investors are beginning to discover that sustainability can become a powerful driver of overall business

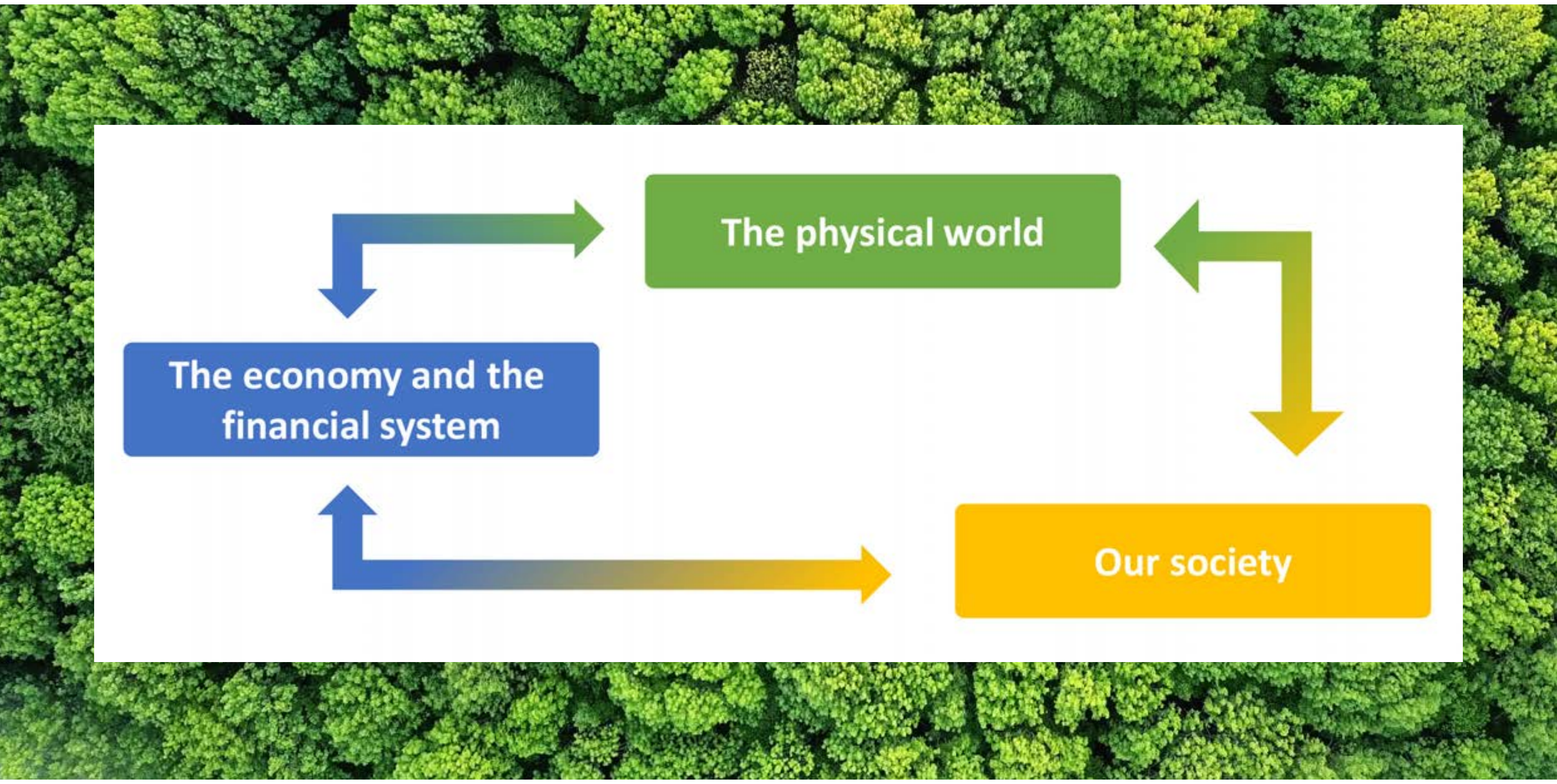
This is precisely the type of investment analysis delivered by our partner HIP Investor – companies that score well under its rating system have delivered both share price outperformance and reduced share price volatility over time.

As ESG-related activity expands, companies and investors are beginning to discover that sustainability can become a powerful driver of overall business and portfolio performance. As they do, the business case for acting more widely and more assertively gets stronger, creating a virtuous circle of impact and performance.

Where will this lead? Before long, investors and indeed shareholders will begin to ask about "Impact-adjusted return on investment" or "Impact-adjusted return on capital". This is, amazingly, a novel term – a search on Google for either term yielded not a single result before I posted an earlier version of this paper on LinkedIn.

Though in theory this a simple concept, rendering an analysis that is meaningful is

Composition of mammals on earth by body mass: Source - Bar-On et al, 2018



Modelling how these systems are likely to evolve in the future, including how they interact with each other, is a challenging and incredibly important systems-dynamics problem – and perhaps one of the most important business problems of our time

much more challenging as we do not yet have a single, universal measure of impact. To create one, we would need to calibrate the relative importance of objectives such as:

- **Massively expanding renewable energy** and implementing other measures to eliminate carbon dioxide emissions to slow climate change, and then beginning to recapture those emissions from the air;

- Reshaping our **food supply chains** to ensure long-term sustainability and to eradicate hunger, as well as eliminating the pollution of our environment on land and water, and reducing the many conflicts between man and nature;

- **Eliminating poverty,** by applying new development models in poor countries and implementing policies that will achieve inclusive growth;

- **Reducing inequality,** to ensure that everyone in society has access to sufficient income to live to a reasonable standard; and

- **Delivering gender equity** and equity on other metrics, so that our society becomes more inclusive and fairer for all, irrespective of birth place.

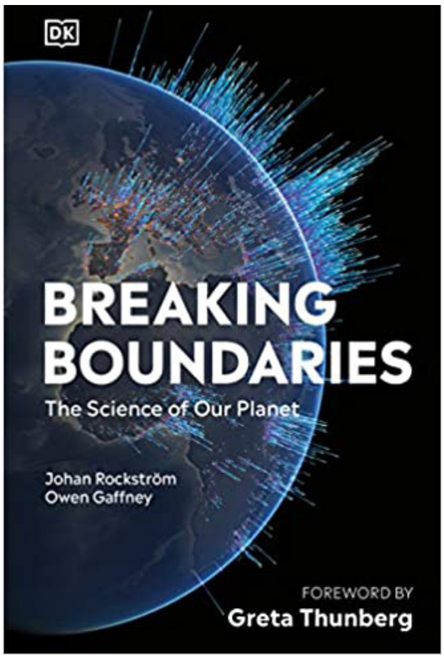
The above are, of course, the five transformational turnarounds laid out in the 2018 Stockholm Resilience Centre's report to the Club of Rome *"Transformation is feasible"* by Jorgen Randers, Johan Rockström, Per Espen Stoknes, Ulrich Golüke, David Collste and Sarah Cornell. This important analysis demonstrated that it is possible for the UN's sustainable development goals to be achieved whilst remaining within the nine planetary boundaries that define a safe operating zone for our planet.

Part of the challenge is thus to understand how actions in each of these five categories interact with each other. Dramatic economic growth may help to eliminate poverty, but it may come at a cost of environmental degradation or increasing inequality. If we could explain these systems effects, then we could prospectively assess the relative importance of the various measures, and indeed how these might evolve over time if different policies were pursued. This type of analysis would also allow us to identify variations across different regions and even countries.

We do not – yet – have the tools we need to answer these critical questions. Historically, the approach has typically been to attempt to place a financial value on nature or on people, to translate events in the real world into the language of economics and financial systems. This rudimentary approach does not, however, recognise or reflect the impact of interactions between these three systems.

Modelling how these systems are likely

The Sustainable Development Goals are a collection of 17 interlinked global goals designed to be a "blueprint to achieve a better and more sustainable future for all". The SDGs were set up in 2015 by the United Nations General Assembly.



to evolve in the future, including how they interact with each other, is a challenging and incredibly important systems-dynamics problem – and perhaps one of the most important business problems of our time.

In the meantime, as any good management accountant knows, if you want to maximise the output from your business, then you need to maximise the return on your scarce resources. What impact-adjusted return on investment will recognise is that those scarce resources now must include the impact on our natural environmental and the impact on society. Many investors have already understood the importance of this type of thinking, which explains both the dramatic rise in ESG-related investment, as well as the shift to focus on so-called 'impact investing'.

The good news is that the tools we need to grapple with these challenges are emerging. They include the "Earth" models developed by Jorgen Randers, Ulrich Golüke and various other colleagues over the last (hold your breath) 50 years, as well as more recent work by Johan Rockström and his colleagues at the Stockholm Resilience Centre and the Potsdam Institute for Climate Impact Research. If you want to be well-prepared for the coming changes, it is well worth your time to:

• Read ***Breaking Boundaries: The Science of our Planet*** (Rockström/Gaffney - DK), or watch David Attenborough's new Netflix film of the book;
• Read ***Tomorrow's Economy: A Guide to Creating Healthy Green Growth*** (Stoknes - MIT Press); and

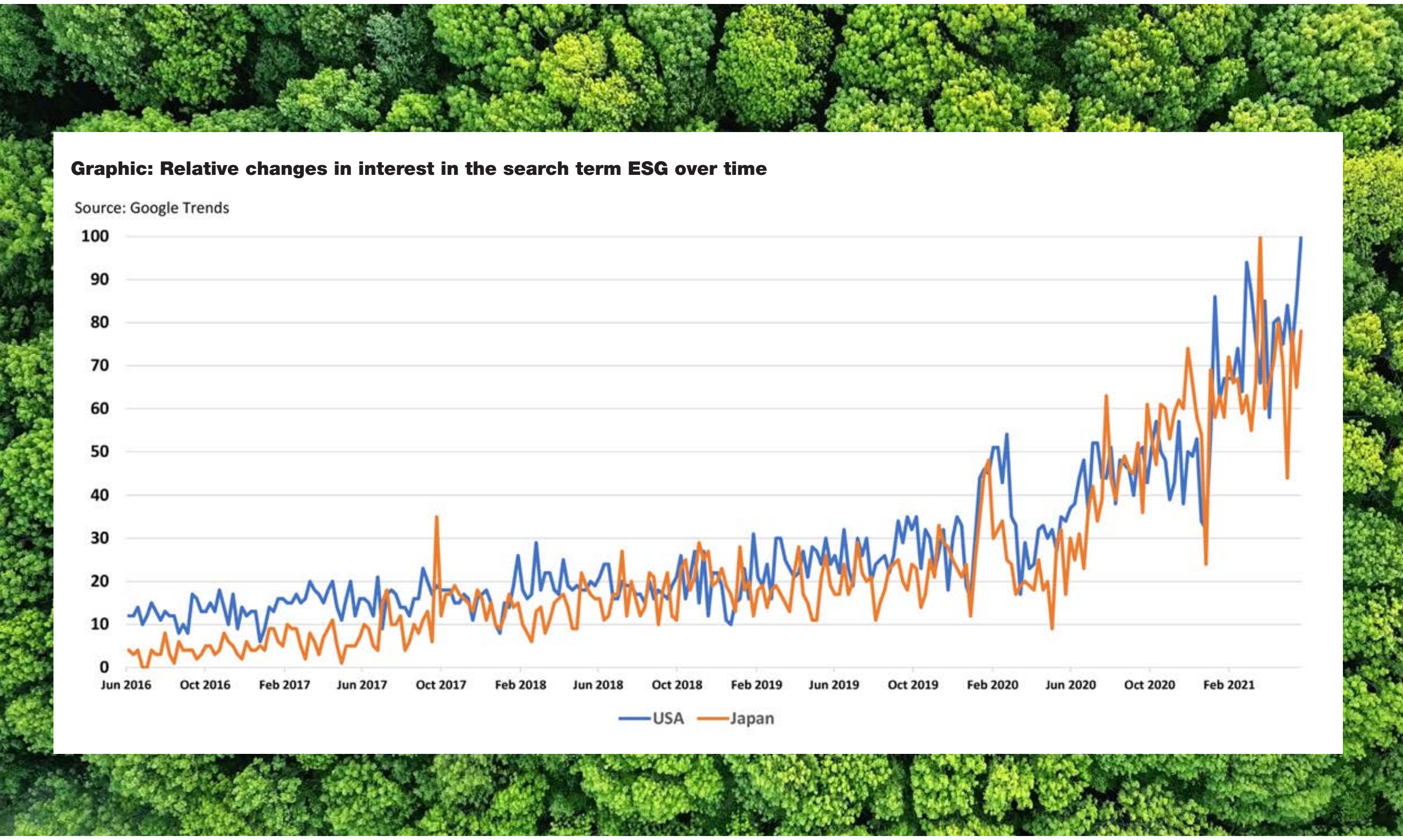
• Browse through ***The Global Handbook of Impact Investing*** (Sarmento/Herman - Wiley) - at 1300 pages, you're unlike to finish it in a single sitting - or watch the interactive discussions with the 50 contributors that we're hosting on ESGX.

In the meantime, there is plenty that leaders and their teams can do to adapt to this new paradigm. The starting point is to begin to reframe activity related to ESG so that it focuses on how adopting a sustainability mindset can help to drive business performance. In the simplest terms, this means thinking about:

• **Efficiency,** ie ways that a business can become more productive and make better use of the people and resources at its disposal;

• **Stakeholders,** and in particular the benefits to business performance that can flow from improving your relationships with employees, customers and suppliers; and

• **Growth,** ie the potential to create new



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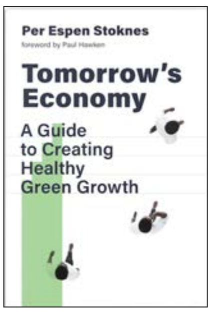

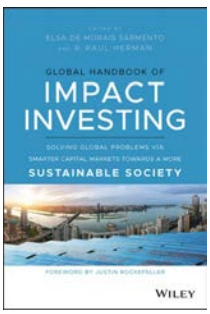

revenues through offering new or improved products that meet growing consumer interest in impact and sustainability, as well as the potential benefits to valuation of improving business resilience and reducing risk.

I wrote about this philosophy recently (see this link) so I won't go over the detail here. What I will reiterate, however, is that this approach will reposition sustainability from what is sometimes seen as a somewhat peripheral compliance activity to being a central focus in every CEO's office. This is what we have already seen in recent years from early-adopter businesses such as Unilever.

At a deeper level, this mindset will also provide a beacon to help you to escape the noise that has been created by the morass of frameworks, reporting standards and industry codes and practices. It will also make it easier to build enthusiasm for action in areas where you and your organisation can make a real difference, by aligning environmental and social impact with shareholders' interests.

Importantly, this approach should also make it easier to draw a direct line between major strategic and investment decisions and the UN's Sustainable Development Goals. The latter still represent the best overall enunciation of the problems we are collectively seeking to address, though most of the SDGs do not speak the items that typically appear on a company's board agenda.

Finally, watch this space! New thinking, new tools and new technology continue to emerge. In the meantime, as you invest, make sure that you explore how to optimise the impact of your investments. This will translate into improved quality of earnings, stronger stakeholder relationships, lower risk and growing value over time. P

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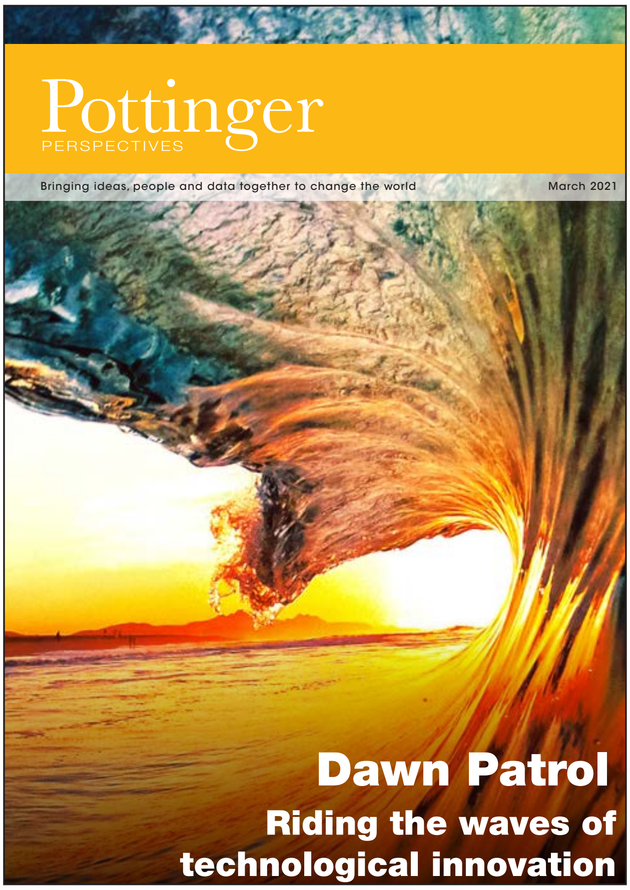

Dawn Patrol

A year has passed since the effects of the COVID-19 outbreak first began to be seriously felt in the West. For most, it has been a challenging year both at work and at home, and plenty of uncertainties still lie ahead. Nevertheless, technological development has continued apace, not least with the development of multiple vaccines in record time.

Meanwhile, the immediate pressure on businesses and governments to deliver short-term results remains as high as ever, making it hard to find time to position your business – or country – for what lies ahead in 2022 and beyond. That said, powerful technological shifts are happening in several major industry sectors, creating opportunity for those that can find the time to think through the implications and begin to act.

In Dawn Patrol, Nigel Lake shares his perspectives on what is unfolding and how best to ride the technological waves as they build momentum.

By Nigel Lake

https://www.pottinger.com/uploads/1/9/5/1/19512909/pottinger_-_dawn_patrol.pdf

About Pottinger

Pottinger is a global advisory firm headquartered in Sydney and New York. We combine strategic, commercial, financial and transaction perspectives, and focus first on long term outcomes, to deliver commercial advice that is practical and complete. We navigate the uncertainty inherent in commercial decisions, helping our clients to identify value overlooked by others, and to avoid risks which others may not see.

Pottinger helps organisations to adapt, innovate and transform, by providing insight and advice on strategy and public policy matters, as well as the negotiation and execution of M&A and financing transactions. Our combination of strategic thinking, M&A advice and financing capabilities allow us to find innovative solutions to the challenges arising in industries facing dynamic change and disruption.

Our team has exceptionally broad and deep strategic advisory and transaction execution experience, encompassing all of the world's top thirty countries. Examples include:

- Advice on market entry, strategic repositioning, identification of new growth opportunities, spin-outs and other forms of restructuring and advice on strategic investments, using our proprietary Destination-led Strategy® methodology, together with analogous advice to governments on public policy;
- Advice in relation to large and small-scale acquisitions, divestments and takeover responses for both publicly listed and private companies;
- Capital optimisation and financing advice for large enterprises, together with advice on commercialisation planning, capital strategy and capital raising for emerging companies;
- Specialist input in relation to the design, formation, restructuring, sale and dissolution of large scale joint ventures and partnerships; and
- Identification and quantification of risk, by applying advanced statistical techniques to relevant data pools, thus simplifying decisions impacted by significant uncertainty.

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