

Environmental, Social, Governance Issues Impact on Company Valuation

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When, exactly, did Enron cross the line? ...The Enron scandal grew out of a steady accumulation of habits and values and actions that began years before and finally spiraled out of control.¹

As investment managers, McLean Budden's research process spends a lot of time assessing risk in order to maximize risk-adjusted returns. We employ fundamental analysis to assist us in making these assessments, specifically, we look at both qualitative and quantitative factors. Those familiar with our process will know that we employ qualitative analysis in order to "get the story right first" which significantly improves the quantitative inputs used to construct our valuation models.

There is a subset of qualitative analysis that has taken centre stage recently, collectively referred to as Environmental, Social, Governance (ESG) and sustainability issues. Although these buzzwords are now part of the mainstream vernacular, we have

always believed the greatest companies have, whether intuitively or by design, adopted these best practices and made them part of their firm's culture. Notwithstanding what the companies are doing, we strive to follow an ethical compass that defines our firm's culture. But before we go any further, we need to define the buzzwords.

What are ESG Issues?

Environmental, social and governance issues include legislative, regulatory, legal, reputational and operational risks and opportunities that must be considered in order to fully understand the companies in which we invest.² Sustainable development, a goal to meet the needs of the present without compromising the ability of future generations to meet their own needs,³ often goes hand-in-hand with ESG, and is also assessed as part of our long-term investment view.

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How do Companies Respond to ESG Issues?

These issues seem intuitive and yet can be difficult to quantify. Difficult or not, we need to understand how they impact company valuations. The logical place to begin is with what companies do and why? Wal-Mart is an interesting example. The 14th largest company in the S&P 500 at time of writing, the company has had its share of bad press regarding social issues from “sweat shop” accusations to class action sexual discrimination lawsuits, reaching their apex in mid-2004. That year was a turning point for the company. Since then, Wal-Mart has worked at changing its image, presenting a more socially responsible message, from selling fair trade coffee, and improving employee health insurance to decreasing its overall environmental footprint.

Wal-Mart published its 2009 Sustainability Report, all 111 pages, that “covers our efforts to provide quality health care options for associates, increase diversity among associates, source products from responsible factories and reduce our footprint on the environment.” Their website devotes a section to its sustainability progress to date, its impact on the company as well as suppliers, some documented in case studies, as follows:

“With more than 7,000 stores and one of the largest trucking fleets in the world, the magnitude of our direct footprint means that our environmental efforts must begin with our own operations. By making changes within, we not only have an opportunity to minimize our environmental footprint and save money for our business, but to lead by example. In addition, we realize that we can influence our indirect footprint and therefore have a positive impact on our supply chain. This impact is important because the vast majority of our footprint comes from these indirect sources.”⁷⁴

“Reducing packaging at Wal-Mart overall by 5 percent could be equal to removing 213,000 trucks from the road and preventing 66.7 million gallons of diesel fuel from being burned, per year. Not only will this benefit the environment, but it could save our supply chain more than \$3.4 billion.”⁷⁵

Whether the company’s motivation is sheer altruism or to improve its perception, thereby leading to better in-store traffic, lower costs and improved profitability, the outcome looks to benefit both society and shareholders. Since adopting its new theology, the company’s stock performance has outstripped the S&P 500 by approximately 30% in the period from the end of 2005. Is this a coincident factor or a contributing factor? We will never know with 100% certainty, but whatever the company is doing appears to be working.

Another example is Potash Corporation of Saskatchewan, a leading fertilizer company that operates some of the world’s biggest mines.

We learn a lot about a company and its culture when we meet with its people. Here are the goals of the company in its own words:

Our Goals

- > Be the preferred supplier to the markets we serve
- > Maximize long-term shareholder value
- > Build strong relationships with and improve the socioeconomic well-being of our communities
- > Attract and retain talented, motivated and productive employees who are committed to our long-term goals
- > Prevent harm to people and damage to the environment⁶

It’s a pretty simple message, but a powerful one. However, we all know there is a difference between writing down goals and living them. How is your New Year’s resolution progressing? Site visits at the offices and the mines, along with management interviews, discussions with customers and competitors have illustrated to us that there is a consistency of employee actions with the company’s stated goals. In addition, it also devotes time to...

...Environmental...

“It was PotashCorp’s commitment to sustainability that moved Illinois architect George Cary to suggest the company’s new feed phosphates administrative center in Marseilles, IL should be a green building. Now PotashCorp has the first commercial building in LaSalle County, IL designed to meet the US Green Building Council’s standards for Leadership in Energy and Environmental Design (LEED).”⁷⁷

...Social...

“PotashCorp staff and operations in Saskatchewan and Ohio have received awards from their respective United Way organizations for their superior efforts to help improve the lives of people in their communities.”⁷⁸

...and Governance...

“PotashCorp takes great pride in recognizing the achievement of our Chair of Board of Directors Dallas J. Howe, on being named by the Institute of Corporate Directors (ICD) as one of four recipients of a 2009 Fellowship Award Honouring Excellence in Corporate Governance.”⁷⁹

...issues.

Lots of Words, but No Numbers

In our research we have seen only one paper that tries to empirically prove that corporate governance has an impact on future investment returns. In January 2009, Spellman and Watson co-authored a paper entitled GMI Ratings and Corporate Performance: 2003 to 2008. The objective was to evaluate whether the governance ratings done by Governance Metrics International (GMI) had any significant impact on share price performance. The conclusion was that “GMI ratings have historically had a significant influence upon future returns and that investors could have used them

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to earn economically significant excess returns from implementing simple investment strategies involving the holding of a portfolio that is, say, long on GMI highly rated firms and short on low rated firms.”¹⁰ This is only one datapoint, but it could be the beginning of a compelling trend.

It's a Way of Thinking

The issues are greater than jumping on the 'green' bandwagon. Many companies now make environmental rankings on businesses a prerequisite to bid on jobs. Good practices benefit hiring and getting business - who wants to work for a polluter and be interviewed about it on 60 Minutes? Think about it - if one wanted to start a new widget-making company, what are the key success factors? The widgets need to be well-made, good quality, reasonable cost, and have an advantage over the competition. There needs to be an understanding of end market demand and, whether implicitly or explicitly, an appreciation of the ESG impacts.

To be clear, we are not saying that because we like the mission statement we will buy the company. We are saying that understanding how a company views all of its issues, including ESG, helps us to better understand the risks of our investment and should lead to better decision-making.

Ultimately, we are unlikely to find a good investment where there is not good business practice and ESG issues make up part of that practice.

What we try to establish is how choices made by management impact the sustainability of the business model of the company. Understanding these impacts should allow us to better assess the risk/return potential of our investments. If this all sounds suspiciously like qualitative analysis, that's because it is. There is nothing new in our process, but given the rising emphasis placed on ESG issues, we are now explicitly breaking it out as a separate section of our qualitative analysis, using guidance from the CFA Institute's paper and incorporating its checklist into our research framework.

Qualitative Analysis Assesses ESG Issues

The CFA Institute published a manual on the subject in 2008 stating, "A company that incorporates ESG exposures into its long-term strategic planning and adequately communicates these factors and strategies to investors will provide a more complete picture of the company's prospective value. Strategically incorporating ESG analysis may also position companies to better anticipate future operating environments, including potential costs or burdens to their existing business model... However, it is as important as ever that the analyst maintain a balanced and professional approach - factor in

environmental or social issues while being careful not to distort investment decisions with political or emotional agendas that do not serve the clients' interests."

We wholeheartedly concur.

Balancing Head and Heart: The Rational vs. the Emotional

The last point in the Institute's paper is an important one. We have a fiduciary responsibility to our investors. As individuals, we all have belief systems that inform our opinions of issues. Our role as analysts is to be dispassionate about our investments and to rationally incorporate issues, either positive or negative, into our valuation models. Our research process has been designed to assist in overriding the more primitive, emotional portion of our brain with the more logical portion. For example, the die-hard environmentalist cannot negate an investment on the basis that 'all coal-fired generation is bad' but rather is guided by structure to assess the potential costs of emissions of the coal-fired generator and the potential costs of compliance to adhere to new environmental regulations. Similarly, the belief that all solar and wind companies are good is not good enough. The companies still need to be profitable to be good investments. All good corporate citizens may not necessarily be good investments. It is our fiduciary role to weigh, to the best of our ability, the factors that make a good investment.

At the core of all this is our belief that responsible decisions can also be the most profitable decisions. Paying a fair wage may lead to a higher operating expense, but not paying a fair wage may lead to substantial legal costs and product boycotts in the future that eradicate any gains from a lower operating expense. Damage to a brand is hard to quantify, but we need to attempt to do that as well. Good managers take all the potential ramifications of their actions into account when making decisions.

Change takes time, but we are seeing proactive company managements publishing sustainability reports to accompany annual reports. There seems to be some recognition that there is value in maximizing environmental and social values in conjunction with economic values. Changes need not be dramatic: think of shareholders as stakeholders; assess production costs in the context of all costs; accept that maximizing net present value may be at the expense of near-term earnings. What all these subtle changes have in common is an alignment with long-term investment goals.

Process Leads to Responsible and Profitable Investments

In a look back to 2007, it is interesting to note that as a fall-out of our investment process, McLean Budden Limited held 4 out of the 5 Canadian companies that made the Global 100 List: Most Sustainable

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Corporations in the World. They were Alcan, Enbridge, Royal Bank, TransCanada Corporation. In 2009, we hold all 5: Encana, Royal Bank, Telus, TD Bank, TransCanada Corporation.¹¹ Furthermore, at any given time, we generally hold approximately 20% of those on the list in our global portfolios, while a larger percentage is represented in our “focus list”, which are those companies currently under consideration as possible investments.

Do the Right Thing

As previously stated, qualitative benefits can be difficult to quantify, but it's blatantly apparent when the lack of ESG causes things to go wrong. It took years to take down Enron, which had a culture aimed at duping Wall Street about earnings using regulatory loopholes but then morphed toward criminal at the end¹² rather than operating a sustainable and profitable business model. Enron took Arthur Andersen down with them as that 89-year old firm got caught up in the profitability of one account and became an enabler. That's another business that would have done well to pass on near-term profitability. Ultimately, it cost 85,000 people their jobs. We don't know when the cumulative effect of bad decisions will come home to roost, but the costs can be enormous. Saying no and 'missing' a stock that goes up for the wrong reasons is also a valid investment decision. That is part of the McLean Budden culture and the direction in which our ethical compass points.

The bottom line is that we believe being responsible pays in the long run.

¹¹ McLean, Bethany & Elkind, Peter. (2004). The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron. Toronto: Penguin Group (Canada) Ltd. p. 132

¹² CFA Institute. 2008. Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors

¹³ Sustainable development as defined at United Nations 1983 Brundtland Commission.

¹⁴ <http://walmartstores.com/sites/sustainabilityreport/2007/environmentSupply.html>

¹⁵ <http://walmartstores.com/sites/sustainabilityreport/2007/environmentFootprint.html>

¹⁶ http://www.potashcorp.com/about_potashcorp/

¹⁷ <http://www.potashcorp.com/sustainability/environment/news/>

¹⁸ <http://www.potashcorp.com/sustainability/social/news/employee/>

¹⁹ http://www.potashcorp.com/sustainability/governance_and_management/news/

²⁰ Spellman, G. Kevin and Watson, Robert, GMI Ratings and Corporate Performance: 2003 to 2008 (January 1, 2009). Available at SSRN: <http://ssrn.com/abstract=1392313>

²¹ The 5th company is Sun Life Financial (McLean Budden's majority shareholder)

²² After getting the word that EES needed to close another deal by the end of the quarter to make its numbers, one senior executive recalls persuading a customer to sign a simple commodity agreement while putting the more lucrative outsourcing agreement on hold. “I knew I had to get creative,” he says... The quarter was riding on it. This same executive recalls an instance where he closed a deal that had a total contract value of \$500 million, only to see Enron issue a press release claiming the contract was worth \$1.3 billion. p.182

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