

Why should environmental performance matter to investors?

Until recently, most investment professionals have not paid much attention to companies' environmental performance, perhaps because they believe it to have only a marginal impact on their day-to-day investment analysis and decisions. Where investors have considered environmental issues this has usually been because of perceived risk or liability.

Poor environmental performance is impacting negatively on the reputations and profits of a growing number of companies. This, in turn, affects shareholders. For example, in May 1998, the US forest products company Louisiana-Pacific was fined US \$37 million, which included US \$5 million for violations of the Clean Air Act. When the court case was announced three years ago, the company's stock price fell by 20%. The company was also forced to take a US 13c per share after-tax charge against second quarter earnings.

MacMillan Bloedel is another forest products company whose environmental policies have been subjected to strong criticism. Based in Canada, it manages 3.1 million hectares of forests, with 1997 sales of US \$4.5 billion. Recently, several large US and European companies cancelled or reduced orders from MacMillan Bloedel owing to its controversial forestry practices. It announced in June 1998 that it would make major changes in these practices and seek certification to demonstrate improved forest management.

However, examples from many industries also show that good environmental performance can have a positive effect on business and financial performance. There are a number of reasons for this: good environmental performance is increasingly associated with gains in productivity, growth in market share, better business relationships and lower costs of capital. Innovest, a Toronto-based investment advisory firm, analysed 300 'Fortune 500' companies from an environmental perspective, and showed that those with the highest environmental rating outperformed their competitors financially by as much as 5%. Investment professionals are now realising that by using such systems for analysis¹ and taking account of their findings, their evaluation of companies' performance will be more comprehensive and therefore more accurate.

These kinds of analyses are still evolving. Companies and groups working on fine-tuning environmental reporting and analysis methods include SustainAbility in the UK, Ellipson AG of Switzerland, and the United Nations Environmental Programme's Financial Institutions Initiative. The literature and studies generated by these and others suggest that good environmental performance can often be linked to good financial performance.

Recent legal opinions in the US and the UK have challenged an often-heard claim about fiduciary duty – that considering companies' environmental performance is incompatible with the search for the highest returns for investors. Indeed, since the environmental and social actions of a company are increasingly capable of altering its financial performance either positively or negatively, fiduciary duty might well require analysis of these actions. And choosing a company with superior environmental performance over another of equal financial performance may well be the prudent course of action.

¹ Innovest's is called EcoRisc '21

Environment as risk for the forest products industry

In recent years the forest products industry has shown weak overall financial performance. It is an industry beset by poor returns and high leverage ratios. These problems stem from the difficulty of differentiating its products in a commodity business, its cyclical nature, high capital intensity for modern pulp and paper mills, slow-growing northern markets and challenges to its right to operate. Responses to these problems, such as building larger mills, merger and acquisition activity and expansion into emerging markets, have not yet shown clear financial benefits.

Share price performance of US wood and forest products sectors

Sector	3-year average % return	3-year rank out of 94 sectors	5-year average return %	5-year rank out of 94 sectors
US forest products	7.3	87	8.3	83
US paper products	9.2	85	9.8	84
Dow Jones Industrial Average	30.9		22.6	
Airlines	44.3	13	19.9	36
Aluminium	15.8	77	12.7	70
Auto manufacturers	21.6	62	20.5	32
Long-distance telephones	26.6	45	15.7	53
Oil-integrated majors	25.4	52	18.8	40
Semiconductors and related	44.1	14	40.6	2
Soft drinks	37.8	22	24.4	22
Steel	(3.0)	92	3.3	90

Source: 'Shareholders' scoreboard', *Wall Street Journal* supplement, February 1998.

Standard & Poor's Paper and Forest Products Index against 500 index, 1989–1998



Source: Bloomberg.

Of all trees felled worldwide, 48% are used as raw material in the forest products industry. Forest products companies therefore have a significant influence over forest ecosystems, either through the forests they own or their relationships with customers and suppliers. Because of the wide range of relationships arising from this land ownership, publicly traded forest products companies are particularly vulnerable to community, customer, or environmental pressure that challenges poor environmental performance. Such pressure can have financial consequences.

What are the environmental problems associated with forests?

The world's forests face two major problems – deforestation and loss of quality. Deforestation is the disappearance of areas of forest, and is well known as a problem – almost half the earth's original forest area has gone. 'Loss of quality' is a less familiar concept. It is used to describe forests that no longer provide the full range of ecological services essential to life. For example, biodiversity is one important aspect of quality: if a forest is harvested and then replanted with just one kind of tree instead of the many that used to flourish, it provides a habitat for fewer species (which is one reason why plantations, being of one kind of tree and all of the same age, often do little to redress the problems of deforestation). Other aspects of quality may include, for example, soil and water supply protection, local climate regulation and carbon storage.

A key problem is that timber is *the* major priced and traded commodity, and although it is only one of many services that forests provide, its pricing dominates the way in which forests are managed. Pricing signals and markets are not structured to encourage or reward companies for managing a broader range of goods and services from the forests. Many forest companies manage their forests under time-limited concessions from a government, and all too often these give no financial incentive to return the forests to the authorities in a healthy state. While most forest products companies make some provision to protect watersheds or local flora and fauna, these efforts are often insufficient to protect the overall forest ecosystem and to satisfy consumers and local communities. Because of economic development pressures, and corruption or industry lobbying, government agencies in the north and south have often not been very effective at regulating the industry to ensure that forests are kept in a healthy state. International efforts to address forest loss and degradation, although they have had promising results in some countries and at some levels, have not made the significant difference that forests need on a world scale.

Worldwide concern

Consumers, interest groups and the media worldwide have identified forest management as the most important issue for the forest products industry. Initial concern for tropical forests alone has spread to all forests – to those in the US, Europe and Russia, for example – as research has revealed that these too are threatened by outright loss as well as degradation of forest quality. Today, a growing number of wood products buyers – industrial and end-users – prefer to buy from companies that they believe are doing a good job of managing their forests.

The broad concern for forest health has implications for financiers, whose job it is to understand how any emerging issues or trends will impact business. These implications were summed up in a speech to a forest products industry conference by Stephen J. Karper, Managing Director of Citibank New York.²

'Another business fundamental of increasing importance to us – and I know it's becoming increasingly important to you too – is sensitivity to the environment. Going forward, it won't be enough to satisfy environmental regulators. We're also going to have to convince the

² Speech by Stephen J. Karper, Managing Director, Head of Global Structured Finance and Advisory, Citibank, New York to Second World Conference on Finance and marketing for the forest, pulp and paper industries, 29–31 March, 1998

market place that you are a responsible corporate citizen. Failure to do so will invite attack by non-governmental organisations, by which I mean environmental activists. This is already very much an issue in Europe and the US, and it will only become more prevalent around the world. We have already seen environmental groups call for boycotts of companies they claim are cutting down old-growth forests. And some retailers have begun to audit their suppliers for compliance with environmental regulations. If the financial viability of your project or acquisition is threatened by this kind of activity, it will become that much harder – or more expensive – to finance.'

From regulation to market-based solutions

Because regulation alone has often failed to make the significant difference needed, many environmental groups have been promoting voluntary, market-based solutions to stem the loss and degradation of forests.

As Bill Howe of Collins Pine, a Californian forest products company has said:

'We have long argued against stifling governmental regulations. But certification may provide the internal desire for industry to voluntarily achieve results that regulations rarely accomplish.'

WWF believes that there is now a viable, voluntary market-based solution to improving forest management practices that also has the potential to alleviate some of the problems contributing to the poor financial performance of the forest products industry. The Forest Stewardship Council (FSC) based scheme provides companies with a simple and clear way to demonstrate that they are committed to the highest international standards in forest management.

How FSC-based certification works

The Forest Stewardship Council accredits certification bodies, which then conduct a detailed audit of a company's forests according to measurable and numerically based standards. A tracking system allows forest products certified under the FSC system to be followed from forest to outlet, where it can be labelled with the FSC Trademark. Consumers can therefore identify forest products that come from forests managed to the highest international standards.

The FSC programme includes all the necessary elements for an industry selling to increasingly environmentally conscious consumers in many countries at once. These are:

- independent assessment by third parties that consumers can trust
- comparable results because companies are adjudged according to measurable, numerical standards
- a system to track forest products from the forest floor to the shop floor
- a clearly identifiable label to place on those products
- extensive support from the environmental community
- international applicability.

Other systems have been developed that companies use to give confidence in their management of forests, but WWF believes that FSC-based certification is uniquely placed to benefit both companies and the environment. The table below compares the schemes.

A comparison of forest management and environmental management systems

Evaluation criteria	FSC	ISO	CSA	SFI
Sets minimum forest management practice standards?	●			
Requires independent third-party auditing?	●	●	●	
Undertakes forest-based assessment?	●		●	
Evaluates internal Environmental Management System?	●	●	●	
Provides products label or market-based claim?	●			
Has extensive environmental community support?	●			
Has extensive industry support?		●	●	●

ISO is the International Organization for Standards' ISO 14000 series, which measures companies' efforts to implement their own generic environmental management systems

CSA is the Canadian Standards Association's Sustainable Forest Management System Standards

SFI is the Sustainable Forestry Initiative of the American Forests and Paper Association

Although WWF encourages companies to demonstrate their environmental commitment through management quality marks such as ISO 14000, it recommends FSC certification as the only viable and independent system that directly addresses forest management.

Ten million hectares of forest have been certified to date in 25 countries: WWF's target is to reach 25 million hectares by 2001.

Competitive advantage through FSC-based certification

Surveys in Northern Europe and the US clearly show that consumers and businesses prefer products from well-managed forests: this market interest is predicted to continue to grow rapidly.

The commercial benefits enjoyed by companies as a result of FSC-based certification are growing, despite the fact that the system has only been in operation for four years. Companies that are able to capture such benefits are likely to be the winners in this increasingly competitive global industry. These may include:

- **protecting and increasing market share** – one reason why major forest product companies (for example, South Africa's SAFCOL and Sweden's STORA) certify their lands is to maintain access to European markets.
- **a way to differentiate products** – a certified label helps customers to identify more environmentally sound products; surveys have shown that all else being equal, consumers prefer goods with a trusted green label

- **a long-term guaranteed wood supply** – certification ensures that forests are managed so that the harvest does not exceed the growth rate; companies therefore avoid the risk of investing in expensive pulp mills that cannot operate to full capacity because of subsequent timber supply problems
- **increased forest productivity** – after the appraisal process for FSC-based certification showed that 66,000 acres were growing below maximum quality and quantity potential, Menominee Tribal Enterprises modified management in the area to favour higher volume and value species, yielding more material to be processed into higher-value products
- **consolidation and protection of the right to operate** – for example, avoiding the experience of companies which have been criticised or boycotted because of their forest management practices
- **better relations with shareholders, regulators and local communities** – Collins Pine in the US and STORA both report much-improved relations with local communities since they certified their lands
- **better employee morale and ability to attract good staff** – Collins Pine reports significant goodwill benefits conferred by certification; its employee turnover is significantly below the industry average
- **lessened risk and liability exposure** – which may lead to lower costs of capital
- **price premiums** – in some cases certified companies may be able to obtain price premiums. AssiDomän reports achieving a 5% price premium for its products certified under the FSC system.

An alignment of interests

The risks and the benefits flowing from a company's environmental performance make it an issue of increasing interest to investment managers. In the case of forest products companies, FSC-based certification gives them a simple way to identify high standards of forest management. As well as generating business benefits, FSC-based certification can help solve two of the most serious problems facing the forest products industry today – price pressure in a business based on a standard commodity, and challenges from communities and environmentalists over the right to operate. By using the FSC Trademark, companies can differentiate their product, with corresponding benefits in premium prices and/or market share. And because FSC-based certification has widespread support from respected environmental bodies, companies that have gained it for their forests are unlikely to receive challenges to their right to operate.

FSC-based certification aligns the interests of many other groups as well. Its alignment with the interests of environmentalists is clear because it is based on the highest agreed standards. Because it requires the needs of local communities and private forest owners to be taken into account, it can help to integrate forest products companies into those communities. Because it ensures healthy forests but does not depend on government funding, it is likely to be welcomed by national governments, and already international organisations such as the World Bank have signalled their support for independent certification. Because it is simple and increasingly well known, it makes life easier for consumers who want to spend their money in an environmentally responsible manner.

In a press statement in June 1998 to announce that MacMillan Bloedel would seek independent certification of its forestry practices, its President Tom Stephens said:

‘Today marks the beginning of the end of clear-cutting and recognition of non-timber values in our old growth forests. This is the future of forests. It reflects what our customers are telling us about the need for certified products.’

FSC-based certification is not a panacea to cure every single environmental and financial problem facing the forest products industry, but it does offer companies a way to manage risk and generate competitive advantage. Hence its potential contribution to overall performance.

WWF believes that knowledge of FSC-based certification will help investment managers in their search for high-performing companies in the forest products sector. WWF recommends that they read the full report of *Investing in Tomorrow’s Forests* and incorporate FSC-based certification into their investment criteria.