Covid-19 and Corporate Purpose

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Covid-19 continues to test mankind. Apart from a huge public health crisis, the pandemic has led to severe social, economic and geopolitical challenges. While the lethal virus gathers force, the initial shocks are behind us. It is perhaps time to reflect upon some lessons emanating from the mother of all black swans.

Today the entire world is in the same boat. The pandemic has reminded us about the interconnectedness of human lives across continents. How one conducts one's life – activities, pursuits, interaction with nature, communities, food habits etc. – can have far reaching implications for humanity. The same is also true for corporate conduct.

This piece focuses on the potential impact of Covid-19 on the ongoing debate on corporate purpose and the associated issues of capital allocation, investing and disclosures.

Debate on corporate purpose

Irresponsible corporate behaviour can result in negative externalities for the society. Debate about the purpose, conduct and accountability of corporations beyond profit making was gathering momentum globally in pre-Covid times. Milton Friedman's doctrine that the sole purpose of the business is to generate profits is under challenge today. In August 2018, one of the preeminent business lobbies in the United States, the Business Roundtable issued an open letter signed by 181 CEOs on the purpose of a corporation committing to deliver value to all stakeholders and not just shareholders.

This discussion has become much more relevant in the wake of Covid-19. The pandemic has brought us face to face with existential questions. It has heightened the need for a more conscientious and responsible corporate behaviour. An excessive focus on profits to the neglect of communities, nature and environment can be self-defeating in the long run. This is no longer a theoretical argument. Covid-19 has rung the alarm bell, loud and clear.

Evidence

Notwithstanding the call for a shift from maximization of shareholders' interest to stakeholders' interest, the majority of companies continue to be focused on profit maximization. Stock markets valuations are largely driven by quarterly numbers and price earnings multiples. At the same time, it is argued with growing evidence that if one invests in a portfolio of purposeful, sustainable, socially responsible companies with a long-term horizon, then one can comfortably outperform their less enlightened counterparts. Further research and empirical analysis that can demonstrate such outcomes would provide an impetus to this movement.

Legislative shifts

Legislative intent in this space in India has been ahead of the curve. Much ahead of the Business Roundtable declaration in 2018, the new Companies Act passed in 2013 requires a director of a company to act in the best interests of the company, its employees, the community and for the protection of the environment. The Companies Act also made spending on Corporate Social Responsibility (CSR) mandatory.

The SEBI (Listing Obligations and Disclosure Requirements) Regulations echoes similar expectations. Kotak Committee in its report on corporate governance submitted in 2017 noted that corporate India needs to move to a custodian model on the Gandhian principles whereby promoters, management and the board wear the hat of trustees and act in the interest of all stakeholders before self-interest.

While high level legislative resolve becomes more explicit, globally the corporate laws are mainly written from the perspective of shareholders. There is a dichotomy. Going forward as the corporate purpose widens, one can expect amplification of the interest of broader stakeholders in laws relating to corporate governance. The ongoing pandemic as well as ongoing market forces present an opportunity for reflection to move towards this direction.

ESG Investing

While legislative push will continue to evolve, market forces have been playing out to drive the change. The needle is moving towards greater environmental, social and governance (ESG) investing - it is no longer a fad.

The world's largest asset manager, BlackRock is making a bigger bet on ESG investing. Its Chairman and CEO Larry Fink in his annual letters to corporate CEOs has been making a strong pitch for redefining the purpose of the corporation and putting ESG concerns on par with the quest for financial returns.

Trends

Worldwide, total assets in sustainable funds have increased from USD 550 billion at the beginning of 2018 to USD 1062 billion at the end of June 2020, an increase of 93% which equates to a CAGR of 30%. Net inflows in sustainable funds increased from approximately USD

65 billion in 2018 to USD 156 billion in 2019, an increase of around 140%. In the first half of 2020 (Jan to Jun 2020), inflows have already crossed USD 116 billion, reflecting the growing investor interest in ESG related issues.

In Europe, there has been a steady rise in assets in sustainable funds over the past few years, from approximately USD 350 billion at the end of December 2015 to USD 870 billion at the end of June 2020, an increase of 2.5 times which equates to a CAGR of 22%. With 2,703 sustainable funds currently available, Europe is by far the most developed and diverse ESG market. Europe continues to dominate sustainable investing and is home to 78% of sustainable funds (by number) and 82% of assets owing to the long history of responsible investing and the favourable regulatory environment in Europe.

In contrast, as of June 2020, India had only 3 ESG themed mutual funds with their assets under management aggregating USD 550 mn. 2 of these 3 mutual funds have been launched within the past year.

Covid-19 sets the stage for further boost to sustainable investing. It will trigger fresh thinking on allocation of capital not just by companies, but also by governments and investors. The pandemic will also bring a renewed focus on companies for reporting on sustainability related aspects.

Disclosures

Disclosures requirements and practices are rapidly evolving in the ESG space. There are two main driving forces seeking greater accountability for the social and environmental impacts of companies through disclosures - Stakeholder groups, including investors and Governments / regulators.

Companies in Europe have a relatively higher percentage of disclosure on ESG and climate-related information as compared to companies in Asia or USA. Countries are at different stages of development, with varied needs and therefore the approach that is adopted in approaching ESG issues is bound to vary. Nonetheless, self regulation may not suffice and governments / regulators have to step in to step up the game.

A major driver for increased disclosures in Europe has been pressure from investors and Asset managers who are considering ESG related risks while making investments. There has also been a regulatory push with the 'Action Plan on Financing Sustainable Growth', published by the European Commission in 2018 leading to adoption of regulations on Disclosures, Taxonomy and Low Carbon Benchmark.

Business Responsibility Reporting

In India, SEBI introduced mandatory Business Responsibility Reporting (BRR) for top 100 listed entities in 2012, which has been progressively extended to top 500 listed companies in 2015 and to top 1000 in 2019. BRR requires description of the initiatives taken by companies from an ESG perspective in a prescribed format. In 2017, SEBI had also introduced voluntary adoption of Integrated by top 500 companies.

In 2019, a Committee on BRR was set up by the Ministry of Corporate Affairs for revisiting disclosure requirements. The Committee in its recently released report in August 2020 lays emphasis on disclosure of quantifiable information to allow for easy and timely measurement and comparability across companies and sectors. The Committee has suggested that the BRR be called the Business Responsibility and Sustainability Report with two sets of indicators - essential (mandatory) and leadership (voluntary). The report sets the stage for taking a leap for better disclosures in the ESG space in India.

Another report released by SEBI on Social Stock Exchange (SSE) recently makes an interesting proposal for listing of For profit enterprises (apart from non profits) with a richer impact narrative to list on SSEs. The report recommends common minimum standards for reporting on a social impact scorecard with the parameters such as reach / lives touched, depth of impact, diversity, inclusion, equity etc. The companies who commit to make such enhanced disclosures will be eligible for listing on SSE and be better placed for attracting substantial impact investments.

Summing up

Society's expectations from company boards to serve the interest of all stakeholders have been rising. Shifts in focus from shareholders to stakeholders are validated by increasing sustainable investments around the world. Investors, more than the regulators, are driving these trends. Due to such shifts, conventional financial reports are increasingly not meeting the needs of users. Today, a large amount of valuable information sits outside the financial statements which is pushing for integrated and sustainable reporting.

Covid-19 would accelerate these trends towards stakeholder based responsible capitalism. The companies, particularly the listed ones are under scrutiny today in terms of their response to the crisis and treatment of stakeholders. The crisis is testing the stated corporate culture and values including commitments towards various stakeholders - are these merely ornamental or actually practiced when the need arises ? Covid19 has brought the corporate sector to a tipping point in moving towards purpose beyond profits.

(Views are personal) (Data sources - Morningstar and AMFI)