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Editorial

MARIO DRAGHI'S REPORT ON COMPETITIVENESS AND SUSTAINABLE GROWTH IN EUROPE

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In early September, the former Italian Prime Minister and former ECB President Mario Draghi released his competitiveness report requested by the new European Commission. After ten years of slower growth in Europe, Draghi calls for urgent action to close the economic gap with the US and China. He focuses on three main priorities: innovation, decarbonization and security. For Draghi, the energy and environmental transition needed to meet the Paris Agreement, including the circular economy, is core to Europe's competitiveness and growth. In this area, he blows hot, emphasising both the importance of achieving climate goals and Europe's leadership in the field of clean technologies, including wind farms, heat pumps, energy storage and hydrogen. With 77% of European companies reporting difficulties in finding workers with the necessary skills, this will require initial and further training to allow workers to be recruited or reskilled within these high growth industries.

At the same time, Draghi rightly blew cold, calling for moderation after five years of intense sustainability regulation rollouts. He recommends simplifying the European regulatory framework on sustainability. The report notably referred to the CSRD regulation on corporate sustainability disclosures, warning of the danger of 'regulatory burdens' for small and mid-sized companies. Other frameworks (SFDR, Green Taxonomy...) were also mentioned. Indeed, sustainable development shouldn't require overly complex and labyrinthine systems – the bread and butter of lawyers, auditors and consultants – to make strides forward.

Finally, the "elephant in the room". With a nod to the Marshall Plan, Draghi concludes that 800 billion euros - or 5% of Europe's GDP - in additional public and private investment will be required each year.

We wish you a pleasant read.

Sustainable Finance and Responsible Investment Chair

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News

PUBLIC HEALTH AND FOOD LABELLING

Obesity is a growing public health issue that affects millions of people throughout the world. According to WHO Global Health Estimates, 2 billion people – or 1 person in 8 – are overweight or obese. Food with low nutritional value, known as "junk food", is largely responsible. And there is growing evidence that ultra-processed industrial food causes addictions among the most vulnerable consumers.

Europe's public health strategy advocates transparency rather than bans or taxes in order to inform and ultimately influence consumers as they make their food choices. To achieve this, several tools have been made available to the public. The Nutri-Score, a food label created in 2017, is based on a colour scheme ranging from A (highest nutritional value) to E (lowest nutritional value). Supported by several consumer associations, this label is designed to provide buyers with information on the nutritional quality of food products. By early 2024, 1,359 brands had actively embraced the Nutri-Score in the French market, including large groups such as Danone, Franprix, Nestlé, Caudalie and Picard. In contrast, food industry giants - including Coca-Cola, Lactalis, Mondelez and Ferrero - are still opposing the label, as are some local producers.

In addition to food labelling, apps can also provide insights into the nutritional quality of many food products. The best known is Yuka, used by 55 million people. This app scans the barcodes on food and cosmetics to give a quick color-coded score out of 100 (green, orange or red). Products are assessed based on different criteria: nutritional, health (presence of additives/risk to health) and environmental (organic label).

The "Quelproduit" app, on the other hand, considers the composition as well as the nutritional and environmental quality of food, cosmetics, and household cleaning products, based on the UFC Que Choisir endowment fund's assessments.

The Nutri-Score and other apps can potentially influence consumers' buying habits, thereby encouraging the food industry to alter food components to achieve better ratings. The latter are eager to embrace the Nutri-Score as a marketing argument when it is in their favour. According to Eurofins, the score now appears on almost half of the food products sold in supermarkets. And the A score is the most prevalent.

Danone's recent announcement that the group would stop reporting the Nutri-Score label on some of its products - after changes were made to the calculation rules - has called into question the voluntary nature of this informative, and now marketing tool, which is discarded when it is unfavourable.

A mandatory labelling requirement is now being debated at European level and has been rejected by several industrial players. The European Commission has delayed its plans, arguing it needs to finalise its impact assessment before proposing draft regulation aimed at standardising the nutritional logo to be placed on food products at EU level.

SUSTAINABILITY PERFORMANCE AND THE COST OF CAPITAL

The recent surge in the environmental, social, and governance (ESG) factors has highlighted many unanswered questions in the financial market world. There is no consensus on the association between sustainability performance and the cost of equity and the cost of debt. However, most research shows a negative relationship between sustainability performance and cost of equity and cost of debt. Contrarily, other studies find a positive relationship between both variables or an inconclusive one. The authors argue that debtholders and equity holders are not exposed to the same risks; their response to sustainability practices is then unlikely to be aligned. In addition, an increasing body of literature shows that other factors have an impact on this association, such as industry membership and country-level factors such as stakeholder orientation, financial transparency, and governance.

This study aims to fill precisely this gap in the literature. In this research, the authors use an analysis of the association between the two channels of corporate cost of capital and sustainability performance in a European context, thus examining the responses of cost of equity and cost of debt to sustainability performance within the same research framework.

GLOBAL APPROACH

To answer that question, two samples are considered: the sample to study the cost of debt, which consists of 388 unique firms in a sample of 4383 firm-year observations and the sample to study the cost of equity, which comprises 4276 firm-year observations of 413 unique firms. All firms are constituents of the STOXX Europe 600, and these firms belong to 17 countries of the European Union, in a period between 2002 and 2018. This study employs an ex ante cost of equity measure, using the abnormal growth models. In this study, sustainability performance was measured through the ESG score, a score based on the weighted average of the ESG scores and ESG controversies score.

RESULTS

The authors take a step further and assess effects grounded in competing literature streams. The results from this study point to a statistically significant positive relationship between a firm's cost of debt and sustainability performance, suggesting that lenders perceive sustainability activities as a waste of a firms' resources, in line with overinvestment theory. Regarding the cost of equity, results show a negative relationship with corporate sustainability. This suggests equity markets perceive sustainable investments as a source of value, possibly through risk-mitigation arguments.

After segmenting the sample into firms below and above the industry median corporate sustainability performance, the results show that lenders penalize firms for their efforts to be industry leaders in sustainability, while not finding evidence that they reward those investing less than their peers. An inverse association is found regarding how equity markets perceive sustainable practices; investors penalize firms who are laggers in sustainability with higher required equity premiums, while no significant association is found for the group of leaders. This suggests that the industry median corporate sustainability performance score is optimal, as investors penalize below industry performance and lenders penalize above industry performance. The results also show that the relationship is only statistically significant during a period of stability, implying that sustainability is not value-relevant to capital markets during periods of crises. The studies explain that during periods of crisis, firms prioritize avoiding financial distress and bankruptcy and maintaining profitability. The positive effects sustainability might have on the cost of capital, by reducing the probability of negative events or increasing moral capital, become secondary in such circumstances.

In this way, short-term financial performance is prioritized over long-term sustainability performance.

CONTRIBUTIONS OF THE STUDY TO THE LITERATURE

This study provides evidence on pricing corporate sustainability performance by the capital markets. The results point to divergent positioning by lenders and investors, forcing socially responsible managers to weight the cost of each source of capital when allocating firm resources. Second, the authors examine how capital markets perceive leaders and laggers in sustainability within an industry to account for its idiosyncrasies. Not all industries respond to the same sustainability drivers. Being a lagger and investing in sustainability is rewarded by equity holders, while leaders appear to be penalized by debtholders. Overall, positioning corporate sustainability around the industry median appears to drive value the most. Third, the authors also add to the literature that worked around external shocks and find that sustainability performance in periods of crisis is not priced for both equity holders and debtholders.

STRATEGY TO FOLLOW

The results point to an optimal level of sustainability investment as lenders and investors seem to penalize firms who overinvest in sustainability (corporate sustainability performance above industry-standard) and reward those who underinvest in sustainability (below industry-standard corporate sustainability performance). A 10% deviation from industry median impacts both cost of debt and cost of capital by about 4 b.p. According to the robustness tests, lenders are only sensitive to firms who overinvest in sustainability, while investors are sensitive only to firms who underinvest in sustainability.

CONCLUSION

The authors find that ESG performance is priced by both debt and equity markets, although in different directions, forcing company managers to adopt nuanced strategies. While better ESG performance is associated with a lower cost of equity, the relationship is positive regarding the cost of debt. The relationship with the cost of equity is penalized for firms lagging in ESG performance compared with industry peers, and the industry median corporate sustainability performance score is around optimal to balance the cost of equity and cost of debt. This underscores the need for companies to find a balance in their ESG practices to minimize their cost of capital. This study also finds that during periods of financial crisis, sustainability and the degree of under- and overinvestment in sustainability activities become ir-relevant to lenders and investors. Overall, in the same research setting, we find that the channels of firms' cost of capital composition behave differently in response to changes in sustainability performance. Finally, environmental and social issues like climate change have driven major political policies, such as the Paris Agreement, which aims for climate neutrality by the century's end, requiring policymakers to understand how capital markets price sustainable activities and regulate accordingly.

Gonçalves, Tiago Cruz, João Dias, and Victor Barros. 2022. Sustainability Performance and the Cost of Capital. International Journal of Financial Studies 10: 63. https:// doi.org/10.3390/ijfs10030063

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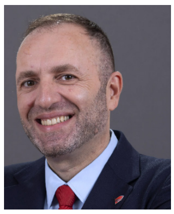

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He holds a PhD in Management, Finance and Accounting from ISEG.

Company meetings

EDP RENOVAVEIS

EDP Renovaveis is a Portuguese company specializing in renewable energy production through the operation of onshore wind farms (80% of capacities) and increasingly implementing solar farms. Geographically, its production capacities are mainly located in the United States (49%), Europe (34%), and Latin America (9%).

As a signatory of the Global Compact since 2013, its sustainability approach is long-standing and well-structured. 100% of its electricity generation assets are ISO 14001 certified. With a Net Zero ambition in terms of climate by 2040, 99.8% of EDPR's revenues and investments are already aligned with the European Green Taxonomy.

Socially, the company, which is regularly growing, structurally creates sustainable and local employment. Employee training efforts are satisfactory, and the results in terms of occupational accident prevention are positive.

Controlled by over 70% by its parent company Energia de Portugal (EDP), EDPR distinguishes itself positively in terms of governance through the adherence to "one share, one vote," a high-quality management team that arrived in 2021 following a corruption scandal that led to the departure of the previous team, good quality of both financial and non-financial communication, and a satisfactory 50% board independence rate.

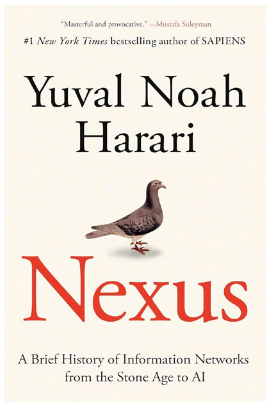
The information about the companies cannot be assimilated to an opinion of Edmond de Rothschild Asset Management (France) on the expected evolution of the securities and on the foreseeable evolution of the price of the financial instruments they issue. This information cannot be interpreted as a recommendation to buy or sell such securities.

Recommended reading

A REALISTIC VIEW OF AI

Our species, "homo sapiens" or wise man, sometimes does not live up to its name. For thousands of years, information technologies have brought truth and/or order. However, while truth has often brought wisdom, the pursuit of order has also led to the quest for power at the expense of wisdom. AI is revolutionizing the world because it can make decisions and generate ideas independently, raising the question of its potential to eventually dominate humans once it can replace human decision-making. In light of the risks to our democracies, the concluding message is simple: we must continually ensure that our institutions and information networks are equipped with robust self-correcting mechanisms capable of effectively addressing the myth of AI's infallibility and predictability, the limits of which we have not yet mastered.

A must-read for your human intelligence!



Nexus

A brief history of information networks from the stone age to AI

by Yuval Noah Harari

Environment: 754,303 vs. 753,905

Norway, electric vehicles outnumber gasoline-powered ones - a world first

Source: Road Traffic Information Council (OFV)

Social: 3.6 billion

Between 3.3 and 3.6 billion people live in areas of high climate vulnerability

Source: IPCC Sixth Report

NEW EXCLUSION POLICY ON PALM OIL TO FIGHT AGAINST DEFORESTATION

As the European Commission proposed a 12-month delay in implementing the EU Deforestation Regulation (EUDR), deforestation remains a major issue in the fight against climate change and biodiversity loss.

EU consumption significantly contributes to global deforestation and forest degradation. According to the impact analysis of the EU deforestation regulation, without appropriate regulatory intervention, deforestation driven by EU consumption and production of just six commodities (cattle, cocoa, coffee, palm oil, soy, and wood) could increase to 248,000 hectares annually by 2030[1].

This prompted us to add a new tool to our suite of exclusion policies, which we deem necessary when engagement alone is insufficient, or when financial and non-financial risks are too high.

We have targeted deforestation linked to palm oil production as it's the leading cause of EU-driven deforestation (34%)[2]. Risks associated with palm oil cultivation and trade include deforestation, forest degradation, land grabs, and human rights violations.

With limited means to ensure palm plantations didn't lead to deforestation, we rely on two complementary tools: the RSPO (Roundtable on Sustainable Palm Oil)[3] certification, which has strict requirements and is a good risk mitigation measure, and monitoring controversies that reveal poor environmental or social practices.

We will enhance our exclusion policy and analysis as more tools and comparable data become available.

1. https://eur-lex.europa.eu/legal-content/FR/TXT/HTML/?uri=CELEX:32023R1115
2. https://eur-lex.europa.eu/legal-content/FR/TXT/HTML/?uri=CELEX:32023R1115
3. RSPO certification assures individuals that RSPO members who produce or physically handle RSPO-certified sustainable palm oil (CSPO) have achieved RSPO certification. This includes assurance that the member has committed to and complied with sustainability requirements, and can claim and communicate its certified status throughout the supply chain.

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