Active ownership: for what impact?

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1 Executive Summary

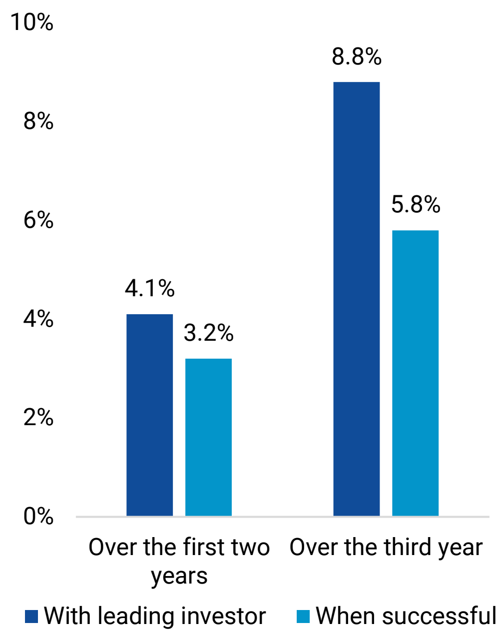
Exit vs. voice – this is the general choice that responsible shareholders face when invested in a company that behaves in a way that does not align with their values. The first option is to dissociate themselves and divest. The second is to engage in dialogue to initiate positive change. The latter strategy refers to active ownership and is the focus of this analysis.

But what is the real impact of active ownership, on the investor and the target company? By divesting from companies with poor environmental, social or governance (ESG) performance, investors have, until the last two years, been rewarded with a momentum effect, but it cannot last indefinitely. On the corporate side, the waves of divestment may encourage a change in practice, but many conditions are necessary for this to take place. What about active ownership, especially when it focuses on ESG issues?

Investors using active ownership incur high administrative and indirect costs but are generally rewarded with higher returns. Active ownership requires listening skills and determination as well as significant resources to rigorously assess the company as well as set and monitor targets. Apart from ESG improvements, investors exposing themselves to the costs of active ownership can justify them in two ways: through increased company value and reduced ex-post risks, and informational and reputational benefits. The latter are not necessarily shared with other shareholders.

Target companies generally improve their ESG practices, especially when lagging their peers. They also experience improved operational and financial performance, through sales growth and increased productivity. Stakeholder relationships are also impacted: shareholders want to retain their stake and employees are more loyal to the company after an improvement in their ESG practices, but auditors appear to be more diligent.

Change in annual cumulative abnormal returns for ESG collaborative engagements



Note: The leading investor guides the dialogue and is supported by the other investors in the collaborative engagement. Successful engagements consider engagements with and without leading investors. Source: Dimson et al. (2021)

Collaboration between investors appears to be a key factor in the impact potential of active ownership. It reduces the costs of duplicating responsibilities and research efforts. While also appearing to be more effective: companies targeted by collaborative engagement perform better over time. A diversified group of shareholders has indeed more influence and sometimes a better understanding of the company's environment and can thus be successful in cases where individual engagement fails or is not financially feasible for the investor.

KEY POINTS

1. Investors participating in active ownership face high administrative and indirect costs, particularly when they engage. However, they are generally rewarded with higher returns, especially when engagement is successful and conducted in collaboration with other investors.
2. Companies engaged on environmental, social, and governance issues generally improve their practices, especially when they are lagging their peers. They also see improvements in operational and financial performance and changes in stakeholder relations.
3. Investor collaboration is key. Not only does it spread costs, but it also appears as more effective, further enhancing corporate value and performance.

E4S ACTIVE OWNERSHIP SERIES

In December 2021, E4S studied **the impact of divestment** as a response strategy. The E4S series on active ownership investigates an alternative to divestment: engagement and voting. The first analysis of the E4S series on active ownership, **Active ownership: by whom and how?** outlines the status quo of this strategy. **Active ownership: for what impact?**, is the second of the series and analyses the impact of active ownership and more specifically the benefits and costs for the investor who engages as well as the reactions behavioural oral changes of the target company. To be successful in their engagements, however, investors will need to consider several factors. **Active ownership: the keys to success** develops how the profile of the target company and the investor, as well as the characteristics of the engagement, can influence the outcome of a shareholder initiative.

2 Introduction

Exit vs. voice – this is the general choice that responsible shareholders face when invested in a company that behaves in a way that does not align with their values [1]. The first option is to dissociate themselves and divest [2]. The second is to engage in dialogue to initiate positive change. The latter strategy refers to active ownership and is the focus of this analysis.

Through their rights and in particular, their status, shareholders can signal disapproval or influence corporate strategy. The goal is to promote the company's sustainability and thus protect and increase its value [3]. These are the principles on which active ownership is based.

It generally applies to publicly traded shares and is based on two main components: voting and engagement. Both are extremely interrelated, complement each other and can be triggered by one another. Engagement may be private or public, individual, or collaborative, or a combination depending on the receptivity of the target company. The themes and stakeholders are diverse and the regulations and culture around active ownership vary by region. Also, the engagement extends to other asset classes such as corporate and sovereign bonds, as well as private equity [4].

The importance of active ownership of environmental, social and governance (ESG) issues is growing. In 2020, active ownership accounted for USD 10 504 billion of assets under management, or 35.9% of the total global assets, and was the second most used investment strategy in Japan, Europe and Canada behind ESG integration or exclusion [5]. In the same year, ESG engagement moved up to be the second most used approach by Swiss investors, overtaking exclusion. The use of engagement and voting strategies among Swiss responsible investors increased by 65% and 37% respectively, compared to a 29% increase in exclusion between 2019 and 2020 [6].

But what is the real impact of active ownership, on the investor and the target company? By divesting from companies with poor environmental, social or governance (ESG) performance, investors have, until the last two years, been rewarded with a momentum effect, but it cannot last indefinitely. On the corporate side, the waves of divestment may encourage a change in practice, but many conditions are necessary for this to take place. What about active ownership, especially when it focuses on ESG issues? Our analysis discusses the implications for an engaging investor, through its financial and non-financial costs and benefits (Section 3), and its impact on the performance of the target company (Section 4).

3 Cost-benefit analysis for the investor

In addition to the positive impact that ESG active ownership can have on stakeholders and society at large, investors need to balance the costs and benefits involved - if only to carry out their fiduciary duty or mandate. Engaging and exercising voting rights entails administrative and indirect costs as well as financial and non-financial benefits.

3.1 Costs

Active ownership requires listening skills and determination as well as significant resources to rigorously evaluate the company as well as set and monitor objectives. It is difficult to generalise the cost incurred to the investor as they vary depending on the investor's involvement, economic and sectoral trends, and the operating environment of the company. The costs incurred can however be categorised into two groups: administrative and monitoring costs and indirect costs.

3.1.1 Administrative and monitoring costs

The direct costs of active ownership vary according to the type of action taken. Voting, as opposed to engagement, is likely to be less costly, given the difference in involvement in the company's strategy.

3.1.1.1 Voting

As with engagement, shareholders receive only a fraction of the benefit of their vote, usually related to their shareholding, but bear the full cost of vote-related research. In this case, investors may decide to adopt a passive vote, an active vote, or a mix of the two. Each has different cost models [7].

Active voting is based on an independent assessment of the issues being voted on. The associated costs then depend on the investors' prior knowledge of the company and their ability to gather and analyse the relevant information. They, therefore, vary from one investor to another. Investors with large holdings or in several funds may spread the costs over a wider asset base, resulting in a lower unit cost [7]. Large asset managers such as BlackRock can devote such resources to constructing voting guidelines and evaluating voting issues internally, but small and medium-sized funds cannot afford it.

Passive voting is based on the recommendations of proxy voting advisors **and is a more affordable strategy,** which allows for regulatory requirements, i.e., fiduciary duty, to be met. It generally attracts investors with a negative net profit to vote: the unit cost of the in-house analysis required to determine the optimal vote is higher than the benefits derived [8].

In practice, asset managers and asset owners seem to employ a mix of both. They use proxy voting advisory services and adapt recommendations based on their engagement track record with the company and the views of their clients. This is what the investment management company Federated Hermes does through its engagement services EOS [9].

3.1.1.2 Engagement

Compared to voting, engagement goes one step further in involving the investor and therefore requires more resources.

The investor must first bear the costs of research, even before initiating action. They must define the problem, develop performance criteria, estimate the company's performance, compare it to its peers, and identify the objectives to be achieved. Note that some of these costs are also shared by divestment strategies. Investors opting for divestment must also continue to incur monitoring costs to reinvest if the target company has revised its practices [10].

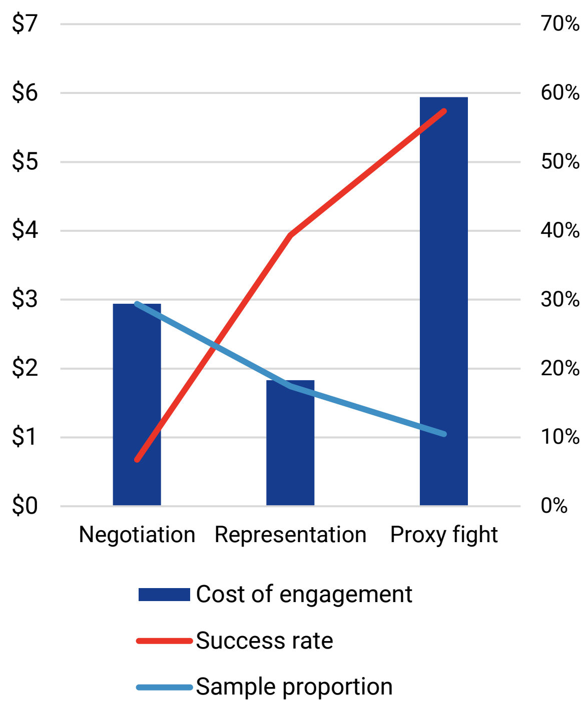
These follow-up costs are necessary to incentivize a company to reform.

The direct costs resulting from engagement will depend on the type of action. As the investor moves further along in the escalation process, the costs accumulate. Gantchev (2013) estimates that on average the costs of negotiation amount to USD 2.94m and increase by USD 1.83m when negotiations are followed by requests for board representation and by an additional USD 5.94m if the campaign results in the filing of a shareholder resolution and a proxy fight (Figure 1). The costs generated thus play an important role in the decision-making process and represent on average two thirds of the activist's gross return [11]. Another estimate put the costs of activism at 4.6% of the value of the initiating investor's stake before engagement [12]. In practice, activists sometimes put forward even larger amounts: the hedge fund Engine No.1 had spent between December 2020 and March 2021 almost USD 30m in the proxy fight against ExxonMobil, i.e. about half the value of its stake [13].

Although infrequent, shareholder resolution fillings are particularly costly and administratively burdensome. Filers must bear the costs of formulating and submitting the resolution to the company and attending the AGM. Escalation costs should also be considered. If the company does not include the resolution in the ballot, the shareholder will have to bear the cost of litigation to get it on the ballot, and if the resolution gets a majority but nothing is implemented, the shareholder may have to further escalate the engagement [10].

Collaborative engagement is an effective response to high administrative and monitoring costs. It reduces the costs of duplicating responsibilities and research efforts, for example when filing shareholder resolutions. A diverse group of shareholders also has more influence and sometimes a better understanding of the company's environment. They can thus be successful in a case where individual engagement fails. In addition to this, it appears to be more efficient, improving the value (Section 3.2.1.2) and the operational and financial performance of the company (Section 4.3.2). There are a variety of collaborative groups tackling, for example, the reduction of greenhouse gas emissions (Climate Action 100+, IIGCC), plastic pollution (As You Sow), or human rights abuse (Investors for Human Rights) [2].

Figure 1: Cost of different engagement types in millions of USD (left) and success rate and frequency of the engagement type (right)



Note: Successful action is achieved when the activist accomplishes their goals or an agreement with the target company is reached. These data consider engagements conducted by hedge funds with more than 5% of the voting rights, between 2000 and 2007 in the US, and that address corporate governance. Source : Gantchev (2013) [11]

3.1.2 Indirect costs

At the same time, the engaging investor must consider indirect and sometimes non-transactional costs. These include opportunity costs, particularly concerning the deterioration in the company value as well as the free-rider problem.

3.1.2.1 Opportunity costs and short-term value deterioration

There is an opportunity cost to engaging. Being a shareholder in a non-ethical company entails an ex-ante risk of fluctuation in the market value of the investment. These fluctuations are due to the potential for litigation, increased regulation, or reputational risk that may deteriorate the value of the company. Being a shareholder and engaging a non-ethical company, therefore, entails, in addition to the administrative costs, an additional cost: by engaging a company, the investor loses the possibility of selling during the campaign period. This opportunity cost is proportional to the investor's stake and increases as the value of the company deteriorates (Box 1) [10]. High reform costs and resistance to demands can also contribute to the deterioration of business value and short-term investment losses.

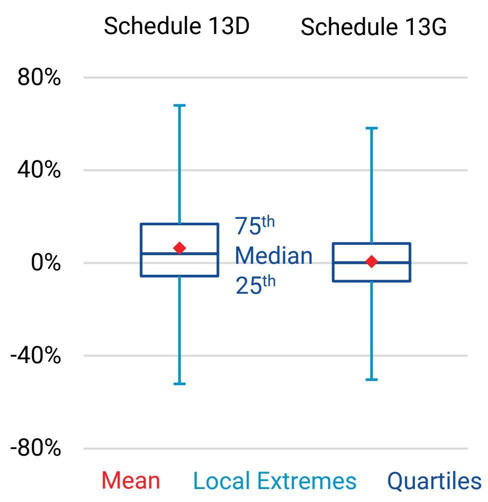
3.1.2.2 Engagement and the free-rider problem

Opportunity costs and the indirect costs of engagement create another obstacle, the free-rider problem. Non-engaging investors also reap the benefits of successful actions led by other investors without bearing the costs. The free-rider problem can be alleviated through private or collaborative engagement. In the former case, investors obtain benefits that they are not required to share with other shareholders [14]. In the latter case, the cost of engagement for each investor is lower and the efficiency of each monetary unit spent in terms of impact on the company is higher.

BOX 1: BP DEEPWATER HORIZON AND THE OPPORTUNITY COST OF ENGAGEMENT

BP's Deepwater Horizon oil rig disaster provides a good example of the risk of deteriorating corporate value during an engagement. In April 2010, a group of shareholders filed a proposal requesting a report on the financial, social, and environmental risks associated with tar sands mining projects. It received only 15% support at the annual AGM. Five days after the vote, the BP oil rig off the Gulf of Mexico exploded, creating an unprecedented ecological and human disaster. The share price fell from USD 60.5 on 20 April to USD 27 on 28 June and has never since returned to pre-explosion levels. If the co-filers had sold immediately after the resolution was rejected, their investment losses - caused by a behaviour they were denouncing - would not have been so large [10].

Figure 2: Cumulative abnormal returns around the date of shareholding acquisition announcement



Note: The observation period begins two days before and ends two days after the announcement. The SEC requires a public filing when an investor holds more than 5% of a company's stock. Schedule 13D is required if investors intend to influence the management of the company (activist investors). Otherwise, they can file a Schedule 13G, which is less restrictive and associated with more passive investment. Source: Albuquerque et al (2021)

3.2 Benefits

Apart from societal improvements, investors exposing themselves to the costs of ESG active ownership can hope to justify their exposure in two ways: through increased company value and reduced ex-post risks, as well as through indirect benefits (informational or reputational) that are not necessarily shared with other shareholders. In the first case, investors, especially hedge funds, may see an opportunity to invest in and engage with non-responsible companies and transform them. The value of the company increases through improved processes and reduced ESG risks that investors believe are undervalued by management and potentially by the market [15].

3.2.1 Increase in enterprise value

The financial benefits generated by ESG engagement depend on the investor's time horizon. Indeed, the value of the company will be impacted when the engagement is announced, but also throughout the engagement[1].

3.2.1.1 At engagement announcement

In general, the market responds positively to announcements of engagement, particularly from hedge funds. Hedge funds see an increase in the value of the company in which they have invested when they make the SEC-required equity announcement (Box 2) (Figure 2) [12], [16]. This positive market reaction suggests that the market sees hedge funds as better positioned to identify undervalued companies or to increase their value by influencing their management.

Surprisingly, most of the observed value gain occurs before the stake announcement and the stock trading volume not only reflects the activist's purchases but also the transactions of other investors. This suggests two things: either the initiating hedge fund shares this information with like-minded investors in advance to increase voting power, or the brokers executing the trade on behalf of the initiating hedge fund share the order flow with other favoured clients before the announcement [16].[2]

1 The post-engagement returns discussed below do not include the costs involved in the shareholder initiative. A significant proportion of activist hedge funds do not break-even net engagement costs. Only the top quarter show higher returns on their activist holdings than on their non-activist holdings [11].

2 The customers of the broker executing the originating investor's order seem more likely to buy the shares of the target company. This second explanation is more consistent with the incentives of the engaging investor willing increase her or his stake beyond the 5% crossing date (Box 2) [16].

Box 2: Hedge fund participation and activism in the United States

To gain influence, activist hedge funds typically acquire a significant stake in the target company. In the US, once investors become beneficial owners of 5% or more of the stock of a publicly traded company, they are required to file a Schedule 13D or Schedule 13G with the SEC within ten days after acquisition. The Schedule 13D is required if the investors intend to influence the management of the company, i.e., become an activist investor. Otherwise, the investor may file a Schedule 13G, which is less burdensome and associated with more passive investment. The filing of a Schedule 13D publicly disclose the activist hedge fund's willingness to engage [12]. The SEC is considering rescheduling the acquisition announcement period. According to hedge fund managers, the current ten-day deadline is already too short. If this were to happen, it would be more difficult for them to make profits from their strategies [20].

3.2.1.2 Throughout the engagement period

In the year following an ESG engagement, investors observe an increase in company value and abnormal positive returns [17]–[19]. The reasons behind this outperformance can be diverse. On the one hand, it may be due to changes in strategy causing the market to revise the fundamental value of the company upwards. The changes observed will be discussed in Section 4.3. On the other, medium-term outperformance can also be explained by certain characteristics of the engagement itself. Its theme, the profile of the target, the structure of collaborative engagements or its outcome could also explain the observed outperformance and its magnitude.

Engagement themes

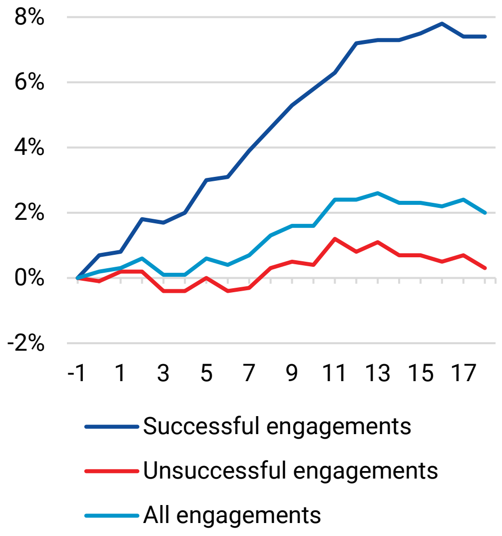
Climate and governance engagements are more rewarded. Cumulative abnormal returns seem to be higher when the engagement addresses climate or corporate governance issues [17], [18]. The study by Barko et al. (2018) estimates higher cumulative abnormal returns of 3% (over 6 months after engagement) and 14.1% (over one year) for companies targeted for environmental and governance issues, respectively.

The materiality of investor demands on the company's operations must be emphasised. Although important, not all sustainability issues are prioritised over the operations and going concerns of the company. A significant proportion of shareholder proposals are related to non-material issues as described by the Sustainability Accounting Standards Board (SASB) materiality map (Box 3) [21]. Companies engaged on issues that are material to their activities see an increase in their value. On the contrary, engagement on non-material issues seems to hurt the value of the company.

Company profile

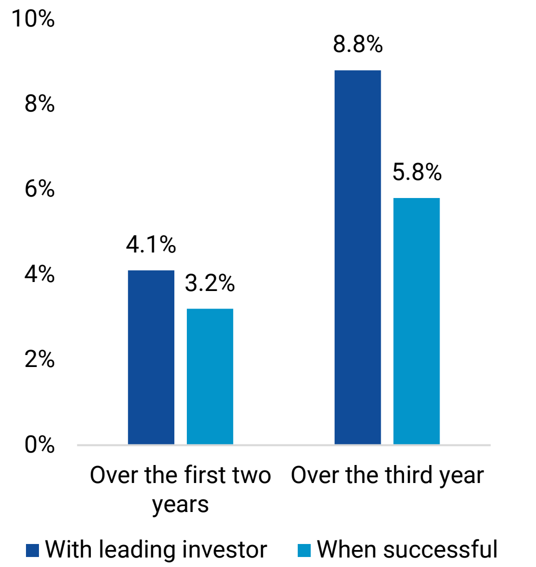
Companies with low ESG scores would benefit more from engagement on these issues. They appear to outperform their peers with a cumulative return of +7.5% over one year after the start of an ESG engagement. On the contrary, the value of targeted companies with high ESG scores does not seem does be significantly impacted by the new demands of responsible investors [17].

Figure 3: Monthly cumulative abnormal returns observed in the months following an ESG engagement



Note: Cumulative abnormal returns smooth out after one year - i.e., when the target is generally met. Source: Dimson et al. (2015)

Figure 4: Change in annual abnormal returns for ESG collaborative engagements



Note: These values are significantly different from zero. Source Dimson et al. (2021)

Collaborative engagement

Markets seem to react more positively to the presence of a leading investor in collaborative engagements. A two-tiered structure can be seen as more effective in monitoring processes and more likely to achieve the improvements mandated by the shareholder group. Dimson et al (2021) observe an increase in abnormal returns of companies engaged under such a structure in the first three years after engagement but no change in the absence of a lead coordinating investor (Figure 4).

Successful engagement

Markets also distinguish successful engagements, demonstrating a company's willingness to improve its practices. Companies with ESG demands appear to have higher positive cumulative abnormal returns over the engagement period than non-compliant companies. According to Dimson et al (2015), cumulative abnormal returns are +7.1% for successful engagements, compared to almost +1.0% for unsuccessful engagements in the sample (Figure 3). The trends are similar for collaborative engagements. The study by Dimson et al (2021) shows an increase in annual cumulative abnormal returns of +3.2% in the first two years after the start of an engagement (Figure 4)[3].

The positive impact on the target's market value is particularly observable at the announcement of a deal between with the engaging investor. There would be an benchmark-adjusted abnormal return of 1.16% over a two-day window around the announcement. This trend is even more pronounced for high impact deals such as the replacement of several board members, a

3 The company's management might therefore incur costs in non-material initiatives that ultimately have a negligible impact on society without increasing the value of the company. Grewal et al (2016) explains this by the presence of agency problems, a lack of knowledge about the materiality of the claims, underperformance on material sustainability issues or an attempt at greenwashing.

strategic transaction, or the departure of a CEO [22].

3.2.1.3 ESG risks and steady-state returns

Companies improving their ESG practices, especially environmental ones, have a lower cost of capital **and therefore lower returns** at the steady state. ESG engagement thus leads to a reduction in the risk of losses and in the volatility of the share; and even more so when it is successful or deals with environmental risks [19], [23].

Environmental risks are very costly when they materialise (Box 1) and, for this reason, investors demand compensation for the risks associated with bad practices, especially environmental ones. For example, high-emitting companies have a higher carbon premium and higher returns even when controlling for performance drivers such as size or book-to-market ratio [30]. Investors should therefore expect that the good ESG performers, perhaps new thanks to active ownership, tend to have lower returns than their bad performers [2].

Box 3: Materiality and engagement

The SASB Materiality Map, which is updated annually, provides an overview of sector-specific priorities. More specifically, it ranks sustainability issues by sector based on two types of criteria: investor interest in the issue and the potential impact of the issue on companies in the sector [24].

Coca-Cola and recycling: material engagement in the beverage industry

In 2002, a group of Coca-Cola shareholders proposed a resolution aimed at the recyclability of the containers of the American giant, often criticised for being one of the largest producers of plastic waste. It called for a 25% recycled plastic content in plastic bottles and an 80% recycling rate for glass and beverage containers by 2005 in North America [25]. The Materiality Map classifies the issue of waste management as material to the food and beverage sector. Twenty years later, the recycling rate for all consumer packaging is 60% and nearly 30 markets offer 100% recycled PET bottles [26].

Oracle and labour rights: intangible engagement in the software industry

From 2002 to 2004, Oracle - a database management systems provider - was engaged by SRI specialist Harrington Investments on its human and labour rights record in China. The activist aimed to push the company to comply with the code of conduct for companies operating in China as defined by the International Labour Organisation [27]. The resolutions submitted were then rejected by the shareholders at the annual general meeting [28]. Although the issues at stake are considered immaterial for the software sector according to SASB, Oracle has been challenged on several occasions on these issues since then [29].

3.2.2 Non-financial benefits of engagement

ESG engagement can create value for investors beyond the impact on returns. By engaging with a company, they can strengthen their activist identity and reputation for sustainability, have a positive impact on society at large, or influence the introduction of regulations to facilitate shareholder monitoring. These reasons may explain why some investors support causes that are unlikely to be supported by other investors or management [14]. After its successful engagement with ExxonMobil in 2021, just one year after its inception, the Engine No. 1 hedge fund gained notoriety in the active shareholder world and has since launched several exchange-traded funds (ETF), including one investing in 500 large US companies. The ETF has already received USD 100m in engagements and aims to improve the profile of companies on environmental, social and governance issues [31], [32].

Successful or not, engagement can also create spill over effects. In other words, companies are likely to react to the active ownership of their competitors when they are not directly targeted. In the case of hedge fund activism, it appears that non-targeted firms with a higher perceived threat of engagement tend to change their policies, most notably by increasing their leverage and decreasing their capital expenditures[4]. They also show an improvement in ROA and asset turnover, changes that are consistent with those observed among targets [33].

4 RESPONSES AND IMPACT ON THE TARGET

Active shareholding is generally triggered by a deterioration in the financial or ESG performance of the company. When faced with the intervention of activist shareholders, the company may respond in different ways. Its response will impact its ESG, operational and financial performance as well as its stakeholder relations.

4.1 REASONS TO ENGAGE

The reasons for ESG engagement are varied. Investors engage on these issues typically to mitigate their exposure to ESG risks, to increase the ex-post value of the company, to gain reputational benefits or to have a positive impact on society. To do this, they can demand more transparency or create a shift in the company's strategy and governance. In the first case, they will demand more financial and non-financial information, or the publication of improvement plans – e.g., to reduce direct carbon emissions, divest from fossil fuels, or ensure respect for human rights in the supply chain. In the second, this may mean appointing new board members or creating better management incentives.

Mature companies under financial constraints are often targeted, whether they have poor ESG practices or expertise in the area [34]. Targeting large companies has several advantages such as greater impact potential and the increased visibility provided to the engaging investor. Also, a company under financial pressure and underperforming its peers is more willing to accept shareholder demands. In contrast, shareholder activists target both companies with a high level of improvement in ESG practices and companies which

4 According to Gantchev et al. (2019), the threat perception of a non-target firm is defined as the number of connections with a target firm averaged over all leaders of the non-target firm; a connection being when the leaders of the target firm and the non-target firm went to the same school. The management of a company may indeed feel more personally concerned about an engagement if they have connections to a target company [33].

demonstrated ESG expertise. This suggests that activist investors base their decision to engage on the target's financial situation, believing that an improvement in ESG practices will benefit the company's financial performance.

4.2 Company reactions

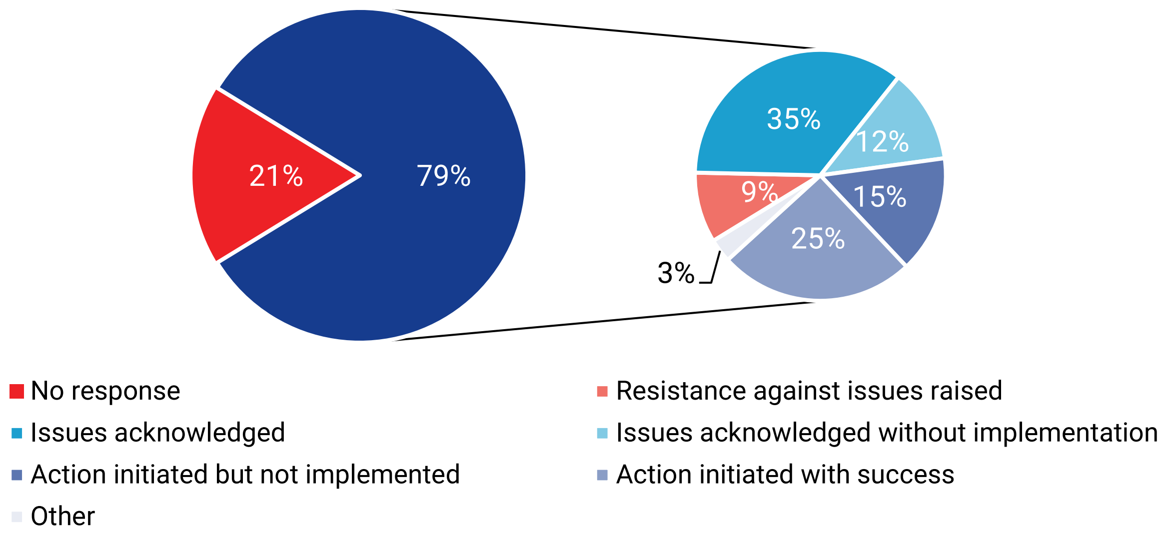
"Reputation and legitimacy are intangible assets that firms use to acquire resources and create shareholder value." [35]. Both can be impacted by a company's attitude towards stakeholder demands.

Reactions of companies to ESG engagement vary. Some management teams are indifferent and ignore activist investors' requests unless forced to do so. Others prefer to court new shareholders more in line with their strategies rather than respond to requests from existing shareholders. Still others decide to react only after being attacked relentlessly. Ideally, however, they adopt a more proactive behaviour, sometimes even anticipating potential shareholder demands. Krueger et al (2019) give an indication of the target's reactions to environmental engagement by institutional investors. 28% of engaged companies were inactive or resistant, while 37% recognised a problem and only 20% undertook changes successfully (Figure 5). The response chosen depends on many factors [34] and will impact ESG, operational and financial performance, as well as stakeholder relations in different ways.

4.3 Changes observed and the impact of engagement

The impact of engagement on the target company depends on shareholder demands, which, as mentioned above, can range from voluntary non-financial disclosure to the setting of climate targets or more extensive restructuring. ESG performance is likely to be the first to be impacted. An improvement in operational and financial performance is also observed. Finally, stakeholders may react differently to ESG engagement and thus in turn affect the operational and financial performance of the target.

Figure 5: Targeted companies' responses to climate engagement from institutional investors



Note: n=373. Source: Krueger et al. (2019)

4.3.1 ESG performance

Companies that are less advanced on ESG matters particularly benefit from their improvement, especially in the case of successful engagement. Their ESG score increases by an average of 10.6% [17]. Conversely, companies already experienced in the ESG fields are sometimes sanctioned by ESG rating agencies and see their score decrease compared to their peer's following engagement. Rating agencies may indeed be influenced by the controversies revealed and adjust scores based on the new information made available by the activist [17]. For example, the ESG rating agency MSCI downgraded Solvay's rating in March 2021, following the engagement of the hedge fund Bluebell Capital Partners in opposition to the waste management of the Belgian giant's Tuscany plant [36]. It should be added that this improvement in ESG performance is observed for both material and immaterial engagements (Box 3) [21].

4.3.2 Company financial and operational performance

Active ownership is usually rewarded by the market, especially when successful (Section 3.2.1.2). This observed outperformance can result from the signal that engagement sends to the ecosystem but also from the improved operational performance induced by the ESG best practices implemented. Increased growth and productivity are observed because of ESG engagement, but it can also involve significant costs.

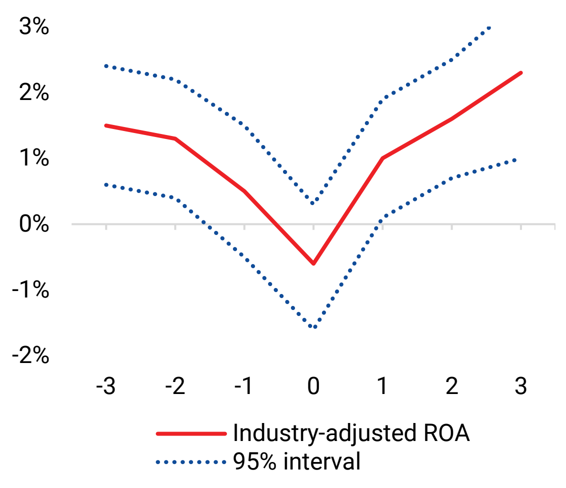
4.3.2.1 Growth

Growth prospects brought about by engagement translate into increased sales. The responsiveness of companies to environmental and social improvements can attract consumers who are more concerned about these matters. Sales growth is particularly present for collaborative initiatives with a lead investor as well as environmental and social engagements [18], [19]. It also becomes more important for companies with a low ex-ante ESG score [17].

4.3.2.2 Productivity

ESG engagement also appears to generate increased productivity. This trend is observed in traditional hedge fund activsm. The companies targeted by these engagements mostly see their productivity deteriorate from previous levels. This deterioration triggers the intervention of the activist fund but is reversed in the two to three years following the engagement (Figure 6) [37]. Companies that are engaged on ESG matters also see an increase in their ROA. Dimson et al (2015), studying environmental and social engagements of US companies, estimate this increase at 1.4% one year after the start of successful engagements. Dimson et al (2021), focusing on collaborative engagements, estimate it at 3.2% three years after the start of the engagement.

Figure 6: Evolution of engaged companies' ROA over the years



Note: The variable focuses on hedge fund engagements in the US from 1994 to 2007. The ROA deteriorates in the three years before engagement and reverses in the following three years. Source: Brav et al. (2015)[37]

4.3.2.3 *Profitability and costs of engagement*

Implementing reforms requested by shareholders can be costly but also profitable for the company. For example, reducing polluting facilities can impose costs on the companies that own them and increase production costs [38]. However, most companies are able to reduce their environmental impact at a low cost and still achieve significant results. According to the Carbon Trust, an organisation that helps companies reduce their environmental footprint, energy costs can be reduced by at least 10% on average, by adopting measures at no cost [39]. [5]

The engaged company also faces direct administrative costs. As with the investor, these costs increase with the resistance of the company and as engagement intensifies. Until the resolution is filed, and if the company does not react, the direct administrative costs are usually negligible. The costs of a resolution filing are approximately USD 46,000, including the costs of requests to the SEC to omit the resolution - which could therefore be avoided if management was willing to respond.6 The bill starts to get high when the company is not allowed to omit the resolution it opposes and must run its counter-campaign to dissuade neutral investors from supporting the activists [10]. In Engine No. 1's campaign, ExxonMobil allocated a budget of close to USD 35m for the proxy fight, despite the company's negative net income the previous year [40], [41].

4.3.3 Stakeholder relationships

4.3.3.1 *Shareholders*

Responsible investors remain invested in their target companies and are attracted to other engaged companies for the same reasons. Given their traditional business model, hedge funds specialising in shareholder engagement tend to invest in the target company, change its practices and sell their stake to a premium on a short-term horizon. But in contrast to this type of activism, shareholders engaged in ESG collaborative initiatives, such as the UN PRI, seem determined to keep their stake for the long term even in the case of successful engagements [19]. They sometimes even invest more in the original target company and are joined by pension funds and SRI funds [18]. These institutional investors may be attracted by the prospects of improving the profile and thus reducing the ESG risks of the company in which the original shareholders invested on their behalf.

4.3.3.2 *Employees*

Employees increase their productivity following an engagement initiative. In traditional hedge fund engagement, employees of target companies are reported to be more productive at work despite unchanged working hours and wages [37]. This trend is similar for companies engaged in environmental and social issues, with an increase in sales per employee in the year following shareholder intervention [18].

5 A 20% reduction in energy costs is equivalent to a 5% increase in sales for most of the companies studied [39].

6 Specifically, it still indicates today that a shareholder with voting rights at the AGM is allowed to submit a shareholder proposal and that the company's management may thereafter choose to (i) publish and distribute it for the AGM, (ii) negotiate with the engaging shareholder to withdraw the proposal, or (iii) omit the proposal with the authorization of the SEC.

Improved ESG performance may be the cause of increased loyalty. Companies with more sustainable practices are characterised by a decrease in employee turnover [42]. This environment ultimately improves the financial performance of the company. Employees are even willing to accept lower wages when their employer deploys sustainable practices in some instances [43].

4.3.3.3 Auditors

Shareholder engagement would increase auditor scrutiny. Engagement can expose flaws in a company's practices and increase auditor diligence. Targeted companies also have higher audit fees and a greater likelihood of receiving an adverse opinion on internal control or a going concern opinion [44].[7]

7 However, a study by Guo et al (2021) does not investigate how specific shareholder demands can influence auditor behaviour. It defines categories of engagements including requests for information, board appointments, discussions with management or litigation, but does not indicate the theme e.g. environmental, social or governance [44].

5 GLOSSARY

Cost of capital – Cost of capital is the return a company needs to achieve in order to justify the cost of a capital project.

Escalation process – The process by which shareholder engagement develops. The investor will make his or her engagement increasingly public and, if not already the case, will try to convince other investors to join his or her cause to increase the pressure on the company.

ESG integration – The inclusion of ESG risks and opportunities in traditional financial analysis and investment decisions.

Exchange-traded funds or ETFs – Index funds listed on a stock exchange and tracking a particular index such as the Nasdaq or the SMI.

Exclusion – A screening strategy that excludes certain sectors, companies, or securities from the investor portfolio by comparing their relative ESG performance to that of industry peers or by relying on specific ESG criteria on an absolute basis.

Free rider problem – A type of market failure in which actors seek to profit from service by charging others for it.

Materiality – The relevance of a sustainability factor to a company's financial performance. Financially significant ESG factors are factors that could have a significant impact - both positive and negative - on the business model and value drivers of a company.

Opportunity cost – Also called opportunity cost. The cost of measuring the benefits and disadvantages of the decision to forego one investment in favour of another.

Proxy fight – An action by one or more dissenting shareholders in which they solicit proxies from other shareholders to vote against or for a proposal

Proxy voting advisors – Proxy voting advisors. Proxy voting advisors are agencies that provide voting recommendations primarily to institutional investors.

SASB – Sustainability Accounting Standards Board. A non-profit organisation is active in setting sustainability accounting standards.

SEC – Securities and Exchange Commission. US government agency that regulates the financial markets and aims to protect investors.

Shareholder resolution – A proposal submitted by one or more shareholders for a vote at the AGM of a company**.**

SRI – Socially Responsible Investment. An investment strategy that links economic performance with social and economic impact.

UN PRI – United Nations Principles for Responsible Investment. United Nations network for the promotion of the integration of ESG issues in investment strategies.

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