

Sustainable Management and Financial Performance: Sustainability pays

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Corporate sustainability -understood as an approach to business focused on creating value for shareholders and other stakeholders through risk management and the use of economic, social and environmental opportunities¹ - is today a fundamental component of the business strategy of major companies recognized around the world.

This growing interest in ensuring an appropriate balance between results and economic, social and environmental impacts of the business activity is reflected in a growing participation of leading companies in the world in assessments of sustainability performed by specialized firms. Their results allow the comparison against leading companies and the identification of opportunities for improvement, strengths and best practices around the different criteria that characterize sustainable management (see Table 1).

Table 1
Criteria for sustainable management
Oil and Gas Sector

Economic Dimension	Environmental Dimension	Social Dimension
<ul style="list-style-type: none"> • Exploration and production • Gas portfolio • Risk and crisis management. • Strategy for relationship with customers (CRM) • Corporate governance • Transparency • Code of conduct 	<ul style="list-style-type: none"> • Climate strategy • Ecoefficiency • Environmental policy • Biodiversity • Environmental reporting • Risk management for use of water • Refining and clean fuels 	<ul style="list-style-type: none"> • Attracting and retaining talent • Labor practices • Development of human capital • Social impact on communities • Corporate citizenship • Social reporting • Standards for suppliers • Health and safety • Relations with stakeholders

Source: SAM - Sustainability Investment

Evaluations serve to select the leading companies in terms of corporate sustainability in each economic sector. They are part of preferential lists for institutional investors that privilege investments in "sustainable companies," as a result of their better prospects in terms of corporate management, soundness, stability and long-term financial returns.

¹ Dow Jones Sustainability World Index Guide Book. Version 11.1, September 2009. Page 8.

SUSTAINABLE MANAGEMENT: A KEY POINT OF THE CORPORATE AGENDA

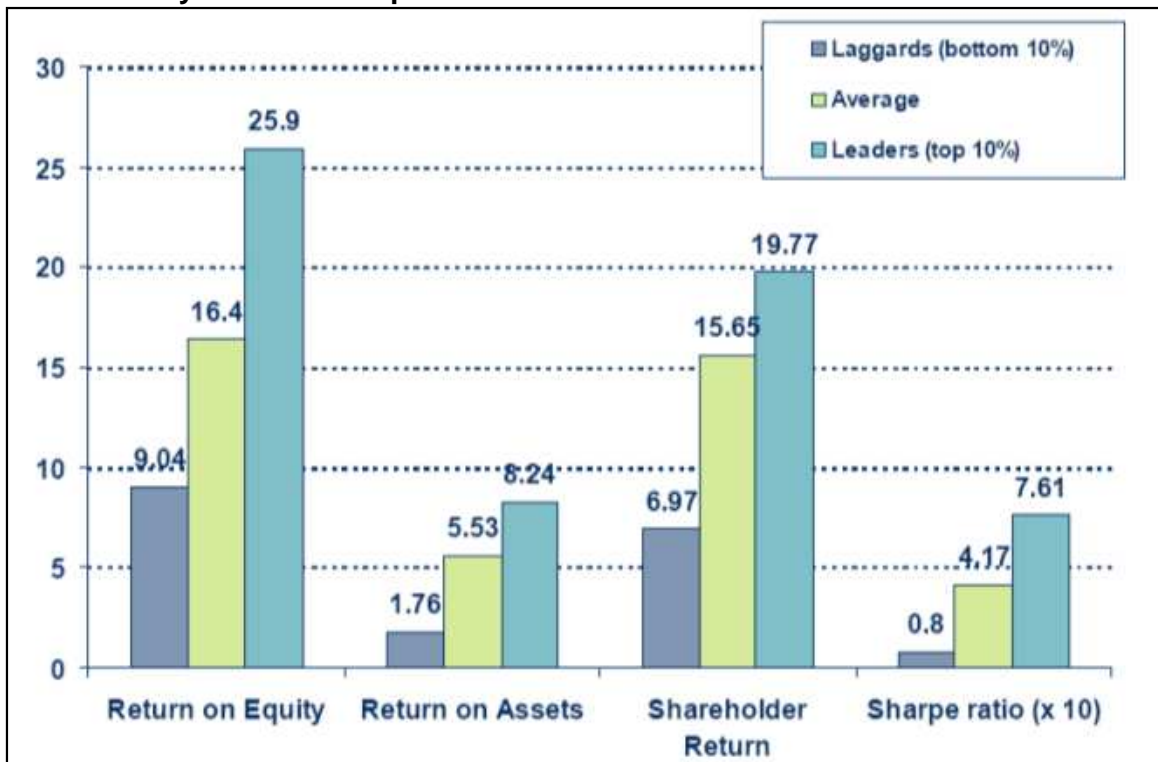
Why does an increasing number of companies incorporate sustainability as a strategic point of their corporate agenda? The following arguments contribute to answer this question.

Corporate sustainability and financial performance.

In accordance with the results of the studies conducted by SAM Sustainability Investment², institutional investors are increasingly aware of the sustainability criteria in their investment decision-making.

This is due to the fact that the companies that are leaders in corporate sustainability (i.e., those with the best results in annual sustainability assessments) obtain results considerably higher regarding return on equity (ROE), return on assets (ROA), shareholder return and yield per risk unit (see Graph 1).

Graph 1
Sustainability and financial performance³



Source: SAM - Sustainability Investment

Taken from: Blasco, José Luis. "Investing in the companies of the future". KPMG, 2011.

² For more information, see: SAM, "SAM White Paper, Alpha from Sustainability," (2009).

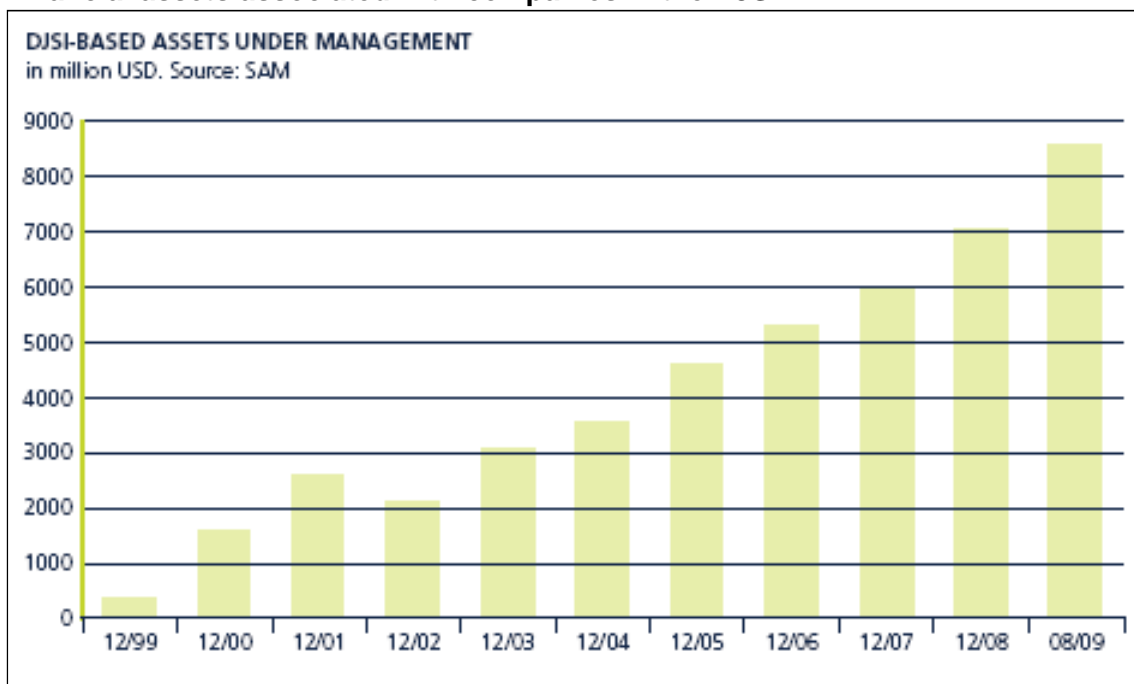
³ Taken from Blasco, José Luis. "Investing in the companies of the future". KPMG, 2011. Presentation made as part of the academic agenda of the event to release the Sustainability Report 2010 of Ecopetrol on June 3, 2011.

Sustainability and behavior of institutional investors

Another factor that explains the growing importance of sustainability relates to the current trends of institutional investors. According to the figures shown in Graph 2, it is clear that in the past ten years, the tendency is to diversify their portfolios toward investments in companies identified as international benchmarks in the field of corporate sustainability.

In fact, in 2009, institutional investors made investments of over US\$8 billion in financial products associated with companies in the Dow Jones Sustainability Index. This figure is significantly higher than that recorded ten years ago (less than US\$500 million).

Graph 2
Financial assets associated with companies in the DJSI



Source: SAM - Sustainability Investment

Among the reasons for this behavior, the following are to be mentioned:

- The recognition of the high risks associated with investments in portfolio with short-term prospects.
- The increasing search for investment in companies with an attractive long-term potential return.
- The preference for portfolios of stock in companies that integrate economic, social and environmental criteria.

Other arguments found in the academic literature

Following are additional arguments that support - from an academic point of view - the existence of a positive relationship between sustainability and financial performance.

- **Increase in operational efficiency:** Porter and Van der Linde (1995)⁴ conclude that the performance of a company in corporate sustainability can be regarded as a measure of operational efficiency. Adopting a business model in accordance with the principles of sustainability requires structural changes that can lead to competitive advantages, such as technological innovation.
- **A long-term perspective:** Companies that incorporate principles of sustainability must have a better performance in comparison to those that do not. This is because they prioritize opportunities for long-term investment over short-term returns. Thus, they benefit from a more stable growth of their profits and are exposed to lower downward volatility. As stated in the report from Ernst & Young " ...the financial performance reflects what a company has done, while the non-financial performance reflects how it will behave in the future"⁵.
- **Relations with stakeholders:** Freeman and Evan (1990)⁶ conclude that sustainability must have a positive impact on the financial performance because companies benefit when they consider the needs and expectations of their stakeholders. When these expectations are not taken into account, the confidence of investors is reduced, which increases the financing cost and adversely affects the opportunities for profit generation.
- **Benefits in reputation:** sustainability can be translated into benefits in reputation. Sustainable companies have a greater ability to attract and retain high-quality human talent.⁷ At the same time, they can obtain additional benefits in terms of sales to the extent that consumers are increasingly sensitive to issues related to sustainability⁸.

Both from an academic point of view and from the analysis of the business practice, it may be noted that corporate sustainability is a key factor to generate competitive advantages, mitigate risks and take advantage of the opportunities arising from the new economic, social and environmental trends.

Ensuring sustainable management pays. Not only is it translated into better financial results but it also increases the attractiveness of a company in the eyes of institutional investors who seek to diversify their portfolios toward investments in sustainable companies.

In the specific case of the oil and gas sector, the last corporate performance assessment conducted by SAM identifies five (5) major challenges:

⁴ Porter M.; Van der Linde, C.: "Green and Competitive: Ending the Stalemate". Harvard Business Review (1995).

⁵ Ernst & Young: Measures That Matter (2003).

⁶ Freeman, E.; Evan, W.: "Corporate Governance: a Stakeholder Interpretation": Journal of Behavioral Economics, 19 (1990).

⁷ Turban, D.; Greening, D.: "Corporate Social Performance and Organizational Attractiveness to Prospective Employees": Academy of Management Journal, 40 (1997).

⁸ Russo, M.; Fouts, P.: "A Resource-Based Perspective on Corporate Environmental Performance and Profitability": Academy of Management Journal, 40. (1997).

- Increasing the Reserve Life Index (RLI) and the Reserve Replenishment Rate (RRR) of oil and gas. A RLI > 20 years and RRR > 100% is considered as the best practice.
- Reducing the Finding and Development Costs. US\$ 6.90 per BOE is considered as the best practice.
- Reducing emissions associated with exploitation activities.
- Adopting strict environmental standards.
- Identifying and maintaining highly qualified human talent

These great challenges illustrate the path that the companies in the oil and gas sector must take if they want to stand out among their peers. At the same time, they are clear guidelines to identify key issues of the corporate agenda that should be taken into account to guarantee the competitiveness of the sector in the future.