The Case for Culture: Higher Returns through ESGC

Teresa C. Barger

"Culture eats strategy for breakfast." The late management guru Peter Drucker is thought to have coined this aphorism while talking to a friend at Ford Motor Company. We've all seen the truth in this sentiment after the cultures of Uber, Wells Fargo, Satyam, and numerous other firms derailed what were otherwise smart, strategic companies.

While the academic studies are just beginning to explore the connection between culture and company performance, early research indicates that companies with strong and appropriate cultures produce higher stock performance. So why aren't top asset managers asking their analysts to incorporate corporate culture directly into stock selection? Why not Environment, Social, Governance and Cultural analysis – **ESGC**?

It is time to step up the debate on how we can describe, analyze, and even measure corporate culture. Today's headlines are full of fodder on the topic: The Weinstein Company's existence is threatened by a toxic leader and a culture that abetted him, and corporate culture has been identified as one of the root causes behind the Equifax breach. These stories are all too familiar, and they're global. In our world of Emerging Markets (EM) investing at Cartica, we see the same factors at work when customers of Hanssem, the furniture maker in South Korea, call for a boycott of the firm's products following reports of sexual assault or when Kobe Steel suffers from letting a product-quality oriented culture slip into a culture of meeting sales targets.

These developments can have a meaningful impact on returns for all companies – regardless of size, industry, location or notoriety. It is time for investors to start paying attention and developing a methodology to assess the behaviors and outcomes that are associated with company culture. The next frontier of ESG investing will be crossed by those investors who are able to understand and quantify how culture can help or hinder the success of a business strategy.

A Short History of "ESG"

The debate around the link between corporations' social responsibilities and their performance started in the 1970s as program-related investment and eventually evolved into what we began to call "ESG" in the 2000s. Fifteen years ago, the debate revolved around the risks to reputation, licenses, or the ability to operate arising from major breaches such as mercury spills, child labor, or fraud by top management. Earlier terms, like "social investing" and "Corporate Social Responsibility" were too broad and nebulous, often resulting in companies donating profits to any cause the CEO or his favorite uncle found worthy. By contrast, ESG analysis laid out specific metrics that enabled companies and investors to be held accountable for their practices.

Two of the factors, Environment and Social, largely addressed the *externalities* caused by businesses in the course of running their operations. If a paint company produced effluent, it had to de-toxify the waste water. If a hydro-electric dam displaced people, the company had to provide new housing in a nearby location.

The other, Governance, addressed structures and processes firmly planted *within the company*. During the early 2000s there was a flurry of academic research demonstrating how better governance produced better returns. Governance structures in turn helped companies create and maintain positive approaches to environmental and social factors. This firmly welded the G onto the E&S.

© COPYRIGHT CARTICA MANAGEMENT, LLC. ALL RIGHTS RESERVED.

ESG has become so accepted that it is now rare to find asset managers who do not tout their prowess in ESG. However, there's much disparity between managers' approaches. Many investment houses merely bolt on an ESG matrix, or complete a summary checklist, and then call themselves "socially aware." But times are changing: institutional and retail investors are requesting true ESG analysis as the approach is connected to higher returns, especially within EM investing.

At Cartica, we have always found that having a fully integrated approach to stock selection incorporating financial analysis, business context, and ESG has facilitated our understanding of the risks and upside potential of target companies. It also has helped us engage actively with our portfolio companies in ways that add value. When there are ESG weaknesses we can work with companies on specific issues and remedies.

As we analyze and engage with the management of a target company on E, S and G initiatives, we often find that culture becomes part of the conversation just naturally. Initially we would raise the topic to ensure that there was not a toxic "tone at the top" which we've seen lead to blow-ups (in companies we have not, thank goodness, invested in) like the Satyam fraud in India, or the Odebrecht scandal in Brazil. We then started asking questions about the adaptability of firms to changing market environments, wondering if we could successfully invest, for example, in a corporate turnaround if we did not understand the cultural changes required to make a turnaround stick. What was missing was good frameworks for analyzing the cultural factors. We are now working on creating these.

Measurability Enhances Investment Conviction

The questions we face at Cartica in analyzing culture are akin to those we faced 10 plus years ago as we first started incorporating E, S, and G into investment analysis. How can these elements be measured? Do these factors mitigate risk? Can they enhance value by lowering the cost of capital or by enhancing efficiency or by increasing revenues? How can we, as investors, encourage change in these factors to increase a company's value?

Incorporating ESG factors into investment analysis is a greater imperative in EM than in the developed markets (DM). In EM, there is often less institutional capacity for governments to enforce laws and regulations. And the private infrastructure/civil society are often too weak to discourage impunity for bad behavior. While often the laws themselves may be acceptable, it is rare to see strict governmental or societal enforcement of laws and norms touching on E, S, and G in our countries.

In addition, over 85% of listed companies in EM are "controlled companies," meaning that at least 51% of the company is owned by a family, founder, or the state. This ownership pattern complicates many compliance relationships and can inhibit transparency. Knowing that the personality of top managers can affect culture and be productive for stock performance, culture may be even more important in these closely-controlled companies in EM. Thus, we in EM investing are highly motivated to find frameworks with which to analyze corporate culture and metrics to calibrate its effectiveness or success.

A Practitioner's Perspective on Corporate Culture

While culture's link to performance is an under-studied area in finance, most investors recognize that stock picking is often at least indirectly influenced by elements of corporate culture. There are a few key findings from academic research to consider when working to build a comprehensive analytical framework that quantifies the link between culture and valuation:

1. A strong culture is value enhancing but only if it is aligned with the correct direction for a company. I call this **an "appropriately strong" culture**.

© COPYRIGHT CARTICA MANAGEMENT, LLC. ALL RIGHTS RESERVED.

2. Most successful cultures have an **external** orientation and specifically are concerned with three constituencies: shareholders, employees, and customers. Cultures focused on these three outside constituencies that *also* exhibit strong top leadership outperform **other companies with 5x revenue growth and 9x stock performance**.[1]

3. Since virtually all companies work in evolving environments, some element of **flexibility, adaptability or entrepreneurialism** should be part of the appropriately strong culture. An external focus can help reinforce adaptability.[2]

4. Strong, appropriate cultures endure better when **top management has high integrity**. Employees' perception of high-integrity management has been found to be linked to superior productivity, profits, and employee relations.[3] It is also important to parse out what "tone at the top" really is. **CEO personality affects culture, reputation, employee attitudes and, important to investors, financial outcomes**.[4]

An integrity assessment of the controlling shareholder and management team has always been embedded into our process at Cartica. This is specifically because most of our portfolio companies are "controlled companies." We have access only to public information, while the insiders with controlling shares have access to all information. This asymmetry creates an obvious temptation for an opportunistic, low-integrity controlling shareholder to steal from minority shareholders.

We ask three questions in our Integrity check about the company's management: Are they truthful? Do they play by the rules? Do they intend to keep promises? Surveys have shown that **the truthfulness of top management** indicates to employees whether integrity is valued at their firm. Furthermore, research indicates that a culture of "keeping your word" can lead to **better financial performance**.[5] As investors in listed companies we rely on public disclosures which makes their truthfulness paramount.

Mining Our Own Experience

Taking an example from our own portfolio, Cartica's investment in Page Industries, owner of the Jockey brand in India, demonstrates how company culture influences our investment decisions and value-addition efforts. Page is a labor-intensive company with **unique supply chain efficiencies**. Over the years, Page has maintained its market leading position and scaled into an operation that sells over 140 million pieces per year and employs over 20,000 individuals. Importantly, it has managed to achieve this success while maintaining **staff turnover levels that are about half** that of the industry. We believe this reflects good culture. Unlike many of its peers, Page subsidizes food for facility workers and provides childcare facilities and athletic activities on premise, which contribute to its low turnover. The company has also invested in building a strong human resource team that is quick to respond to employee grievances when they arise. These corporate decisions have come to define the culture of Page and could have a material impact on the company's success as **labor strikes and protests** can significantly detract from a retail company's performance. As we as investors came to appreciate the

---

[1] Kotter, John P. and James L. Heskett. Corporate Culture and Performance. New York: The Free Press, 1992.
[2] Gordan, George and Nancy Di Tomaso. "Predicting Corporate Performance from Organizational Culture." Journal of Management Studies. 6 November 1992.
[3] Guiso, Luigi, Paola Sapienza, Luigi Zingales. "The Value of Corporate Culture" Journal of Financial Economics. 28 May 2014.
[4] O'Reilly III, Charles A. and David F. Caldwell and Jennifer A. Chatman, Bernadette Doerr. "The Promise and Problems of Organizational Culture: CEO Personality, Culture and Firm Performance." Stanford University. 25 September 2014. Stanford University.
[5] Guiso et al.

© COPYRIGHT CARTICA MANAGEMENT, LLC. ALL RIGHTS RESERVED.

competitive advantage of Page's culture, we began engaging with the management team on the topic. Important to our longer-term investment thesis, we are encouraging Page to reinforce these positive elements of their culture through their supply chain and institutionalize them so that they can persist.

How to Assess Corporate Culture?

So **how can we measure corporate culture and quantify its investment implications?** To date, most of the measurement has been based on employee surveys. As the ESGC agenda progresses, we will likely be looking at processes and behaviors and their relation to outcomes. Certainly, financial and non-financial rewards and incentives play a role. Personnel processes including hiring, evaluation, promotion and complaint handling will be considered. Board agendas can also constitute indicators of what a firm finds important. For the moment we interview customers, suppliers, regulators and other partners to get anecdotal information on a target company's trajectory. Can this process be more systematic?

At this early stage, I believe **culture will first** be used by the investment community as a **risk mitigant**, much like E&S were in the early 1990s. Investors will begin using "C" to look for red flags and avoid toxic cultures that could threaten a company's value, or even its existence. But I predict that, similar to how governance is now seen as the cement for E&S, **Corporate Culture will eventually be seen as the foundation for Governance – and by extension Environmental and Social factors.** It can be seen as a set of nesting dolls.

Can a corporation's culture indeed change for the better and what needs to be in place for this to happen? One clear characteristic of successful cultures is that they adapt constantly. Even positive business cultures can deteriorate over time as they take success for granted and become arrogant or insular. But **how, as investors, can we engage a company on adapting its culture?**

As trailblazers in constructive activist investing who believe in the influence of company culture, we at Cartica are exploring the incorporation of culture analysis into our investment process. We hope other investors will join us in creating a framework to assess culture that identifies related metrics, signals, and sources of value addition that can be used to integrate the E, S, G and C factors holistically into the investment process.

© COPYRIGHT CARTICA MANAGEMENT, LLC. ALL RIGHTS RESERVED.