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Opinion

Culture: The Next Frontier of ESG Investing

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The renowned management guru Peter Drucker was known to say, "Culture eats strategy for breakfast." The truth of this maxim is clear after the cultural failings of Uber, Equifax, Wynn Resorts, and the Weinstein Company have derailed what were seemingly sound companies, often tanking their valuations. The reverse holds true as well; the cultures of Google and Apple are widely credited with enabling their tremendous, sustained success.

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These examples, and a nascent field of academic research, indicate companies with strong cultures can produce higher financial performance, while rotten cultures can present significant investment risk. So why aren't asset managers incorporating corporate culture evaluation directly into stock selection, similar to now widely used environmental, social and governance (ESG) criteria? Why not environment, social, governance *and* cultural analysis – ESGC?

Savvy investors should start developing methodologies to assess the behaviors and outcomes associated with good and bad company cultures. The next frontier of ESG investing will be crossed by those who can better understand and quantify how culture can help or hinder the success of a business strategy.

As activist investors, corporate culture is never absent from our analysis. When we engage with a target company, culture often enters the equation naturally. Initially, we ensure there is not a toxic "tone at the top," which could lead to eventual scandal or implosion. We then assess the adaptability of a firm's culture to changing market environments. For instance, we have learned to analyze the probable success of turnarounds which, as activists, we often see as opportunities. We have learned from research that turnarounds succeed more frequently if there is a new CEO who

creates a sense of urgency and has an outsider's perspective and also has an insider's command of resources.

While investors can incorporate culture in this rudimentary way, what is still missing is a robust framework to identify, measure and analyze specific cultural factors. The challenges investors face in creating these frameworks are akin to the issues faced decades ago when ESG criteria were first incorporated into investment analysis: How can these elements be identified and measured? Do these factors mitigate risk? Can they enhance value by lowering the cost of capital, enhancing efficiency, or increasing revenues? How can investors encourage companies to change these cultural factors to increase company value?

Academic research has identified elements around business culture that can serve as a foundation to develop a robust analytical framework. Four academic findings are particularly important, and jibe with conventional wisdom on corporate culture:

1. A strong culture is value-enhancing, but only when aligned with the correct direction for a company – in other words, companies need an "appropriately strong" culture. For instance, a strong but risk-averse culture will not be value-enhancing for a company that needs to evolve rapidly to keep pace with competition.

2. Most successful cultures are concerned with three specific constituencies: shareholders, employees, and customers. Research shows cultures focused on these constituencies that also exhibit strong leadership from management outperform other companies by a wide margin.

3. All companies work in evolving environments, so an element of adaptability or entrepreneurialism should be part of the culture, with an external focus helping to reinforce the flexibility.

4. Good cultures endure when top management has high integrity. Employees' perception of high-integrity management has been linked to superior productivity, profits, and employee relations. Research also shows CEO personality affects culture, reputation, employee attitudes, and financial outcomes.

We seek answers to three questions about management executives: Are they truthful? Do they play by the rules? Do they intend to keep promises? Surveys show that the truthfulness of top management indicates to employees whether integrity is valued at their firm, which is key to employee relations and retention. Furthermore, research indicates a culture of "keeping your word" can lead to better financial performance.

While the foundations of a framework are becoming clearer, the effort to systematically assess the impact of corporate culture on company value is embryonic. Measurement is mainly based on employee survey data that paints an incomplete picture. As asset managers progress in building

sophisticated frameworks, they will be able to assess specific company processes and behaviors, such as hiring, employee evaluation, promotion, and complaint-handling practices, then associate them with changes in shareholder returns. It is possible that the study of firm culture is to finance what behavioral science was to economics before Daniel Kahneman won the Nobel Prize for behavioral economics in 2002.

Similar to how environmental and social factors were first considered in the 1990s, culture analysis initially will probably be used to mitigate risk. Investors will, I predict, begin using cultural factors to identify red flags and avoid toxic cultures that pose existential threats to a corporation.

Governance is the cement for addressing environmental and social factors, and corporate culture may eventually be viewed as the foundation for governance, and by extension, all of ESG. If ESGC is adopted, corporate culture could become an important measurable driver of company success and shareholder value.

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