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Mainstreaming Transparency and Disclosure - S&P ESG India Index

Sunil K Sinha

**Head of Economic Research & Senior Economist
CRISIL Ltd**

Outline of the Presentation

- ▶ **Transparency & Disclosure: The Business Case**
- ▶ **Using T&D for Assessing Companies on ESG Parameters**
- ▶ **S&P ESG India Index**
- ▶ **CG Score and Market Valuation: Some Results**

Transparency and Disclosure: The Business Case

Transparency and Disclosure (T&D)

It revolves around three questions:

- ▶ **What to disclose and what is material information?**
- ▶ **Who benefits from disclosure - shareholders, investors, the public etc?**
- ▶ **What are the consequences of non-disclosure?**

Transparency and Disclosure (T&D)

Disclosure has two component:

▶ **Mandatory**

▶ **Voluntary**

- Relevant/ Material disclosure
- Self-selecting disclosure (for example green-washing)

Why T & D Matter

- ▶ **T&D standards can have a material impact on the cost of capital.**
- ▶ **Reliable and timely information enables decision-makers within the organization to take good and timely business decisions impacting growth and profitability of the company**
- ▶ **Information also affects other stake holders -- Shareholders, Investors and Lenders-- who must decide where and at what risk to place their money.**
- ▶ **Information provided by a company helps decision-makers and outside interests whether and to what extent corporations meet legal and regulatory compliance**

Why T & D Matter

- ▶ **T&D enhances public understanding of a company's activities, policies and performance with regard to environmental, social and governance standards, as well as its relationship with the communities where the company operates.**
- ▶ **T&D coupled with proper auditing serve as a deterrent to fraud and corruption, allowing firms to compete on the basis of their best offerings and to differentiate themselves from firms who do not practice good governance.**
- ▶ **T&D also enhance stock market liquidity**

Using T&D for Assessing Companies on ESG Parameters

Transparency and Disclosure (T&D)

**“What gets measured gets done;
What gets rewarded gets done repeatedly”.**

- Percy Barnevik

T&D: What Gets Disclosed Gets Management Attention

▶ T&D is the key for evaluating emerging market companies as ESG disclosures are at a very rudimentary stage

▶ Is one of the most useful/practical ways to assess qualitative factors and uneven information in a comparative model

▶ Provides an object foundation for index construction, whether or not there is incremental disclosure through public information screening

▶ Simple and Objective Scoring

▶ Lead to increased pressure on companies to display greater and more sophisticated T&D

ESG Parameters: T&D Screening Framework

127 Corporate Governance (G) disclosure indicators identified

- ▶ **Shareholder rights**
- ▶ **Audit Process**
- ▶ **Financial and operational indicators**
- ▶ **Board and management profile**
- ▶ **Ownership structure**
- ▶ **Business Ethics**

70 Environmental and Social (ES) disclosure indicators identified

- ▶ **Environment**
- ▶ **Employees**
- ▶ **Community**
- ▶ **Customers/Product**

T&D – Scoring Process

- ▶ All 197 indicators scored on a binary (1/0) basis for each disclosure item
- ▶ 197 indicators include 27 “Extra Point” G and 9 “Extra Point” ES indicators
 - **Extra point questions contain greater weighting**
- ▶ Weighting of ES disclosure items differs according to sector
 - **High, Medium and Low impact**
- ▶ Composite ESG T&D score is 50% G and 50% ES
- ▶ Based on the T&D score, the top 150 companies, qualify for the qualitative screening.

ESG Parameters : Qualitative Screening Framework

Corporate Governance	Environment	Employee Relations	Community	Customers / Product	Business Ethics
Ownership Structure	Environmental Pollution	Labor Rights	Human Rights	Product Safety and Quality	Business Ethics
Shareholder Rights	Natural Resources Use	Employee Health & Safety (H&S)	Community Investment	Monopolistic Practices	Corruption
Transparency, Disclosure and Audit	Management Policy and Performance Indicators	Equal Opportunity		Customer Relations	
Board Structure and Effectiveness		Employee Relations			

Qualitative Assessment: Scoring Process

- ▶ **Analysis of independent sources of information from regulatory agencies, NGOs, and the media as well as company sources such as websites, regulatory filings, and CSR reports.**

- ▶ **Qualitative review can be expressed quantitatively. Scoring is on negative scale**
 - **5 point scale: 1 – 2 – 3 – 4 – 5**
 - **5 if no negative information**

- ▶ **Qualitative performance factors that are clearly material from both a social and a business impact perspective used as “flags” or screens**
 - **Catching instances of “extremes”**
 - **Assessing differences between disclosure quality and examples of specific performance**

Obtaining Final ESG Score

- ▶ **The scores obtained at the qualitative level is used to adjust the T&D score and obtain the final score.**
- ▶ **Since the qualitative score is on a negative scale, the final score is obtained by reducing the T&D score by a well defined criteria. However, in cases where company gets no negative points that is 5 on all the qualitative parameters the final score remains same as T&D score**
- ▶ **Here, the effort is to ensure that companies with good ESG T&D score but poor performance that are clearly material from social, environmental and business perspective are not included in the index**

S&P ESG India Index

Why An Index?

- ▶ **An Index relates companies ESG performance to stock market performance**
- ▶ **An Index can incorporate several subtleties, e.g. rules and rewards for performance relative to certain indicators**
- ▶ **An Index can create incentives for companies to improve ESG performance**
 - *An index has assets attached to it, raising the cost of capital for those that aren't on the index*
 - *An index creates a public list of leaders and therefore laggards, driving companies to be on “the list”*

Parameters of Index Construction

- ▶ **A liquid tradable index with 50 stocks which are the highest scoring companies on the combined ESG scale**
- ▶ **The weights in index are primarily determined by ESG scores of a company**
- ▶ **This takes away the size impact of companies and the index measures performance on ESG basis**
- ▶ **This index structure differentiates between a standard market capitalization weighted index performance and an ESG based performance**

Index Construction

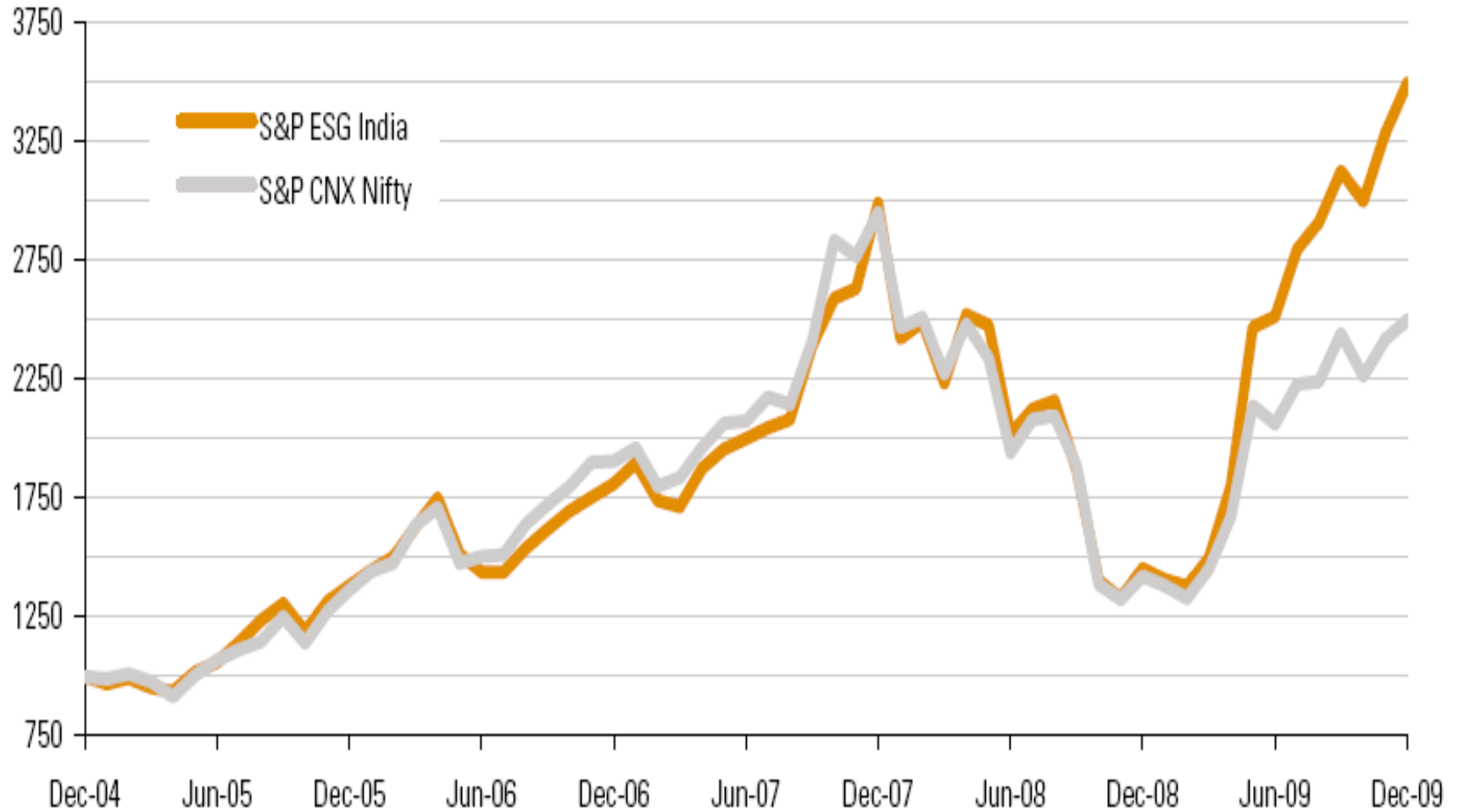
- ▶ **Companies are ranked in descending order of ESG scores.**
- ▶ **A companies liquidity by value traded for the last twelve months is computed.**
- ▶ **The 50 highest scoring companies are selected each year, provided they have traded a minimum of Rs. 20 billion in the last twelve months.**
- ▶ **To limit turnover, a company will not be excluded from the index if its ESG score varies by 10% or less from previous year**
- ▶ **The weight of the company in the index is a product of its float adjusted market capitalization and its score adjusted weight factor score.**

Index Review and Reconstitution

- ▶ Reconstitution of the index is done once a year on the first business day of the year
- ▶ New scores for the entire pool of 500 companies are calculated once a year
- ▶ Mid year companies in the index will be reviewed for any aberrations which could cause their score to go lower
- ▶ If the score is reduced, then the weight of the company can be adjusted down or if a serious enough concern, that it causes the score to fall steeply, then the company may be removed.
- ▶ At the time of the reconstitution, value traded will be reviewed again to ensure adequate liquidity
- ▶ If stocks are removed intra year either due to corporate activity or due to lowered scores, the stock is not replaced immediately and the index will be calculated with fewer stocks
- ▶ The Index is maintained by India Index Services Ltd (IISL), which is a joint venture between CRISIL and the National Stock Exchange of India. IISL also manages the flagship S&P CNX NIFTY index of India's largest and most liquid companies

S&P ESG India Index

5 Year Historical Performance



CG Score and Market Valuation: Some Results

Objective, Hypothesis & Sample Characteristics

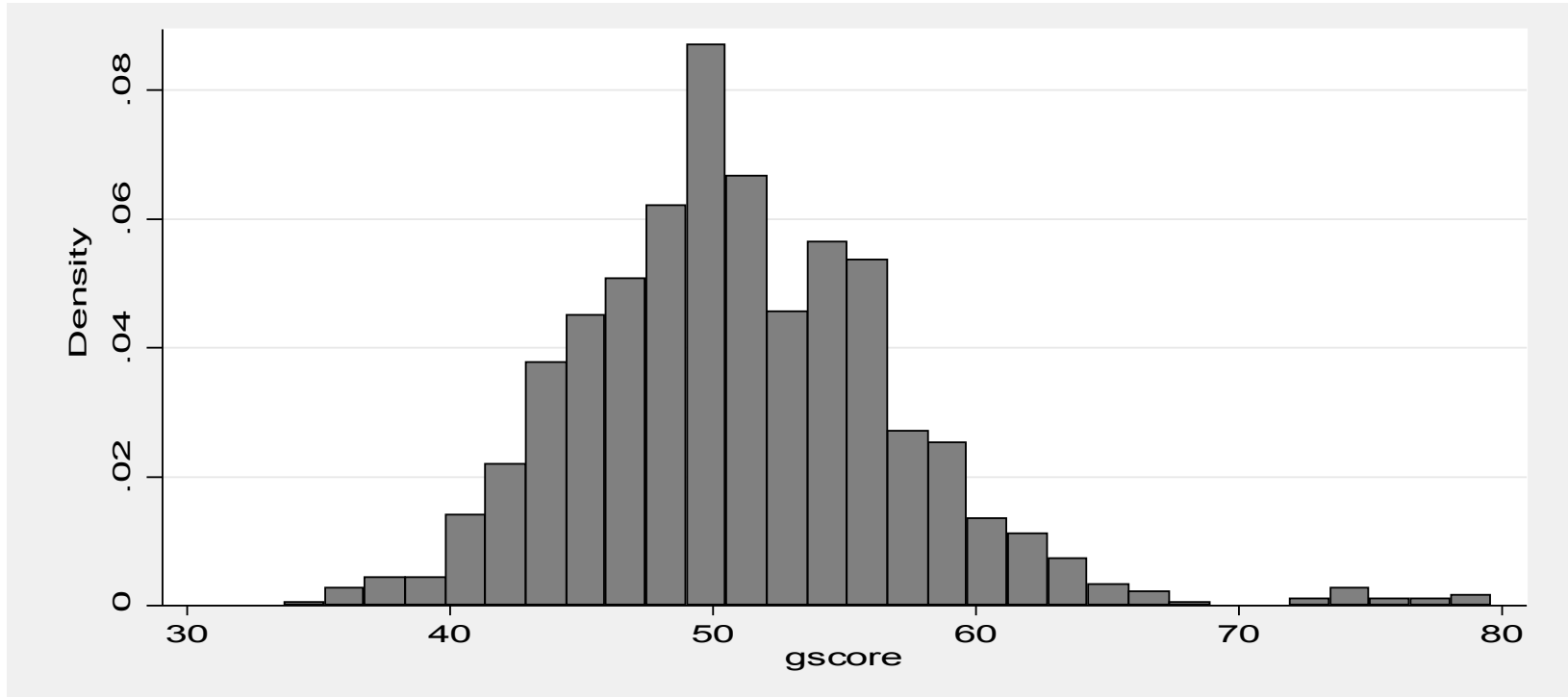
Objective: To Examine the Relationship Between Corporate Governance Score and Market Value

Hypothesis: Market Rewards Firms Having Higher Corporate Governance Score

Sample Characteristics:

- Our sample consist of 279 firms
- The time period was 2005 to 2008
- Sample firms were distributed across 10 industry groups
- 42 per cent of the firms were from Industrials and Materials
- CG score varied from 33.7 to 79.6 with median value 50.3

Distribution of Firms according to CG Score



Category 1 Firms= CG Score ≤ 45

Category 2 Firms= CG Score > 45 and < 55

Category 3 Firms= CG Score ≥ 55

Data Analysis

First Approach:

- We categorized companies on the basis of CG score and compared their financial ratios/indicators such as return on net worth, return on capital employed, profitability ratio (PAT/Sales) and interest coverage ratio

Second Approach:

- We used regression technique to empirically test the nature of relationship between CG score and market value as measured by Tobin's Q. We also used three control variables like age, sales and debt/equity ratio in regression analysis.

$$Q = \beta_0 + \beta_1(Gscore) + \beta_2 \ln(sales) + \beta_3 \ln(age) + \beta_4(Debt / Equity) + \varepsilon$$

- Tobin's Q is defined as: (Market Value of Equity + Book Value of Debt)/ Book Value of Assets
- Since stock prices move in accordance with the changes in expectations about the future cash flows and the cost of capital, Tobin's Q is a forward-looking measure of firm's performance. A higher Tobin's Q therefore indicates higher valuation by the market.

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Summary Results of First Approach

- **Gross profit margin of firms having highest CG score (Cat3) are more stable**
- **Return on Net Worth is higher in Cat3 firms**
- **Return on Capital Employed is higher in Cat3 firms**
- **Debt/equity is lower in Cat3 firms**
- **Interest coverage ratio of Cat3 firms is higher**
- **P/E of Cat3 firms is higher**
- **Dividend yield is higher for Cat3 firms**

Summary Results of Second Approach

- **CG score and firm's value are positively related. *Ceteris paribus* a unit increase in CG score increases the firm's value by 0.03 units.**
- **Category 3 firms command higher market valuation than Category 1 and 2 firms.**
- **The governance practices of firms having CG score less than 45 have no bearing on their firm value.**
- **There is a threshold beyond which firm's value increases with increase in CG score and investors assign a premium on the firm value when the CG score crosses this threshold.**

Take Away

Though preliminary, these results are significant in three ways:

- **Investors are using information available from companies on their CG practices to differentiate between them. Therefore, it is in the interest of the companies to improve their CG practices and put them in public domain to get higher market valuation**
- **Existence of a “threshold” effect indicates that only companies that are above a certain threshold of governance level receive premium**
- **Regulatory mechanism should encourage investors that value and put premium on better governed companies**