Sustainable behaviour and value creation: communication to the financial markets

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Abstract :
From a uniquely financial standpoint, businesses aim to create value and therefore make investments whose generated rate of return is higher than the rate of return required by contributors of financial resources, factoring in the risks taken. This means that listed companies are bound by this profitability goal demanded by shareholders. The latter are looking for a fast return on their capital and bring pressure to bear on managers to spur them to roll out projects that turn a rapid profit. The 2008 and 2011 crises highlighted the repercussions of the financial markets' short-term and risky perspective, as well as those due to the partiality of information communicated by businesses. Nevertheless, these crises also revealed a new trend, namely that value creation was no longer to be assessed for shareholders alone but for all stakeholders. This situation requires companies to come up with a long-term strategy that is in line with the interests of their employees, suppliers and customers, whilst guaranteeing short-term profitability for their shareholders. In light of the foregoing, this paper will strive to show how businesses, through their finance departments, address market constraints while implementing a profitable long-term growth strategy for the benefit of all stakeholders.

Constraints dictated by the financial markets

The "financialisation" of businesses has underscored the heightened influence of shareholders in the governance of listed companies, especially the power of institutional investors who have become much more numerous in recent years. But, unlike employees whose compensation is set *ex ante* or lenders who are aware of the debt repayment schedule, shareholders are "residual creditors" whose interests should be upheld exclusively as they assume part of the risk. And, as they take this risk, shareholders are therefore justified in applying pressure even if it is not always relevant and may even destroy value. Recent financial crises and scandals have led the financial markets to require greater transparency from companies. However, the markets have become somewhat hesitant and unstable due to the exponential rise in the volume of information to be processed and analysed. The immediate nature of announcements may cause major capital movements and share price volatility which could affect a company's valuation. The British mathematician, Thomas Bayes, made a theorem out of the fact that investors set greater store by the most-recently published information than in prior information, despite the latter having been used to warrant both the company's strategy and their investment decision. For instance, the financial markets are guilty of excessive reactions and short-termism as regards periodic regulated communications. Indeed, companies are under pressure to post on-target earnings, and may even suspend investments or cut costs to do so. As Warren Buffet and Jamie Dimon, CEO of JPMorgan Chase, have stated “quarterly earnings guidance often leads to an unhealthy focus on short-term profits at the expense of long-term strategy, growth and sustainability”. The health of companies is affected by the behaviour of market operators. Sudden share price fluctuations have ramifications not only on share volatility but also on the stability of corporate governance and the credibility of businesses’ strategies.

For finance departments, relevant financial communication to the markets is a vital instructive instrument to inform them of the company’s short-term performance and elicit their support for its long-term strategy. Ensuring that this strategy is properly understood involves frequent and proactive communication to forge a trust-based relationship with analysts and investors.

Are companies well placed to impose their financial vision?

Value creation from a purely financial viewpoint cannot be an absolute goal and be carried out at the expense of jobs, the expansion of the economy, environmental requirements or even human rights. Quite the opposite is true! Groups that have generated sustainable value for their shareholders are most often those which have consistently innovated, grown, addressed fresh requirements, hired, trained, secured their employees’ loyalty and established trust-based relationships with their suppliers and customers. These are businesses which are aware that a commitment from staff based on values shared with the company leads to a clear improvement in economic and operational performance levels. This connection has now been established as Robert Eccles and George Serafein of Harvard Business School and Ioannis Ioannou of London Business School have demonstrated that companies which integrate economic, environmental and social issues are more profitable in the long-term. These businesses do not strive to generate a solely financial return on investment but aim for economic, social, and environmental returns. Only companies that factor in their externalities and look to cater for the requirements of all their stakeholders can expect to create sustainable value and have adequate resources to fund their expansion, elicit a commitment from their employees and, ultimately, produce high quality goods and services.

Two options are open to companies. The first involves risk management (market risks, operational risks, reputational risks, etc.). Taking account of externalities in the business’s financial policy mitigates its overall risk, optimises the weighted average cost of capital and generates a lower beta.

The second choice transcends ordinary risk management by changing the business model into a direct response to externalities. For instance, Fnac Darty, which makes consumers central to its strategy, has rolled out a responsible and differentiating business model. The Group has made a large number of investments, some of which are costly in the short-term, that provide long-term benefits by buttressing growth and value creation. Darty provides a good example with its policy for a “second life” for its products. Short-termism dictates that a distributor should sell as much as possible to generate maximum turnover. But, this is not a sustainable strategy as it can be easily replicated and can therefore put the firm in difficulty over time. Fnac Darty’s approach is grounded in high-end positioning and the concept of a circular economy (by repairing) to establish a sustainable and differentiating competitive advantage over its competitors. As reparability can lead to lower sales and turnover, it may be seen as destroying "value" for the company if a short-term vision is taken. But, in view of consumers' increasingly urgent demands to be able to "better consume", the *Contrat de Confiance* (trust-based contract) and after-sales service, which are part of Fnac Darty's make-up, are very powerful resources for, on one hand, ensuring customer loyalty and supporting the firm's profitability and, on the other, providing a real competitive advantage compared to the competition. In 2018, Darty's teams made 2.5 million troubleshooting interventions and carried out 1.5 million repairs. This year, this situation has been further consolidated with the introduction of the *Baromètre du SAV* (After-sales service indicator) and the reparability index, hence anticipating future French legislation. These changes mean that the company is able to solidify its positioning as a committed stakeholder in the circular economy and to protect itself from its competitors. This allows it to reduce its overall risk by establishing high entry barriers and therefore to create value.

The finance department has a central role in value creation by assessing the firm's strategy and acting as a relay point between investors' expectations and the valuation of investments granted as part of a long-term strategy which aims to be sustainable. Combining a long-term and sustainable vision of value with taking account of the importance stakeholders attach to achieving this objective therefore resonates with the concept of corporate social responsibility (CSR). Recent changes to the legal framework governing CSR, such as the extra-financial performance declaration (*Déclaration de performance extra-financière*, DPEF), that was introduced in 2018, are increasingly forcing companies to act on the basis of the main risks with which they are confronted in a number of areas: social, environment, human rights, corruption and tax avoidance. To be able to comply with these legal requirements, businesses have to integrate CSR issues into their strategy and inform the financial markets of their quantified targets and the resources being used to achieve them. This scenario was altered with the arrival of funds certified for socially responsible investments (SRIs) which optimise asset allocation, no longer only according to financial criteria but also extra-financial ones. This therefore requires social, environmental and societal issues to be factored in.

Socially responsible investment: a new model

The attitudes and behaviour of company managers are being recast by extra-legal pressures which fall outside the context of their statutory mandate. As stated above, it is important to bear in mind that these pressures are exerted by private players whose influence on companies forces them to change. This obliges firms to rethink their corporate purpose. During the last decade, financial markets have witnessed the arrival of funds certified for SRIs which favour an analysis and valuation of extra-financial information and long-term initiatives that meet the expectations of investors looking to reward or encourage "virtuous" companies. To have a better understanding of a company's activity, investors are increasingly factoring extra-financial criteria into their investment decisions. These criteria act as "whistle-blowers" for risk anticipation and taking account of them provides a more cross-cutting vision of the company, allows ordinary financial criteria to be surpassed and spurs higher performance levels. Businesses need to protect themselves against threats of loss/damage or reputational risks which could harm their image and have a serious effect on their share prices.

With the mainstreaming of responsible funds and the factoring in of these criteria, extra-financial communication requirements have increased. For investors, sustainable development issues are central to investment decision-making. A poll revealed that 88% of institutional investors consider that taking account of environmental, social and governance (ESG) criteria helps boost the financial value of investments.

As a result, the arrival of these new funds constitutes an avenue for diversification for businesses looking to attract new shareholders and may therefore encourage them to change by including these issues to a greater extent in their financial strategy.

Conclusion

Clearly, the goal of businesses is to generate wealth and, in this respect, finance departments are tasked with measuring and steering this creation of financial value.

Nevertheless, all the company's responsibilities and its role in upholding the interests of all stakeholders, to wit its employees, suppliers, customers and shareholders, should be borne in mind. This may be a complicated exercise as the firm's short-term performance does not always provide a picture of its potential long-term performance.

Finance departments have to control figures, foresee their development, explain the firm's short-term performance levels to creditors and shareholders, and place them against a more long-term backdrop. In addition, as businesses are currently required to measure their extra-financial performance, besides simply focusing on quantified issues, finance departments have to also take account of extra-financial issues to ensure the sustainability of future business models.

Fnac Darty has introduced a large number of initiatives to enable its customers to make "informed choices" and thereby to foster more responsible consumption. This long-term vision will allow the Group to bolster its role in society by generating value for all, including for its shareholders.

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