Financial Health of Sustainable Companies

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Abstract
Increasingly, companies are taking initiatives towards adopting sustainable practices to mitigate the negative social and environmental impacts that arise from their operations. To address the emerging needs of society, companies have started to change their business processes and have started releasing sustainability reports. Sustainable companies not only manufacture products that are sustainable and sourced ethically, but they also have established environmentally friendly production methods. Moreover, sustainable companies are important factors when considering the influence these companies have in fully changing the landscape of businesses' involvement and responsibility in the protection of the environment. For this study companies that were rated as the most sustainable companies for 2021 by SG Analytics and that also scored a high ESG score in the Refinitiv Eikon database. The companies were picked from different GICS industry codes to offer a better view of the financial health of companies that operate in different sectors and are subject to a different customer base. The financial reports of the selected companies were analyzed with a focus on their levels of liquidity and the financial structure to provide a clear image of how healthy these companies are from a financial perspective. Additionally, environmental considerations are provided for each company while analyzing the areas where the businesses conduct operations, with regards to challenges that might arise and impact the financial health of said companies in their future business endeavors. The study contributes to the body of knowledge in the field of corporate sustainability and corporate risk, utilizing a different methodology from the statistical studies in the field. The study employs accounting ratios and a risk management approach, analyzing the balance sheet, income statements, and cash flow statements for each company.

Keywords
Sustainability; finance; sustainable corporation; ESG; financial health.

Introduction

With the rise of ESG and sustainability issues, companies have more than just the worries of profitability and compliance with the law (Borger, 2001). However, to this day only a small number of companies have managed to attain the model status for incorporating sustainability in their strategies (Bansal, 2002). Theoretically, a sustainable company can generate profits while protecting the environmental and social resources that are used as inputs. Consequently, a company like that would remain in the market for generations (Savitz, 2007). Considering the aforementioned, we can assume that such a company can achieve low levels of risk since it manages its environmental and social impacts. This, in turn, generates investor interest due to low levels of risk and profitability (Markowitz, 1952).

Different studies have been made in this field where the comparison of sustainable companies in terms of financial performances has been made. Most of the studies take into account the market performance and the stock price (Lopez, Garcia, & Rodriguez, 2007), while others tend to focus on accounting measures (Macedo et al., 2008). The results vary from study to study as in some of them the sustainable companies come out as profitable (Lopez, Garcia, & Rodriguez, 2007), while other studies highlight the opposite (Lee, Faff, & Langfield-Smith, 2009). There is also evidence of this in the cases where companies that claim sustainability investments will hinder profitability and jeopardize the generation of wealth (McWilliams & Siegel, 2000). However, there is little to no evidence on studies that focus on the financial health of sustainable companies. Casa Nova, Garcia, and Cornacchine (2014) took a different approach when analyzing the riskiness of sustainable companies, however, the results showed no clear difference between sustainable and unsustainable companies. Papers from 1972 to 2002 that have been reviewed by Margolis and Walsh (2003) on the relation between financial performance and sustainability show a positive association between the two variables in most cases, with only a small number of them showing a negative association. Moreover, a study by Bertagnolli (2006) shows that what types of social and environmental have the most significant effect on revenue and operating profits, and employee benefits and investments in education were amongst the highest factors to influence the said measures. However, the study of Lee, Faff, and Langfield-Smith (2009), considered both listed companies in DJSI and unlisted companies. In their method, probit regression was used and contrasting results were found. By using market data, they obtained a negative association between sustainability and financial performance with regard to accounting measures. This study takes a different approach and considers an in-depth analysis of the financials of 5 companies that are highly regarded as sustainable (SG Analytics, 2021).

Methodology

As regards the methodology, both a qualitative and quantitative approach has been taken. Bloomberg Terminal and Refinitiv Eikon are both used as primary data sources for this study. Both software provides official information for the companies that will be used as units of analysis. Qualitative data is found in the annual reports of the companies, official press conferences, and the Thomson Reuters ESG rating system. Quantitative data consists of the financial reports and accounting data of the companies that are crucial in the financial analysis of the companies. Five companies that had high sustainability scores in Refinitiv Eikon were picked for the study, with each one of them belonging to a different GICS industry from the other. However, companies of financial nature were filtered out due to their accounting specificities. Moreover, the study incorporates accounting and financial risk ratios in the analysis and a qualitative approach in analyzing the business areas of the companies that are provided in the annual reports and the financial terminals to provide the environmental considerations for each company.

Unit of Analysis

The unit of analysis for this study consists of five companies that were ranked as the companies by SG Analytics (2021) and that had also a high ESG score in the Refinitiv Eikon database.

American Water Works Company, Inc. (AWK). Headquartered in Camden, New Jersey. American Water Works Company, Inc. is the largest investor-owned provider of wastewater and related services in North America, with operations that serve more than 15 million people across 46 states. The company has roughly $23 billion of total assets (AWK, Annual Report, 2020) making it 2.5 times the size of the next largest investor-owned primarily water utility holding company.

Canadian National Railway Company (CN). Headquartered in Montreal, Canada. CN is Canada's largest railroad. With a transcontinental network covering roughly 19,500 route miles across Canada and down to the Guld of Mexico. CN managed to generate CAD 14.2 billion for the twelve months ending in June 2021 (CN, Financial Reports Q2, 2021).

McCormick & Company Inc. (McCormick). McCormick & Company Inc is headquartered in Hunt Valley, Maryland, and is a global company that specializes in manufacturing, marketing, and distribution of cooking ingredients with an overall number one market share position in herbs and spices. The company operates in two business segments – consumer and flavor solutions. The consumer segment sells spices, herbs, sauces, blends, and other products of the genre to the consumer market. While, flavor solutions segment sells seasoning, blends, spices, herbs, wet flavors, compound flavors, and coating systems to food manufacturers and the food industry. As of August 31, 2020, the company reported $5.5 billion in revenue (McCormick & Company Financial Reports, 2020).

Orsted A/S (Orsted). Orsted A/S is the world's largest developer and operator of offshore wind farms, having established a total of 7.6 gigawatts in capacity (Orsted Annual Report, 2020). Its owned capacity amounts to around 6.4 GW out of which 4.0 GW in offshore wind and 2.4 GW in onshore wind and solar. Moreover, the company also owns 2.1 GW of biomass thermal heat capacity in Denmark (Orsted Annual Report, 2020).

Schneider Electric SE (Schneider). Schneider is organized in two reporting segments: Industrial Automation and Energy Management. In 2020 the company managed to generate €25.2 billion through a workforce of 128,000 employees. The company is an active player in the global arena, with around 190 manufacturing plants and about 100 distributions centers worldwide. The biggest geographic areas of operations are that of Western Europe, Asia-Pacific, and North America. Moreover, the company had a market capitalization of €84 billion as of Q3 2021 (Schneider Electric, 2020)

Liquidity and structural analysis

Liquidity and structural analysis for each company is performed with financial data obtained by the financial reports of the companies from their official websites and financial terminals. All the information collected and used will be provided in the appendix of the research paper.

American Water Works Company, Inc. AWK has approximately $8.7 billion of consolidated reported long-term debt. The majority of which has been advanced via inter-company notes to various regulated subsidiaries and has remained part of their respective regulated capital structures. However, the company receives regulatory approved cost recovery, this eliminates the consideration of the company as a "holding company" debt that affects the dividends for interest and principal payments. The liquidity of AWK is adequate considering its access to external sources. However, the impact of COVID-19 has left the company with around $1.4 billion that lags the pace of capital spending of $2.0 billion, and growing dividends the company has to pay. Moreover, the company issued a $750 million one-year loan which was used to bolster liquidity resources amid financial market stress. As of 31st of December 2019, $76 million letters of credit and $786 million of commercial paper and credit facility borrowing were outstanding, leaving the company with around $2.17 billion available under the facility and the long-term debt maturity at $310 million in 2021. This is evidence that AWK has access to capital markets if needed and even in the current situation the company is in good financial health.

Canadian National Railway Company. CN has high levels of liquidity with CAD6.5 billion sources compared to CAD 1.7 billion of uses. We can break down the sources as CAD 569 million of cash as of Q2 2020, $700 million received from agreements, full availability of CAD 2.5 billion in revolving credit facility, and approximately CAD 2.6 billion free cash flow. On the other hand, uses makeup in $790 million of outstanding commercial paper, approximately CAD 530 million of maturing debt and lease liabilities, and a working cash need of approximately CAD 150 million also adding CAD 450 million in committed accounts receivable securitization program that remains available. Considering the financial position, the company is in outstanding financial health.

McCormick & Company Inc. McCormick liquidity is supported by approximately $221 million of cash as of Q3 2020, good cash flow, and $2 billion in availability under its committed bank credit agreement. However, the company has $1 billion upcoming debt maturities over the next two years that might threaten its position, considering the company paid off $213 million outstanding balance of their 5-year term loan due 2022 and the acquisition of Cholula might further threaten the position. Yet, the company has strong annual free cash flows in the range of $100-$300 million. The liquidity position is compromised more by short term revolving credit facility that is due, but the EBIT to interest covenant should provide an abundant cushion for McCormick. Thus, the company still remains in a stable financial position despite the rising financial obligations.

Orsted A/S. The company had a good operating performance with an EBITDA of DKK 18.1 billion. The performance received a boost from both offshore and onshore wind farms. However, due to heavy capital expenditure, the company's net debt increased. Orsted's capital structure includes a mix of senior unsecured bonds, bank debt, and hybrid securities. Considering the features of hybrid securities, these could also be treated as 50% debt and 50% equity for financial leverage calculations. Moreover, the company's liquidity position is supported by DKK 30.6 million of cash and marketable securities and committed bank facilities of DKK 15.8 billion. This should be enough to fend the larger debt maturity that falls in December 2021 with a DKK 2 billion maturing bond. This puts the company in a stable financial position.

Schneider Electric SE. Schneider has an excellent liquidity position. At the end of Q2 2021, Schneider had a total of available liquidity of €6.2 billion, including cash and cash equivalents at €3.6 billion with access to unused credit lines of €2.6 billion, all without financial covenants. By the end of Q2 2021, the company reported around €3.2 billion of short-term debt. Schneider has a very strong financial profile that is accompanied by a well-balanced debt maturity profile.

Environmental considerations

This part of the study explores the business areas where the companies operate and analyses the risks that could impact the financial health of the companies considering the issues that arise from the operations.

American Water Works Company, Inc. Compared to other utility companies that serve in the gas and electricity, AWK has a lower carbon transition risk. However, AWK is not immune to climate change risk, which usually accounts for the supply variability and exposure to man-made disasters, including flooding and soil/water pollution. These and other severe weather conditions could disrupt operations, change water usage patterns, and consequently have a financial impact on the company that might lead to a hit in the financial health.

Canadian National Railway Company. Considering its high ESG score, CN is exposed to moderate environmental risks like air pollution, carbon emission regulations, and natural man-made hazards. The biggest environmental risk that faces CN is the regulations that aim the emissions reduction from its diesel-powered locomotives. However, the company has targeted to reduce Scope 1 and Scope 2 greenhouse gas emissions by 43% gross ton-mile by 2030 from a base 2019 base year (CN 2019). Moreover, CN is exposed to social risks such as labor relations and health and safety issues. Though, the company's business model has incorporated mechanisms in place to address them (CN, 2020).

McCormick & Company Inc. McCormick is heavily invested in sustainability and that is also evident from its high ESG score. When considering the environmental impact, McCormick is exposed to agrochemicals that are used by its agricultural suppliers. Moreover, water conservation and biodiversity, and habitat conservation is also important matter when considering the suppliers of the company. So far, the company has applied filters when choosing suppliers to minimize the indirect effect on the environment (McCormick, 2021).

Orsted A/S. Orsted A/S is headquartered and operates in European Union (EU). Considering the EU has committed to reducing the greenhouse gas emissions by 40% from the 1990 level, a target that the EU has also proposed to increase to 55% and reach carbon neutrality by 2050 (SDSN, 2021). Despite the risks that might arise for unregulated utilities which account for 40% of the EU's carbon emissions (Suarez-Bertoa et al., 2020), this backdrop actually provides an opportunity for Orsted A/S. The company is well-positioned to face carbon transition risks compared to its peers, given the company's portfolio of renewables and the conversion of coal-fired CHP plants to biomass (Orsted, 2020). Moreover, Orsted is aiming to be carbon neutral by 2025 as it phases out coal completely by 2023 (Orsted, 2020).

Schneider Electric SE. The manufacturing industry has a moderate risk score for the materiality of environmental risks to credit quality considering the environmental risk heat map from Moody's (2020). The company has implemented transition strategies that comprise several targets, including achieving carbon neutrality by 2025 with a CO2 offset or by 2030 without CO2 offset and achieving a net-zero CO2 supply chain by 2050 (Schneider Electric, 2020). Considering that Schneider also manufactures products that help its customers shift towards more efficient less resource-intensive practices, also further reduces the company's environmental risk.

Conclusion

Considering the in-depth analysis of financial reports of the 5 picked companies, we can conclude that the sustainable companies can manage to have sustainable practices while also enjoying good financial health. However, in the case of Orsted that offers renewable energy sources, the company had higher capital expenditures despite the stable financial profile. This outcome can also highlight that financial difficulties might arise for companies that offer renewable energy, where a financial cushion might be harder to achieve when compared to companies that operated in the other GICS industrial codes. It should be noted that the study's focus remains narrowed only to the highest sustainable companies in their GICS industry code, while the study can be furthered by including more companies from different GICS codes that in turn will provide a clearer view of the financial health of sustainable companies in different areas.

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Appendix

For ease of access and for the material to be clear and within frames, the researcher has uploaded them to the personal cloud drive and the documents are available through the respective link:
American Water Works Company, Inc, Financial Statements available at: https://docs.google.com/spreadsheets/d/1W_PW_AxXWNSyR8fJ12OjBTSnN1LdTsjZ/edit?usp=sharing&ouid=113646127222421636910&rtpof=true&sd=true
Canadian National Railway Company Financial Statements available at: https://docs.google.com/spreadsheets/d/1XR1KaOJQxRzqBiy1TuZZNowQXIkysPpF/edit?usp=sharing&ouid=113646127222421636910&rtpof=true&sd=true
McCormick & Company Inc Financial Statements available at: https://docs.google.com/spreadsheets/d/1EQl4_-l10Or530ErMPdllwoxv6niNWA4/edit?usp=sharing&ouid=113646127222421636910&rtpof=true&sd=true
Orsted A/S Financial Statements available at: https://docs.google.com/spreadsheets/d/1RDsSJq65hN70YO7LeLSIKlD7A6ZnGasq/edit?usp=sharing&ouid=113646127222421636910&rtpof=true&sd=true
Schneider Electric SE Financial Statements available at: https://docs.google.com/spreadsheets/d/1Pgdu3-aFk6Eu8dBRvBelwiOOULpSpl-k/edit?usp=sharing&ouid=113646127222421636910&rtpof=true&sd=true