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In recent years, investors and companies have become increasingly aware of the many ways that environmental issues affect their businesses, presenting both challenges and opportunities. Environmental issues generate business risks that have to be carefully managed. Regulations aimed at protecting human health and the environment constantly evolve and often create uncertainties for firms with significant implications for their financial performance. Consumer reactions, toxic torts, and other environmentally motivated litigation create serious non-regulatory risks that may reduce a company’s markets or undermine its balance sheet.

At the same time, rich rewards are increasingly available to companies able to transform environmental concern into market opportunity or competitive advantage. Some companies have recognized new demands for “green” products and established new market niches. Some companies find their reputations are enhanced and their earnings increased by adopting cleaner production techniques or facilities. Companies have even made a changing regulatory framework into a source of competitive advantage by pre-empting environmental regulations and voluntarily going beyond compliance on their own terms, knowing that rivals will likely be compelled to react later. In many different ways, the environment is directly affecting the bottom line, often with very different consequences for companies even within the same sector.

All these risks and opportunities carry directly over into the capital markets. Stock prices move in response to various environmental events—falling, sometimes dramatically, in the wake of oil spills, accidents, and new lawsuits; rising on the back of a good environmental image founded on “green” products and “green” processes. Given these trends, investors knowledgeable enough to discern good environmental performers from bad should see a better return on their portfolio.

There is a problem for investors who seek to respond to environmental issues, however. Even as capital markets come to recognize the importance of environmental matters for financial performance, environmental issues remain outside the mainstream of financial analysis and valuation that provide the foundations for investment decisions and corporate strategy. For the most part, fundamental tools of financial analysis and investment decisionmaking are not being applied to environmental issues, impeding the ability of investors to make sound choices when the environment poses financial risk or opportunity. This is largely because of the lack of a feasible methodology for translating environmental performance into financial terms. In particular, no approach has adequately translated environmental risks into the dollars-and-cents terms with which investors and businesses are used to working. Instead, environmental issues are often reduced to checklists, qualitative screens, or compliance-based decisions.

In Pure Profit: The Financial Implications of Environmental Performance, WRI economists Robert Repetto and Duncan Austin present a new approach that fills this gap. They outline a methodology that investors and analysts could use to evaluate how uncertainties associated with future environmental issues can be translated into financial terms and integrated into established decision-making frameworks. The approach is forward-looking, readily adaptable to a range of environmental issues and different sectors, and consistent with techniques
already widely used by investors and managers to assess conventional business risks.

Moreover, in applying the methodology to the pulp and paper sector the authors demonstrate why evaluating environmental issues should be a central part of investment analysis. Looking at just a subset of the salient environmental issues that firms in this industry will confront over the next five or ten years, the study reveals significant financial implications for many companies that should be of interest to any investor, irrespective of his or her interest in the environment. This evidence directly challenges the notion that environmental issues are too small to merit Wall Street’s attention and reinforces the notion that the environment presents a new dimension in which differences in the relative value of companies can be discerned, and exploited, by investors.

At a time when environmental issues are becoming more and more prominent, and when the prospect of policies to address new issues, such as climate, looms large, investors ignore these issues at their peril. In trying to make sense of these issues in financial terms, the approach described in this report should provide a useful foundation for both investors and companies.

This report is the latest in a series of WRI publications aimed at improving the management of environmental issues by the private sector, including The Next Bottom Line: Making Sustainable Development Tangible; Green Shareholder Value: Hype or Hit?; and Green Ledgers: Case Studies in Corporate Environmental Accounting. WRI remains committed to helping the private sector improve its environmental performance and to encouraging corporate leadership in the area of environmental protection.

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