ESG has become an increasingly important topic for businesses, governments, and regulators in recent years. This is highlighted by the shift in societal perception of environmental and social issues, the integration of ESG concerns into the EU regulatory framework and the rapid growth of ESG-focused funds.

Consequently, issuers that want to retain existing capital and attract new investors will have to take action and address relevant ESG risks and opportunities. However, this can be challenging. The ESG space is still in its teenage years and therefore lacks uniform terminology, universal best practice and mandatory standards, which makes improving ESG practices, a daunting task for many companies, especially those with limited resources.

“The Corporate ESG Guide: A 360 view on the current landscape and trends” intends to provide answers to some of the fundamental questions issuers have regarding ESG. The White Paper comes in two parts: Part I serves as a guide to current developments in the ESG space; Part II offers detailed market views on key ESG topics, drawn from over 35 interviews with leading asset managers, corporates, advisors, and ESG rating agencies. This abridged version of the White Paper combines essential insights from both Parts I and II.

Understanding ESG

The lack of uniform standards and terminology is one of the key challenges in the ESG sphere. Such terms as ‘sustainable investment’, ‘ethical’, ‘CSR’, and ‘impact’ are often used interchangeably and can have different meanings. This lack of clarity can be the reason many companies fail to realise the strategic importance of ESG.

Our corporate interviewees viewed ESG as understanding, addressing, and reporting on non-financial risks and opportunities that environmental, social, and governance factors bring to their business operations. We also asked corporates about specific factors they consider material under the Environmental, Social, and Governance umbrella. Relevant factors covered by each of these elements depend on the particular industry. Part II of the White Paper included thoughts from companies spanning a multitude of sectors including, pharmaceuticals, automotive, consumer products, energy, industrial, construction, mining, financial, and IT.

Investors also offered their views on the key drivers behind successful ESG implementation. They observed an increase in environmental focus over the last few years, with the current pandemic bringing a new perspective on social and governance factors.

Diego Martínez, Senior IR Manager at Iberdrola: “ESG is a way of deciding, from all participants in the market, from corporates to investors to advisors, that the focus will not be just on shareholders like it was in the past, but also on stakeholders.”

David King, Head of ESG Stewardship at Fidelity Investments: “We live in a world of finite resources, and how companies manage the use of their resources and their impact has an influence on their success and competitiveness in the long term.”

ESG investing & size of the market

ESG investment levels are increasing exponentially, with some of the largest asset managers advocating a greater focus on environment and social issues. In terms of ESG investing strategies, widespread approaches include ESG integration, negative screening, positive screening, and impact investing. Part I of the White Paper highlights how Passive investors rely on indices offered by various ESG data and index providers, such as MSCI, FTSE, Bloomberg, and STOXX. Whilst in Part II of the White Paper, we asked how Active investors incorporate ESG in their decision-making process. ESG integration is adopted or is in the process of being implemented by 85% of investors we spoke with. ESG integration usually involves consideration of ESG factors alongside financial metrics in the investment process. Another quickly growing ESG strategy is impact investing, which involves targeted investment in companies that achieve measurable environmental or social goals. As ESG integration becomes more mainstream, even companies that do not target ESG-focused funds will have to improve their ESG practices to retain existing investors.

Estimations of the ESG investment universe vary significantly. The numbers range from $560 billion (2019 IMF report) to $30.7 trillion (GSIA 2018). The majority of investor participants (69%) thought that the estimation would entirely depend on the definition of ESG. Responses indicated that ESG integration takes up the largest proportion of the market, followed by SRI strategies (usually exclusionary techniques that avoid investing in controversial industries), followed by impact investing.

Maria Lombardo, European Head of ESG Client Strategies at Invesco Ltd: “When we consider ESG integration – you want to have ESG factors alongside financial factors in the investment process. They do not just apply to an investment fund that has to be ESG-focused, it applies anywhere.”

Maria-Elena Drew, Director of Research for Responsible Investing at T. Rowe Price: “…we broke down ESG funds into different categories: incorporating ESG to enhance your performance – that is a significant portion of the market today (in the active market), SRI universe, applying positive or negative screening – that is a smaller part, but pretty sizeable, impact investing is very small, but is growing very fast.”
Greenwashing
Greenwashing usually describes a marketing-focused commitment to ESG that does not have any impact on a company’s business operations. Without universally accepted terminology or mandatory standards in the ESG space, greenwashing is a frequent occurrence among corporates and investors alike. Most interview participants recognised greenwashing as an ongoing challenge. At the same time, several interviewees noted that while a company might start their ESG journey with marketing it can eventually transition to genuine change, especially with increasing investor and regulatory pressure. Investors also observed that with the increasing availability of ESG data, greenwashing becomes easier to detect, allowing them to adapt their ESG evaluation models. In addition, as ESG disclosures become more and more important, investors are increasingly developing an appetite for audited ESG data. This more transparent environment makes greenwashing an increasingly hazardous endeavour.

Lucian Firth, Partner at Simmons & Simmons: “I think people need to take their ESG disclosure very seriously in a way it wasn’t before. Before, people might have overemphasised what they were doing, but now they need to make sure it’s genuine and it can be substantiated. Because if they do not, there is a risk of litigation.”

How important is it to have an effective ESG strategy?
Many companies still do not have a clear picture of how ESG-related risks and opportunities impact their business. This question is especially important for small and mid-sized companies, who might find the future benefits brought by improved ESG practices difficult to recognise. To address this concern, we asked corporates, investors, and advisors to discuss the importance of considering ESG factors as part of an over-arching business strategy.

Most issuers (76%) thought that not having a comprehensive approach to ESG can cause significant negative impact to a company. This was generally associated with changing societal attitudes, consumer sentiment, and regulatory pressure. Investor pressure was another important factor, with 50% of the issuers commenting that mainstream investors are including ESG topics in their one-to-one and group meetings. This trend is likely to intensify due to the upcoming EU regulatory measures designed to steer capital flows towards sustainable investment.

Far from being a side topic, as it was in the past, ESG is now a mainstream consideration that needs to be communicated to all investors. The increasing scale of ESG integration means that corporates with a flawed ESG profile will face a higher cost of capital in the near future. ESG is also starting to become important in the context of corporate M&A, with companies taking into account ESG characteristics when considering the merits of a transaction. Finally, shifting societal attitudes and environmental change represent risks that will affect companies in all industries. These developments mean that incorporating ESG into the business strategy will improve a company’s risk management and empower them to meet future challenges. Companies that fail to address material ESG factors are likely to experience negative financial consequences as a result of the developments outlined above.

Corporates and investors suggested several ways to effectively address ESG with minimal resources:

- Making sure a company has a detailed understanding of its business and its impact on the world
- Ensuring transparency around ESG practices by putting as much data as possible on the company website
- Prioritising ESG issues that need to be addressed and dedicating available resources towards the most material factors
- Concentrating on the impact of ESG policies and the marketing around it

Armin Peter, Head of Sustainable Banking EMEA at UBS: “ESG change is as big as tech was. Once regulation starts, you cannot stop it.”

Lucian Firth, Partner at Simmons & Simmons: “Corporates are giving ESG factors serious thought in the context of M&A transactions. When parties are looking at each other’s M&A credentials, they are thinking about how that transaction is going to impact their ESG profile. It is becoming super mainstream.”

Teodora Bozhilova, IR Manager at Wienerberger: “Every company can do ESG independent of their size. Every company can make a positive impact on the environment and society, and every small impact counts.”
ESG integration, external evaluation, investor communications and reporting

Integration

Conviction and commitment from the top are key to effective ESG integration, according to 58% of issuers. Most corporates we spoke with (67%) have a dedicated sustainability strategy, with several being in the process of phasing out their separate ESG policy and fully integrating ESG into their overall strategy.

In terms of board accountability, some issuers interviewed disclosed they make specific board appointments based on their individual ESG credentials, while others integrated ESG into general board appointment criteria. The third option suggested making the head of sustainability a board-reporting role.

KPIs tied to ESG goals add another layer of accountability and commitment, a popular measure employed by 83% of issuers. Examples of ESG KPIs include targets on emissions reduction, health and safety, waste reduction, and sustainable packaging. Incorporating ESG KPIs into senior management compensation schemes was a less popular measure, supported by just 50% of the corporate participants.

Uwe Bergmann, Head of Sustainability Management at Henkel: “If I was an investor, I would be looking for understanding and commitment at the top, but also the wider organisation’s ability to deal with it in terms of culture, processes and systems.”

May Jaramillo, European Head for Sustainable and Impact Banking at Barclays Investment Bank: “ESG investment is about setting up a strategy that really demonstrates to your investor base that ESG is an integral part of the business, and no longer just a part of your PR. Accountability is very important, as it will show how meaningful it is to the board and the direction the company is heading in.”

External evaluation

The way corporate ESG strategy is evaluated by the market is one of the most important questions for corporates. Without universal standards or disclosure frameworks, ESG ratings agencies and data providers enable investors to easily compare companies’ ESG profiles. This means that agencies’ scores can significantly influence the market perception of the stock.

Corporate participants engage with a variety of ratings agencies, with 75% mentioning MSCI. A common criticism of ESG ratings refers to the significant data, which ranges from using a large number of public data sources to closely communicating data. Incorporating ESG KPIs into senior management compensation schemes was a less popular measure, supported by just 50% of the corporate participants.

My-Linh Ngo, Head of ESG Investment at BlueBay Asset Management: “We recognise there can be a potential size bias when it comes to a company’s level of public ESG disclosure and ESG practices. This is taken into consideration when we look at companies - we don’t apply one size fits all.”

Roland Rott, Head of ESG at La Française Asset Management: “Financial fundamentals in combination with a relatively weak ESG score, gives you a screen of companies where there’s a need for change. And these are usually companies that I really like to invest in.”

Communicating ESG strategy to the market

Issuers communicate their ESG strategy to the market through reporting, information published on their corporate website, and direct investor interaction.

ESG reporting usually takes the form of a separate sustainability report, with some companies including sustainability information in their annual report. In addition, some companies also provide quarterly reports on ESG KPIs. Investors did not express a strong preference on the frequency of ESG reporting. Instead, they highlighted that reporting should be regular and focus on material factors.

Information placed on a website can include ESG-specific investor presentations, ESG targets, sustainability reports, and other relevant materials. This method of communication was favoured by investors, with 64% commenting that issuers should publish more disclosure materials on their websites.

Investors highlighted that ratings agencies played an important part in mainstreaming ESG by providing a convenient way to integrate ESG considerations into the investment process. Most investors (64%) stated that they use ratings by multiple agencies, rather than relying on one. Also, the majority of interviewees supplement these scores with their own, in-house, evaluation models. A negative ESG score does not necessarily exclude the company from the pool - several investors indicated that engagement results can be a decisive factor. A positive response to engagement and willingness to change can, sometimes, compensate for a flawed ESG profile.

Hendrik Garz, Executive Director at Sustainalytics: “The challenge for ratings agencies is to provide products that speak to differing needs. You can’t speak to all the different objectives with one rating.”

Aurelie Ratte, Vice President of MSCI ESG Research: “We have done some analysis, and about 2/3 of our rating is independent from the companies’ reports. We use thousands of global and local news sources in different languages. And we are increasing the use of social media, satellite images, NLP techniques, and machine learning to extract information that is not accessible through more traditional sources.”

Patricia Torres, Head of Sustainable Finance Solutions at Bloomberg: “The ESG story is not about the score, it is about where you are today vs where you were in the past and where you see yourself going and how you are changing your business model to support that vision.”

The ESG story is not about the score, it is about where you are today vs where you were in the past.
Several investors highlighted that ESG data should be presented in a quantitative format that could be easily picked up by AI tools.

Direct investor interactions can involve attending sustainability conferences, holding ESG-focused roadshows, or virtual events. Most issuers prefer to channel their communications through IR; sometimes involving sustainability experts or senior management. While investors see IR as a reasonable first contact, 79% prefer to have substantive communication on ESG with senior management. Most investors felt that top management must have a good understanding of relevant ESG issues. Concerning sustainability-focused roadshows, many issuers (58%) observed that ESG is increasingly discussed at mainstream corporate events. This was echoed by investors, who generally preferred integrated roadshows, where ESG factors form part of standard discussions.

Maria Elena Drew, Director of Research for Responsible Investing at T. Rowe Price: "If you do one thing, take the key data points, put them in a table that AI can read - that just means clear data points with no text, and put that on the website."

Andrea Carzana, ESG European Equities Fund Manager at Columbia Threadneedle Investments: “Not providing data is worse than reporting bad data.”

Andrew Parry, Head of Sustainable Investing at Newton Investment Management: "We like companies where the CEO is fluent in matters of sustainability, whether it is environmental or social, is fluent in all the numbers and how it's integrated into the business strategy.”

Lindsey Stewart, Senior Manager in Investor Engagement at KPMG UK: "If ESG integration is to be real, it has to be that common thread throughout all corporate reporting and outreach.”

ESG disclosure frameworks, regulation, and the future direction

Disclosure guidelines

Some of the most well-known ESG disclosure frameworks are provided by the Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), and the Task Force on Climate-related Financial Disclosures (TCFD). Speaking to industry participants revealed that a substantial number of the issuers (50%) use GRI. At the same time, several corporates stated that they intended to integrate SASB and/or TCFD into their GRI reporting. Investors’ opinions generally lean in favour of SASB (57%), with some referring to its focus on materiality and investor focus. Advisors spoke of both SASB and GRI, with a few highlighting the increasing significance of TCFD. While there was no united preference for a particular disclosure framework, many investors stated that transparency is the most important concern with regards to ESG disclosure. This is true even for data showing negative results – several investors stated that negative, but transparent negative data is preferable to companies attempting to obscure it.

Regulation

Most participants have expressed a strong wish for greater standardisation of ESG data and disclosure. In providing a comprehensive classification of sustainable activities, the EU Taxonomy is an important step towards this goal. Most interviewees viewed the incoming regulatory regime positively, with 71% speaking in support of the Taxonomy. Moreover, many felt that regulatory action was necessary to ensure a timely and appropriate response to existing environmental challenges. At the same time, a number of corporates and investors viewed the incoming regulation as too prescriptive. Other concerns included a narrow focus on environmental issues and limited jurisdictional reach. In addition to the Taxonomy, issuers will have to consider the implications of other EU regulatory measures under the umbrella of the EU Sustainable Finance Strategy, including the Sustainable Finance Disclosure Regulation and changes to the MiFID II Directive. These measures, aimed at further embedding sustainability considerations into the investment process, are going to increase the demand for ESG disclosures from corporates.

Nick Stone, IR Director at AstraZeneca: “I think the Taxonomy is a good thing, fundamentally. Why is the EU doing this? Part of this is to raise standards, and I think that is the right ethos because many companies probably don’t do as much as they can. The challenge then becomes whether the US or other jurisdictions adopt something similar.”

Lindsey Stewart, Senior Manager in Investor Engagement at KPMG UK: “If there’s one thing investors have been crying out for, it’s standardisation. And given the reach of EU regulations, the Taxonomy is likely to become a foundation of whatever standardisation will look like in the coming years, particularly in Europe.”

Lucian Firth, Partner at Simmons & Simmons: “I think that for issuers, it is important to understand that asset managers are under immense pressure to be seen to be integrating ESG factors into their investment decisions. Investors are having to comply with these regulations, and therefore they will really be thinking about ESG in a way that they have never before.”
Future direction

The major themes discussed throughout this White Paper – societal shifts, climate change, incoming regulation make it clear that ESG will remain a key strategic consideration for business in the coming years. All corporates we interviewed felt that ESG will continue to have a significant impact on their strategy. Environmental concerns, changing regulatory regimes, supply chain management, consumer sentiment, and hiring practices were named as key factors in this context. Investors talked about ESG integration becoming even more mainstream in the near future, to the point of becoming a natural part of the investment process. Several investors suggested that more targeted ESG investment strategies, such as impact investing, will grow exponentially in response to the increasing consumer demand for sustainable investment.

Teodora Bozhilova, Investor Relations Manager at Wienerberger: “Companies need to invest into sustainability improvements but there will be clear pay-backs and it will pay-off in the mid- and long-term. Also, companies will have more potential costs in the future if they don’t take certain steps now.”

Roland Rott, Head of ESG at La Française Asset Management: “In 5 to 10 years’ time ESG integration won’t exist anymore, it’s just investing. And there will be a bigger market, compared to today, of impact investing, where we create outcomes in terms of environmental and social factors.”

The common opinion of the White Paper’s participants is clear – companies have to address their material ESG factors to prepare for future challenges and attract investment. As regulatory standards around ESG develop, companies that do not take action will face significant negative financial consequences.