Social Impact Efforts That Create Real Value

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ESG

- Until the mid-2010s few investors paid attention to **environmental**, **social,** and **governance** (**ESG**) data—information about companies' carbon footprints, labor policies, board makeup, and so forth.

- Some seek out high ESG performers, expecting exemplary ESG behaviors to drive superior financial results.

ESG

ENVIRONMENTAL

Climate change strategy,
Biodiversity,
Water efficiency,
Energy efficiency,
Carbon intensity,
Enviromental
management system

SOCIAL

Equal opportunities,
Freedom of association,
Health and safety,
Human rights,
Customer &
products resposibility,
Child labour

GOVERNANCE

Business ethics,
Compliance,
Board independence,
Executive compensation,
Shareholder democracy

Pandemic!

- It’s an open question whether ESG issues will remain as salient to investors during a global pandemic and the associated economic downturn.
- when global financial markets were collapsing—we found that the ones the public perceived as **behaving more responsibly had less-negative stock returns** than their competitors.

ESG in Future

- It seems clear that companies will be under growing pressure to improve their performance on ESG dimensions in the future.

- Many executives incorrectly believe that simple actions will suffice:
  - improving ESG disclosures,
  - releasing a sustainability report, or
  - holding a sustainability-focused investor relations event.

- Some companies take those actions, fail to see a benefit, and grow disappointed or frustrated. In some cases they face criticism and negative reactions from investors.

Box-ticking

- It’s easy to see why this has happened. Too many companies have embraced a “box-ticking” culture.

- After all, ESG measures such as reducing waste, strengthening relationships with external stakeholders, and improving risk management and compliance are good business hygiene. In many industries such efforts are now table stakes for enterprises wishing to remain competitive.

ESG in Strategy

- In a world that increasingly judges them on their ESG performance, they must look to more-fundamental drivers—particularly strategy—to achieve real results and be rewarded for them.

Why ESG Issues Matter?

- First, an ESG focus can help management **reduce capital costs** and **improve the firm's valuation.** That's because as more investors look to put money into companies with stronger ESG performance.

- ING, for example, did just that in 2017 when it made a $1.2 billion loan to Philips, an innovator in health technology and consumer products.

Why ESG Issues Matter?

- Second, positive action and transparency on ESG matters can help companies protect their valuations as more **global regulators and governments mandate ESG disclosures.**

- The stock market reacted positively to firms with strong ESG disclosure and negatively to those with weak disclosure.

Why ESG Issues Matter?

- Third, efforts to ensure sustainable practices will help maintain shareholder satisfaction with board leadership.

- To avoid votes against directors, challenges to executive-pay initiatives, and the like, management needs to be proactive about addressing ESG issues.

Why ESG Issues Matter?

- Finally, and perhaps most importantly, ESG practices are part of long-term strategy, and every company needs investors who support management’s vision and plans for the future.

Paul Polman: Captain planet

A Strategic ESG Program

- Michael Porter draws a distinction between operational effectiveness and strategy.
- The former, he writes, “means performing similar activities better than rivals”; the latter “is about being different.”
- To outperform their competitors, companies need to find approaches that are more difficult to imitate.

What is difficult to imitate?

- Actions are easy to imitate.
- Culture is very difficult to imitate.

IKEA

- IKEA is one company that has mapped out a strategic ESG program, transforming itself in response to accelerating environmental degradation.
- It recently entered the home solar and energy-storage business, which grew by 29% in 2019.
- While most competitors are focusing on using materials more efficiently or trying to find ways to recycle products *after* they have been designed, IKEA has launched an effort to completely rethink product design. IKEA products are modularized to make them easy to dismantle and reuse as raw materials when they’re no longer functional.

Accountability Mechanisms

- One of the characteristics of organizations with high ESG performance is a process that deeply embeds ESG issues in the **board’s work** and in **executive pay**.

The Power of Purpose

- A top-down approach to sustainability and good governance is not effective if it is not supported from the bottom up by a culture that rallies around ESG initiatives.
- Many strategic efforts fail because people further down in the organizational hierarchy don’t believe.
- To remedy this problem, organizations must identify a corporate purpose and build a culture around it.

The Power of Purpose

- Asking participants to rate their level of agreement with statements such as
  - “My work has special meaning; it’s not just a job,”
  - “I feel proud of the ways that we contribute to the community,” and
  - “Management has a clear view of where the organization is going and how to get there.”

- If I work only to earn money, I need to rethink!

- Investors are paying more attentions to purpose!

The Power of Purpose

- For some companies, defining their purpose means leaving money on the table, at least in the short term. This is the case with automakers that are transitioning away from carbon-emitting gas-powered cars and moving toward electric vehicles, which are **more eco-friendly but less profitable**.

- Consider Philips Lighting, which has shifted from **selling light bulb products with limited lifespans to selling lighting as a sustainable service.** Customers pay for the light they use rather than investing in the physical assets, while Philips retains ownership of all lighting equipment and takes it back when it’s suitable for recycling or upgrading.

Operational Changes

- In studying firms that have successfully implemented an ESG strategy, I’ve noticed that they tend to pass through **three** phases:
  - efforts to reduce risk and ensure compliance with environmental regulations and other laws;
  - efforts to improve operating efficiency; and
  - efforts to innovate and grow.

- To reach the innovation and growth stage, companies need to decentralize ESG activities and empower corporate functions to take responsibility for them. This is true in terms of distributing power from the C-suite to middle management, but it’s also true at the board level.

Operational Changes

- Initially a board needs to set up a separate sustainability committee.
- Of course, decentralization requires appropriate support mechanisms.
- From 2016 to 2018 Solvay saw 4% annual growth in sales of products that have low environmental impact, while sales of more-damaging products declined by 5%.

Operational Changes

- A first step is to ensure that the chief sustainability officer, or the senior executive charged with ESG responsibilities.
- At Tyson Foods, the former chief sustainability officer also served as the executive vice president of corporate strategy and led continuous-improvement efforts.
- Goal setting can be useful in helping companies progress from centralization to decentralization of ESG activities. Although top leaders should set ESG targets, unit heads and middle management should be empowered to figure out how to hit them.

Communicate with the (Right) Investors

- The first misconception is the belief among many corporate leaders that a firm's investor base is not subject to influence or control by management. In reality, a company *can* influence who buys its stock.

- The second misconception is that the demands of sell-side analysts employed by big brokerage houses should determine what must be communicated.

Communicate with the (Right) Investors

- The third misconception is that ESG metrics are sufficient for investors to integrate ESG considerations into their business analysis, valuation, and modeling.

- In fact, investors struggle to embed those metrics in financial models because it’s not clear what they mean or how they can affect the financials.

- One solution might be the creation of a system of impact-weighted accounting that could measure a firm’s environmental and social impacts (both positive and negative), convert them to monetary terms, and then reflect them in financial statements.

Communicate with the (Right) Investors

- A final, fundamental misconception about investor relations is the idea that ESG disclosure is transaction-based and can happen intermittently. Companies need to instead see it as an opportunity for continual reputation and relationship building.

The Path Forward

- Many companies have failed to recognize that the functional role of ESG data has changed over time. Initially such data was used to judge a company’s willingness to avoid harm and do good.

- However, investors are increasingly asking a different question: not whether a company has good intentions but whether it has the strategic vision and capabilities to achieve and maintain strong ESG performance.

The Path Forward

- Moving from intention to results is the next evolution that investors are looking for.

The Board’s Role in Sustainability

Sustainability in the Board's Discussion!

- A 2019 PwC survey of more than 700 public-company directors found that 56% thought boards were spending *too much* time on sustainability.
- Some of the myopia can be traced to a lack of diversity on boards.
- Most directors are male, white, and from a similar background, and many are retired executives who came of age professionally at a time when the link between ESG factors and corporate performance was not clearly understood.
- But a large part of the problem is that until recently, boards didn't have a mandate to grapple with sustainability; instead, their time was consumed by compliance tasks driven by the corporate secretary and by inside and outside counsel.

SCORE

- Score is a framework to help boards deliver on purpose.
- SCORE outlines five actions—**simplify**, **connect**, **own**, **reward**, and **exemplify**—that can help boards articulate and foster a firm's durable value proposition and its drivers.

Simplify

- Enacting purpose begins with knowing what it is. For that reason, purpose needs to be simple and clear—straightforward enough to be understood by the entire corporate workforce.

- A good place for boards to start is with a statement of purpose signed and issued by all the directors.

Connect

- Once corporate purpose has been articulated, it must be connected to strategy and capital allocation decisions.

- Connecting purpose to strategy gives a CEO the necessary foundation to prioritize long-term goals and resist pressure from activist investors and others who care only about short-term returns.

Own

- Ownership of purpose starts with the board, which must put in place appropriate structures, control systems, and processes for enacting purpose.

- It spreads among all.

Reward

- Primarily through its compensation committee, the board is responsible for establishing the metrics that will be used to determine promotion and remuneration throughout the organization.
- During the financial crisis of 2008, the bank’s board of directors linked 25% of executives’ variable pay to key performance indicators in the areas of “customer and stakeholder” and “people and culture.”

Exemplify

- Purpose and how it is being achieved must be exemplified in both quantitative and qualitative terms.
- Quantitatively, a company should integrate its reporting on financial performance with its reporting on sustainability performance, showing how results in the two areas are related.

A New Duty

- Shareholders and short term profits!
- A new way of leadership!

The Challenge of Rating ESG Performance

- It is important to us that the companies we assess understand how we arrive at our ratings. We consider two elements: what risks the businesses are exposed to and how well they’re managing them.

- A decade ago only 10% of firms responded to our requests and talked with us about our analysis. Today more than 60% of large companies share information with us, and that number has been growing each year.

- In general, businesses that take special pride in their reputation and those that have an ESG-minded investor base are willing to spend more time communicating with us.
- In other cases, companies that fare poorly in our ratings or are facing criticism of their sustainability or governance practices are encouraged by their investors to interact with us.


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- Survey Fatigue!

- For companies that want to put their best foot forward, good disclosure of their most material ESG challenges—and how they're addressing them—goes far.

COVID as a Catalyst: The Rise of the Remote Workforce

Changes in the Work

- None thought this would happen!
- Now we are accepting new reality!
- More remote operations!
- Better results! 60% mature organizations are more satisfied.
- Reduced costs!

What is next?