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CORPORATE
ESG INVESTING

Making sense of ESG investment capital

Quantifying the value of environmental, social and governance returns is no easy task for investors

It can be challenging for companies to understand how investors quantify the value of environmental, social, and governance (ESG) returns when making investment decisions.

ESG investing, often referred to as sustainable or socially responsible investing, has turned a corner. According to a recent McKinsey report, more than a quarter of assets under management are now invested with the thesis that ESG can affect a company's financial performance. Green bonds alone are projected to grow into a trillion dollar market.

An increasing number of institutional investors subscribe to the United Nations' Principles for Responsible Investment, and 84% of millennial investors, who are set to inherit $30 trillion, report that ESG performance is important, according to the Institute of Sustainable Investing at Morgan Stanley. The US Business Roundtable announced on August 19 2019 that it is reframing the purpose of companies to include stakeholders broadly, as opposed to only shareholders. In this context, companies can no longer afford to disappoint investor expectations with respect to industry standards for ESG performance if they want to access these rapidly growing pools of capital.

Our project: understanding quantitative ESG measurement

There are already a bewildering number of standards in use by ESG data providers, asset managers and corporations. Some measure performance against the 169 targets which underscore the 17 United Nations Sustainable Development Goals. Many have established proprietary valuation methodologies such as MSCI, Sustainability Accounting Standards Board (SASB) and the Embankment Project for Inclusive Capitalism.

Although many organisations have agreed to cooperate, standardisation remains an enormous challenge given the subjective nature of ESG analysis, often resulting in little consensus about a company's ESG performance. The ratings can be frustratingly opaque to companies, particularly when receiving a negative score on a

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In recent years, the adoption of environmental, social and governance (ESG) investing has risen steadily. Yet many companies are finding it challenging to understand how investors quantify the value of ESG returns when making investment decisions. To solve this problem, Freshfields set out to understand what is being measured, speaking with researchers at the London School of Economics and the University of Chicago to gain a perspective. The firm also interviewed dozens of asset managers and fund industry service providers to understand how institutional investors mine through the flood of ESG quantitative data.

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particular metric without a clear explanation. For example, companies have received negative scores relative to their peers based on the absolute value of ESG fines imposed without due account being taken of the relative scale of activities as evidenced by market capitalisation. As ESG becomes embedded in mainstream investment analysis, companies need a clear and consistent set of baseline metrics, and more detailed explanations as to how they are generated.

To understand how institutional investors wade through the flood of ESG quantitative data, we interviewed dozens of asset managers and fund industry service providers. To gain an academic perspective we spoke with researchers from the Marshall Institute at the London School of Economics and the Rustandy Center for Social Sector Innovation at the University of Chicago. Our report can be found at *freshfields.us/esginvestment*.

Our report, based on this research, identifies a number of key points:

- the most important ESG data providers that are commonly used by investors;
- the categories of positive and negative criteria utilised by ESG data providers (e.g., environmental risk management, water use, labour management, prevention of corruption);
- the extent of correlation across ESG data providers;
- which criteria are most commonly relevant for ESG ratings across multiple ESG data providers;
- the 10 most common types of globally reported ESG incident activity;
- the relative materiality of common key performance indicators in ESG frameworks;
- the underlying data sources utilised by ESG data providers;
- which ESG data providers require company involvement (eg through responses to questionnaires);
- how investors use multiple ESG data providers to reach their own conclusions; and
- how companies integrate ESG data into their decision-making processes to identify risks and opportunities.

Increasingly, investors are developing in-house proprietary methodologies that utilise multiple ESG data sources and complement analyst-based ESG research with artificial intelligence or machine learning-systems.

There are several important strategies that companies can adopt to communicate their progress towards ESG targets to investors.

Developing a strategy to access ESG capital

Different companies have varying levels of sophistication when it comes to their ESG disclosure and strategy. Those companies looking to develop a strategy to access ESG capital from the ground up must adhere to the practical recommendations outlined below.

1. Data collection and monitoring strategy

- Identify core ESG data providers whose reports to monitor, taking into account (a) guidance as to which sources are most commonly used by asset managers; (b) the burden represented by any additional bespoke information delivery requirements of such providers; (c) available resources to answer their informational requests; and (d) any feedback from current investors. MSCI ESG research and Sustainalytics have emerged as two of the most prevalent providers;
- Set up a procedure for monitoring on a regular basis any ESG data reporting from the identified sources;
- Identify the base ESG metrics most relevant to the appropriate business sector from the perspective of both opportunity and risk, taking into account the fact that data providers may tend to pay more attention to ESG risk than opportunity;
- Identify any negative data points among the ESG metrics available for the company and identify whether there is a rational basis for it, or if it ought to be defended against. Many ESG data providers have been critiqued for a lack of transparency which makes it difficult for companies to understand how they are assessed;
- Establish channels of communication with the ESG data providers identified as most relevant to the industry and investor base so as to better understand their approach, and if necessary explain why that approach may be unfair or unrepresentative;
- Talk to your key investors about their own methodologies for analysing ESG data that relates to your company – many of our interviewees indicated that they would welcome such approaches from companies, not least as an indication of the importance attached by the company to their ESG performance
- In the longer term, join (or, if one doesn't already exist, form) an industry association with peers to establish a consensus as to the most relevant ESG data metrics for the industry and how they should be measured. Industry associations can educate and lobby both ESG data providers and institutional investors to adopt a standardised approach to the industry. This is in everyone's interest because it enables comparison of relative ESG performance by investors. To date, the best example of this is BIER, the Beverage Industry Environmental Roundtable, which developed a standard methodology for measuring the ratio of water usage to product volume which can be incorporated by ESG data providers into their data feeds.

2. Disclosure strategy

Today, sustainability reporting is a widespread practice, with 85% of the S&P 500 producing sustainability reports as opposed to only 20% a few years ago. ESG disclosure has been shown to relate to positive changes in stock price, lower cost of equity capital and lower capital constraints. However, investors continue to find the data provided unhelpful for comparative purposes due to the lack of standardisation. At the same time, companies are frustrated because they have to divert significant resources to responding to numerous requests for the same data presented in marginally differentiated formats. Nevertheless, once companies have a data collection and monitoring strategy in place as recommended above, there are several steps that companies can take to improve their

ESG disclosure in ways that will be interpreted as meaningful by investors:

- Develop a consistent reporting framework with a baseline of metrics that are responsive to the metrics identified in our report as being most commonly utilised by the most important ESG data providers, and communicate to investors why these metrics are most relevant to the industry and your company's ESG strategy. This has the potential to improve ESG data provider scores as many methodologies have a bias against firms without consistent reporting.
- Integrate ESG reporting with regular financial reporting. In integrated reports, companies can make a clear case for the connection between ESG issues and business strategy and show how the business case for a project has been properly analysed using appropriate ESG criteria. Moreover, integrated reporting forces companies to eliminate wherever possible the time lag between sustainability and financial disclosure, which research has shown can often be separated by 90 days or more.

  Perhaps unsurprisingly, given the need for information that is as current as possible to make educated investment decisions, there is widespread support for the adoption of integrated reporting which has been shown to attract a long-term investor base. This in turn can create a virtuous circle whereby a company has an investor base that is patient enough to allow it to make the necessary investments to tackle ESG issues such as climate change, which require a longer-term strategy.

  The first integrated reports appeared in Europe. Novozymes' (a Danish bioindustrial product company) ground-breaking 2003 report was swiftly followed by a host of imitators, and more recently, many US companies such as United Technologies Company, American Electric Power, Pfizer, and Southwest Airlines have since adopted the practice. The greater risk of disclosure-related shareholder litigation means that it is imperative to involve litigation counsel at an early stage when developing an integrated reporting strategy.
- Finally, ensure that reported ESG disclosures are independently audited or otherwise verified by a suitably accredited organisation. According to a recent McKinsey report, investors almost universally agree that ESG disclosure should be audited, with 67% arguing for audits as rigorous as those imposed on financial disclosures.

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3. Governance strategy

There is a common misconception that quantitative metrics about ESG issues are focused on the environment. In fact, many investors feel that governance is the most important ESG factor, although it is difficult to quantify. In addition to seeking an active dialogue with management about ESG issues, several investors are developing proprietary analytical tools to evaluate several governance areas as part of their assessment of management's commitment to ESG issues, including:

- Clarity in the communication of management's understanding of how ESG considerations affect the business and strategic decision-making;
- Board accountability for ESG strategy and performance based on agreed ESG metrics;
- Executive compensation tied to performance on ESG criteria, perhaps the strongest signal of commitment to ESG which investors consider – as one asset manager told us "if you understand how a person is compensated, you can predict how they will perform on ESG issues";
- Expansion of capital budgeting for ESG-related projects;
- Maintenance and improvement of the integrity of supply chains by thorough due diligence of suppliers from focused questions in requests for proposals, heat mapping analysis, and ongoing monitoring;
- Gender and other forms of diversity, not only at board and management level but also throughout the organisation, and the provision of related data that enables comparison and identification of potential issues such as salary disparity; and
- Conversion of a corporation into a Delaware public benefit corporation (or its jurisdictional equivalent) that is obligated under its purpose provision to balance public benefit with the pecuniary interests of shareholders and the interests of stakeholders materially affected by its conduct.

  Many clients have not yet considered the possible benefits of this, not only from an investor but also an employee and branding perspective. Our firm is beginning to see momentum build in this direction, particularly following the recent recommendations of the US Business Roundtable, and we are advising a number of major companies to consider a possible conversion.

4. Structuring capital raising for ESG-related projects

The burgeoning green bond market represents the easiest existing avenue by which companies can access ESG investment capital to execute sustainability-focused projects, without driving up the cost of borrowing. Citigroup predicts that green bonds will grow into a trillion-dollar conduit for climate investments by 2020. This will present possibly as much as one fifth of all bonds in the next few years, according to Swedish Bank SEB.

The Green Bond Principles published by the International Capital Market Association (ICMA) are the most common framework for appraising green bonds. The criteria includes four steps: use of proceeds, process for project evaluation, management of proceeds, and project reporting. Many issuers also obtain certification from the Climate Bonds Initiative (CBI). If more than five percent of the proceeds are used for general corporate purposes, the project does not satisfy the CBI's criteria.

Moody's has also developed a methodology to evaluate the environmental criteria of issuers based on their approach for managing, allocating, and reporting on each project. Of

any single criterion, the use of proceeds has the highest weight at 40%. For many impact investors, 100% of bond proceeds must be applied towards a green project, and transactions need to be legally structured to ensure that this will be the case. One example of a company which has successfully issued green bonds with CBI certification is Apple, which allocated $2.5 billion in under three years to its green bond issuance programme.

The success of any particular issuance is measured using a variety of quantitative ESG criteria, and the interest rate payable on the bond can be adjusted upwards or downwards depending on the extent of compliance with the relevant ESG targets. For example, Apple uses constructed square footage as the yardstick for its green building agenda, installed capacity and estimated energy generation for renewable energy projects, and waste volumes diverted from landfills for recycling targets.

ESG leaders unanimously agree that further regulation designed to promote ESG investing is on the horizon, including the eagerly-anticipated EU Sustainable Finance Action Plan. Such regulation will likely draw on the results of recent UN initiatives to develop a template regulatory policy framework for ESG investing and incorporate many of the recommendations made above, including policy measures designed to both mandate and at the same time facilitate integrated, verified ESG reporting by incentivising standardisation and accreditation at the ESG data provider, asset manager/investor and industry/reporting at the company level.

It is evident that ESG investment strategies will increasingly be adopted to identify risk, uncover opportunities and promote new ways of doing business. As ESG investing is embraced by the investor community, companies will hopefully respond accordingly to attract new pools of capital by following the aforementioned recommendations. A virtuous circle where these two communities feed off each other's ESG impetus is not too far away.

Freshfields has been appointed by the UN and the Generation Foundation to produce a global report exploring whether and how legal frameworks allow for investors to consider the sustainability impact across major markets. The report will be published in the second half of 2020 and will build on the 2005 sustainability report.

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