MOVING FROM CSR TO ESG REPORTING – WHERE TO START FOR THE GREATEST IMPACT?

The notion of corporate and social responsibility (CSR) has been around for years, its history is going back to environmental reporting. The first environmental reports were published in the late 1980s by companies in the chemical industry, which had serious image problems. Since then, many companies who wanted to attract new talent and build strong internal culture would publish CSR reports, featuring team-building races for the cure, volunteering in soup kitchens, planting trees and donating to the United Way on a mandatory basis. These reports were purely voluntary, the Boards paid little attention to them beyond the "good for you" attitude, and most certainly, none of this information was a meaningful part of regulatory documents filed with the SEC, such as S-1 and 10-K forms. Established corporate CSR practice was as important as "Other Accomplishments" section of an individual's resume, adding to the character of the company, but ultimately, not changing the fundamentals.

Thus, despite the concept of sustainable investment having been around for decades, it has grown in significance, popularity and scale only in the last couple of years. The actual meaning that now fills the term "sustainable company" has also changed and moral corporate portrait became of ***tangible*** significance to investors. Why has such an evolution taken place? What can companies do to clearly communicate their ESG practices, which now increasingly contribute to their market capitalization?

SHIFT THE CSR "GOOD TO HAVE" MINDSET TO THE ESG REPORTING "MUST HAVE" PRACTICE

Things are rapidly changing. CSR has evolved into ESG reporting and is now almost mandatory (and only a matter of time before it actually becomes required). The focus around ESG-conscious companies is increasing within the private and public investment community. Global sustainable investment now tops $30 trillion—up 1,000% percent since 2004 and 68% from only 5 years ago.[1] While there is no "right" way to deliver ESG reporting to the target audience, there remains much room for improvement for items that are lost in translation—such as the *what and how* information is communicated by the issuers—and *what and why* is sought by investors. Most of the ESG reports that we have reviewed, even from large cap / blue chip companies, carry amazing graphics and tons of great information, however, they still look like good ol' CSR reports, but now, with a new cover titled: "ESG report". There is a lot going on in these publications – certainly enough for a "Wow, great job!" comment, but certainly not enough to write a check from a pension fund. Why? Most reports, after going through the trouble of collecting loads of useful info, stop short of explaining "the last mile" impact on their financial performance!

WHAT INVESTORS ARE LOOKING FOR TODAY

Over the past decades numerous studies have shown that besides the simple do-good notions of sustainability, the companies that care about ESG, perform better operationally. They also tend to monitor and mitigate the risks that usually scare the bejesus out of investors in the SEC filings.

[1] *Global Sustainable Investment Review 2018,* Global Sustainable Investment Alliance, 2018, gsi-alliance.org.

Knowing that the management and Board of Directors are proactively monitoring key risk factors and have mitigation strategies, warrants a valuation premium for the added peace of mind to investors. A recent McKinsey article illustrating results of over 2,000 studies on the impact of ESG on equity returns, shows 63% positive correlation.[2] Therefore, investors that pursue ESG-focused strategies are enhancing their returns on the same financial fundamentals by simply selecting the companies that run their ship tight and tidy, with all other financial metrics being equal among the peers at a given moment in time.

Most investors, even if not specifically focused on sustainability in their mandates, assign some weight to ESG and ask, “So what?” while examining reporting components in sustainability reports. There are only a handful of companies in the world who truly understand how to communicate their ESG practices in the impactful way to the capital markets.

ENSURE VISIBILITY ON INVESTOR RADAR – HELP INVESTORS HELP YOU

While portfolio managers know how to find companies with good investment metrics through their experience and numerous smart software programs, scanning for companies with the magic ESG touch is not as easy (ratings agencies are not the answer for many portfolio managers). Why? Because most of the companies (even publicly traded ones) have not yet jumped on the reporting train. Out of 41,000 listed companies in the world, according to the latest OECD data from October 2019, only around 120 companies are delivering ESG reporting by SASB standards[2], 5,000 have used GRI for their reporting at least once[3], and a total of 785 organizations support TCFD reporting guidelines.[4] It is safe to conclude that this is still a very much unchartered, informal and unstructured practice for most public and private companies. However, while many issuers are in the elementary school getting through ABCs of ESG, investors are grading them at the post-college level. In order to compete for their dollars, companies are required to meet a high bar of ESG compliance.

This has put a lot of pressure on corporations, and their Boards, to rapidly get up to speed on sustainability – just take a look at recent push from BlackRock, State Street, Alliance Bernstein, Walden AM and Calvert WM, to name a few. While companies are happy to oblige, it seems as if many issuers got caught off guard on where to start, whose responsibility is it? IR departments are already stretched to the limit post MIFID II changes. Most importantly – what should companies report on first?

There are three steps that we recommend to those who are starting their ESG journey that should generate impactful results after reporting even minimal amounts to the capital markets audience.

MOVE FROM DO GOOD / FEEL GOOD REPORTING TO QUANTIFIABLE METRICS MATERIALLY AFFECTING CAPITALIZATON

[2] “*More than 100 companies using SASB standards*”, IR Magazine, December 12, 2019
[3] FBRH Consultants, “*GRI: the Gold Standard in CSR/ ESG/ SDG/ Sustainability Reporting*” (http://database.globalreporting.org/search, last updated in this article: May 2020)
[4] “*TCFD report finds encouraging progress on climate-related financial disclosure, but also need for further progress to consider financial risks*”, Financial Stability Board, 5 June, 2019

These steps are achievable in a short amount of time, delivering a high-quality, steep learning curve, so any issuer can secure its place on investors' radar even while its internal team is still getting up to speed in its ESG practices.

Understanding reporting standards. There are over half a dozen of reporting standards: TCFD, GRI, CDSB, CDP, SASB, UN SDGs, EU Guidelines, etc. Learning the difference between those and selecting one or two frameworks to follow should be the first step. For example:

- GRI has the broadest scope, it ensures that companies report with all stakeholders in mind, including customers and vendors of the business;
- TCFD is laser focused on climate change and corporate contribution to reducing the heat injected into the ecosystem of our Mother Earth;
- SASB is laser-focused on financially material issues for all capital markets participants; and
- UN SDGs focus on what each company contributes to a sustainable future of their country for future generations.

Therefore, the immediate choice is clear – zero in on the task at hand of delivering measurable information that easily addresses the, "So what?" questions of the investment community reading an ESG report. We believe SASB standards are the natural choice here.

1) Understanding Material Concepts. Determine what subjects are most material, most impactful for the core business and the industry. SASB has an easy to follow materiality map that each corporate can rely on and answer detailed questions that SASB put together with a great degree of help from prominent buy-side institutions. As issuers build out their ESG practices, they should add items of lower materiality to their reporting as well as other standards into their framework. Ultimately, all standards are highly complementary but SASB is the closest to home in addressing the investor community.

2) Clearly answering the "So What?" questions. The last, the quickest, and probably the most important remedy we suggest, regardless of the reporting subject, is to relate each particular topic to a financial statement item or a risk factor, and quantify the impact, if possible. This simple step will generate more eureka moments from investors, which currently have to spend time and extract meanings from lengthy ESG reports, converting them into quantitative elements for their financial models. Therefore, even if the issuer can't report on a myriad of items in a short time, the ones selected should have a meaningful impact for the buy-side and for the rating agencies.

The bottom line is – move away from good by inconsequential CSR, to an impactful ESG mindset. Regardless of the reporting maturity of corporate ESG practices, all capital markets participants, public and private, will appreciate corporations' ability to effectively connect the dots and demonstrate additional value their business model brings through the power of internal ESG practices. It is too easy for investors and the issuers to get lost in the enigma of an overwhelming landscape of ESG concepts, multiple standards, oceans of data and third-party ratings. While TCFD's emissions formulas look intimidating, let's keep in mind it is not a rocket science and simplicity always wins. Reporting on a few material items is much better than not reporting until the company gets fully up to speed on sustainability. “Taking proper account of investment returns requires that you start from the proper baseline. When it comes to ESG, a do-nothing approach is usually an eroding line, not a straight line.”[5] At the start of the impactful ESG reporting journey, all we are trying to say to investors is: “Hey, look at us. We know what keeps you up at night and here’s what we do to make the following things 15% better, every year...”

[5] “*Five ways that ESG creates value*”, McKinsey & Co, Nov, 14, 2019, by Tim Koller, a partner in McKinsey’s Stamford office, Robin Nuttall, a partner in the London office, and by Witold Henisz, a professor at the Wharton School of the University of Pennsylvania.