LAVAUX

# ESG In Focus

## About LAVAUX

We are a leading strategy, operations consulting and organizational transformation firm.

At the heart of everything we do is our unrelenting drive to peek into and make sense of the future.

We are strategists, management consultants and advisors — inspired by transforming clients' businesses so that they can reach escape velocity.

ESG is a three-pillar framework for assessing risk and opportunities related to sustainability and ethical impact of the business, and represents a stakeholder-centric approach of doing business. It encompasses a range of factors, from climate change to human rights, board diversity and governance practices.

Unlike the social responsibility investing (SRI) framework, which is based on elimination, ESG goes beyond simply excluding companies, by including the positive consideration of companies that have strong environmental, social and governance practices. Investors and consumers alike, are now demanding that companies be more socially responsible, and ethical in their practices.

A survey conducted by Morningstar found that 64% of public companies have a formal ESG strategy, 78% have identified strategic ESG issues, and 61% have set specific goals and/or key performance indicators (KPIs).

Shifts in public and corporate thinking about "stakeholder capitalism", led many corporate social responsibility (CSR) professionals to become focused on ESG issues that are relevant to their firms' operations, which may fall outside the remit of traditional CSR and sustainability.

The main influencers for ESG planning and strategy are: senior leadership (81%), followed by regulators (54%), clients and customers (53%), then institutional investors (46%). Respondents of various surveys reported that the least influential stakeholders are activist investors and finance and treasury departments.

In this guide, we explore how ESG can bring value to all stakeholders and examine the issue of ESG reporting, ESG score, and how ESG relates to the broader United Nations Sustainable Development Goals (SDGs), a globally accepted framework with clearly defined indicators and metadata.

## What is ESG and how is ESG different from SDGs?

ESG stands for Environmental, Social, and Governance. It's a criterion stakeholders use to check a company's performance on sustainability and ethical issues.

ESG factors are usually divided into three main categories:

- **Environmental:** Climate change, energy efficiency, waste management, and pollution
- **Social:** Human rights, labour practices, community engagement, and product safety
- **Governance:** Board diversity, executive compensation, and shareholder rights.

Despite recent efforts to reach a global standardisation framework, ESG still enables corporate greenwashing.

By contrast, SDGs set by the UN are a globally accepted framework with goal-oriented recommendations and unbiased assessment. The United Nations has clearly defined 17 global goals, 169 targets and 231 detailed indicators and accompanying metadata.

For full transparency, companies are advised to map their ESG impact areas to the SDGs to show not only how well they are managing the E, S and G risks, but also to what extent the company positively contributes to society.

## Investments and ESG

Today, ESG investments account for a third of global assets under management and are to exceed USD 50tr by 2025. In Australia, the total value of investments managed under the “responsible investment framework” reached AUD 1.5tr at the beginning of 2022.

Regulatory and consumer pressures on businesses with poor ESG performance are intensifying. Recently the International Sustainability Standards Board (ISSB) voted that scope 3 emissions should be part of a robust and truthful emissions reporting, which may now be mandated in the near future.

In matters of investing, we can apply ESG in various ways. The first strategy involves *ESG integration*, which identifies risks and implements policies that set and achieve ESG goals.

Other strategies include *exclusionary screening* (rejecting organisations that don't meet a specific standard), *inclusionary screening* (selecting companies that meet a certain standard) and *impact investing* (creating portfolios to enact positive, measurable social or environmental change).

Your company's ESG strategy can draw on elements of any of these strategies and tailor them to your unique timeline, challenges, opportunities, weaknesses, and strengths. The key here is to determine the ESG data and the technology requirements to acquire such data - especially in the case of forthcoming scope 3 inclusion in the reporting structure.

Currently in Australia, only 14% of companies have measured their Scope 3 emissions and 49% have disclosed “some” Scope 3 emissions. To be able to progress on this front, companies will need to rely on technologies and digital capabilities that can quickly assess the far-reaching impact of Scope 3 emissions.

By considering ESG factors in their decision-making, investors can identify companies that are better positioned for success. Most of them contribute to a more sustainable and equitable future.

ESG factors are important because they can help companies to manage risks and seize opportunities. For example, when considering Governance (G), companies that focus on diversity and inclusion are likely to have a more diverse and innovative workforce. But the notion of diversity should also include diversity of thought, competencies and opinions not merely gender and race.

Companies that focus on stakeholder engagement are more likely to build strong relationships with their customers, employees, and communities. This can lead to greater loyalty and brand value.

## Why an ESG Score?

An ESG score is a tool that investors and stakeholders use to assess a company's performance on ESG factors.

The score can be incorporated into the analysis. Investors can gain a clearer understanding of a company's ESG performance and they will make more informed investment decisions.

A high ESG score can be a key driver of value creation for all stakeholders. It signals to investors and customers a company's commitment to sustainability and ethical practices. This can lead to greater brand value, customer loyalty, and long-term financial performance.

Recent research studies by The Economist Group and PwC show that:

- Companies and investors are in alignment as far as ESG metrics are concerned with both seeing the E and S metrics more important than the G metrics.
- For 75% of main ESG metrics, a plurality of investors engage with Companies *directly* to assess performance against these metrics.
- Only 58% of the ESG metrics are published by more than half of corporate respondents.
- 75% of the ASX200 companies have a board member with climate competencies.

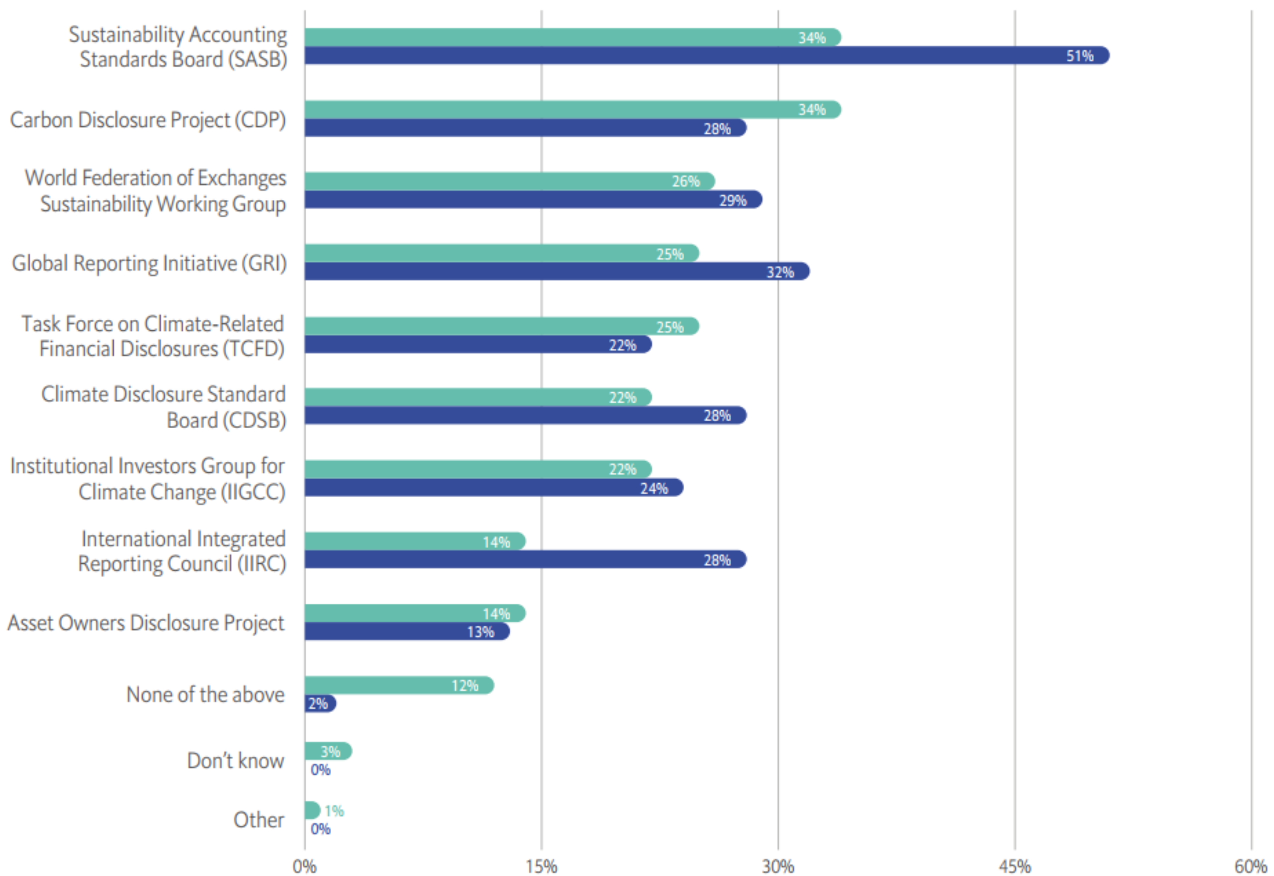
Until a global benchmark is published for all elements of ESG reporting, companies need to navigate a plethora of standards and frameworks. Among these, the most popular are:

- The Sustainability Accounting Standards Board (SASB) (now part of the IFRS Foundation)
- The Carbon Disclosure Project (CDP)
- The Global Reporting Initiative (GRI)
- The Taskforce on Climate-Related Financial Disclosures (TCFD)
- Institutional Investors Group for Climate Change (IIGCC)

There are of course differences among these standards. Moreover, a sizeable minority of 9% among UK and APAC companies say that they do not follow any framework. The US-based companies favour GRI and IIGCC while UK and APAC rely on SASB, CDP and GRI.

To help globalise the spirit of ESG principles, the International Sustainability Standards Board (ISSB) formed by the International Financial Reporting Standards (IFRS) Foundation, is coalescing various voluntary ESG frameworks into a single set of global disclosure standards.

Figure 1. Frameworks or guidelines companies follow in reporting the ESG.




*Source:* Economist Impact survey

UK ■ APAC ■

Between October 21, 2022 and November 3, 2022, The ISSB published, two updates:

- the Exposure Draft IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information (the "**Sustainability Standards**") and
- the Exposure Draft IFRS S2 Climate-related Disclosures (the "**Climate Standards**").

Furthermore, ISSB agreed for IERS S1 and IFRS S2 to be effective from January 2024, which means that companies would be able to collect sustainability disclosure information for the 2024 reporting cycle and publish reports in 2025.

The ISSB's focus on "significant" sustainability risks will prompt companies to consider the investors' financial materiality and company's impact materiality in their reporting.

Hence, the **"double materiality"** concept combines:

- the information on the economic value creation *for the benefit of investors* with,
- the information on company's impact on the broader economy, communities, and environment *for the benefit of all stakeholders* such as investors, local communities, employees, customers and suppliers.

## Value Creation

## For Investors

One of the key stakeholders in a business is an investor. As such, investors are looking for companies that pay attention to environmental, social and governance issues. They also use the data to inform ESG scores and ESG rating platforms.

Most recently it has been reported in the media that MSCI, which rates over 8,500 companies (14,000 issuers including subsidiaries) and more than 680,000 equity and fixed income securities globally, is planning to downgrade its triple-A ESG portfolio by the hundreds. According to their website, MSCI were the first ESG provider to assess companies based on industry materiality, dating back to 1999.

ESG is not only important for financial performance but also for creating value for all stakeholders. Companies are more likely to attract and keep customers, employees, and investors who share their values.

### For Employees

Employees are looking at the companies they work for to remain committed to making a positive impact on the world. They are engaged in social and environmental issues more than any other time in history and so, companies taking positive steps on the environment, social equity, and inclusive governance can lead to greater innovation and creativity.

### For Customers

Customers are looking for products and services that align with their values and have a positive impact on the world. Companies that are listening to their customers’ concerns are more likely to build strong relationships with them in the future and build brand loyalty. Before the Ukraine aggression by Russia, European buyers of LNG were demanding a greater transparency on sellers’ scope 1 and 2 emissions, insisting for clean LNG volumes.

### For Communities

Companies that focus on community engagement are more likely to build strong relationships with their stakeholders and understand their needs and concerns.

By focusing on social and environmental issues, companies are more likely to contribute to the well-being of the communities in which they operate.

In the future, significant effort will be required on behalf of certain companies to report Scope 3 emissions, a requirement present in the ISSB S2 document.

## ESG and SDGs

The United Nations Sustainability Development Goals (SDGs) are a set of 17 global goals adopted by the United Nations in 2015. They address some of the world's most pressing social, environmental, and economic challenges.

The SDGs provide a framework for governments, businesses, and other business stakeholders to work together to create a more sustainable and equitable world.

Here is a great example of how the Israeli company Enlight reported their progress as early as 2020 against the SDGs. What Enlight founders say about their business:

> *"At Enlight, doing business while doing good is very real and embedded in our work. We truly believe that there is a strong connection between the company's value beyond revenue and long-term success. While striving to be a gamechanger in the renewable energy revolution in Israel, we aim to integrate our strong ethical and environmental values into every process and to build a strong sustainability management system."*

Figure 2. Enlight's alignment of ESG with SDG.

| | Environmental Impact | Social Impact | Organizational Impact |
|---|---|---|---|
| Goals | 7, 11, 12, 13, 15 | 4, 8, 9, 10, 11, 13 | 8, 10 |
| Targets | Ensure universal access to affordable, reliable and modern energy services<br>Substantially increase the share of renewable energy in the global energy mix<br>Double the global rate of improvement in energy efficiency<br>Enhance international cooperation to facilitate access to clean energy research and technology, and promote investment in energy infrastructure and clean energy technology<br>Expand infrastructure and upgrade technology for supplying modern and sustainable energy services for all in developing countries<br>Integrate climate change measures into national policies, strategies and planning<br>Take urgent and significant action to reduce the degradation of natural habitats, halt the loss of biodiversity, and prevent the extinction of threatened species<br>Reduce the adverse per capita environmental impact of cities, including by paying special attention to air quality as well as municipal and other waste management<br>Promote public procurement practices that are sustainable and in accordance with national policies and priorities | Develop quality, reliable, sustainable and resilient infrastructure, including regional and transborder infrastructure, to support economic development and human well-being, with a focus on affordable and equitable access for all<br>Strengthen resilience and adaptive capacity to climate-related hazards and natural disasters in all countries<br>Promote development-oriented policies that support productive activities, decent job creation, entrepreneurship, creativity and innovation, and encourage the formalization and growth of micro-, small- and medium-sized enterprises<br>Improve education, awareness-raising and human and institutional capacity on climate change mitigation, adaptation, impact reduction and early warning<br>Support positive economic, social and environmental links between urban, peri-urban and rural areas by strengthening national and regional development planning<br>Empower and promote the social, economic and political inclusion of all, irrespective of age, sex, disability, race, ethnicity, origin, religion or economic or other status<br>Ensure that all learners acquire the knowledge and skills needed to promote sustainable development and lifestyles<br>Substantially reduce the proportion of youth not in employment, education or training | Achieve higher levels of economic productivity through diversification, technological upgrading and innovation, including through a focus on high-value added and labor-intensive sectors<br>Substantially reduce the proportion of youth not in employment, education or training<br>Empower and promote the social, economic and political inclusion of all, irrespective of age, sex, disability, race, ethnicity, origin, religion or economic or other status |

ESG issues are intertwined with the SDGs, as they provide a way for companies to contribute to the achievement of the SDGs. By prioritising ESG factors, companies can contribute to the achievement of the SDGs and create value for all stakeholders.

## Embracing ESG: A Win-Win Strategy for Companies and the Society

ESG is an important framework for assessing the sustainability and ethical impact of a business, and companies that have their strategic objectives aligned with ESG factors are more likely to have a positive impact.

This can lead to a *virtuous cycle of value creation* as it ultimately redefines the success in business — beyond wealth creation, toward making the world, its people and the planet, safer and better over the long term.

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