As Jim Cudahy, NIRI’s new president and CEO, crisscrossed the country to visit local chapters, we were struck by his opening remarks about how the digital disruption of the last decade has fundamentally changed the way companies create value. For example, the world’s largest taxi company owns no taxis (Uber) and the largest accommodation provider owns no real estate (Airbnb).

Jim’s observations prompted us to think about another fundamental shift in the creation of business value. This shift is also rapidly changing the way investors evaluate risks and opportunities across sectors. This long-term investment approach is increasingly becoming known as ESG (environmental, social, and governance) investment integration and value creation. We know you may be skeptical, but we challenge and encourage you to read on.

More investment professionals are taking a longer-term approach and are evaluating companies based on ESG criteria.

By Barb Brown and Mike Wallace

THE ESG DISRUPTION: DON’T BE LEFT BEHIND

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The age-old narrative around ESG is that investors don’t care, or that the “majority/mainstream/normal/non-activist/insert your qualifier” investors don’t care. Investor relations professionals are quick to point out that they don’t receive ESG questions during quarterly calls; rarely hear a question during roadshow presentations; never field calls about the topic; and on and on it goes. While these comments are true, there is more happening behind the scenes than most IR professionals realize, especially with regard to institutional investors.

According to the U.S. Social Investment Forum, “ESG incorporation” by institutional investors increased by more than 60 percent between 2012 and 2014. ESG incorporation is the systematic integration of ESG criteria into investment evaluations. Why does this matter? Because ESG incorporation is a passive strategy, meaning that analysts compile information based on publicly available data and create evaluations of your data. Because it is a passive strategy, it does not typically include direct engagement with a company. You may be completely unaware that your company is being evaluated on its ESG performance.

Those evaluating your progress include a wide range of investment research firms, such as MSCI, which have a suite of products and indexes focused about this topic. ESG-focused investors, or socially responsible investing (SRI) groups and funds, are not the only ones buying this data. All the major asset managers, those like BlackRock and Goldman Sachs, are buying this type of data as well. Firms like MSCI make reports available to issuers at no cost. Obtaining these reports is a good first step for IRs to understand how your company is being evaluated.

One of the main issues graded by these research firms is your company’s carbon footprint. At COP21, the recent global climate change negotiations, approximately 120 portfolio managers announced their signing of the Montreal Carbon Pledge and will begin disclosing the carbon footprint of their portfolios. This means that companies that are in carbon-intensive sectors, or are not disclosing carbon reduction targets, might find access to capital restricted. In our own review of the Fortune 25, only 56 percent of these companies are currently disclosing their climate risk. In the aftermath of COP21, we believe this kind of disclosure will become routine.

Beyond the increase in assets under management, investment professionals are using ESG data more frequently. According to a CFA Institute survey in June 2015, nearly 75 percent of respondents said they take ESG issues into consideration during the investment process. This research debunks several common myths and indicates that these investment professionals are seeking ESG data more frequently. According to a CFA Institute survey in June 2013, nearly 75 percent of respondents said they take ESG issues into consideration during the investment process. This research debunks several common myths and indicates that these investment professionals are seeking ESG data more frequently. According to a CFA Institute survey in June 2013, nearly 75 percent of respondents said they take ESG issues into consideration during the investment process. This research debunks several common myths and indicates that these investment professionals are seeking ESG products primarily to manage risk, as well as responding to rising client demand. The study also noted that exclusionary screening has declined in favor of the integration of ESG data. Publicly available data is the primary resource among those surveyed. This point is reinforced by investment research firms that cite the quality of public disclosures as an imperative to accurate analysis.

Many companies are leveraging their ESG disclosure to benefit from the rising tide of investor interest and activity. American Electric Power Company (AEP) has a strong commitment to public disclosure and recognizes the value with investors in two primary ways. Given its industry, AEP leverages the direct tie between environmental performance metrics and increased value delivered to shareholders. Sustainability information is included in investor roadshow presentations specifically for this purpose. Additionally, AEP has found annual reporting to be an excellent component for resolving shareholder proposals during proxy season. If, for example, an activist investor would like further information about ESG impacts, AEP has the ability to negotiate and consider additional disclosures in its next annual report that meet the investor’s request. This approach is helpful in persuading shareholders to withdraw proposals that seek more disclosure.

Are your biggest investors involved in the ESG space? Finding out is easy. Look at the signatories for the United Nations Principles for Responsible Investment and CDP (formerly the Carbon Disclosure Project). If you are a Fortune 500 company, you are likely
to see your largest investors on one or both of these lists.

Market Activities

In addition to the rising tide of investor activity, several market developments in 2015 have prompted new focus on investor interest in ESG issues. In October, the U.S. Department of Labor announced new guidance that clarified that pension funds governed by the Employee Retirement Income Security Act of 1974 (ERISA) may consider ESG factors when making investment decisions. This guidance rescinds previous guidelines issued in 2008 that discouraged this activity.

While many IR professionals may not welcome this new guidance based on fear of increased activism by these pension funds, these investors actually represent an opportunity for your company, should they decide to invest based on ESG performance. ERISA-governed retirement funds account for $8.4 trillion in assets and all seek long-term value creation over short-term payouts.

Investor ESG interest is also impacting our global stock exchanges. In November, the World Federation of Exchanges (WFE) presented a recommendation to its member exchanges about the implementation of sustainability guidance for listed companies. This guidance is optional for listed companies, but demand for information regarding sustainability prompted the project. The WFE’s Sustainability Working Group, formed in early 2014, created these guidelines following a nearly two-year effort to provide practical advice to member exchanges. Nasdaq chairs the group and its members include 25 exchanges from around the world, including IntercontinentalExchange/NYSE, Deutsche Borse, Shenzhen Stock Exchange, and the National Stock Exchange of India. The working group specified 33 indicators of material ESG significance for exchanges to consider when guiding listed-companies on preferred data to disclose.

“Understanding these metrics helps member exchanges engage with listed companies about the real and lasting business opportunities that ESG disclosure creates. And this guidance underscores the vital role that stock exchanges play as a trusted intermediary between issuers, shareholders, and regulators,” says Evan Harvey, director of corporate responsibility for Nasdaq.

While U.S. exchanges do not currently mandate ESG disclosure for listed companies, it is reasonable to assume that attention in the U.S. is increasing quickly. Moody’s announced in September 2015 that ESG factors are now included in credit analysis, and Standard & Poor’s closely followed the latest ESG developments in Paris during COP21.

In the United Kingdom, companies will need to comply with the Financial Reporting Council’s mandate for non-financial disclosure beginning this year. Companies with 500 or more employees in the European Union will need to report under similar guidelines beginning with financial year 2017. Although Europe has generally led the world in adopting ESG standards, the U.S. may not be far behind.

Going Long

In the age of short sellers and hedge fund activists, companies increasingly seek to attract and retain long-term investors. Many of the largest asset managers in the world are emphasizing the long-term focus that ESG investing provides. Long-term strategies demonstrate the need for effective environmental, social, and governance management. The world’s largest asset managers, such as BlackRock, expect company leadership to plan for the long term and disclose the associated strategies. These firms seek explanations of how companies are managing ESG risks and opportunities and notice problems

IR VIEWS ON SUSTAINABILITY

IN LATE JANUARY 2016, NIRI published a survey report about the views of IR professionals on sustainability. The survey was part of a joint research project with the Massachusetts Institute of Technology Sloan Management Review. This full report, “NIRI-MIT SMR Corporate Sustainability Communications Report – 2015,” can be found at www.niri.org/analytics. Here are a few key findings:

• Sixty-nine percent of non-U.S. based IR professionals said that sustainability issues are either “permanently” or “temporarily” on their top management’s agenda, as compared with 39 percent of U.S.-based IR respondents, a 30 percentage-point difference.

• Overall, IR professionals have very mixed views regarding whether a sustainability strategy is necessary to be competitive in their industry. For many sectors, only between 40 and 60 percent said they thought a sustainability strategy is necessary to be competitive.

• Interestingly, the topic IR professionals said companies communicate about the least (how sustainability aligns with corporate strategy, 18 percent), is also the item that investors most frequently want to know about (23 percent).

• The regular (more often than not) integration of sustainability talking points into investor presentations is not a common practice for any of the industries surveyed. IR professionals in the consumer goods sector are the most likely to do so, with 46 percent of respondents reporting they regularly include sustainability talking points in presentations.

• Sixty-nine percent of non-U.S. based IR professionals said they post company sustainability commitments/achievements on their corporate websites, while 58 percent of U.S.-based IR professionals do the same.

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stemming from an inarticulate vision or a strategy that opts for short-term gain over long-term prosperity.

Committing to enhanced ESG transparency practices can help attract long-term investors. As former SEC Chair Mary Schapiro said in November 2015, investors increasingly seek ESG information, but often do not obtain data of high enough quality to compare companies to each other or to make the most informed decisions. This lack of effective information is primarily due to the voluntary adherence to sustainability or ESG reporting frameworks. Nonetheless, these reporting frameworks are providing useful guidance to companies and are resulting in a growing body of non-financial data that is being analyzed by specialized research firms, asset managers and owners.

The most widely used approach for non-financial reporting is the Global Reporting Initiative (GRI). GRI – the nonprofit organization and its reporting framework – has been around for 20 years and has resulted in tens of thousands of corporate sustainability reports. Today, GRI reporting is written into national laws, integrated into exchange listing guidelines, requested by large asset owners and managers, and expected by large institutional customers, so even more disclosure will be coming.

This type of reporting has also led to the evolution of other non-profit reporting initiatives, such as the International Integrated Reporting Council (IIRC) and the Sustainability Accounting Standards Board (SASB).

The IIRC initially evolved as a means of helping to bring financial and non-financial reporting into closer alignment. The IIRC is a global coalition of regulators, investors, companies, standard setters, the accounting profession, and NGOs. The coalition is promoting communication about value creation as the next step in the evolution of corporate reporting.

SASB, where both Mary Schapiro and Michael Bloomberg (former New York mayor and founder of Bloomberg LP) serve as board members, is a nonprofit organization that issues industry-specific standards for use in disclosing material sustainability information in filings to the SEC. More than 2,800 individuals representing $23.4 trillion in assets under management and $11 trillion in market capital have participated in industry working groups informing standards development.

Nevertheless, even with these reporting frameworks, the current data provided by companies lacks uniformity and creates difficulties for investors. Often investment analysts may fill gaps with educated guesses based on the company’s profile and industry. These estimates may disadvantage some issuers, so IR professionals should proactively seek and understand their company’s ESG information. Broader integration of financial and ESG discussions, both internally and externally, may lead to greater appreciation regarding the inherent relationship of ESG and financial performance.

Leveraging Integrated Thinking

To demonstrate the kind of value that will attract long-term investors, your company may consider developing an approach to integrating ESG within its financial practices. While some refer to this practice as integrated reporting, the practices demonstrate a closer alignment with what we would call integrated thinking.

Novo Nordisk, a Danish pharmaceutical company, was one of the pioneers of integrated thinking and reporting. Through understanding the significant ESG issues of the company, the relationship of each issue with financial performance, and strong stakeholder engagement, Novo Nordisk created a foundation for integrated thinking. This foundation is based on strong cultural understanding and executive leadership support for integrated performance management and communication with shareholders. Other companies, mostly outside the U.S., have followed similar paths toward integrated reporting. In the U.S., some companies have created integrated reports, but do not adopt all of the necessary factors to demonstrate integrated thinking. The legal and regulatory pressure that American companies experience within the current business climate may feel too restrictive, but the long-term benefits of the integrated approach far outweigh the costs.

To determine whether you are prepared to develop your corporate practices around integrated thinking, consider several elements of your current practices. First, consider how your company currently views the relationship between return on investment (ROI) as it’s traditionally evaluated and how it is evaluated in terms of ESG. Companies that practice integrated thinking demonstrate a connection between value creation for shareholders and value creation for society. By doing so, these companies set a tone, both internally and externally, that the separate ROIs are equally important and inherently linked. The support and example set by executive leadership is crucial to achieving this tone.

After receiving support from leadership, the next step is to raise the discussion and execution of ESG risks and opportunities to the level of corporate strategy. Evaluations of non-financial factors provide additional context for financial metrics and your company’s continued ability to operate within its context. As much as possible, companies should strive to communicate the overlap of financial and non-financial metrics to shareholders and provide a richer analysis of corporate performance and risk mitigation across a wide range of issues.
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At the center of all integrated thinking is the teamwork required across divisions within your company. Your company’s IRO, CFO, chief sustainability officer, and risk management officer should all be in sync about the risks and opportunities across the broad spectrum of your business operations. By melding information to demonstrate accountability and value creation, all parties, including shareholders, will benefit from the strategic alignment of your operations and ESG impacts.

**Recommendations**

IR professionals and CFOs have a unique opportunity to understand investors’ concerns and expectations about the risks and opportunities associated with ESG performance and transparency. To manage these ESG concerns, you should consider these steps:

- Determine your investor base’s interest in ESG topics.
- Understand the key ESG topics your peers and customers are tracking, measuring, managing, and disclosing.
- Evaluate your company’s performance about ESG topics as compared to your peers and customers.
- Understand the existing reporting frameworks and the expectations for disclosure according to initiatives like GRI, IIRC, SASB, CDP, and others.
- Identify your company’s external transparency gaps and opportunities to receive acknowledgment for the ESG topics it is tracking, measuring, and managing.
- Gain strategic focus and prioritize the ESG topics your company should actively manage.
- Advance your company’s transparency opportunities to meet or exceed customer and investor expectations.
- Develop opportunities to integrate your approach to financial performance with ESG performance.
- Enhance internal discussions to include integrated thinking for financial and ESG performance.

By performing these important tasks, your company will be well-positioned to leverage the value of ESG management for bottom-line growth. Whether you agree or not, the ESG disruption is underway. Don’t be left behind.

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