ESG: Commerce or Compliance?

ESG is now a hot topic in many boardrooms. Far from being a new compliance burden, with the right approach sustainability and circular economy thinking can improve growth, operational efficiency and employee engagement and reduce risk and cost of capital. The key is to connect long-term benefits with near-term action to build stakeholder support.

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"Climate change has become a defining factor in companies' long-term prospects." Larry Fink, Blackrock, January 2020. Nevertheless, though there is huge economic upside, there are also many significant barriers to making the changes that are needed.

The voices of the status quo are much better funded than those of innovators

Industry structures inhibit change by de-linking upfront costs and benefits

Many believe it is safer to trust the devil they know, no matter what the risks

ESG has become a hot topic in most boardrooms. Five decades after the authors of Limits to Growth warned that the world economy would hit systems limits, the impact of unfettered short-termism on long-term economic performance must no longer be ignored. In his letter, Fink called for "A fundamental reshaping of finance", warning that a significant reallocation of capital was imminent, and advising that Blackrock was beginning to sell down some of its shareholdings.

Fink's message added to the US Business Roundtable statement in 2019 that the primary focus of a company should not only be to create long-term value for its shareholders, but also to [support] its customers, employees, suppliers and communities. Meanwhile, stakeholder activism continues to rise, creating material new risks for companies.

The mainstream economic and financial sands are shifting. Share prices of some coal, oil and gas companies have already underperformed terribly, whilst Tesla has become the most valuable listed car manufacturer. China is making its economy both more sustainable and more efficient through investments in renewable energy and high-speed rail, developing solar panel and wind turbine manufacturing, and advancing new technologies such as thorium-cycle nuclear power.

Recent cataclysmic Australia wildfires symbolize the economic and governance challenges now unfolding. The 10.7 million hectares destroyed – equivalent to over 80% of the land area of England – illustrate the extent and severity of the risks. Strident denials of science by governments and political leaders remind us that companies, boards and executive teams must also contend with national misinformation campaigns and outright political opposition.

This is a nightmare scenario for the private sector, which will inevitably bear much of the financial cost of our collective failure to act, making the words and actions of leading investors such Blackrock and companies such as Philips more important than ever.

The commercial pain for Australia's agricultural and tourism industries will likely be significant. Small-minded politics has had a big impact on bottom lines, not over decades but in a matter of days.

Identifying the sustainability challenge is one thing, but figuring out who should lead the changes, let alone where and how they can act in the most economically effective manner, is much harder. This is where both companies and investors must now focus. Happily, most of the underlying issues and the technologies required to address them are well understood, if you ask the right people.

For many, however, Fink's message is a jarring blow to the comfort of the economic status quo. To drive real change, therefore, we must acknowledge that the same factors that have inhibited better decision-making over the last fifty years continue to prevail.

First, the voices of the status quo are much louder and better financed than those of the innovators – large energy companies will continue to talk a green talk, whilst walking a much blacker walk, spending billions to delay the transition to renewable energy. Second, industrial and societal structures will themselves inhibit change – this happens where the benefits of greater cost efficiency accrue to one stakeholder, but the costs need to be born by another. Third, change itself is uncomfortable, with many in businesses favoring the devil they know rather than risking a shift to a new technology or business model.

Southern Ocean Lodge, Kangaroo Island

Sustainability frameworks will define both your methods and your focus

The key is to prioritize areas with the greatest commercial impact

A robust business case will be essential to establish stakeholder support

Metrics are important, but make sure you do not get lost in the detail

Investors should expect sustainability to drive improved business results

Effective communication is critical to securing recognition of results

These factors all underline the importance of industry-wide initiatives, whether driven by government or by industry-sector representative bodies. The challenges imposed by our closed ecosystem are shared amongst all industries and all nations, so now more than ever is the time for collaborative innovation.

Where do investors, board members and senior executives start? How do you identify where to focus, what data to gather, what initiatives to launch and how to judge their success? What type of business case do you need to build to justify the investment you propose to make, and how can you convince a host of stakeholders to trust that your plans are sufficiently rapid and rational?

Developing the right overall **sustainability framework** is critical. Your approach must hardwire sustainability to fundamental drivers of commercial success, by focusing first on factors such as top line growth, cost efficiency, commercial risks, capital optimization and employee engagement. You may focus purely on environmental issues or may address societal and governance too. Either way, your framework will influence where teams focus and the weight they give to different areas, so its design requires great care.

Next, you must **prioritize** areas that will have the largest impact. There is no point celebrating a switch to paper straws on a cruise-line if you still bunker the dirtiest fuel on the planet. This is one attraction of the SASB standards, which provide useful guidance on the financial materiality of different factors across most major industries.

For every initiative, a **robust business case** will be essential to establish stakeholder support and build momentum. This means ensuring financial rigor as you explore the links between top line business drivers, investment requirements and the wider stakeholder benefits from any particular initiative.

Metrics are important, but do not get lost in the detail. There are hundreds of codes, standards and methodologies to measure and assess sustainability and many more are under development. Take note that investors will place a considerable emphasis on the availability and reliability of data, as well as its comparability across companies. Whatever you use, results must still be translated back into traditional commercial performance metrics – with the right approach and mindset, in most cases you will find that impact and commercial agendas are well aligned.

Lastly, both you and your investors should expect sustainability to drive improved overall business results. As Paul Herman explains in *The HIP Investor*, better-managed companies can deliver better investment performance for lower risk (ie lower volatility of returns) consistently over time.

As investor pressure on boards and companies increases, do not treat the emerging ESG reporting standards as simply a new layer of compliance and cost for your business. Rather, emphasize building your understanding of how sustainability and circular economy thinking can drive better growth, greater operational efficiency, reduced risk, lower capital requirements and improved employee engagement, and make sure you communicate this effectively.

As you address these opportunities, never forget that too strong a focus on short-term profitability has been the downfall of many great companies. The decades-long failure to drive better environmental performance in the business sector does not reflect a failure to prioritize a green agenda over commercial analysis. Rather it is the commercial analysis which has failed to identify that relentless short-termism has undermined both growth and profitability whilst materially increasing risk.

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