

Slaughter and May Podcast

ESG and business strategy - Why corporate purpose is key to demonstrating authenticity

<p>Azadeh Nassiri</p>	<p>Hello and welcome to this Slaughter and May podcast. I am Azadeh Nassiri and I am a partner in the sustainable financing team. I am joined by Jeff Twentyman, corporate partner and head of sustainability.</p> <p>Jeff – From talking with many of our clients, it’s clear that ESG is at or near the top of the agenda for most organisations in the private sector and has been for some time. But there seems perhaps now to be more of a sense of urgency around aligning business strategy with sustainability goals.</p>
<p>Jeff Twentyman</p>	<p>That is right Azadeh, this is reflective of a rapidly changing stakeholder and investor dynamic. There’s both a push and a pull. Already in 2019 there was very much increased momentum to address the risks of climate change coming off the back of the IPCC report in 2018 calling for radical decarbonisation. Increasing consumer pressure and just much better and more widely known information, unignorable facts. That was the push if you like.</p> <p>On top of this investors and asset owners really upped their expectations of companies. The only really growing source of investable capital comes with some ESG preference or screening. And on top of this survey after survey of both before and during Covid have indicated that funds investing in corporates with a strong ESG focus have tended to perform better.</p>
<p>Azadeh Nassiri</p>	<p>Yes and it is no longer sufficient for businesses to just focus on earnings. Broader concepts that inform the value of a company - issues around climate, sustainability, remuneration, diversity and labour conditions, to name just a few - have the power to make or break a company’s reputation as well as impact its investment potential. As Mark Carney has recently said: “virtually every company and country, requires a new strategy.... forced by the dynamics of the crisis.” Any successful strategy will result in climate-related risks and opportunities becoming what he called “core determinants” of perceived asset and project value. And professionals have the information they need to consider the impact of a company or asset on the transition to net-zero and this becomes a natural way of judging value.</p>
<p>Jeff Twentyman</p>	<p>Yes, only a few weeks ago, Paul Polman, former Unilever CEO said "the myth you can't have economic growth if you also attack climate change has been turned upside down. If you want economic growth, you have to attack climate change." So yes rather a lot more momentum and urgency.</p>
<p>Azadeh Nassiri</p>	<p>The key question I suppose, for those companies that wish to present well on ESG, is how then can they ensure that these issues are at the heart of their strategy and are undertaken with a serious level of commitment? And then how can these strategies be communicated to stakeholders both within the business and externally?</p>

<p>Jeff Twentyman</p>	<p>Well the starting point has to be corporate purpose. The board must decide on what this corporate purpose will be –to my mind, purpose is now core. Why are you in business?</p> <p>As the British Academy defines it: Purpose means to produce profitable solutions to the problems of people and planet, and not to profit from producing problems for others, it has to be authentic, and it cannot simply be a mission statement without action.</p> <p>For me the sequence here is purpose and values; strategy that’s informed by those; strategic milestones; KPIs; incentives that support the purpose, values and strategy not just short term financial returns and only then does the reporting and transparency become the focus.</p>
<p>Azadeh Nassiri</p>	<p>I think that’s exactly right, there is now a widespread expectation that a company’s directors will engage clearly and transparently with all stakeholders and not just pay lip service to their company’s goals around whether it be environmental or sustainable matters or whatever else it might be. Directors should be aspiring to achieve social responsibility and shareholder value, but balancing the creation of long-term shareholder value with the delivery of value to all stakeholders as that’s now quite vital to a company’s reputation.</p> <p>And we have seen debt investors and shareholders more and more asking for tangible actions and steps. So for example, introducing longer time limits for executive incentives or making greater linkage between incentives and non-financial performance in line with the corporate purpose. There might also be a recalibration of the proportion of profits paid in dividends (or share buy-backs) and the amount reinvested in the business including to fund sustainable objectives that deliver long term value, whether that’s through opening up opportunities or building in greater resilience.</p>
<p>Jeff Twentyman</p>	<p>I agree, although those examples are more of the means of delivering strategy than strategy itself.</p> <p>Whatever strategy is devised to support the corporate purpose, it needs to be embraced by management to allow for its delivery throughout the business. Board level accountability is absolutely essential. Intermediate milestones or targets are essential (for example if you say you will be carbon neutral in 2050 but don’t have any milestones in the shorter term, no-one’s going to will take that seriously).</p> <p>And if it is part of strategy and not just efforts to mitigate negative effects of the business, then it will be front and centre on the board agenda and what the executive directors live and breathe (and indeed talk about). A business won’t become an ESG high performer with sceptics at its helm. Leadership is absolutely essential to achieving progress and to authenticity throughout the organisation.</p>

<p>Azadeh Nassiri</p>	<p>The trouble I suppose comes when corporates have to provide evidence of this commitment. There are of course frameworks and targets which can be helpful. For example, although there isn't currently a standardised international framework for ESG reporting, there are various indices and metrics against which a company can demonstrate its sustainable credentials.</p> <p>What will be relevant will of course depend on the corporate purpose and strategy a company has set for itself. So for example, an energy company may have ambitions to transition to cleaner energy and reduce emissions in line with the Paris Agreement. Measures for emission reductions that, for example, reflect the UK Government's Streamlined Energy and Carbon Reporting framework, could be included as part of the climate-related and environmental disclosures within the company's broader disclosure regime.</p> <p>Alternatively, a business wanting to improve diversity and social inequality might look to support its strategy by reference to the UN's Sustainable Development Goals, which as you know is part of the UN's Agenda for Sustainable Development, looking to address social inequality alongside climate action.</p>
<p>Jeff Twentyman</p>	<p>Many of the regulatory initiatives are aimed at encouraging capital allocation to sustainable investments. The economic paradigm of markets with perfect information is a myth. Investors struggle to obtain the information to allow them to choose to make sustainable investment decisions, whichever element of ESG they seek. So disclosure and transparency seeks to address this market failure.</p> <p>For example TCFD will be mandatory before long and arguably sooner than current expectations. This is a framework for disclosing climate risk and how it affects the business. There are also several pieces of EU legislation relating to non-financial reporting which currently apply to the UK, including the Non-Financial Reporting Directive (NFRD) which is in process of review and amendment, and things like the EU Taxonomy and the Low Carbon Benchmark Regulation will make a difference to what investors need, and therefore to what issuers will have to produce to satisfy those investor requirements. In contrast to TCFD, these will require disclosure of the impact that the business has on a sustainability. In other words it's known as the double materiality test.</p> <p>One of the challenges is that there are so many frameworks and data points for measuring environmental and sustainable performance, although the marketplace is now seeking to achieve some sense of common approach.</p> <p>Most recently there was a joint statement by five global framework-setting organisations calling for integrated reporting between financial accounting and sustainability disclosure and organisations like the GRI and SASB have also started a joint initiative.</p>

	<p>But a “one-size fits all” method of comparison could also risk losing the detail and value in what companies are actually seeking to do. You know companies are struggling with the range of different systems they want to adopt. In my opinion is that companies should approach this not as some burden of disclosure but as a real opportunity to identify for themselves what ESG characteristics and objectives are their own differentiators and use these positively to tell their story really well. Its better I think to have really high quality narrative on the things that matter.</p>
<p>Azadeh Nassiri</p>	<p>Completely agreed. And Jeff you mention the EU platform. Interestingly despite the lockdown, there has been momentum in the EU for developing a cohesive regime around some of the reporting requirements. So the Disclosure Regulation and Taxonomy Regulation, have come into force (although the operative provisions do not yet apply), and they seek to introduce comparability by the introduction of a common framework to describe and report on environmentally sustainable activities. How the EU system will apply to the UK once the Brexit transition period expires at the end of this year is of course another question, and it is not clear at this stage whether the regimes will align.</p>
<p>Jeff Twentyman</p>	<p>Yes. It awaits to be seen how this will operate post the end of transition but the direction of travel is clear and there will be little to gain in diverging from European standards in this area just when the market is beginning to coalesce around the EU platform of initiatives. That and many other things are still not clear from the Brexit transition period. But what is clear is that ESG is no longer a “nice to have” but an essential part of business strategy. It is a key area of focus for investors, who recognise the connection between sustainability and a return on investment, and it is also important to recognise that it can result in a beneficial cost of capital for the company.</p>
<p>Azadeh Nassiri</p>	<p>Absolutely and we’re seeing some correlation already between ESG performance and a reduction of the cost of capital using sustainable debt products.</p> <p>So people often use the term “green debt” or “sustainable debt” as an umbrella term for a very broad category of products which I think can be divided into 2 buckets: bucket 1 – products where the money raised has to be used for a specific ESG related purpose and bucket 2 – products which don’t have any specific ESG related restrictions around use of proceeds.</p> <p>In the first bucket we have tended to see green bonds, green loans, social bonds and sustainability bonds. In the case of green bonds and green loans we are really talking about bonds and loans where the proceeds are invested in green projects with appropriate green credentials. Social bonds where the proceeds are used for eligible social projects – and in the case of sustainability bonds, in terms of use of proceeds are really going to be around a mixture of eligible green projects and social projects. So very much focused on use of proceeds and therefore not necessarily available or useable by all businesses and organisations.</p>

	<p>In the second bucket we have sustainability-linked loans and bonds, here the proceeds don't have to be used for a specific purpose, but the key feature here is that the pricing is tied to the borrower's performance as against certain pre-determined green or other ESG related performance targets that they've set for themselves. So for example, the margin on an ESG linked loan will adjust if the borrower meets the set targets. And typically what we've seen for investment grade borrowers, the adjustment is around 2.5bps in either direction depending on whether or not the targets are met, so very much there can be a direct link between corporate purpose, strategy and the cost of debt capital.</p>
<p>Jeff Twentyman</p>	<p>It is not just debt either. If equity investors are seeking high ESG performers then this demand will tend to reduce the cost of equity to issuers who display these characteristics. And as we noted earlier, equity market performance appears also now to favour the issuers with inbuilt ESG attractions.</p> <p>So I think that many businesses now are seeing clearly that ESG sits at the core of what they do, it is no longer a marginal 'activity but an integral part of their business strategy.</p> <p>And for that strategy to work and make their business' value go up, it needs to be aligned and focus on tangible targets along with values and incentives designed to achieve them. There's no space for greenwash here.</p> <p>A sustainability strategy which dives into the detail and delivers real-world and concrete outputs will automatically lead to an increase in the value of the company. Because investors, either lenders or equity providers, are already more attracted to more resilient, more purposeful businesses and they are willing to pay extra for this.</p> <p>So to my mind the question about authenticity is not about disclosure, even if this is an important element of accountability, but it is about clarity of purpose and a determination to deliver it.</p>
<p>Azadeh Nassiri</p>	<p>I couldn't agree more. That brings us to the end of today's podcast. Thank you Jeff and thank you all for listening.</p> <p>If you would like to discuss your ESG strategy please feel free to contact us, myself Azadeh Nassiri, Jeff Twentyman or your usual Slaughter and May contact.</p> <p>Thank you and goodbye for now.</p>