

**Dr. S K Gupta**

MD – ICMAI Registered Valuers Organization

New Delhi

cbst.skgupta@gmail.com

LEVERAGING ESG FOR ENSURING SUSTAINABLE GROWTH

“It may well be in the long-run interest of a corporation,” the economist wrote a half-century ago, “to devote resources to providing amenities to [its] community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill or have other worthwhile effects.”

- Milton Friedman

The Perspective

It is increasingly recognized that ESG is a key consideration for businesses, one that goes beyond philanthropic considerations but is a major factor in the sustained development of companies. The structure and processes a company creates to oversee ESG issues will vary depending on a number of factors, such as the size and complexity of the company’s operations (including its supply chain and whether operations are international), its industry, the magnitude of the company’s ESG risks and opportunities, the degree to which ESG issues are central to the company’s strategy, and the level of director expertise regarding relevant ESG issues.

In business, the foundation of success lies in value creation. Value creation is the ability to increase the worth of something to meet a specific demand. This value distinguishes you from your competitors, retains loyal customers, and gives purpose to your brand and offerings. Regardless of size, value creation is essential for all businesses, and it entails offering goods and services that clients constantly find beneficial. By leveraging the long-term value creation metrics businesses can better demonstrate their contributions toward sustainable, long-term value creation across the full ESG strategy development process from vision definition to implementation.

ESG is the new normal

The ESG space has continued to develop rapidly, with amplified ESG awareness and expectations among investors, regulators, and consumers.

- **E**, environmental criteria, includes the energy a company takes in and the waste it discharges, the resources it needs, and the consequences for living beings as a result. Every company uses energy and resources; every company affects, and is affected by, the environment E also encompasses carbon emissions and climate change.
- **S**, social criteria, addresses the relationships the company has and the reputation it fosters with people and institutions in the communities where it does business. Every company operates within a broader, diverse society. S includes labor relations and diversity and inclusion.

- **G**, governance, is the internal system of practices, controls, and procedures a company adopts in order to govern itself, make effective decisions, comply with the law, and meet the needs of external stakeholders. Every company, which is itself a legal creation, requires governance.

ESG is more than ticking boxes. It's about making a difference - for your business and our world. Creating sustained outcomes that drive value and fuel growth, whilst strengthening our environment and societies. ESG is more than good intentions. It's about creating a tangible, practical plan that achieves real results. Success is not about climate change, diversity and disclosures alone. It's about embedding these principles- and more across your business- from investment to sustainable innovation. Just as ESG is an inextricable part of how you do business, its individual elements are themselves intertwined. For example, social criteria overlaps with environmental criteria and governance when companies seek to comply with environmental laws and broader concerns about sustainability.

ESG and Value creation

ESG is essentially rooted in the idea that an organisation's value lies in more than just the bottom line, and that its day-to-day operations have an effect on numerous stakeholders. In a nutshell, ESG factors pertain to everything to do with business that's *not* strictly numbers-related. ESG practices can help corporates become more resilient by getting them ready for the impact of emerging issues, and helping them maintain robust governance, risk management and controls. In addition, to build and retain trust among stakeholders in the current environment, it is imperative to ensure transparent and high-quality communication and reporting on ESG performance. Businesses of all shapes and sizes are looking for ways to include a wider range of ESG information and data into their decision-making. Some are simply seeking to properly quantify their broader carbon footprint for management and reporting. Others are trying to set ESG targets to drive their next wave of improvements. Thus, having a consistent, verified and standardized ESG data management system is important.



The ESG agenda has never been more important as it is recognized ESG issues can be financially material to businesses. ESG reporting is continuing to increase in importance for stakeholders including investors, creditors, central banks and regulators. To build trust with stakeholders, companies need to transparently report on the risks and issues with material financial implications



to the business. Instead of simply a range of ESG initiatives, stakeholders want to understand, from concise disclosures, which issues are of greatest risk or strategic significance to the company, how they are embedded into the core business activities, and whether there is strong executive leadership behind ESG efforts.

Driving Value in today's competitive landscape requires a fresh approach

Historically the main value drivers have been focused on increasing revenue and reducing costs. Whilst the fundamentals do not change, in the new world of sustainable investments, there is increased focus on ensuring that revenue and cost is managed in a way that has a positive impact on a wider set of stakeholders. An ESG strategy is no longer optional for listed companies. Consumers demand it from the products and services they purchase, investors require it in their portfolios, financing increasingly depends on it and employees want to work for a company that embraces it. There is value in this 'good' way of doing business. The value of focusing on ESG is two-fold: from investors and consumers, both closely intertwined.

Incorporating ESG metrics (environmental, social, and governance) into a business strategy can create value for key stakeholders by enhancing operational efficiency, reputation, and financial performance. It would help to acknowledge the ESG risks and opportunities relevant to your business. It requires a thorough assessment of your environmental impact, corporate social responsibility practices, and financial performance while remaining mindful of societal and environmental considerations. Pursuing the following ESG practices can help optimize the value of ESG initiatives:

1. Develop and communicate ESG policies

Developing a clear and explicit ESG policy that reflects the company's principles and integrates ESG goals into the overall business plan is crucial. One of the significant benefits of achieving high ESG performance is its positive influence on financial factors. Improved financial performance, reflected in accounting statements and stock returns, directly contributes to the firm's value calculation, resulting in higher shareholder value.

2. Reduce environmental impact

Companies must reduce their environmental footprint by adopting energy-efficient practices, minimizing waste, and lowering carbon emissions.

3. Foster diversity and inclusion

Encouraging diversity and inclusivity within the workplace holds numerous advantages, such as boosting employee morale, promoting innovation, using human resources, and reducing staff turnover.

4. Engage in socially responsible practices

Businesses must prioritize socially responsible practices, like ethical sourcing and fair labour standards, to succeed in today's society. Participating in community development can create a positive impact and enhance brand perception. Incorporating social and governance ESG principles into a business or corporate strategy can lead to shared value for both companies and society.

The question is no longer "if" but "how" active engagement around ESG drives value

A key tool for an effective implementation of ESG is Value Based Management (VBM), which focuses all organizational processes on a single goal: the creation of sustainable and long-term value.



VBM allows for a 360° look at an organization, its peers, and the environment, thus facilitating the defining of strategy, guidance of key processes and activities, and delineation of metrics that are truly aligned with the creation of long-term value for all parties involved, and therefore shareholders as well. For value to be extracted from ESG initiatives a company should do more than simply add some ESG credentials and statements to its website, annual report, or prospectus. Today's businesses need to prove they are measuring authentic sustainability and social impact, with genuine, continuous improvement.

Many companies still think of ESG as year-over-year reporting metrics. Those that succeed long into the future, however, will be the ones that recognize the permanence of ESG and lay the foundations for resilient value creation in this new reality. They must then be able to clearly articulate the ESG impact of their activities and provide proof of its material value. Once corporates take these steps and the markets accept them, they will be positioned to take full advantage of the opportunity. ESG is a matter of value, not values, addressing material ESG issues is good business practice and essential to a company's long-term financial performance.

In a recent publication by Deloitte ("Does ESG impact company valuations? An Australian perspective", April 2022), in relation to the Australian market, Deloitte analysis of companies in the ASX200 (as a proxy for the Australian listed market) over a three-year period from 2019 through 2021, has highlighted the following key insights:

- There is a 'size effect'. Larger companies have better ESG ratings, despite similar reporting scope coverage.
- There seems to be a reasonable positive correlation between total shareholder returns (TSR) and improvements in ESG scores over a three-year horizon. This holds for excess (industry-adjusted) as well as absolute TSR.
- Improvements in ESG scores also correlate positively with improvements in valuations multiples (EV/EBITDA, EV/Revenue and P/E) over this horizon.

ESG is not a trade-off, but an increasingly important part of creating sustainable long term value. We believe that now, more than ever, embedding environmental and social responsibility into our operating practices, investment processes and value creation initiatives will help us to capitalise on the opportunities of the next decade. Investing in ESG not only impacts your business's current operations — it can also support long-term health. ESG practices can change the way you evolve and innovate, helping you manage market demands and build resiliency.

ESG implementation Concerns

The ESG ecosystem is evolving, including issuers and investors who disclose and use information related to environmental, social and governance issues. Financial intermediaries, as well as government and international organization institutions are influencing the emerging practices in ESG investing. While constructive and inclusive progress has been made to develop ESG practices by several ESG players, it has generated the spread of a wide array of investment terminology, and disclosure frameworks which resulted in metric inconsistencies and lack of comparability for investors.

In this regard, while ESG methodologies are improving and becoming more transparent, scoring remains in a state of transition, with some rating providers still in the way of refining their methodology through the inclusion of factors such as materiality. There is a range of scoring methodologies in terms of determining which data to analyze and include, metrics weighting, materiality and how



to consider missing information. Moreover, subjective judgment is layered particularly regarding absolute and relative scores within and across industries.

Even though progress has been made, a crucial point remains on the alignment with materiality factors. Different institutions, such as SASB and GRI among others, are focusing on the assessment of materiality that is applied to different industries to determine the importance of each factor in the final ESG rating. This can depend on the business model, the external environment and the industry itself. The different materiality approaches have been influential in shaping the choice of key metrics used by the providers, but the discussion remains on the perspective on which metric is material.

Conclusion

Companies focused on ESG opportunities and sustainability goals are better prepared to weather storms that occur in the market, in the environment or in the community. Investing in a robust ESG program in which a company identifies material risks and opportunities and sets forth a plan of action is a key component of maintaining and growing enterprise value. Companies will see the benefits throughout their organizations and with key stakeholders, as ESG drives value, mitigates risk and engages stakeholders. The only way to outperform in this new era will be for companies to make material ESG issues central to their strategy and operations, to go above and beyond their competitors, and then to measure and communicate their superior performance. Integrating ESG into the fabric of scaling companies requires a thoughtful and strategic approach. By embracing ESG practices, companies can position themselves as responsible and sustainable organizations while driving positive change in the world. While navigating the road to integrating ESG concepts into daily management and internal and external reporting may seem daunting, the benefits of doing so are worth the effort. Global society faces enormous challenges. But if companies are bold and strategic with their ESG activities, they will be rewarded.

Strong ESG performance is a sign of a strong business

References

- *Basel Committee on Banking Supervision (2021): Principles for the effective management and supervision of climate-related financial risks, November.*
- *Bolton, P and M Kacperczyk (2021): "Global pricing of carbon-transition risk", NBER Working Papers, no 28510, February.*
- *Derwall, J., Koedijk, K., & Ter Horst, J. (2011). A tale of values-driven and profit-seeking social investors. Journal of Banking & Finance, 35(8), 2137-2147.*
- *Giese et al., "Which ESG Issues Mattered Most? Defining Event and Erosion Risks," MSCI, June 2020.*
- *George Serafeim and Aaron Yoon. "Does positive ESG news help a company's stock price?" Kellogg Insight, August 2, 2021*
- *Neilan, J, P Reilly and G Fitzpatrick (2020): "Time to rethink the S in ESG", Harvard Law School Forum on Corporate Governance*
- *Pedersen, L, S Fitzgibbons and L Pomorski (2021): "Responsible investing: the ESG efficient frontier", Journal of Financial Economics, vol 142, no 2, November, pp 57297.*
- *Tensie Whelan. "Monetizing the Return on Sustainability Investment (ROSI)." NYU Stern Center for Sustainable Business, 2022.*