Getting on the right track:

How to demonstrate the value of sustainable business to investors

CORPORATE CITIZENSHIP
Sustainability, simplified

Contents

S&P Dow Jones Indices

An S&P Global Division

This research was undertaken by Corporate Citizenship, the report was created in association with S&P Dow Jones Indices. The views expressed here are those of Corporate Citizenship alone. We are grateful for the input from Martina Macpherson, Global Head of Sustainability Indices at S&P Dow Jones Indices into this project, as well as to all the other interviewees who gave up their time to speak to us:

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Foreword

I am a saver. I am a 58-year-old saver. My interest is in the long term. No surprise about that. After all, the most common age of death for men in the UK is 86 (and rising). I have a long retirement to finance.

Just reading the financial media shows how attention concentrates on the short term and immediate. Seemingly the investment community is not as fixated on long-term returns as I am. Recently, though, there are signs that this is changing. Investor interest in, and modelling of, the relation between non-financial data and long-term commercial success is blossoming.

This growth of interest is less evident amongst the community of sustainability professionals, the guardians and generators of much of the non-financial data. Having worked in sustainability for 25 years, I have long found the sustainability profession's indifference towards the investor puzzling. Many corporate sustainability strategies have much to say about the multiple stakeholders who do not own the company but hardly anything to say to those who do.

This is not satisfactory. It is not, in any sense of the word, sustainable.

This document is the first-fruit of Corporate Citizenship's Long-Term Value Project. We want to identify better ways for companies, and particularly sustainability professionals, to find common ground with their investors. This paper proposes an initial framework for starting the dialogue. We want to hear from companies, investors and other interested parties. What's worked? What's still left to do? Please get in touch and let us know your views on the Project.

Our purpose is to help close the gaps in the investment value chain and help more companies to speed up their sustainability journey. It's surely the best way to align the power and influence of finance in today's markets with our shared vision for a more sustainable world.

Peter Truesdale OBE
Director, Corporate Citizenship

Key definitions

CR and CR teams
Companies use a range of terms to describe corporate responsibility (CR) – in other words, their approaches to managing the social, environmental, economic and ethical issues that make up a business' relationships with stakeholders and society. Other ways companies describe CR include: responsible and sustainable business practices, corporate sustainability, corporate citizenship and corporate social responsibility (CSR).

By 'CR team' we refer to the primary organizational function and team within a business that is responsible for managing these issues and stakeholder relationships, which in turn mitigates operational and reputational risk, fosters trust and creates value for the company in the long term.

IR and IR teams
Investor relations (IR) is the communication of information and insight between a company and the investment community. This process enables a full appreciation of the company's business activities, strategy and prospects, and allows the market to make an informed judgement about the fair value and appropriate ownership of a company.[1]

By 'IR team' we refer to the primary organizational function and team within listed companies that is assigned strategic management responsibility – integrating finance, communication, marketing and securities law compliance – to enable the most effective two-way communication between a company, the financial community and other constituencies.[2]

Long term value
Businesses and investors have different perspectives on what long term value means for them.

For business, it is about making investment decisions based on responsible and sustainable operational processes and policies over a 5+ year time horizon.

For investors, it refers to investment portfolio decision making from a future oriented perspective. This may include a commitment to long term ownership and the ongoing stewardship of equity investments, which can ensure a continued focus on sustainable value creation.

ESG
The term environmental, social and governance (ESG) often means different things to different stakeholders.

For business, it refers to a set of issues, risks and opportunities that is ever-changing as a result of shifting business strategy and geopolitical, environmental and demographic trends, including but not limited to:

- Environmental: climate change, greenhouse gas (GHG) emissions, resource depletion, including water, waste and pollution, deforestation.
- Social: working conditions, including slavery and child labour, local communities, including indigenous communities, health and safety, employee relations and diversity.
- Governance: executive pay, bribery and corruption, political lobbying and donations, board diversity and structure, tax strategy.[3]

For investors, it can refer to a set of environmental, social and governance issues. It can also be shorthand for responsible investment, which is an approach to investing that aims to incorporate ESG factors into investment decisions, to better manage risk and generate sustainable, long term returns.

Materiality
Materiality is a principle used in decision making to define whether an aspect or issue is sufficiently important to warrant attention by the business. Material ESG issues are the economic, environmental, social, ethical and governance issues critically important to both a company's stakeholders and its long term business success. The materiality assessment process galvanizes companies to prioritize action on risks and opportunities of greatest importance to their business and stakeholders.

Investors
In this paper we refer to investors as a wide group of actors that can be institutional or individual investors, asset owners, asset managers who invest capital into a company in exchange for a share of ownership in the company.[4]

Companies
This paper primarily focuses on companies with publicly traded shares, but some findings and recommendations are also relevant to privately-owned companies.

[1] IR Society: Definition of Investor Relations < http://www.irs.org.uk/about/definition-of-investor-relations>
[2] National Investor Relations Institute: Definition of Investor Relations < https://www.niri.org/about-niri>
[3] PRI: What is Responsible Investing <https://www.unpri.org/about/what-is-responsible-investment>
[4] Ibid.

Introduction: a challenging but changing landscape

Corporate responsibility (CR) has grown at a rapid pace in the past two decades. More companies are taking action and reporting on their social, environmental and economic performance. Investors are also beginning to pay increasing attention to environmental, social and governance (ESG) issues. But there is a disconnect: CR professionals are often unaware of how the ESG information they disclose is used by their investors, what kind of ESG information investors are actually looking for and ultimately which ESG factors they then incorporate into their decision-making processes. This misalignment is hindering both investor engagement with long-term value creation and the integration of CR issues into corporate strategy.

Corporate Citizenship has launched the Long-Term Value Project to diagnose and find solutions to address challenges linked to long term value creation and gaps in the corporate and investment value chain. This follows recent initiatives such as 'Focusing Capital on the Long Term' (FCLT), which was launched by Canada Pension Plan Investment Board (CPPIB) and McKinsey & Company in 2013 and is supported by S&P Dow Jones Indices. At Corporate Citizenship, we want to help bridge the gaps in the investment value chain and better align CR with investor relations (IR) internally to enhance the conversations of companies with investors externally.

To explore this issue, we conducted a detailed review of existing studies, undertook our own desk research and engaged in a series of interviews with key thought leaders and investor stakeholders.

Our findings shed light on three main reasons why the current model isn't working:

1. ***Tyranny of the short term*** **–** traditionally, investors and corporates have short-term horizons and are too focused on a narrow number of financial items.
2. ***Catch 22 of sustainable investing*** – companies and investors are deadlocked. Most companies provide inadequate ESG information for investors to use in their investment decisions, preventing investors from asking targeted questions on these issues. The role of ESG research houses and ratings schemes has not yet led to dramatic transparency in this area.
3. ***Companies treat investors as one group*** – relatively few companies identify their investors as being a varied group. Each investor will have different needs and interests, as well as time horizons and motivations for investing.

The future of responsible and sustainable business lies in a closer alignment between CR and IR. By working together on the issues that matter, focusing performance and measurement where it makes the most difference, we can align around a shared set of goals that create genuine, sustainable value for all stakeholders. This report outlines our initial research findings and recommendations. It aims to provide practical guidance for CR and IR teams on how to better demonstrate ESG performance to investor audiences.

We intend to further strengthen this work through our ongoing programme of engagement as part of the Long-Term Value Project.

Tyranny of the short term

One of the most frequent complaints that we hear from our clients – corporate responsibility professionals within large companies – is a preoccupation with the short term. Traditionally, most quarterly earnings reports (one of the primary investor interfaces) focus on tangible financial items such as net income or earnings per share. This is what drives much of the corporate machine in a quarterly cycle of short-term performance monitoring and reporting. Consequently, companies often forgo longer-term value-creating investments in favor of short-term results in the belief that this is in the best interests of their shareholders.

This means that elements such as strategy, ESG factors and a company's ability to deliver long term value creation are often relegated to an afterthought. Whilst many annual reports to shareholders have paragraphs and even whole chapters on these issues, they rarely feature in the quarterly cycle. *Why?* Because strategic thinking about the big opportunities and risks for business and about the changing context of society, are inherently longer term in nature. The resulting behavioural norms have led to a deadlock: companies do not give due consideration to social and environmental trends in investor communications. But changes are afoot.

International stock exchanges are becoming more interventionist to address the short-termism of market participants. For instance, many are now mandating the inclusion of ESG factors in listed company reports. The pioneer was the Johannesburg Stock Exchange, which stated a requirement for integrated reports, incorporating environmental and social performance alongside financial performance. The establishment of the UN Sustainable Stock Exchange initiative and the Sustainability Working Group of the World Federation of Exchanges have helped to maintain international momentum on enhancing corporate disclosure and transparency. As ESG factors tend to have long term implications for company performance, their inclusion in mainstream investor communications helps to further shift the time horizons of both companies and investors.

'Elements such as strategy, ESG factors and a company's ability to deliver long term value creation are often relegated to an afterthought... The resulting behavioural norms have led to a deadlock: companies do not give due consideration to social and environmental trends in investor communications. But changes are afoot.'

[5] In September 2016, the project has rebranded as a non-profit organization called 'FCLT Global'. The organization aims to develop practical solutions and educational resources to drive long term value creation and economic growth.

The catch 22 of sustainable investing

Investors talk of information asymmetries regarding the availability of quality ESG information, while corporates cite a general lack of interest from their investment community on ESG issues and an absence of questions related to ESG factors coming from their investors. As a result, they do not see a need to provide such information. The evolving investor landscape is, however, helping to create a virtuous cycle of sustainable investment approaches and focusing corporates on long term value creation.

In response to heightened investor demand for transparency on ESG issues, Morningstar has rolled out a new sustainability rating scheme across 20,000 retail funds globally, giving investors the opportunity to evaluate their investments based on ESG factors. Investor and corporate coalitions are also beginning to create greater certainty in the demand and supply of ESG information. However, the sheer number and varying objectives of these coalitions has also led to more confusion in relation to material ESG issues, their weight and their impact.

The Investment Leaders Group facilitated by the Cambridge Institute for Sustainability Leadership aims to advance responsible investment through implementing recommendations it makes among the member investment firms. Meanwhile, the We Mean Business Coalition encourages member companies, currently at 450 at the time of writing, to commit to initiatives that will help in a transition to a low-carbon economy. This puts pressure on corporates to report on their new ESG commitments, in turn providing greater quality and consistency of ESG information.

Investable indices that are weighted in favour of long term and ESG focused corporate strategies are also on the rise. Earlier in 2016, S&P Dow Jones Indices (S&P DJI), one of the world's leading index providers, launched the S&P Long term Value Creation (LTVC) Global Index.

An in-depth look at Long-Term Value Creation through an Index Approach: S&P Long-Term Value Creation (LTVC) Global Index

S&P DJI worked with CPPIB to create an index reflecting the advantages of 'long-termism' in liquid equities as defined in the 'Focusing capital on the long term' project.[6]

The LTVC Index uses a unique 'vintage' approach to constituent management. It selects constituent stocks annually to create a 'vintage', based on a combined S&P Financial Quality score for business viability assessed over a three-year rolling period – reflecting a longer-term holding philosophy– and a RobecoSAM's Economic Dimension score on operational excellence:

The Index selects the top 50% of stocks based on a combined S&P Quality Score, which assesses:

- Profitability Generation
- Earnings Quality
- Financial Robustness

It then combines this RobecoSAM Economic Dimension Score from the Corporate Sustainability Assessment, which assesses:

- Corporate Governance
- Risk & Crisis Management
- Supply Chain Management
- Tax Strategy

Constituents are weighted by their combined Financial Quality and Economic Dimension scores.

The index aims to 'engage companies on the issue of long-termism in order to motivate them to improve disclosure on their sources of LTVC.'[7]

Two large institutional investors in the form of the Canada Pension Plan Investment Board and GIC Singapore have already invested US$2 billion in the Index.

[6] See also CPPIB's Initiative 'Focusing Capital on the Long Term', 2013: http://www.fclt.org/en/theinitiative.html
[7] Tang, K . and Greenwald, C. (2016) Long termism: Index Impossible? <https://us.spindices.com/documents/research/research-long termism-index-impossible.pdf?force_download=true.>

Companies treat investors as one group

Investors, like companies, come in all shapes and sizes – and 'shades of green and grey'. Corporates should differentiate between investors that are more short-termist and speculative in their equity investments and the many others who adopt a long term perspective. GE, for example, specifically calls out the need to take into account a range of different shareholder requirements in its Annual Report:

'For every company, there is a fine line between staying the course and listening to new voices; between short term and long term. GE is a 138-yearold company. Frequently, our investors hold our stock for only an hour, six months, three years. They are important, but can't be the only voice. Not because these investors ask for too much, but because they ask for too little.'

GE Annual Report and Accounts 2015

Most institutional investors such as pension funds, insurance companies and sovereign wealth funds are well placed to look at longer-term investment horizons, as they are by their nature patient capital.

DJSI data goes mainstream

From September 2016, ESG data (percentiles) from the DJSI questionnaire will be available within the Bloomberg Terminal. This added functionality means that anyone with access to the terminal will eventually be able to view the percentile ranking for 20-odd criteria – ranging from corporate governance and supply chain management to eco-efficiency and human capital development – of over 2,000 individual companies. This will empower investors to be far more targeted in their questions to companies on ESG issues. RobecoSAM states that one of the benefits will be that 'Investor Relations teams can now answer questions about the company's "DJSI Score" when speaking to analysts and investors'. For some IR teams, mainstream investors becoming well versed in a company's ESG performance relative to its peers and asking about individual DJSI scores might come as quite a shock.

Unilever conducted a survey in March 2016[8] of the investment community to gain an 'understanding of views on investment horizons, quarterly reporting and sustainability as a driver of long term value creation.' Of those that responded, 70% indicated that they typically held equities for more than three years and, on balance, investment time horizons were found to be increasing.

[8] Unilever (2016) Investor Survey <https://www.unilever.com/Images/investor-survey-march-2016_tcm244-480293_en.pdf>

High-profile executives from investment management firms are even laying down the gauntlet for corporations to focus on the long term. In 2016, Larry Fink, CEO of BlackRock, wrote a letter to fellow CEOs to think more long term and take into account wider macro-economic trends and ESG factors – instead of emphasizing quarterly targets. Asset managers Schroders and Legal & General Investment Management have also written to FTSE 350 firms asking them to discontinue quarterly reporting if they do not think it is right for their business.

This is not just rhetoric, but has also resulted in practical action on these issues. BlackRock, for instance, has revised its proxy guidelines to highlight that it expects board members to protect shareholders against short-term thinking. So, far from being a standardized group, disinterested in ESG performance, there are pockets – often powerful pockets – of the investment community with a growing interest in long term value creation.

The key questions companies should ask themselves:

1. Who are the company's largest investors?
2. What type of investors does the business want to attract and keep?
3. Has the business engaged with key investors to understand what ESG information they require, and how they use it?[9]
4. Does the business understand the risks of not disclosing material ESG information to investors and grasp the opportunity for leadership and differentiation?

[9] Sustainable Stock Exchanges Initiative: Model Guidance on Reporting ESG Information to Investors < http://www.sseinitiative.org/wp-content/uploads/2015/09/SSE-Model-Guidance-on-Reporting-ESG.pdf>

Company reporting on long term value creation

Corporate Citizenship undertook research into the reporting practices of some of the world's largest companies.[10] The aim of the research was to surface whether companies were currently articulating the concept of long term value creation, i.e. combining core financial indicators with future-focussed economic and ESG factors, and identify where this took place.

US

Apple
Alphabet
Microsoft
Exxon Mobil
Berkshire Hathaway
Amazon
Facebook
Johnson & Johnson
General Electric
AT&T

UK

Royal Dutch Shell
HSBC Holdings
British American Tobacco
BP
GlaxoSmithKline
SABMiller
Vodafone Group
AstraZeneca
Diageo
Reckitt Benckiser Group

Eurozone

Anheuser-Busch InBev
NovoNordisk
Unilever
Total
Sanofi
Medtronic
Inditex
L'Oreal
SAP
Bayer AG

Singapore

SingTel
DBS
Wilmar International
United Overseas Bank
CapitalLand Mall Trust
OCBC Bank
Ascendas Real Estate Investment Trust
CapitaLand Limited
ComfortDelGro Corporation Limited
Jardine Cycle & Carriage

Chile

Empresas Copec
S.A.C.I Falabella
LATAM Airlines Group
Cencosud
Banco Santander-Chile
Empresa Nacional de Electricidad
Itau Corpbanca
Empresas CMPC
Enersis Chile
Banco De Chile

[10] We chose the top ten listed companies by market capitalization in July 2016 in the regions we covered in our research.

Company reporting on long term value creation

Methodology

We reviewed the main reports available to shareholder audiences, including: the annual report, investor presentations, and the sustainability/CR report.[11] As well as organizations in the US and UK, we also reviewed the largest companies in the Eurozone, Singapore and Chile.

We allowed companies to self-identify as being integrated reporters. This does not necessarily mean they adhere to the Integrated Reporting framework,[12] hence it will also cover where a company simply includes sustainability data along with financial data, rather than effectively embedding sustainability into the wider business strategy.

Key stats

From all the countries examined, the

UK's top ten companies

by market cap had the greatest number of relevant mentions of 'long term value'.[13]

26%

of all companies analysed had no relevant mentions of long term value.[14]

100%

of integrated reports examined included a relevant mention of the concept of long term value creation.

Counting up long term

The research was based on a simple methodology of counting up the total number of mentions of 'long term' in the context of value creation. We started with a count of overall 'long term' mentions in the report. For each mention, we analysed whether this was in relation to value creation (whether for investors, other stakeholders or society, or the environment more generally). For example, 'long term sustainable value for our shareholders' would have been included but 'long term debt financing plans' would not. The aim was to provide a high-level snapshot of how widespread the use of terminology about long term value is in reporting today.

Key findings

1. **Few companies report on long term value creation today.** We found a low overall count of relevant mentions of long term value creation. Even when mentioned, it is often skin deep and only in relation to fiduciary duty to investors – other stakeholders and wider society are rarely referenced.

   However, in the US, Johnson & Johnson has one of the clearest articulations of a concept of long term valuation, with all the relevant mentions taking place in the Chairman's foreword. The foreword outlines a set of company objectives on how it intends to manage for long term value. This includes a discussion of 'disciplined capital allocation' as well as collaboration with its partners to improve 'social, environmental and economic impact and influence'.

[11] We reviewed the most detailed report we could find in the last two years.
[12] As defined by the International Integrated Reporting Council (IIRC)
[13] The UK had 39 mentions, while Chile's leading companies had the fewest mentions with only six. (UK: 39, EU: 36, Singapore: 30, US: 26, Chile: 6).
[14] Out of 50 in total across five geographies, 13 had zero relevant mentions of long-term value in any of their reporting.

2. Key performance indicators (KPIs) are often missing. Where long term value creation is mentioned, KPIs are rarely linked to the accompanying strategy. One notable exception is Diageo, the UK drinks company, which measures progress against its long term business strategy according to a series of financial and non-financial indicators, including:

- Reach and impact of responsible drinking programmes.
- Water efficiency.
- Carbon emissions.
- Health and safety.
- Employee engagement index.

3. Relevant mentions of long term value creation are most commonly found in integrated reports. Integrated reports were most prevalent in the EU and UK, whereas the US had no companies in the top ten with an integrated report and only one in Chile. Although they were not in our research universe, two companies in Singapore (City Developments Limited and DBS Bank) have been recognized by the International Integrated Reporting Council (IIRC) for having produced integrated reports in accordance with the established IR framework.

NovoNordisk's integrated report had the most relevant mentions of 'long term value' of any company, reflecting a deeper understanding of the balance between long term shareholder value creation and shareholder returns in the short term.

Note on integrated reporting

In recent years, the idea of businesses publishing one integrated report – instead of two separate financial and CR reports – has gained traction, albeit with varying interpretations of what an integrated report is. In 2013, the International <IR> Framework was launched by the IIRC. The <IR Framework> is now the most comprehensive guidance on how to communicate the interdependence of financial and ESG data in one report.

Any company that sets its sights on publishing an integrated report will sooner or later face the challenge of defining an integrated strategy first – that is, a comprehensive business strategy based on long term principles and ESG factors. In our experience, implementing the IR Framework ultimately requires a shift in strategic thinking, revamped systems and processes, and revised performance measures. It should not be undertaken lightly.[16]

[15]Corporate Citizenship: Mastering Resilient Growth < http://corporate-citizenship.com/our-insights/mastering-resilient-growth/>

Recommendations for corporate reporting

1. Establish a link between business strategy and external macroeconomic drivers. When looking at a company's place in wider society, it's crucial to start with the need that the business fulfils. The strategy should explain the steps taken to meet this need, managing risks and being mindful of the opportunities. Companies that do this well are able to understand the complex interaction of economic, social, political, technological and environmental trends that shape their context.[15]

For instance, SABMiller has embedded its 'Prosper' sustainable development strategy within its wider business strategy. The company has identified water scarcity as its most significant climate related challenge and has set a series of 2020 targets in order to address this. SABMiller then reports its performance on an annual basis – including the measurement of the cost savings to the business as a result of water efficiency initiatives.

It's important to primarily look for future opportunities arising from present challenges, rather than looking to address concerns through a compliance and risk mitigation approach. In doing so, a company articulates the long term role of its business in society and, therefore, its ability to create sustained value.

2. Identify financially material ESG issues over the short, mid and long term. Materiality exercises identify the issues that matter most to the business and its stakeholders. These have become the mainstay of many CR and sustainability teams. In our experience, too few address really material issues for long term financial performance. CR departments need to get better at aligning their issues with business criteria. In doing so, they can make a stronger case for investment.

In a statement on materiality in its Annual Report, Novo Nordisk states that information on the most material social and environmental areas is tied directly or indirectly to the company's ability to create short-term and long term value. The formal reviews, research, stakeholder engagement and internal materiality discussions are then presented to the executive management and board of directors.

3. Set the ESG agenda for investors. Businesses should be proactive in articulating their long term value creation potential by incorporating ESG factors into their investor communications.

The steps a company can take will vary according to industry and the make-up of its investor base. Companies such as Timberland, part of the VF group, reports on key 'CSR performance indicators' on a quarterly basis. SAP used to issue quarterly sustainability reports but has since adopted an annual integrated reporting model, which includes a section outlining how the non-financial and financial performance indicators it measures are interconnected.

Companies should be empowered to make the decisions that are right for them. Paul Polman, Unilever CEO, made the following statement to Henderson Global Investors back in 2010 before launching the company's Sustainable Living Plan:

'Unilever has been around for 100-plus years. We want to be around for several hundred more years. So if you buy into this long term value-creation model, which is equitable, which is shared, which is sustainable, then come and invest with us. If you don't buy into this, I respect you as a human being, but don't put your money in our company.'

[16] Corporate Citizenship: The Future of Reporting <http://corporate-citizenship.com/our-insights/the-future-of-reporting-from-routine-to-strategic/>

Demonstrating the business case for sustainability

There are two critical disconnects that are preventing companies and financial market actors from creating a virtuous cycle that rewards sustainable business practices:

1. **The external disconnect.** There is a need for better alignment on material ESG factors and indicators between companies and investors as a foundation for demonstrating long term value creation to shareholders and stakeholders. Disclosure of extra-financial information in the context of financial statements needs to receive more attention.

2. **The internal disconnect.** There is a need for better collaboration between CR and IR teams to define, measure and proactively communicate the company's ESG risks and performance to both mainstream and specialist sustainable and responsible investors.

The external disconnect between companies and investors

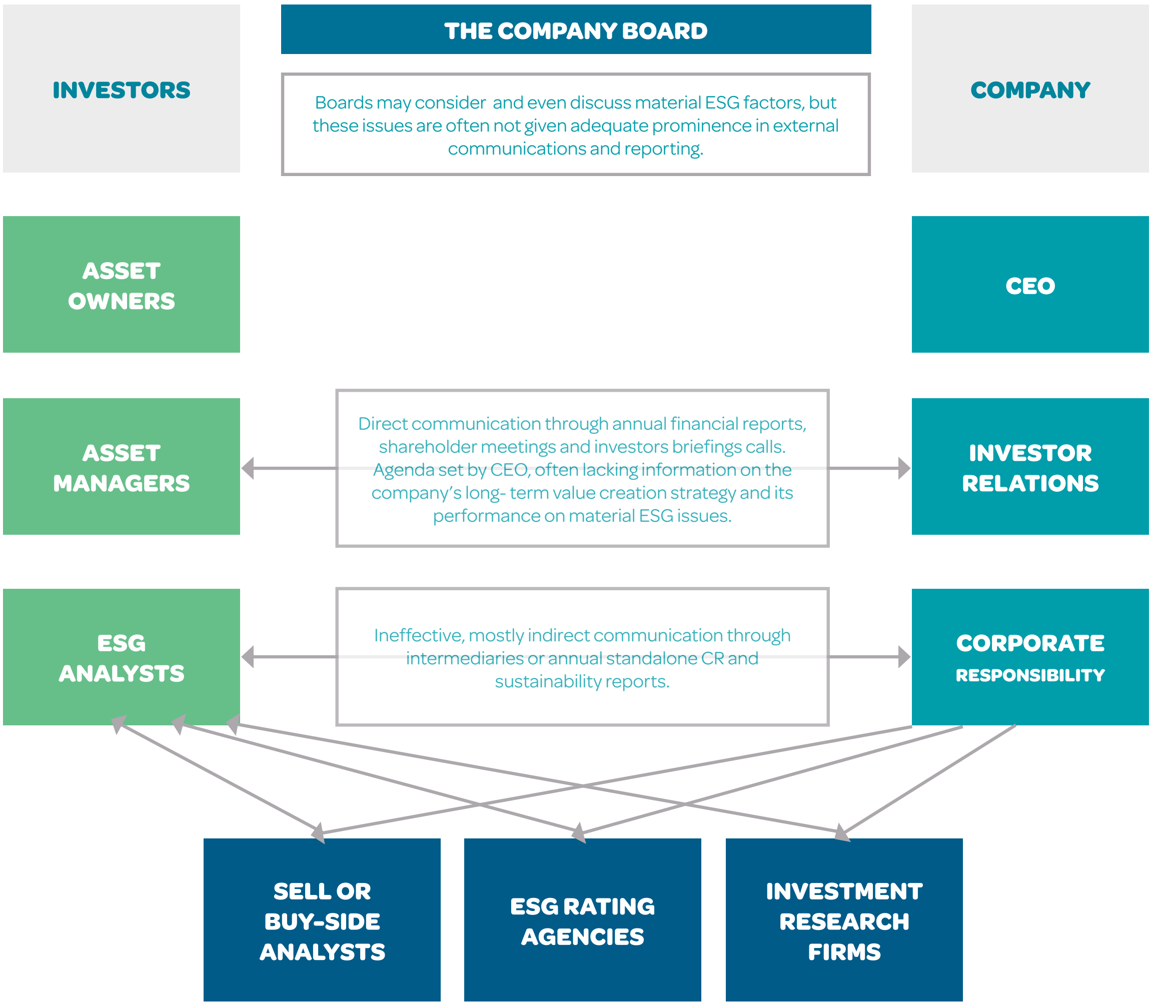
A recent report, by MIT Sloan Management Review, showed that while 75% of investment community respondents see improved revenue performance from sustainability as a strong reason to invest, many businesses do not have a compelling story to tell about their ESG performance. Most companies acknowledge the importance of a sustainability strategy to their overall competitiveness, but only a minority of managers reported that their organizations have developed a business case for their sustainability efforts.[17]

While it is not yet the norm, the number of investors that incorporate ESG information into their financial analysis and decision making has grown substantially over the last 15 years. The UN Principles for Responsible Investment (PRI) expects this positive trend of investors systematically valuing ESG factors alongside other financial factors to continue.[18]

This growing investor interest in, and use of ESG data appears not to be matched by companies' ability to communicate. Our research indicates an insufficient ability to communicate effectively how material ESG issues affect profitability and long term business success. This disconnect results in companies missing out on attracting the growing base of mainstream and specialist investors who consider ESG factors in their decision making – may that be through screening, integration or active investment strategies – and have a longer-term investment horizon.

Additionally, company management ought to realize that their performance will be evaluated even if disclosure is sporadic on ESG issues and indicators. Therefore, it is in the interest of a company to better understand how their shareholders and investors use ESG information and seek to provide them with the desired data and information.

[17]Gregory Unruh et al. (2016) Investing for a Sustainable Future. MIT Sloan Management Review <http://sloanreview.mit.edu/projects/investing-for-a-sustainable-future/?utm_medium=referral&utm_source=BCG&utm_campaign=susrpt16>
[16]PRI: A Practical Guide to ESG Integration for Equity Investing <https://www.unpri.org/download_report/22600>



Source: Corporate Citizenship adapted from UNEP FI Translating ESG into Sustainably Business Value[19]

Information asymmetry creates gaps in understanding, as shown in the diagram. This prevents the flow of relevant ESG information between companies and investors.

The two established channels through which companies currently communicate material ESG factors and performance indicators to investors are:

- **Direct communication** through the annual reporting cycle and related meetings, briefings and investor calls led by IR and company management, often without a reference to long term value creation and material ESG factors.
- **Indirect communication** through ESG research and rating providers and other stakeholders such as NGOs that conduct issue-specific research. This is based on ESG information reported by CR departments, which is often disclosed without a reference to financial materiality and bottom-line impacts.

[19]UNEP Finance Initiative (2016) Translating Environmental, Social and Governance Factors into Sustainable Business Value: Key Insights for Companies and Investors <http://www.unepfi.org/fileadmin/documents/translatingESG.pdf>

Corporate reporting has not kept pace with emerging and varying needs of a diverse investor audience. Key to a company's long term value creation strategy will be a distinct number of non-financial factors that are economically and financially material. Corporate reporting therefore must go beyond a compliance, risk-mitigation and backward looking approach to place a new focus on the future and long term value creation. To do this effectively, sustainability and other corporate professionals will need to adopt a new skillset to understand and demonstrate the financial materiality of ESG issues.

In many cases, sustainability teams have the necessary resources to produce sufficiently detailed sustainability reports, but these often go unnoticed by investors or are not presented in a way that can be incorporated into financial analysis. ESG information reflected in annual financial reports – often a summary of the standalone CSR or sustainability report – is usually destined to a similar fate. Especially if this section is an add-on to the annual report and accounts, without clear linkages to the business strategy, the company's products and services, human resource allocation and key markets.

A growing number of ESG ratings agencies and research firms provide in-depth insights into companies' performance. Each initiative is unique and methodologies differ significantly, especially in terms of extent to which they rely on publicly disclosed ESG information. For the sustainability practitioner, the landscape can seem overwhelming. There is often a nagging doubt about the real value of such schemes. *What* are the benefits to the business? *How* effective are the schemes at getting your company recognized? And do investors and stakeholders really care? Differing approaches taken by each scheme can make submissions complex and time consuming. Companies have to prioritize. To do this effectively, they need to identify specific ESG ratings, rankings and research providers that their investors subscribe to and use in their decision making. Only then will ESG ratings deliver value to the business, in terms of both reputation and core performance.[20]

Note on frameworks and sustainability indices

The lack of standardization in ESG combined with a proliferation of reporting standards, guidelines and ratings has not made it easy for companies to report on ESG factors.

Without defined frameworks and ESG factors /metrics the work for both corporates and investors remains challenging. ESG reporting frameworks at company level and ESG benchmarks such as DJSI that track corporate (sustainability) practices help to address this challenge and to provide more transparency.

According to a 2013 survey of CR professionals,[21] the most commonly used reporting frameworks are:

1. Carbon Disclosure Project (CDP),
2. Global Reporting Initiative (GRI) and
3. Dow Jones Sustainability Index (DJSI).

These frameworks alongside other important ones such as the Sustainability Accounting Standards Board (SASB) seek to create consistency within and across sectors.

[20] Corporate Citizenship: Rankings Standards and Awards <http://corporate-citizenship.com/our-insights/rankings-standards-and-awards/>
[21] GreenBiz: Why CDP, GRI, DJSI Stand Out Among Sustainability Frameworks <https://www.greenbiz.com/blog/2013/08/19/why-cdp-gri-djsi-stand-out-among-sustainability-frameworks>

The internal disconnect between IR and CR

Companies face an internal challenge. Without a clear mandate by leadership, bringing the CR and IR teams together can appear to be an uphill struggle. The disconnect is not accidental, but rather a consequence of the way most businesses are structured. These two teams deal with very different issues and stakeholders on a day-to-day basis. They may use very different time horizons for their strategy and activity planning and, often, different language to explain issues.

The two departments rarely have shared incentives and common goals. IR often reports to the chief financial officer (CFO), and by extension usually also the chief executive officer (CEO) and board of directors. These senior managers are traditionally pressured by shareholders for tangible, short-term performance. CR departments can be subordinated under various functions in the corporate organizational structure from communications and public affairs to corporate risk management. Therefore, the expectations of CR teams to gather and consolidate ESG information and monitor organization-wide ESG performance can vary.

Without the right incentives, it will be very hard for CR and IR teams to find a common ground for ongoing dialogue and collaboration. As a result, companies tend to have relatively little information on ESG factors, especially in their communication to mainstream investors. Even among continental European companies, which appear to be the most engaged on ESG issues globally, less than one-third include ESG data in their financial presentations.[22]

Even without organizational barriers, there are still a few important hurdles to overcome before companies can begin proactively engaging investors on their long term value creation strategy and the company's ESG performance:

- **Using shared terminology and language.** Most CR departments can articulate which ESG issues are material to their business. However, due to the specialized terminology, the definitions and framing of these issues can differ from what IR departments would deem to be material for corporate disclosure. A common language is needed.

- **Defining and demonstrating materiality.** The CR and IR teams are likely to have diverging views on and understanding of what are considered to be material economic, environmental and ESG issues for the business. CR departments should ensure that their materiality processes use a disciplined focus on relevance to external stakeholders as well as core, commercial performance.

The lack of standardization in ESG combined with a proliferation of reporting standards, guidelines and ratings has not made it easy for companies to navigate the complexities around reporting on ESG factors.

Ultimately, companies should start to move towards integrated profitability and sustainability models, practices, accounting and statements.

[19]Kepler Cheuvreux: European Corporate Survey Next is ESG Communication <http://www.keplercheuvreux.com/pdf/IRO_Survey_ESG_Focus_2014.pdf>

Building bridges through green bonds

Green bonds use debt capital markets to fund climate solutions. Green bond issuances by corporations, instead of development banks, over the last two to three years have led to a new trend – for the first time, finance, IR and CR departments are coming together to jointly work on projects with a positive environmental impact.

Starbucks shook up the market recently with the issuance of a US$500million 'sustainability bond'. This had a broader remit than traditional green bonds. Funds will be earmarked to finance the company's ethical sourcing efforts. The associated programmes ensure growing and distribution methods that can be maintained in the long run – from fair pay for workers through to education and support to foster sustainable farming practices.

In announcing the bond, the CFO and Executive Vice President of Starbucks made statements outlining how they saw positive environmental and social impacts of the company being integral to its long-term viability. The sustainability bond's ten-year maturity period represents an opportunity for continued collaboration between internal departments on material environmental, social and economic issues.

Recommendations

We have identified two enablers to bridge the internal and external disconnects -

Collaboration between IR and CR teams:

- Create an investor ESG query register and collaborate to respond to questions raised by investors
- Develop dedicated material on ESG risks and opportunities that can be used reactively with investors
- Define metrics to articulate how sustainability adds value to the business to achieve leadership buy-in and support for defining the company's long term value creation strategy
- Work together on relevant ESG indices e.g. CDP and DJSI

Content creation by CR and IR teams:

- Build a compelling long-term value strategy that can be communicated to investors (and other stakeholder audiences), outlining how sustainability and ESG performance contributes to superior financial performance and competitive advantage
- Create and execute a proactive communication and engagement strategy including both mainstream and sustainable and responsible investors
- Report consistently on a set of robust set of ESG KPIs and metrics

The diagram on the next page presents how these enablers help companies to move toward systemic ESG integration.

A fast-track framework for improvement

The level of engagement and quality of interaction between IR and CR teams within companies can be classified into three categories: Stage 1: SILOED, Stage 2: SIDE BY SIDE, Stage 3: SYSTEMIC

STAGE 1
SILOED

Little interaction between CR and IR teams: it is primarily to respond to ad-hoc investor queries on ESG factors. IR and CR are siloed due to an absence of shared objectives and a clear mandate from the CEO

ENABLER:
COLLABORATION

CR and IR teams begin to speak the same language and jointly develop dedicated material on ESG risks and opportunities.

STAGE 2
SIDE BY SIDE

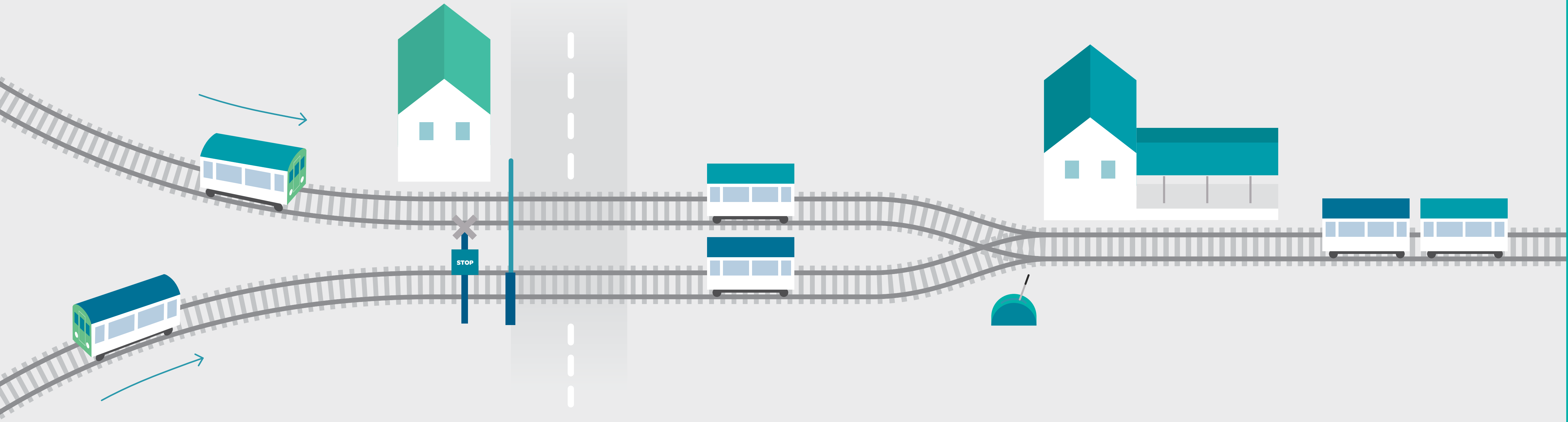
Regular interactions between CR and IR teams take place to proactively engage a selected group of investors on ESG factors. However, these factors are still considered as separate from business strategy and are not discussed with mainstream investors.

ENABLER:
CONTENT

CR and IR teams begin to define a sub-set of financially material ESG issues and build a business case for improving ESG performance.

STAGE 3
SYSTEMIC

CR and IR teams proactively engage investors on the company's long term value creation strategy. The strategy is integrated and articulates the context, i.e. the key macro-economic drivers for the business.



Companies can use this map to diagnose where they are on the journey and identify practical steps to facilitate collaboration between IR and CR professionals to bring about:

- A shared understanding of financially material ESG factors for the company.
- A shared ownership of the responsibility to communicate the company's ESG risks and opportunities to investors.
- A shared ambition to develop a long term value creation strategy for the business.

HALLMARKS OF SUCCESS

Leadership
C-suite taking a leading role in discussing the company's long-term value creation strategy with investors.

Scrutiny
The board of directors scrutinises ESG performance and supports viable investment opportunities that will help the company improve over time.

Linked Pay
Executive compensation is linked to corporate sustainability goals and longer-term performance indicators.

Material issues
Financially material ESG issues for the business are well defined and clearly demonstrated to internal and external audiences.

Measurement
The company is able to measure and demonstrate the value of engaging investors on ESG issues and the long-term value creation strategy.

Conclusion

We are reaching a tipping point. The sustainability and investor agendas are becoming increasingly intertwined. However, the gaps in knowledge and understanding still prevent companies and investors from sharpening their focus on long-term sustainable value creation.

Our research indicates that the interface between companies and their investors is ill-equipped to demonstrate integrated sustainability and profitability models – hindered by both internal and external disconnects. However, there is the opportunity for companies to overcome the barriers and steal a march on their competitors through taking a more proactive approach. By communicating a robust plan and commitment to create long-term sustainable value, leading corporates will become an attractive investment prospect to the ever-growing ranks of investors interested in ESG factors.

For a company to be able to get on the right track, it must be able to report on material ESG factors that underpin its long-term value creation strategy. In a world of volatility and uncertainty corporate resilience is crucial. Companies that are able to build a clear link between outputs and impacts that help in the transition towards a more sustainable economy will position themselves as increasingly competitive investments. But it's not just investors and corporates that stand to benefit, wider society will also profit from the long-term value they create.

About the authors

Esther Toth is an Associate Director at Corporate Citizenship. Working with some of our largest retained clients, she has developed an in-depth expertise in ESG ratings and reporting. She has a particular interest in measuring the impact of sustainable business practices, which in turn can drive scale and innovation. Esther advises multinational companies to adopt tailored strategies to engaging investor audiences on relevant ESG risks and opportunities.

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Further reading

Mastering Resilient Growth

Creating Resilient Strategies

The Future of Reporting
From Routine to Strategic

Ratings and Rankings

Corporate Citizenship

Corporate Citizenship is a global business consultancy specialising in sustainability and corporate responsibility.The team uses expert insight and a simplified approach to sustainability to deliver growth and long term value for business and society.

With teams in London, New York, San Francisco, Melbourne, Santiago and Singapore we work with clients on both a local and global level, to achieve their commitments to responsible business behaviours and sustainable practices.

We advise on a number of areas including strategy, community, engagement, environment, supply chain, socio-economic impacts, SDGs, reporting and assurance – helping clients to make the smart choices that will enable them to survive and thrive in an increasingly challenging business environment.

We have published a variety of resources and information for corporate responsibility and sustainability practitioners, which can be found on our website, corporate-citizenship.com. For further information about the report and our services, please contact
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THE LONG-TERM VALUE PROJECT