HOW TO DEVELOP AN OPTIMAL ESG RESPONSE

Abstract

Asset owners, asset managers, and companies are continuing to face accelerating pressures to adopt more environmental, social, and governance (ESG) -aligned business models. Organizations that fail to design the correct response to these pressures run the risk of significant negative financial implications. When it comes to responding to the ESG pressures, organizations have a range of options to choose from. A wealth of data, analytics, and sophisticated technology capabilities can now be utilized to streamline the decision-making process and ensure data-driven objectivity.

ESG Base Limited

contact@esgbase.com

Introduction

With growing pressures to adopt more environmental, social, and governance (ESG) -aligned business models, sustainability champions must carefully design the organizational ESG responses to maximize net benefits to their firms. We take a closer look at the different categories of ESG responses that organizations are making, and the cost benefit considerations that are leading to these responses. We further discuss how a strategic decision-making framework, the Willing and Able Model, is being used to tailor the optimum organizational response to the ESG pressures. Finally, we elaborate on the use of data and technology to ensure objectivity in the design of the ESG response.

Background

We live in a changing business environment. In today's environment, asset owners, asset managers, and companies are continuing to face accelerating pressures to adopt more environmental, social, and governance (ESG) -aligned business models. Several driving forces are responsible for these pressures, as shown in Figure 1.

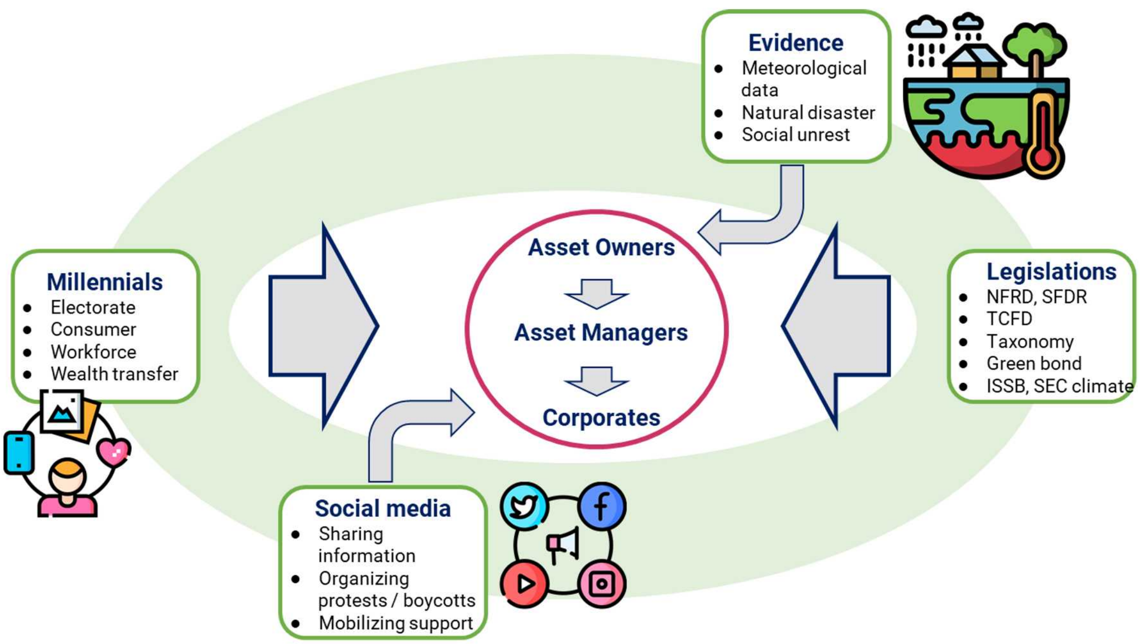

Figure 1: Drivers of ESG alignment

Firstly, increasing segments of the electorate, consumers, workforce, and individual investors are actively preferring organizations that reflect their own personal values of environmental and social impact. Secondly, pro-ESG legislations are continuing to increase. Thirdly, the evidence of climate change and its negative implications to the economy are piling up, as are the evidence of social issues and unrests and the resulting effect on businesses. Fourthly, because of social media, the ease of information sharing and dissemination, organizing protests and boycotts against organizations are easier than ever. Furthermore, recent geopolitical events such as the supply-chain disruption due to covid-19, the Ukraine-Russia conflict, etc. have highlighted the need to rethink and rebuild long-term strategies around global energy, food, commodities, and security that are both financially viable and resilient. All these factors mean that the financial implications of the response of an organization to the ESG pressures can now be significant enough to make or break the organization. Therefore, it is critically important for organizations to design the "right" ESG response.

Categories of ESG response

Given the mounting pressure to align with ESG, how are organizations responding? First, it is important to note that in our experience, different organizations are responding to these pressures differently. Despite the differences, however, it is possible to classify the responses on a continuum, starting from relatively more reactive to relatively more proactive and industry leading responses. In this context, Willard's "five stages of sustainability" classification continues to be a suitable depiction of the categories of these responses. When organizations' responses are studied over a period, it is evident that these categories of responses can also be considered the five stages of an organization's ESG journey, as shown in Figure 2.

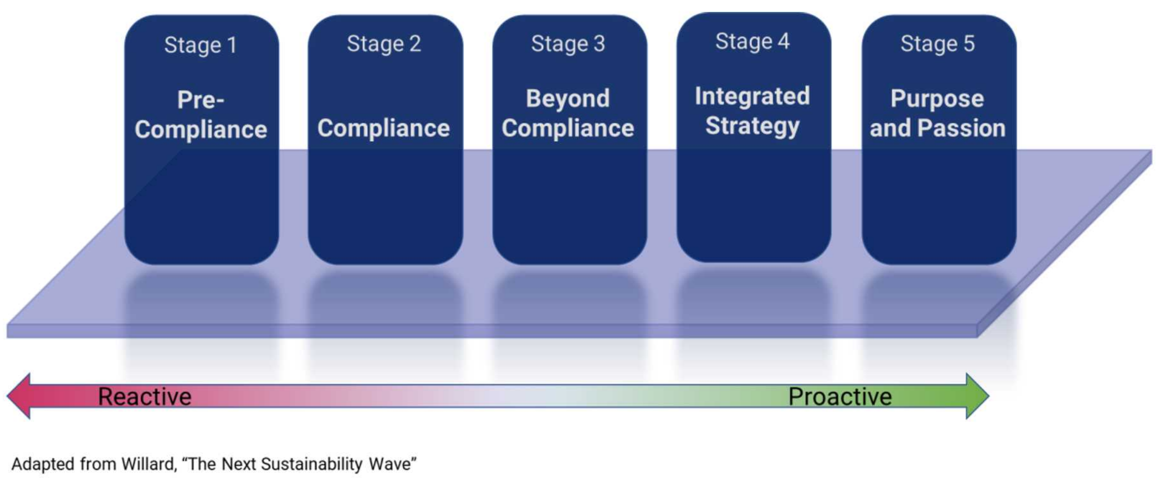

Figure 2: Classification of ESG responses

Early on in this journey, organizations find themselves starting from being in a position of pre-compliance, where they are unable to meet the requirements of the laws and regulations, and moving to a position of compliance, where the focus is on satisfying what is being required of them to stay compliant with laws and regulations.

At the next stage, beyond compliance, organizations are found to adopt a range of practices beyond the legal requirement, though not quite driven strategically yet. These practices are often off-the-shelf practices and may have positive implications on the organization's bottom line. Examples of such practices may be an energy management system or a waste management system. In other words, adopting these practices may be the more efficient or cost-effective thing to do. Sometimes organizations also adopt these practices because their peers or competitors have adopted them. The characteristic feature of this stage is that many of these practices are adopted in a decentralized manner, without strategic oversight.

At the next stage, integrated strategy, an organization strives to make ESG an integral part of its core business model. One key feature of this stage is innovation – organizations develop new product and service offerings that have a positive ESG impact. Furthermore, at this stage, organizations undergo innovative transformation to develop business models that simultaneously generate positive financial value as well as positive ESG impact.

Finally, at the purpose and passion stage, an organization not only makes ESG alignment a core part of its business strategy, but also a defining theme of its very purpose, mission, and values. These organizations inspire their employees, customers, suppliers, distributors, investors, and other stakeholders with their passion and influence economy-wide changes toward greater ESG alignment.

These various stages of response to ESG pressures highlight the fact that each organization has a choice to make regarding how much they are willing to commit when it comes to ESG alignment, beyond being compliant with laws and regulations. This is essentially the reason why the ESG response of a company is fundamentally a strategic choice. A move from a reactive to a proactive response to ESG pressures involves allocating increasing costs and investment. Like any other strategic investment, there are inherent risks and rewards associated with the returns on an organization's investment in ESG alignment.

Determining the right ESG response

Given the wide range of choices of ESG response available, how can asset owners, asset managers, and their portfolio companies design their ESG alignment?

To design the right ESG response, we recommend our client organizations to perform a holistic evaluation of its own ESG landscape using a **W**hat-**W**hen-**H**ow approach.

The first question to ask is **W**hat. What environmental, social and governance issues are material to the organization. In other words, what factors are most likely to have a significant impact on its ability to generate both short and long-term value. Ultimately, every organization has access to finite resources. Therefore, determining the What (the list of material issues) enables the organization to selectively focus on the issues that have more significant implications on the organization's ability to fulfill its core mission. In conjunction with various ESG frameworks, the organization can deploy various quantitative techniques and advanced modeling technologies to objectively determine the list of material issues. A summary of the quantitative approach is described in the next section of this article.

Once the **W**hat has been determined, the organization needs to determine the **W**hen and the **H**ow:

When is the right time to mobilize resources to respond to an issue? For example, Tesla was not the first company to build an electric vehicle, nor was Impossible Foods the first company to build plant-based burgers, yet they were able to create incredible value because of the timing of their effort. In our experience, organizations that can mobilize resources at the right time to address a growing issue can enjoy significant net benefit from its effort and investment. The time of action is closely linked to the change in salience of an ESG issue, described below.

And finally, **H**ow should an organization respond to an issue? Given the wide range of choices of ESG response discussed above, an organization can optimally select the How depending on the expected net benefit of the effort. The key question to ask here is, to what extent does the organization have the capability to mobilize resources to address an issue? Mobilizing any amount of resources requires an organization to incur cost and investment. Also, because every organization has different access to assets and human capital, the cost of mobilizing resources to respond in identical ways is also different for every organization. This is the main reason why competitors in the same market may respond to the same issue in divergent ways.

The When and the How constitutes a two-dimensional coupled problem, and we recommend Durand, Hawn, and Ioannou's "Willing and Able Model of Organizational Responses" to determine the optimum When and How when designing the response to each ESG issue. The Willing and Able Model provides a conceptual decision framework based on the net-benefit of mobilizing resources to address an issue.

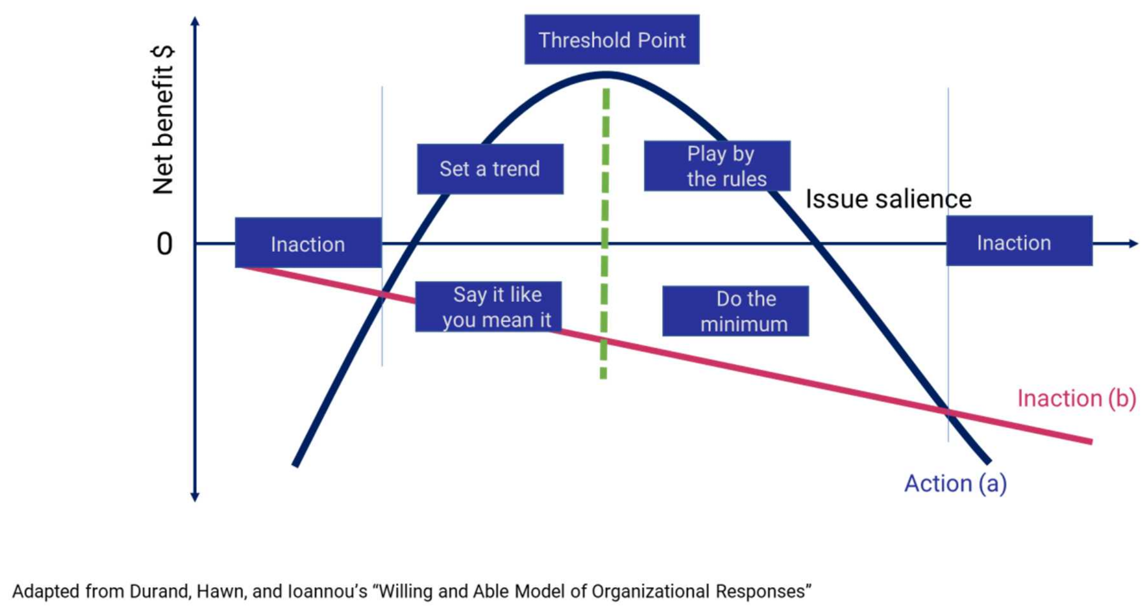

Figure 3: How organizations can decide to respond to an ESG issue

When the salience of an issue is close to zero, the gains from mobilizing resources to address something deemed trivial is insignificant. As a result, the net benefit of taking no action may be more than that of taking any action.

As the salience of an issue increases, an organization can choose between (i) doing the least possible to portray themselves as good citizens (say it like you mean it) and (ii) becoming pioneers in the space by pushing the boundaries of what is possible (set a trend). If the organization has the capability to become a pioneer on a given issue, the gains from designing a pioneering response to the issue may far outweigh the cost of mobilizing resources. However, if the cost of becoming a pioneer is too high, the organization can deploy a feasible response using lower cost techniques, such as by becoming a signatory to sustainable investing principles, or by incorporating the evaluation of specific risk types in their risk assessment models.

As the salience of an issue continues to increase, there is, however, a threshold point. Beyond this threshold point, the incremental cost of addressing the issue outweighs the incremental benefits. Examples of such issues are global warming, water scarcity, etc. – where it is impossible for a single organization to bring about changes in the entire system. In such a situation, the organization can choose between (i) substantive compliance (play by the rules) and (ii) doing the minimum, as required by rules and regulations. In the "play by the rules" scenario, the organization will fulfill its expected role in responding to the issue, but not go beyond that. For example, several companies operating in the insurance industry now require the incorporation of climate change risks into their overall risk calculations, even though this may not be required by the law. In the "doing the minimum" scenario, the organization will minimize its cost by simply adhering to the requirement of the laws and regulations.

By using data-driven approaches to identify the salience of an ESG issue, and advanced analytics to perform the cost and benefit of an action, an organization can objectively design its ESG response to maximize its net benefit.

Ensuring objectivity through data and technology

Given the critical importance of designing the right response to ESG pressures, how can asset owners, asset managers, and their portfolio companies strategically navigate this dynamic and shifting landscape? How can they use the power of technology, data, and innovation to cut out subjective biases to make confident decisions?

In the previous section we discussed the importance of asking the What-When-How questions in designing an ESG response. Here we will provide a brief overview of the types of data-driven approaches that have proven to be useful in helping answer these questions.

It is important to avoid subjective biases and tunnel vision in determination of the What. Apple failed to respond to its supply chain labor rights issues before the Foxconn scandal. Hewlett Packard was unable to respond to the risk of severe flooding in its Houston location before hurricane Harvey. To avoid such exclusions from subjective biases, we advise our clients to start with a holistic 360-degree view of the potential ESG issues, and then narrow down to the What-list using quantitative benchmarking and financial modeling under different scenarios. Such an approach reduces the risk of excluding issues that are unknown to the organization and allows evaluation of a much wider variety of issues. Where does the organization stand on diversity metrics relative to its industry peers? Have they considered the physical risk of climate change in their locations? Is their supply chain resilient from potential modern-slavery issues? How will their profitability change if carbon tax gets implemented in a specific jurisdiction? To support our clients during these analyses, we utilize a wide variety of highly sophisticated and cutting-edge technologies and tools that we have built in-house.

To determine the When and How, organizations need to objectively evaluate the net benefits from the cost or investment made at a specific point in time. Some of these investments may involve significant capital spending and reconfiguration of the assets or operations. If a high emitting company adds a carbon sequestration process in its operation, what are the implications to its profitability? How will its transition risk change because of this investment? Similarly, will a company's physical risk profile change – leading to increased cost of insurance - if it opens a new warehouse in another country? Another example - if the organization enters a long term PPA agreement with a solar farm, is it assured that the solar farm can supply electricity reliably? What if the solar farm is in an area prone to flooding? Once again, our sophisticated data analytics tools now make it easy to study the effects of configuration changes and determine the net present value of ESG responses.

Finally, the use of rich and varied data and state-of-the-art technology allows organizations to monitor the salience of issues with time, track progress against targets, and refresh the ESG response strategy to focus on the most material issues as they evolve in time.

Final thoughts

In summary, asset owners, asset managers, and companies are continuing to face accelerating pressures to adopt more environmental, social, and governance (ESG) -aligned business models. Organizations that fail to design the correct response to these pressures run the risk of significant negative financial implications. As a result, the need to develop coordinated and well-thought-out responses to these pressures is becoming more and more important. When it comes to responding to the ESG pressures, organizations have a range of options to choose from. What set of issues an organization chooses to respond to, When it chooses to respond, and How it chooses to respond to each of these issues – ultimately depend on the organization's net benefit from the action or lack of action. An organization can utilize established conceptual frameworks to support its design of ESG response. A wealth of data, analytics, and sophisticated technology capabilities can now be utilized to streamline the decision-making process and ensure data-driven objectivity.