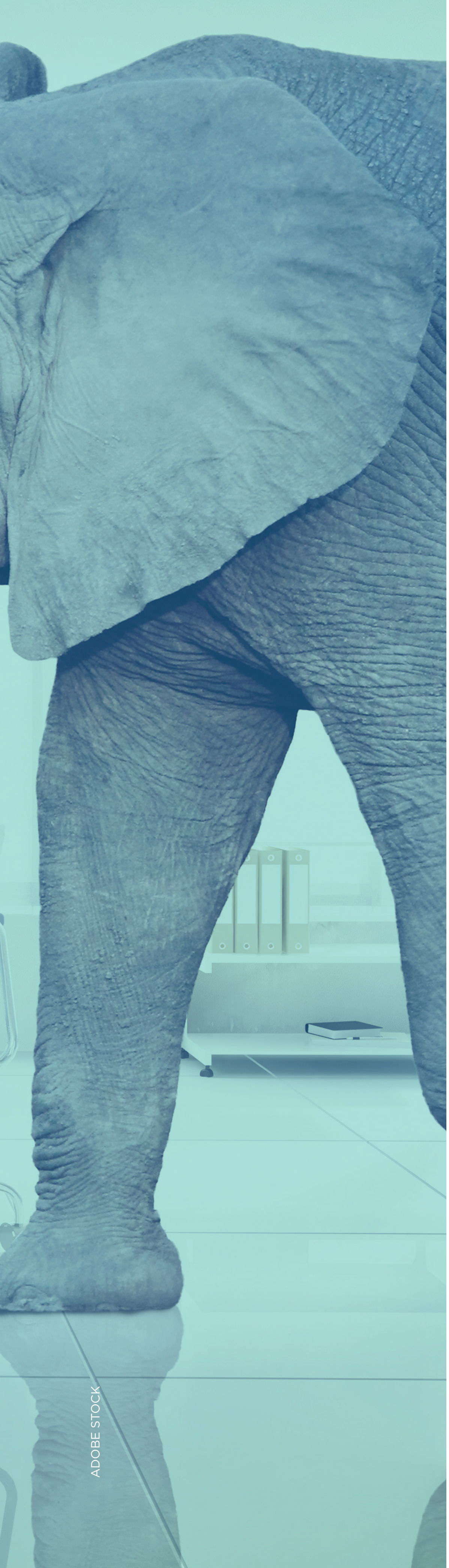
THE "E" IS FOR ELEPHANT

AS BIG INVESTORS FOCUS ON ESG, BOARDS MUST AS WELL. BUT WHAT DOES THAT MEAN EXACTLY?

BY C.J. PRINCE



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"IT'S ONE OF THE THINGS we ask our analysts to focus on in the due diligence that we do on every company," says Peter May, president and co-founder of Trian Partners.

"In the $1.7 trillion in active funds we manage," Larry Fink warned CEOs in a recent missive, "BlackRock can choose to sell the securities of a company if we are doubtful about its strategic direction or long-term growth."

The critical measure of corporate success that's grabbed their attention? It isn't profits or free cash flow or a well-articulated strategy for taking on Amazon. What May, Fink and many other market-shaping investors are focusing on lately is, of course, how you're handling ESG, that inscrutable, all-encompassing acronym that's come to stand for everything from protecting the environment to promoting greater diversity.

Their message to boards: Companies that fail to develop and articulate long-term ESG strategies risk alienating shareholders and potentially earning unwelcome attention from shareholder activists in the form of costly proxy campaigns. "ESG is not only the right thing to do," says May. "It's also really good for business. We believe that ESG issues can have an impact on a company's culture and long-term performance and that companies can implement ESG initiatives that increase their sales and earnings."

If only it were that simple. Whether or not the actual financial performance data backs up May's statement is almost beside the point (though recent studies suggest there is correlation, see sidebar, p. 47). Simply put, companies that fail to take ESG into account when formulating strategy are putting themselves at risk, says Nicole Crum, partner and chair of the corporate governance and board advisory practice at Sullivan & Worcester.

"When you have BlackRock and Vanguard and Fidelity taking positions that were once deemed issues of Birkenstock-wearing environmentalists, that's a pretty radical shift," says Crum. "[Institutional investors] have decided to focus on the economic risk of these things, and there's intentionality around that. This is not a political issue. It's not an ethical issue. It's an economic risk issue."

Until last year, shareholder proposals demanding better disclosure on climate change risk were typically considered dead on arrival; but in 2017, such proposals succeeded over the objection of management at three major companies—Occidental Petroleum, ExxonMobil and PPL. And while energy companies may be the first to feel the sting, momentum is clearly shifting across industries; among all public companies, support for greater climate change risk disclosure reached an average of 45 percent in 2017, up from 32 percent in 2016, according to Institutional Shareholder Services (ISS).

So far, boards are mixed on the issue. Thirty percent of directors responding to PwC's annual director survey said they don't have or need ESG expertise on their boards. When asked to what extent their company should take climate change into account when forming company strategy, only 18 percent said "very much," 43 percent said "somewhat" and 40 percent said "not at all."

Yet, according to PwC's Pulse survey, nearly two-thirds (63 percent) of investors believe ESG helps reduce risk. "There is this disconnect [between investors and boards]," says Paula Loop, leader of the Governance Insights Center at PwC. "I suspect the reason boards don't believe it has an impact on strategy is that executives of the company aren't talking about it. I don't think CEOs are thinking in a broad sense about ESG in their strategy discussions."

A PRIORITY PROBLEM

That's not because directors don't care, says Mike Lorelli, who sits on multiple boards, including Rita's Italian Ices and CP Kelco. But with so many competing, urgent demands on the agenda, other issues get short shrift. "We, as boards, tend to be too numbers oriented. Softer things like sustainability and the environment should be higher on the agenda, but there are 24 hours in the day and you can only get so much done," Lorelli says. "It's the kind of thing that's easier to put off and worry about tomorrow."

It hasn't helped that investors have sent out some fairly mixed signals—on the one hand, wanting long-term strategy around environmental issues and, on the other, promoting a more myopic, short-term view. "Last year, Larry [Fink] said, 'Stop looking at quarterly earnings.' And we said, 'That's nice, Larry, but we don't have that luxury,'" recalls Susan Cain, director and chair of the audit committee for Lithia Motors. “It used to be that when numbers were missed, there were slight dips [in the stock price]. Now a few cents of a miss can translate into a substantial impact on your stock, and then you have investors that really aren’t happy.”

A DEFINITION PROBLEM

Another part of the problem: For many boards, tackling ESG feels a bit like eating an elephant. The acronym itself seems at once too vague and overly broad, encompassing a wide range of disparate issues—diversity, pay equity, resource scarcity, access to healthcare, to name just a few. Some of those may have already been on a company’s radar screen for years—for example, safety concerns at a mining operation—but not as part of an official ESG strategy. Others may not even be in the picture.

Whatever your company’s business, and its relation to ESG, it is worth keeping in mind that investors are not expecting boards and management to develop a strategic plan related to each element of ESG “just for the sake of having a plan,” says Loop. “What they’re more focused on is, ‘Tell us your strategy story and how you’ve thought about these different risks and which ones might be relevant.’ You could potentially say none of them are relevant, but you have to have a story as to why and be able to show that you’ve thought it all through.”

How to start? Our experts suggest these steps:

Understand the company’s ESG priorities.

To be sure, the strategic importance of specific ESG issues will vary greatly from company to company and industry to industry. “For a company that has a big impact on the environment, ‘E’ will be more important,” says Trian’s May. But there are some aspects of ESG that apply to all companies equally, whether they recognize it or not. “Diversity is something everybody needs to pay attention to,” he says.

At pharmaceutical company Aceto, downward pricing pressure in generics and regulatory uncertainty have been critical discussion points for board members. But they’ve had to balance that with investor demands for more diversity.

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“ESG is not only the right thing to do as humans who care about the world, it’s also really good for business.”

“Institutions follow ISS almost blindly,” says Aceto Chairman Albert Eilender. In its 2018 U.S. voting guidelines, proxy advisory firm ISS said it would highlight boards with no gender diversity, although it stopped short of making adverse voting recommendations due to a lack of gender diversity. But that could change.

“If ISS takes a policy position that says it’s going to vote against boards that do not have diversity as the number one criteria, people are going to take notice,” says Eilender, who notes that Aceto’s board has one female director, and it now makes diversity a priority in director searches. The board does not currently have any experts on environmental issues, nor has it brought in any outside consultants. “We haven’t, because we didn’t think that was applicable to our business,” says Eilender.

Do your homework.

Sometimes, identifying ESG risks and opportunities means gathering more data as well as input from subject matter experts—or looking beyond your own company. With environmental sustainability, for example, “boards need to get a good handle on the footprint of the business and its core products, all the environmental and social impacts up and down the supply chain,” says Andrew Winston, co-author of *Green to Gold* and a member of Unilever’s advisory board. Looking deep into the supply chain, virtually any board would find risks. “But most just can’t see it yet.”

Some high-profile boards, such as ConocoPhillips and GM, have addressed this by adding directors with strong ESG backgrounds, while other companies rely on bringing in third-party expertise.

Allocate oversight responsibilities.

May suggests creating a board committee focused exclusively on ESG. May, himself, chairs such a committee at Trian. Then decide which activities will involve the full board and which are best handled by committee. Given how important it is to have everyone on the same page, level setting might be best handled by the full board, while assessment oversight and the various types of stakeholder communications might be best handled by a dedicated committee, or as an added agenda item for an existing committee.

Frame the conversation.

Whether board members and CEOs view ESG as involving business issues that are critical to long-term value creation or as soft, squishy and politically charged fodder will depend in large part on how the topic is framed. A conversation on the legitimacy of climate change, for example, may well inspire a lively debate, but it won't accomplish much on the business strategy front.

"Plus, if you're talking about a 'social good,' that's not typically something a CEO would bring to the board," says Crum. "So packaging is very important." Instead, steer the discussion into specific business risks and opportunities relating to ESG and strategies for addressing them.

Consider your reputational risk.

The #MeToo movement was instructive in demonstrating how quickly information can come to light that will put the company's reputation in peril. "We have to make sure we're asking the questions about what our exposure is," says Cain. "Reputations can be unmade in a day."

One lead director on the board of a food services multinational makes sure management is focused on things like safety, water stewardship and animal welfare because failing to do so will eventually put the company in the crosshairs of regulators and activists, resulting in a much greater cost down the line.

"If you're loose in [those areas], you can't be world class. And your business can't be tight if you're getting fined, which, by my definition, is a waste of shareholder dollars," says the director, who requested anonymity because of his company's communications policy.

He admits it's hard to do the math on costs related to future possible events that may cause waste, but that's true for many areas of risk management.

"It's harder to think about having sufficient resources to make sure we don't have a spill than to think about what it costs to do the cleanup. So what happens is people cut back, and when they cut back, something happens. Then they say, 'That's the cost of doing business.' I just don't see it that way." **CBM**

BY THE NUMBERS

Sentiment is building that in addition to altruism, as Trian's Peter May puts it, "consideration of ESG factors enhances our overall investment process." But what do the numbers say? And what part of E, S or G should companies focus on to best power performance?

Conclusive research proving causation—that strong ESG practices result in stronger performance—remains elusive. However, several recent studies do suggest a correlation between ESG standards and performance, including:

- McKinsey & Co.'s ***Delivering through Diversity*** report (2018), which found that companies in the top quartile for gender diversity on their executive teams were 21 percent more likely to experience above-average profitability than companies in the bottom quartile. The same study found that companies with ethnic and cultural diversity had a 33 percent likelihood of outperformance on EBIT margin.

- In 2015's ***From the Stockholder to the Stakeholder***, global asset management firm Arabesque and the University of Oxford reviewed 200 studies on sustainability and corporate performance and found that 88 percent of the reviewed sources discovered that companies with robust ESG practices demonstrate better operational performance that ultimately translates into cash flow.

- Boston Consulting Group's ***Total Societal Impact: A New Lens for Strategy*** 2017 study of five industries—consumer packaged goods, biopharmaceuticals, oil and gas, retail and business banking and technology—found that top performers in specific ESG topics enjoyed valuation multiples between 3 percent and 19 percent higher and had margins up to 12.4 percentage points higher, all else being equal, than those of the median performers in those topics.

- The 2015 Harvard Business School study ***Corporate Sustainability: First Evidence on Materiality*** showed that firms with good ratings on sustainability issues most relevant to their industries significantly outperformed firms with poor ratings on those issues.


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