Governance Insights Center
PwC's ESG Pulse 2019

Mind the gap: the continued divide between investors and corporates on ESG

February 2019

The gap between corporates and investors on ESG-related disclosures is as wide as ever. Investors are increasingly aligned around a desire to understand the company's long-term value creation plan and receive credible, standardized information to support long-term risk assessments. But many corporates, even when they have a good story to tell and robust processes to manage ESG risk, are not giving investors the right information in the right format. A few straightforward steps could bring the two sides together.

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The gap remains

Two years ago, we identified a serious communications gap between corporates and investors over environmental, social and governance (ESG) information. Investors were looking for standardized, rigorous data to support investment decisions. Many corporates, however, were releasing ESG information inconsistently and in a manner investors found difficult to use.

Since then, this gap has continued and ESG's importance has grown. More and more institutional investors are looking for a company's management to articulate a sustainable long-term value creation strategy that outlines not just growth opportunities, but also the related risks. They view ESG matters as critical to understanding the full risk profile of a company and how prepared it is for the future.

There's good reason for investors to put this emphasis on ESG questions. Companies with risk management practices that take into consideration broader industry, regulatory and societal risks are more likely to drive long-term sustainable performance—and shareholder value.

ESG: what does that really mean?

Examples of questions that investors might ask

Many enterprises have sensitive data stored all over the globe and with third parties. How well can they defend against cyber threats?

Many utilities and industrial companies need plentiful water at adequate temperatures to operate. How robust are their plans to confront possible water scarcity?

Many consumer-facing organizations have vendors in countries with weak labor laws. Can they prevent human rights violations and maintain a stable workforce that meets consumer demands?

Most large enterprises serve diverse markets. Does senior leadership and the board have the diverse backgrounds and skills to understand and meet these customers' needs?

Investors are increasingly aligning their messaging—and engagement practices—to make clear that they want ESG-related data to answer critical questions (see sidebar) for risk and strategy assessments.

Yet this messaging has largely been unsuccessful: many corporates are unclear on why investors want ESG-related data, what exact data they want and in what form they want it. Many are concerned about providing information that might be misunderstood or misapplied. And with little alignment around reporting standards, even when individual corporates do provide good data on ESG-related questions, investors may not be able to make comparisons with peers.

> A company's ability to manage environmental, social and governance matters demonstrates the leadership and good governance that is so essential to sustainable growth, which is why we are increasingly integrating these issues into our investment process.
>
> – Larry Fink, CEO, BlackRock, Annual Letter to CEOs.

Different priorities lead to mixed messaging

More and more investors are telling corporates that they want information on ESG-related risks to support long-term assessments. In a 2017 CFA Institute survey, for example, 65% of investors said that their motive for taking ESG issues into consideration was to help manage investment risks[1]—mirroring our own conclusions in 2016. It's why so many investors are submitting, and often succeeding in passing, shareholder proposals seeking more and better ESG-related information.

Yet different kinds of investors—passive and active, long term and short term, those with and without ESG mandates—have different priorities. Passive investment managers, for example, whose holding period may be indefinite, usually care deeply about long-term ESG-related risks. But a short-term active investor may only care about the chance of an ESG-related disaster (or a new source of value) this quarter. Investors that have ESG as a priority may focus on completely different issues when evaluating a given company. ESG data is also increasingly being relied on for new investment products (e.g., ESG ETFs).

The end result, unfortunately, is that investors are increasingly demanding ESG information, but the messaging is confusing, inconsistent and scattered, which does not command a compelling response.

1 CFA Institue, *Environmental, Social and Governance (ESG) Survey*, 2017.

Many investors have a structural obstacle

Many investment firms also have a structural reason for failing to make a single, consistent request for ESG-related data. Some investors embed stewardship officers, who focus on environmental, social and governance matters, in portfolio management decisions, but such firms are a minority. A recent survey by State Street Global Advisors found that 80% of institutional investors have an ESG component as part of their investment strategies—but only 27% fully integrated ESG criteria into long-term decision making.[2]

Without such integration, corporates may hear about ESG concerns only from investment firms' stewardship officers—not from the chief investment officers and portfolio managers with whom they have more frequent contact. And when they do hear questions from portfolio managers about matters such as cybersecurity, privacy or board diversity, they may not recognize that these questions are part of the ESG landscape.

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2 State Street Global Advisors, *ESG Institutional Investor Survey*, April 2018.

Corporates: a slow evolution

Many companies are falling short on ESG-related communication with investors. But some are making more progress than others.

As we see it, the ESG evolution has three stages:

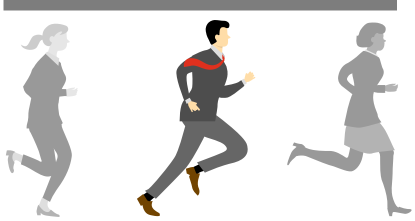
1 Front runners:
cohesive identification, integration and communication

Some leading companies have identified ESG-related risks and opportunities, embedded them into their long-term value creation story and are communicating this story effectively.

Since ESG questions will impact their present and future business model, these forward-thinking organizations are integrating values, goals and metrics into business strategies to mitigate ESG risks. They are seizing related opportunities to innovate and reduce costs. Driven by strong internal leaders, they also tell this story effectively.

Some investors are already rewarding ESG front runners, and we expect more to do so soon.

2 Middle tier:
strong on identification, weak on communication

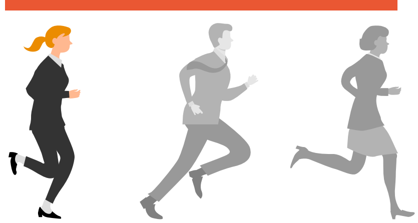


Some companies have integrated ESG questions into enterprise risk management processes, which identify and work to mitigate these risks. Yet they fail to get the message out.

These companies typically provide robust sustainability reports, but neither their content nor their form is aimed at investors. The reports often contain so much information it's hard for investors to find what's most relevant to their needs and make comparisons among competitor companies. These reports also may not appear to have the same credibility as other, more investor-focused disclosures.

Many of these companies have also minimally, if at all, integrated ESG goals into business strategy, limiting further progress.

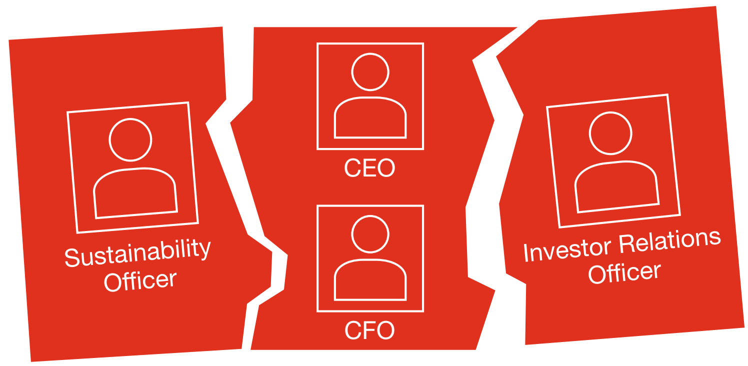
3 Laggards:
even identification is lacking



Companies in this third tier have not dedicated significant attention to how ESG factors might impact their business. They view sustainability issues as areas that belong solely in a corporate responsibility report, which they may or may not provide.

Some of these companies merely publish purpose statements and other material from corporate social responsibility departments. These statements typically focus on employee efforts in their communities and other activities meant to demonstrate good corporate citizenship, but which might not have anything to do with the company's long-term strategy.

Corporates often have a structural obstacle too



Companies in all three tiers may share a structural similarity: they may have a sustainability group or an individual sustainability officer who issues an annual corporate responsibility report. But this team or officer may not be integrated with the company's strategy development, asset allocation, risk assessment, financial reporting or investor relations teams.

ESG risks and risk mitigation strategies may therefore not be embedded (or even considered) in the overall enterprise risk management process or business strategy—preventing that strategy from achieving truly sustainable long-term value creation. Accordingly, when senior executives describe future plans for the company to investors, they may not have even considered ESG risks.

Many officers and senior executives in investor relations, uncomfortable with ESG questions, may also consider ESG discussions a risk in themselves. Such discussions, these leaders worry, could undermine valuation, trigger increased scrutiny or distract from their core narrative.

It is therefore understandable why so many companies have chosen the middle tier of ESG-related communication: it appears to be the "safe zone." These companies are avoiding the downside risks of being an ESG laggard (such as negative screening or targeting by stewardship teams). They are also avoiding the extra work and perceived risks of being an ESG front runner. Although the benefits of advancing to the next tier may not yet appear compelling, as investor alignment grows, the middle ground may not remain safe for long.

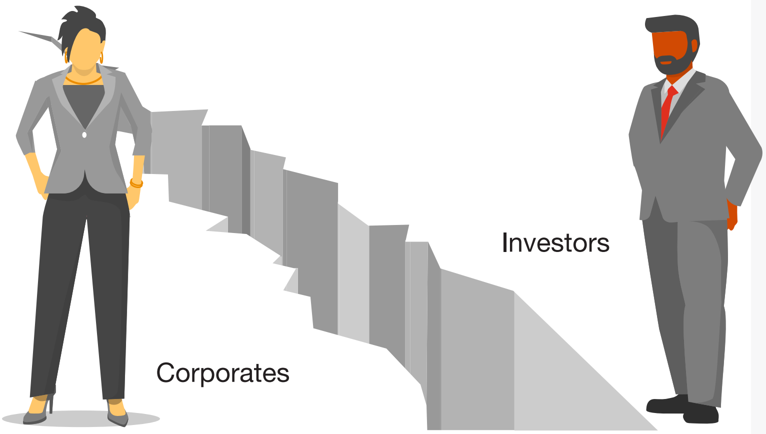
> In an age of rapid technological change, companies increasingly need to articulate their strategies around good corporate governance and areas like talent development, innovation and sustainability. It helps them remain viable and competitive and to maintain credibility among investors.
>
> – Rakhi Kumar, Head of ESG Investments and Asset Stewardship, State Street Global Advisors

Corporates risk losing control of their ESG story

With so many different investor voices asking for different kinds of ESG information in different ways—often without expressing compelling and consistent reasons—many corporates feel only scattered pressure to provide this information. They also may be concerned that meeting all of the demands of these different investors could be a lot of work for limited value.

Yet growing numbers of investors are not merely saying they want better ESG data. They are also investing in data infrastructure to find it. In the CFA Institute survey, investors' top sources of ESG information on companies were public information and third-party research—not communications or filings from the companies themselves.[3] Passive investment managers, for example, typically rely on large ESG datasets from third-party sources to adjust the weighting of their portfolios.

Much of this third-party information is unverified. It may therefore be inaccurate, but without better corporate involvement, no one can be certain.



Given the complexity of how ESG datasets come together it is hard for investors to fully trust the available information.

What is certain is that, by leaving a communications gap for third parties to fill, corporates are losing control over their ESG story.

Capitalizing on ESG reporting

In recent years, a number of groups have proposed ESG-related reporting standards. One of the leaders in this area is the Sustainability Accounting Standards Board (SASB) which has developed industry-based standards intended to "help public corporations disclose financially material information to investors in a cost-effective and decision-useful format." In November 2018, they released standards for 77 specific industries, following a six-year process of obtaining stakeholder feedback.

Many investors like these standards, but corporates are often wary. Some are concerned about presenting ESG-related risks as "financially material." Others may not have completed a robust and rigorous assessment of these risks.

But these reporting standards aren't all or nothing. Companies don't have to disclose all of the recommended metrics for their specific industry designation. They can use their own judgment as to what is financially material and select relevant metrics from across the standards suggested by SASB (or others).

When it comes to ESG, the important thing is start by considering ESG-related risks within the organization's overall risk assessment. Many enterprises will then find that applying the standards offered by SASB or others is an opportunity: to help identify those risks, and to shape the narrative in a format that investors will appreciate.

3 CFA Institue, *Environmental, Social and Governance (ESG) Survey*, 2017.

How to close the gap

While structural challenges persist, there is a path forward to close the gap between investors and corporates.

For investors to get the information they need for long-term risk assessment, they need to align their different voices and priorities. Here's how:

- Connect stewardship and portfolio management groups to understand each other's ESG-related needs and present a consistent, strong message to corporates.
- Show quantitatively how in their investment process they reward or penalize companies for ESG efforts and disclosure.
- Work to align investment industry associations around ESG disclosure standards and norms.
- Encourage chief investment officers to ask corporates for specific data on ESG-related metrics to support their evaluations of a company's long-term prospects.
- Do their due diligence on the accuracy of ESG datasets and work with providers to enhance the quality of information.

Pressures for sustainable practices will likely rise in the coming years. Now's the time to establish best practices in ESG risk management and communications, building the company's brand in this area and establishing credibility with investors.

Here are some measures to take advantage of this opportunity:

- Engage with portfolio managers and analysts to first, understand how they are integrating ESG concerns into investment decisions and second, provide your own vision of how ESG performance should enter into investor models.
- Build a rigorous process to prepare ESG information (with executive certifications, description of control processes, and assurance) and communicate this process to investors.
- Put yourself in an investor's shoes and focus on the information that will help their decision making. One leading practice to consider is providing quantitative evidence of how your superior ESG risk management justifies a higher valuation.
- Promote interaction between the sustainability team, the chief risk officer, investor relations and finance to develop a succinct long-term value creation story that includes ESG risks and opportunities.
- Communicate your ESG risk-mitigation strategy clearly and fully (avoiding boilerplate language) in primary investor communications.
- Educate executives in the finance and investor relations departments on SASB (see page 7), and consider disclosing selected metrics in an investor-friendly format.

Even if investors today are focused primarily on risk, companies should also show the upside potential. CEOs don't wait for investors to ask about innovation in order to share progress on breakthroughs. Similarly, if companies are—as they should be—well-positioned to grow by solving some of the biggest societal challenges, such as the transition to a low-carbon economy, they shouldn't wait for investors to ask before they share these plans.

Conclusion: both sides can gain

For both the corporate and investment world, a failure to discuss ESG risks can be dangerous. Extreme climate events could impact operations; a cyber breach might threaten data; a lawsuit over gender discrimination or product quality could impact the brand and the bottom line. If such risks become reality, both corporates and their investors would suffer.

Investors are increasingly sending strong signals that they are focused on ESG risks, but many corporates still have sustainability teams working in isolation. As a result, investor relations and finance, as well as the C-suite, often fail to integrate sustainability risks into their long-term strategy discussions with investors.

The gap persists, but solutions exist.

If investors send a crisp and consistent message—and clarify the value at stake for companies—they're more likely to get companies to respond. With such pressure from investors, corporates will also be more likely to work toward new norms of standardized, credible information to support assessments of long-term risks and value.

If corporates embed ESG factors into their overall strategy and risk oversight discussions, they'll be better able to present their risk-mitigation and value creation story—including the growth potential from identifying and managing ESG issues—and shape the narrative around their brand and practices.

Both sides stand to gain. It's time to bring perspectives together to build a future with better risk management and sustainable value creation for all stakeholders.

> To be a good business person, you need to know as much in the future about sustainability as you know about sales. You need to know as much about climate change as you do about cash flow… You need to know as much about international development as you do about business development.
>
> – Paul Polman, CEO of Unilever

How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC's Governance Insights Center or Sustainability Services team.

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