ARTICLE

By Joseph Vicari, Managing Director, ESG Practice Lead, Broadridge Consulting Services and Chad Spitler, Founder and CEO, Third Economy

Four ways to communicate the ‘E’ in ESG

Environmental considerations are challenging for companies to integrate into corporate strategy and management because there are many different angles from which stakeholders evaluate them. This variation also makes it difficult for corporations to effectively communicate with a wide array of stakeholder interests on the topic.

To help our corporate clients effectively manage and communicate their approaches to the ‘E’ in ESG, this article explores the differing, but sometimes overlapping or related, perspectives of the institutional investor community.

Here we share four main categories that describe what matters when it comes to the environmental ‘E’ component of ESG. We find that when stakeholders talk about the ‘E’ in ESG, they usually mean one of these four things.

Being alert to these different meanings can help you proactively respond to stakeholder concerns and interests as you advance your ESG program.

1. LONG-TERM FINANCIAL MATERIALITY OR RELEVANCE
2. ATTRACTING IMPACT CAPITAL
3. ADAPTING TO CHANGING REGULATIONS
4. PROMOTING THE MORAL GOOD

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1 LONG-TERM FINANCIAL MATERIALITY OR RELEVANCE

The first way to interpret concerns about the 'E' in ESG is through the lens of corporate earnings and profit. For many investors and stakeholders, ESG is principally about making money by avoiding risk and being alert to available opportunity. So, investors may view environmental issues through the prism of financial materiality.

Under this sort of analysis, when investors talk about the 'E' in ESG, they're talking about the way climate and other environmental factors may impact a company's long-term ability to generate durable financial returns. It is important to note that this applies to virtually all companies and not just those in, say, manufacturing or fossil fuels.

For example, imagine you're considering whether to invest in a company that operates in the beverage industry. An environmental analysis might look at supply chain factors like a company's access to water, sugar, and fruit—all key natural resources required to make their product.

Hypothetically, if your analysis reveals that a particular beverage producer is facing unusual risk to their sugar or clean water sourcing because of climate change or the potential for long-term drought, then you might favor investing in a competitor with less risk. Alternatively, you might also look at available opportunity: Perhaps one of the beverage producers shifts their production facility to an agricultural area with less shipping costs and more reliable labor. You may prefer to invest in that company, given the potential upside.

This example illustrates ESG in its purest sense: Risk and opportunity assessment. The analysis factors climate change to the extent that it may disrupt or improve a company's potential to stay profitable over the long term.

An effective ESG program, therefore, needs to demonstrate that your company is well insulated against—and capable of adapting to—potential environmental disruptions. To report your approach to ESG in a way that resonates with investors focused on this aspect, we recommend reporting to SASB, the Sustainability Accounting Standards Board, which has recently transitioned into the Value Reporting Foundation.

2 ATTRACTING IMPACT CAPITAL

As the market begins to recognize that ESG is really about making money, and that every investment has an impact on the environment or society, the next big trend is impact investing.

'Impact investors' deploy capital to reduce carbon output and promote climate-friendly business practices. In some cases, but less and less so, impact investors may be willing to accept potentially lower returns in exchange for the opportunity to concretely drive positive environmental impact.

Corporations may wish to build an ESG program that appeals to these impact investors as part of an effort to attract capital and earn inclusion in impact funds.

For example, BlackRock's impact funds now include impact reporting. BlackRock and a growing number of institutional investors realize that impact investing appears especially prevalent among Millennial investors, and therefore many expect a greater focus on outcomes and impacts as Millennials accumulate more wealth.

For a corporation to report their impacts effectively, we recommend reporting relative to the United Nations Sustainable Development Goals.

3 ADAPTING TO CHANGING REGULATIONS

No matter what industry you operate in, you're likely to confront environmental regulations of some kind. Some industries will be impacted more than others.

Hence, when stakeholders talk about the 'E' in ESG, sometimes they're talking about regulatory readiness. Corporations unprepared for the changing international regulatory landscape may be subject to additional taxes, fines, and other penalties that impact their ability to operate and achieve durable financial returns.

In this respect, an analysis of regulatory readiness is an extension of the financial materiality analysis described above. Under both analyses, investors are looking for evidence that your business is prepared to take on climate-related risks: Either direct financial risk from climate instability itself, or indirect financial risk stemming from evolving climate or other environmental regulations.

4 PROMOTING THE MORAL GOOD

Finally, there's a camp that believes corporations have a unique moral responsibility to advance toward net-zero carbon emissions and promote other climate-friendly initiatives.

Usually, proponents of this approach use two tools: Avoidance and Activism. Some believe that divestment or avoiding investment in certain companies or industries is the best approach, while others take positions in companies to effect change and push them in a particular direction.

When these stakeholders talk about the 'E' in ESG, usually they mean that corporations should act for the good of the planet and future generations simply because it's the right thing to do. For this camp, financial concerns may be secondary or at least not directly tied to their ESG messaging and interests.

To respond to these stakeholders, corporations may choose to include explicitly moral messaging and practices in their ESG programs. Many already do because they agree it's the right thing to do. But there are also potential financial returns: Moral messaging can help build brand goodwill and strengthen loyalty among employees, customers, and other stakeholders.

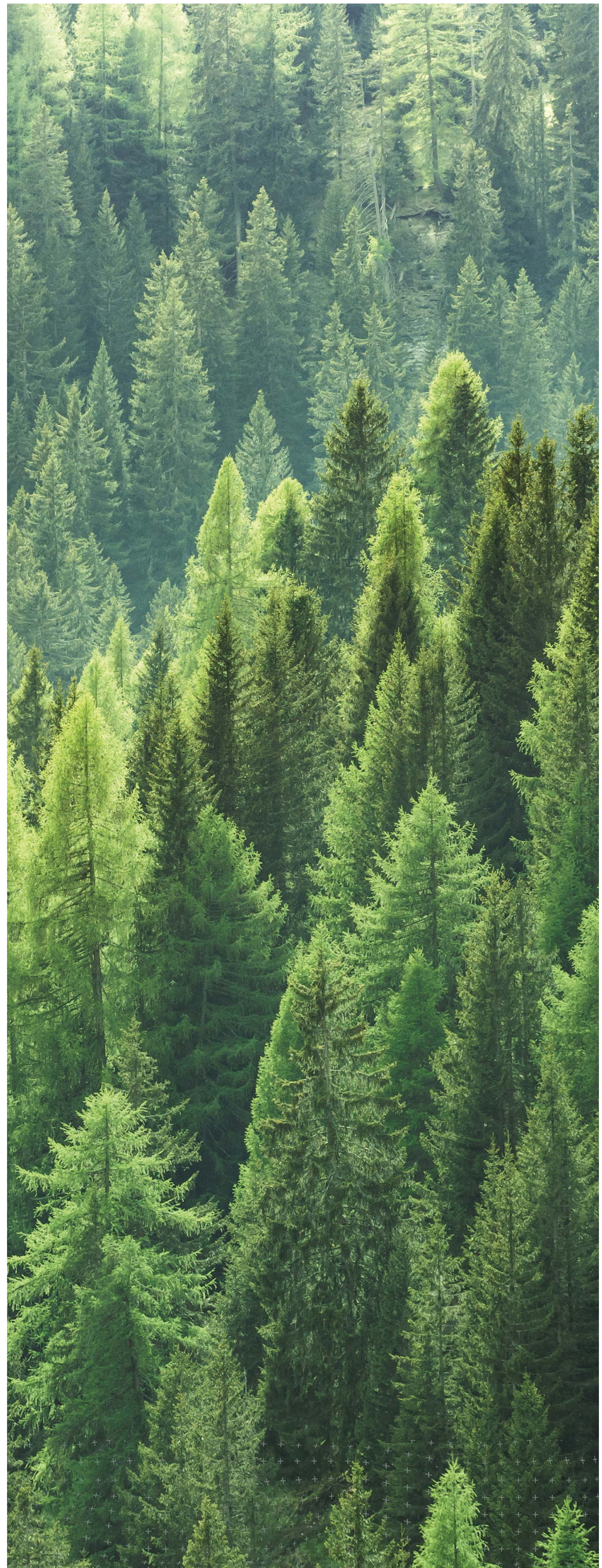
CLARITY IN CONCEPT, CLARITY IN PURPOSE

As you plan and strategize your ESG program, it's vital to be clear about the stakeholder interests you're responding to and the goals you set for your organization. ESG program success requires setting clear targets and defining associated metrics. You can't measure performance unless you're precise about what you're working toward. And precision requires conceptual clarity.

Depending on the audience and purpose, you may frame your messaging differently or identify a different set of targets.

Are you working to shore up long-term financial stability or adjust to shifting regulations? Are you trying to attract impact investors or advance the moral good? In most cases, it's not either/or but some combination of all of these.

In any event, clarity in concept will help you achieve clarity in purpose.



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