ESG AND BUSINESS OPERATIONS

A CORPORATE PERSPECTIVE

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EIGHT INTERNATIONAL

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KEY HIGHLIGHTS

1. ESG HELPS MITIGATE RISKS

There are opportunities for risk mitigation for organisations from embedding ESG parameters into their business operations and decision-making process.

2. ESG HELPS CREATE VALUE

Through an ESG lens, companies can look at achieving resource efficiencies which in-turn can lead to cost savings and margin improvements.

3. ESG INCREASES M&A OPPORTUNITIES

ESG can lead to greater M&A and fund-raising opportunities for corporates, particularly where corporates might be looking at acquisitions to meet their own sustainability targets.

4. ESG HELPS ATTRACT TALENT

Embedding ESG parameters into the business operations can generate value from attracting and employing top-class talent of the future.

FOREWORD

The recently concluded COP26 summit has put climate change and environmental considerations – the 'E' of ESG - at the top of the regulatory and business agenda. Key themes agreed as part of the COP26 agreement include ending deforestation, reducing methane emissions, mobilising the sustainable finance sector and achieving net-zero goals.

While it is the governments that have agreed to these environmental goals, it is eventually going to be businesses that will have to work towards successfully achieving these goals. The targets agreed are long-term. However, businesses across all industry sectors will have to start assessing their value chains and implementing initiatives now, in order to make their operations more relevant for the climate change-informed landscape of the future. As is evident from various scientific literature, the costs of inaction for businesses are only going to increase going forward.

Similarly, changes to business operations required from a Social and Governance perspective will not be achieved overnight. Targets like employee diversity, improved health and safety for employees, and embedding more transparency and accountability in organisational policies also require long term planning and implementation efforts.

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While it might be the next management (or even the one after next) which eventually achieves the diversity targets or the net-zero ambitions, the journey to meet these objectives needs to be kick-started by organisations now, today.

In this article, we set out considerations for business owners and managers as to what an overlay of the ESG lens actually means for organisations.

RISK MITIGATION

There are opportunities for both risk mitigation as well as value creation for organisations from embedding ESG parameters into their business operations.

Let's first look at risk mitigation.

Following COP26, the EU has proposed a legislation that will require companies to prove that agricultural commodities are not linked to any form of land degradation or deforestation after 31 December 2020[1]. Under the draft proposal, commodities covered include soy, beef, palm oil, coffee, cocoa, etc. France is already considering launching an online database to track soyabean imports from Brazil. Bunge, Bianchini, Cargill, etc. are some of the top companies which may be impacted by this[2]. More and more companies in industry sectors like agriculture, FMCG, meat production, etc. relying on these commodities will have to start assessing their supply chains to identify any areas of exposure and work out alternative supplier options, where required.

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Climate change is also negatively impacting supply of various agricultural commodities like vanilla, avocado, wild cotton, banana, etc.[3] as well as critical metals like copper, lithium and rare earth elements[4]. Droughts and related water shortages during 2020-21 heavily impacted the Taiwanese semiconductor industry[5], exacerbating pandemic related supply chain woes and ultimately leading to 'chipageddon', which in-turn had a knock-on impact on other sectors like automotive and consumer electronics. Companies need to plan for raw material shortages and assess the use of alternative, more sustainable inputs for their often-complex production and manufacturing cycles, which might require time and significant R&D investments.

The financial services is another sector where factoring in climate change is going to be crucial for risk management. According to Munich Re, global losses from natural disasters in 2020 came to $210bn[6]. Banks, insurance companies, asset managers and other financial players will have to embed stress tests and inherent climate-risk assessments into their business models and product offerings going forward.

1 https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_5919
2 https://www.ft.com/content/5c44969c-b3a4-4a47-963a-b0b8300ffb2a
3 https://www.weforum.org/agenda/2021/09/climate-change-could-be-causing-some-of-your-favourite-foods-to-go-extinct/
4 https://www.iea.org/reports/the-role-of-critical-minerals-in-clean-energy-transitions/reliable-supply-of-minerals
5 https://www.msci.com/www/blog-posts/how-climate-change-affected/02841370014
6 https://www.munichre.com/en/company/media-relations/media-information-and-corporate-news/media-information/2021/2020-natural-disasters-balance.html

Along with the focus on the environmental footprint, social and governmental risks also need to be factored by organisations into their decision-making process. Negative findings on transparency, good governance, health and safety or other social matters can lead to significant reputational damage as well as financial risks for the company and/or its management. They might also negatively impact an M&A transaction as shown by the recent case where various PE houses dropped out of the bidding process due to social concerns during Unilever's recent divestment of its tea business[7].

These are just some examples of ESG related risks. None of these risks are a binary 'yes' or 'no' or linear in impact. An operational site of a mining company in one country might be impacted by floods and landslide while expansion plans in another jurisdiction might be impacted by droughts and water shortages. Importance of scenario-building and planning for alternatives will become extremely critical for companies. The scenario planning analysis will also be helpful and relevant as companies look to meet growing ESG reporting requirements, some of which require quantifying financial impact of climate risks under multiple scenarios.

[7] https://www.ft.com/content/5c7bbed1-c0ce-4767-a275-530b8ab9a1fc

VALUE CREATION OPPORTUNITIES

Focus on ESG also brings various value creation opportunities for organisations.

Through an ESG lens, companies can look at achieving resource efficiencies which in-turn can lead to cost savings and margin improvements. Research by Ellen MacArthur foundation suggests annual cost savings of approx. $700 million to be achieved by the FMCG industry alone by incorporating circular economy principles[8]. AB InBev, the global brewing company is targeting savings of up to $80 million by 2025 through collaboration with various start-ups in the area of carbon footprint, recycling, alternative fuels, etc.[9] Through ESG-focused partnerships with suppliers and external stakeholders, companies can achieve significant resource efficiencies and cost savings across their value chains.

The ‘Right to Repair’ movement seeks to reduce electronic waste (‘e-waste’) by expanding the lifespan of electronic products and making them easier to be repaired. Countries like France and the UK have already implemented regulations around this. Various states in the US and EU are also looking at similar legislations. Preempting such regulatory changes, companies in the consumer electronics space can initiate plans to work out changes in product design/R&D to produce more repairable products. From a social perspective, it can help companies create opportunities for upskilling existing labour force as well as generating new employment in communities. Apple has very recently announced Self Service Repair programme[10]. More companies will eventually have to follow as additional regulations are introduced.

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Mining companies can take advantage of growing e-waste and engage in extracting and recycling traditional metals like copper, aluminium, gold, etc. from cities - ‘urban’ mines of today. 100 times more gold can be extracted from e-waste compared to traditional mining from raw ore[11]. In addition to using less resources, e-waste recycling is also less damaging for environment as well as for indigenous communities (as deforestation and displacement can be avoided, thereby protecting ecosystems and biodiversity).

[8] https://www.ellenmacarthurfoundation.org/circular-economy/what-is-the-circular-economy
[9] https://www.ab-inbev.com/content/dam/abinbev
[10] https://www.apple.com/uk/newsroom/2021/11/apple-announces-self-service-repair/
[11] https://astute.global/a-ton-of-mobile-phones-has-100-x-more-gold-than-a-ton-of-gold-ore-reports-e-waste-initiative/

Focus on ESG can also lead to greater M&A and fund-raising opportunities for corporates, particularly where corporates might be looking at acquisitions to meet their own sustainability targets.

Let's take the example of Who Gives a Crap, the Australian company selling forest friendly toilet paper. They raised AUD $41.5m from Verlinvest, in a fund-raising round that attracted a very large pool of ESG-focused investors. In such instances, the founders were at a liberty to choose a 'partner' (from the plethora of interested parties) whose principles, investment horizon and value creation focus aligned with theirs. The equation is clear, there is a significant demand for ESG assets. It is up to businesses to take advantage of this by proactively getting on top of their ESG strategy and creating value through deals and M&As.

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Employees are increasingly preferring companies that demonstrate responsible behavior and a purpose. Oil and gas majors are already struggling to attract the right talent as employees chase 'greener' jobs[12]. Over the next decade, 72% of global workforce will consist of Millennials and Gen-Zs[13]. ESG performance will become increasingly important to attracting and retaining talent. Organisations can therefore embed ESG parameters into their business operations and overall purpose/vision to generate value from attracting and employing top-class talent of the future.

A focus on ESG does not only help to mitigate risks, it also brings multiple opportunities for value creation. Overall, organisations need to revisit their decision-making principles and planning horizons to make them medium to long-term oriented vs the traditional short-term focus on quarterly results. Adopting a wider view that includes not only profits, but also people and our planet, will bring opportunities both in the form of reduced risks and increased value creation.

[12] https://www.ft.com/content/3b53f1bd-4625-4733-afb9-af4301257506
[13] https://www.marshmclennan.com/esg-interactive.html

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