ESG RISKS:
Investors & Indian Boards

Companies that successfully incorporate sustainability into their core business strategy are better positioned to lead in an evolving, complex and increasingly transparent marketplace. These companies are also more attractive to institutional investors and are likely to attract the bulk of capital investments going forward.

Barring a few exceptions in recent years, Indian companies have been notorious for poor ESG (Environmental, Social and Governance)/sustainability standards. Though fundamentally different, sustainability is often confused with corporate social responsibility (CSR) and viewed as a compliance matter rather than a performance management tool.

While CSR is a set of socially responsible activities that a company undertakes to convey its commitment to its stakeholders, ESG, predominantly used by investors and lenders, is the criteria upon which a company's practices is evaluated. As FTI Consulting's India Disclosure Index 2018 shows, only 51 percent of India's top 100 listed companies provide sustainability reports that adhere to internationally recognised benchmarks.

Despite a Securities Exchange Board of India (SEBI) notification that mandates listed companies to submit Business Responsibility Reports (BRRs), ESG topics are still regarded by many boards as soft issues that require limited attention in lieu of the other short-term business challenges that a company is otherwise confronted with. This perception is quickly changing.

Globally, there is now irrefutable evidence to prove that a company's bottom-line is directly linked to its sustainability strategy. All major institutional investors in the world such as Blackrock, Vanguard, Canadian Pension Plan and Fidelity have recognised this and are employing teams of ESG analysts that are trained to look for ESG red flags in an investee company as part of the due-diligence process or monitoring their portfolio post an investment.

Over the past few months, two ESG funds have been launched. Three former Tata group veterans led by Mukund Rajan have come together with asset manager Quantum Advisors to launch a $1 billion ESG fund. KKR backed Avendus Capital has also successfully launched its ESG-based fund and will invest in the listed Indian equities space based on pre-determined ESG factors.

Is a company conscious about the impact of its product on the environment and climate along the supply chain? Does the company adhere to sufficient health and safety standards in its workplace? Does a company value diversity and is this reflected in its board composition? These are some of the questions that ESG analysts are now reviewing and their recommendations are strongly factoring into investment decisions.

Institutional investors are not the only group closely monitoring a company's sustainability strategy. NGOs, media and the government are equally interested. Even retailers understand that the market for fair-trade products or goods with a strong sustainability story is expanding rapidly. Sustainability also goes a long way in attracting the best talent. Millennials in particular, would prefer to work with companies that share similar values.

Board Commitment is Critical

Each company has its own set of ESG risks that are unique to its business. For example, a financial institution and a manufacturing entity will have greatly different ESG risks. While banks would be keen on diversifying their lending portfolio to ensure that the bulk of their capital is invested in green projects, manufacturing entities would be concerned about the resilience of their supply chain. As part of an audit, companies may also identify a whole set of material ESG issues peripheral to the core business but still relevant to the ecosystem that it operates in.

Identifying and defining these risks should be primarily the responsibility of the C-suite leadership. Thoroughly reviewing whether all risks have been rightly captured and accounted for is the responsibility of the board. It is also the board's responsibility to identify material issues that are most relevant to the company's competitive advantage and develop a strategy with the management to address and monitor progress of the same.

Boards may also institute KPIs and timelines for the management to report back on. While companies may be dealing with the day-to-day operational challenges, it is the board's responsibility to take a long-term view and future-proof itself from ESG risks.

Sustainability and Business Strategy

In India, almost all the emphasis in ESG reporting has been on the "G" (governance). The realisation that the "E" (environment) and "S" (social) are equally important has only recently set in. Global institutional investors have had a role to play in this as well. Blackrock is calling for all boards to be climate competent if they are to succeed in assessing and mitigating complex environmental issues. Vanguard has also identified climate risks as a top priority in its investment agenda. State Street Global Advisors has voted against 400 companies that had failed to initiate efforts to increase representation of women on their boards.

An FTI Consulting survey of 130 global institutional investors conducted between May and July 2018 also provides insight into the increasing investment weighting of ESG principles. An overwhelming majority of the investors (managing a sum exceeding $8.4 trillion in assets) attribute real corporate value to companies with high ESG ratings.

Going forward, companies need to clearly map out in detail, the impact of its business on customers, employees, communities and investors. A glossy report highlighting a company's sustainability story accounts for little unless there is a long-term consideration of both risks and opportunities.

In this regard, a top-down sustainability approach might appear favourable as it largely ensures enterprise wide buy-in. However, most sustainability decisions are often made on the shop floor. It is vital to train shop-floor workers to have a sustainability mindset and adopt a range of other complimentary initiatives to incentivise action across the labour chain.

Every company has its own unique set of circumstances and there is no set template for crafting the perfect ESG strategy. However, while formulating a strategy, a company's C-suite and the board must work in tandem to solve five key questions:

1) Does the company possess clear ESG objectives and quantifiable targets (KPIs) to measure outcome across geographies?

2) Are ESG issues featuring in all decisions (hiring, marketing, procurement etc.) across the value chain of the company?

3) What standardised disclosure methodology is a company adopting to report its materiality?

4) Is the company communicating its sustainability story in a compelling manner to its stakeholders?

5) Does the company's ESG strategy foster long-term value creation for all its stakeholders?

ESG issues are often viewed as risks that need to be mitigated. Framing these risks as opportunities can potentially unlock new business streams. Deeply embedding this mindset into a company's strategy and culture is the next big challenge that Indian corporations will be confronted with.

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