ESG: A SOUND CASE FOR PROFITABILITY

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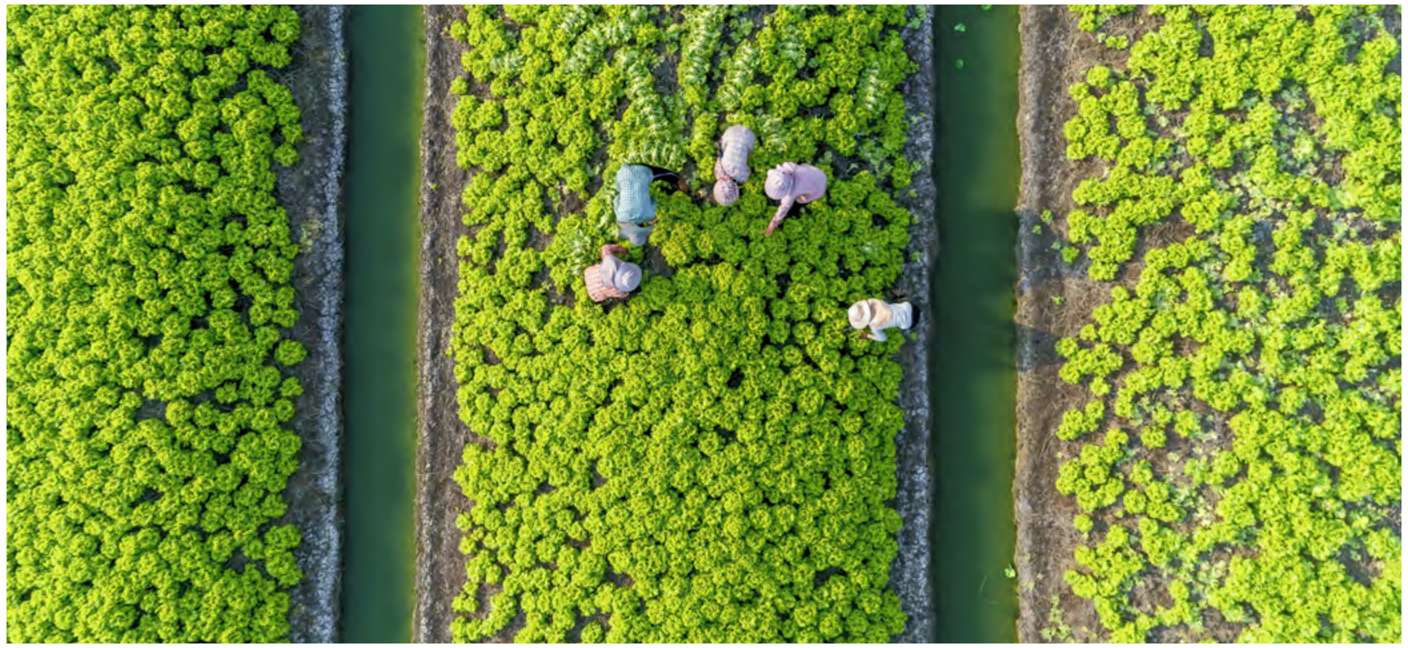
ESG: The Foundations

Environmental, social and governance (ESG) factors have come a long way since their inception in 2005 and have taken the spotlight across all industries to become an integral part of their strategic and investment decision-making processes. Analysis of these factors has provided companies with tools for effective risk management and enabled them to take advantage of growth opportunities. In addition, they are addressing the demands of stakeholders such as customers, employees and investors. Conceptually and historically, ESG has evolved from the foundations set by initiatives such as Corporate Social Responsibility (CSR), Socially Responsible Investment (SRI), Principles for Responsible Investment (PRI), and the Global Reporting Initiative (GRI). Moreover, it has transcended notions of charitable actions or voluntary endeavours. Time has proven ESG's underlying profitability, and scepticism and strong resistance borne out of ill-advised cultural and historical drivers have been more than countered.

ESG: The Profitable Opportunity

Many academic studies exist supporting the thesis that companies practising good ESG tend to outperform their competitors who do not over time. Common sense and scientific studies suggest this logic follows through to better and more productive communities and economies. The positive ripple effects of ESG very much catching on as a theme are being seen in terms of related assets under management, and across different asset classes. Market forecasts suggest the current estimated USD 4 trillion in ESG debt securities could grow to USD 15 trillion by 2025. Total global ESG assets may have exceeded USD 41 trillion by the end of 2022, and could reach USD 50 trillion by 2025, according to Bloomberg Intelligence; ESG assets had probably surpassed USD 35 trillion by the end of 2020, up from USD 22.8 trillion in 2016. Furthermore, ESG assets now represent a third of the total global assets under management according to the Global Sustainable Investment Association. Europe is thought to account for half of global ESG assets and it



dominated this new classification until about 2018. The US, however, has become much more important, seeing growth of over 40% in the last few years.

The so-called "Green" bond market recently hit the milestone of USD 2 trillion in value, and "sustainable" bonds including social, sustainability, sustainability-linked and transition bonds reached a combined value of USD 3.5 trillion at the end of the third quarter of last year, according to a Climate Bonds Initiative report sponsored by FAB and launched at COP27.

During the last five years, the application of ESG factors gained sufficient traction to become mainstream across a majority of industries. The overall concept has achieved inclusion in numerous jurisdictions worldwide, with regulators accelerating the pace of embedding ESG considerations in their frameworks. A good example is the European Union's Green Taxonomy, and also its recently approved Corporate Sustainability Reporting Directive (CSRD), underlining the financial importance of ESG considerations.

Now that ESG is in the forefront of many corporate investment discussions, transparency is playing an increasingly key role to ensure that all stakeholders are updated on companies' progress. Hence, ESG disclosures and statements of commitments are becoming business as usual among companies worldwide. Of the S&P 500 Index constituents, for instance, over 90% of them have published sustainability reports up from only 20% in 2011, according to the World Bank. In recent years, we have also seen companies getting more involved in environment-related matters, often initially to understand and reduce their "carbon footprint" and make their contribution to Net Zero (the balance between the amount of greenhouse gas produced and the amount removed from the atmosphere). More than 5000 businesses have already made net-zero commitments as part of the United Nations' "Race to Zero" campaign. In the banking industry, initiatives like the Net-Zero Banking Alliance (NZBA), launched in 2021, have currently attracted 120 members, and represent 40% of global banking assets.

ESG has also been seen as a business opportunity, for instance, given the growing consumer appetite for sustainability products. According to the Global Sustainability Study 2021 by Simon-Kucher & Partners, 85% of people globally are believed to have shifted their purchase behaviour towards being more sustainable during the past five years. The same research highlights that sustainability is rated an important purchase criterion for 60% of consumers. Within our own region, according to a recent PwC Strategy & Middle East study, more than 60% of UAE consumers would be interested in orienting 5% or more of their available income into sustainable banking or investment products.

ESG: The Risks of Overlooking the Factors

The positive opportunities of ESG are becoming clearer, as are the potential negative consequences of not taking these factors into account. The latter course of (in) action can carry material risks, and can indeed jeopardise the health of a company's businesses and operations over the long-term – in the form of reduced revenue, asset depreciation and litigation costs, among many others. Companies that implement effective ESG practices are less likely to face harmful controversies, while being better able to respond when such incidents do occur. Companies that experienced high-to-severe ESG incidents subsequently lost an average of 6% of their market capitalisation, according to Sustainalytics research.

While some ESG risks pose clear multi-sector potential negatives, others will naturally be more industry-specific. Sectors such as consumer staples and utilities are at the greatest risk of hits to their market value resulting from ESG-related controversies, according to Sustainalytics. Having spelled out some of the negatives of not adopting ESG practices, however, it must also be said that their application is not totally free from concerns, and that it is far from being an automated process.

Besides the risks of not embracing ESG factors, there can be issues from their faulty adoption and/or misrepresentation of compliance with them. Proportional with effective ESG implementation grows the risk of so-called "greenwashing". This is essentially a type of marketing designed, for instance, to make some products or services appear more appealing to environmentally-driven customers (or investors) by advertising a positive environmental feature that they do not actually materially carry. An anonymous Harris poll for Google Cloud conducted in 2022 found that 58% of CEOs worldwide (and 68% in the US) admitted that their companies were guilty of greenwashing. Also, the lack of consistency between the various international ESG protocols can represent significant challenges to effective ESG implementation. Companies may be applying up to 14 different frameworks globally to report on their ESG credentials, making the task for stakeholders of measuring and comparing sustainability

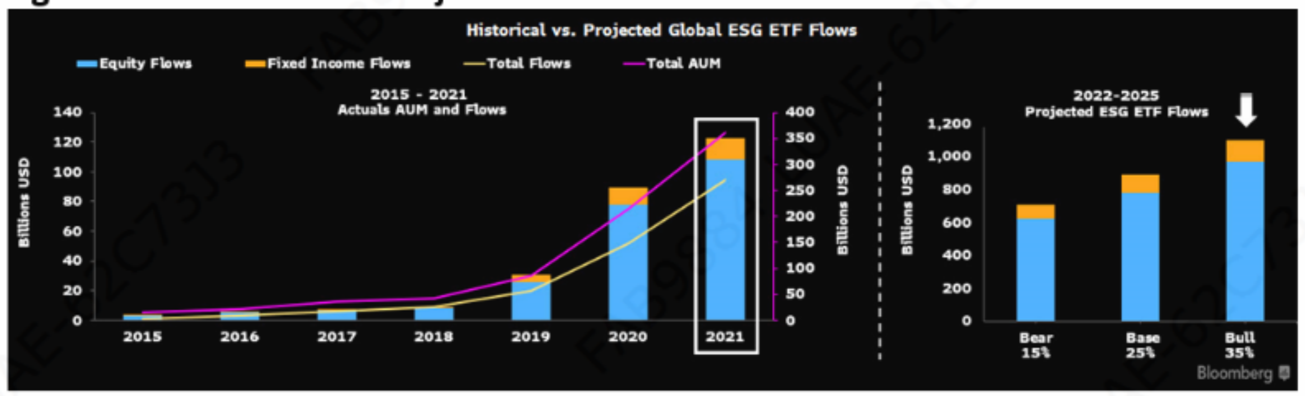
performance more difficult. Research from Duff & Phelps found that almost half of valuation experts believe the lack of a standardised and recognised measurement system is the biggest threat to effective ESG disclosures for businesses.

Given the sometimes poor quality of ESG data, as financial firms and institutional investors aim to measure their ESG exposures, sourcing high quality data from companies and projects is fundamental. Without mandatory and consistent definitions, metrics and reporting, the quality of data can be heavily undermined. Any lack of standardised ESG data may well hide material risks. Accordingly, common standards for ESG definitions are critical, and policymakers and regulators will need to better ensure this over the months and years to come, making requirements increasingly mandatory as they do so.

https://www.climatebonds.net/files/reports/cbi_susdebtsum_highlq32022_final.pdf

https://www.bloomberg.com/company/press/esg-may-surpass-41-trillion-assets-in-2022-but-not-without-challenges-finds-bloomberg-intelligence/

Figure 1: Historical vs. Projected Global ESG ETF Flows



Source: Bloomberg Intelligence, DataExhibit.