

AN FTI CONSULTING REPORT



Stakeholder capitalism in the spotlight: How has COVID-19 changed institutional investors' approach to ESG?

The COVID-19 pandemic has far-reaching implications for public health, individual behaviour, and the global economy. Its tumultuous implications are only starting to be understood, while the reverberations will continue for years to come. One outcome that is already clear is the increased centrality of Environment, Social and Governance factors, or ESG, to corporate strategy.

The pandemic has driven calls from multiple organisations, most notably the World Economic Forum, for a “Great Reset” in which companies develop new practices and business models that enable them to build back better via low-carbon production methods and a more sustainable overall approach. Some businesses are already adapting, including oil major BP which announced in August 2020 that it would reduce oil production by 40% and increase renewable energy spending 10-fold by 2030 with the goal of becoming a net-zero emissions company by 2050.

ESG has been elevated in importance by increased corporate action, and also by the efforts of national and international policymakers, financial regulators, stakeholders including company employees and customers, and among shareholders. This last audience is the primary focus of this report which explores new FTI research into institutional investors' approach to ESG.

This paper covers three topics:

- An overview of key trends in E, S and G during 2020;
- A review of FTI's new research findings which demonstrates how institutional investors have increased their focus on ESG in the course of the COVID-19 pandemic;
- Recommendations for corporations – regardless of past ESG performance – on ways to effectively evolve their approach to sustainability in the light of this new reality.

ESG in 2020: key trends in Environment, Social and Governance

By far the most significant **environmental** factor driving increased regulatory focus on ESG in 2020 is climate. Decades of science-based evidence from the Intergovernmental Panel on Climate Change (IPCC) that greenhouse gas emissions are accelerating global warming, and calls for rapid reductions by 2030 to reverse the trend, have been given added urgency by dramatic climate-related environmental changes. These include Arctic permafrost thawing at scale in Siberia; extensive wildfires in Australia and California; the third mass bleaching event on the Great Barrier Reef in five years; and an exceptionally active Atlantic hurricane season.

Against this backdrop the European Union finalised its Sustainable Finance Action Plan. This contains multiple measures to increase the flow of investments into initiatives aligned with the European Green Deal's goal of achieving a climate-neutral Europe with net-zero greenhouse gas emissions by 2050. In September the EU also added an amendment to the European Green Deal that would commit the 27-nation bloc to reducing emissions by 55% by 2030 compared to 1990 levels, versus the current 40% target. These measures are the latest levers being pulled by global and national policy and financial regulators to direct businesses towards a more sustainable model what the WEF's International Business Council has called stakeholder capitalism. And more are forthcoming: in the United Kingdom for example the Financial Conduct Authority plans to require corporations to report how they will address the risks and opportunities around climate change, in line with the Taskforce on Climate-related Financial Disclosure (TCFD) framework. The UK Government has indicated that it expects all listed companies and large asset owners to disclose in line with TCFD by 2022.

While the race to net-zero has been critical in elevating corporate engagement with ESG, so too have **social** factors. Social equality movements, most notably Black Lives Matter, entered the public discourse in 2020 in an unprecedented way, bringing new urgency to the topic of workplace diversity and inclusion. The UK Parker Review's finding that 37% of FTSE 100 companies surveyed do not have any ethnic minority board representation is being tackled by corporate actions and initiatives including the Confederation of British Industry's Change the Race Ratio, a campaign backed by Aviva, Microsoft, Linklaters and others that calls on businesses to set and publish clear targets for greater racial and ethnic diversity at board, executive committee and senior management levels. Support for the BLM movement has triggered employee-led discussions within global companies around how to increase workplace diversity. And COVID-19 has meant business contingency planning emphasised staff health and welfare as companies grappled with working life during lockdown.

Governance too has gained new saliency on multiple fronts. At Boohoo, a stock market darling for years, the plight of low-paid Leicester garment factory workers during the COVID-19 pandemic revealed that its practice of onshoring fast fashion manufacturing to reduce lead times for UK sales was not accompanied by effective governance oversight of its supply chain. Rather, the independent review by Alison Levitt QC reported in September: *"Boohoo's extraordinary commercial growth has been so fast that its governance processes have failed to keep pace; it has concentrated on revenue generation sometimes at the expense of the other, equally important, obligations which large corporate entities have...Boohoo's monitoring of its Leicester supply chain was inadequate and this was attributable to weak corporate governance."*

Investors took note: Boohoo shares almost halved in value as the supply chain issues emerged, recovering around 10% as the company announced measures to improve governance including adding non-executive directors to its board and ensuring a majority of independent directors. Questions were also raised around both Boohoo's ESG track record, and whether asset managers should have looked more closely at the fast fashion business and its supply chain working practices before including it in ESG-focused funds. As FTI's survey reveals, institutional investors interviewed a few weeks after issues at Boohoo came to light say they are increasingly asking companies for more information about their ESG data. Another governance topic, executive pay, was once again in the spotlight at a time of widespread furloughs and layoffs. Institutional Shareholder Services actively opposed some CEO pay and bonus awards, indicating that executive pay will continue to be a focus for proxy advisors.

At the same time ESG reporting standards continue to evolve. In September 2020 the Big Four accounting firms of Deloitte, EY, KPMG and PwC in partnership with the WEF's International Business Council published joint recommendations on common metrics and reporting methods to track corporations' ability to deliver sustainable value creation. This will result in greater standardisation of ESG reporting, in turn enabling investors to more easily compare companies within a sector. Another notable development is the merger of the Global Reporting Initiative (GRI) with the Sustainable Accounting Standards Board (SASB). The consolidation of these two leading entities in ESG standards will ultimately make it easier for companies to conduct rigorous ESG reporting which in turn will assist investors and analysts.

How COVID-19 has increased Institutional Investors' focus on ESG

Against this backdrop, FTI is helping its clients understand the evolving ESG landscape by publishing findings from a quantitative assessment of the views of global institutional investors.

Our research addresses two primary questions:

- **How have attitudes among global institutional investors towards ESG changed as a result of the pandemic?**
- **What are the ESG issues that matter most to this audience?**

In August 2020 we contacted 267 global institutional investors representing more than \$10 trillion assets under management, comparing the responses against a similar group surveyed on the eve of the pandemic in February 2020. Our research reveals that this important audience is taking an increasingly sophisticated approach to ESG, which in turn raises the stakes for corporate ESG and sustainability strategies.

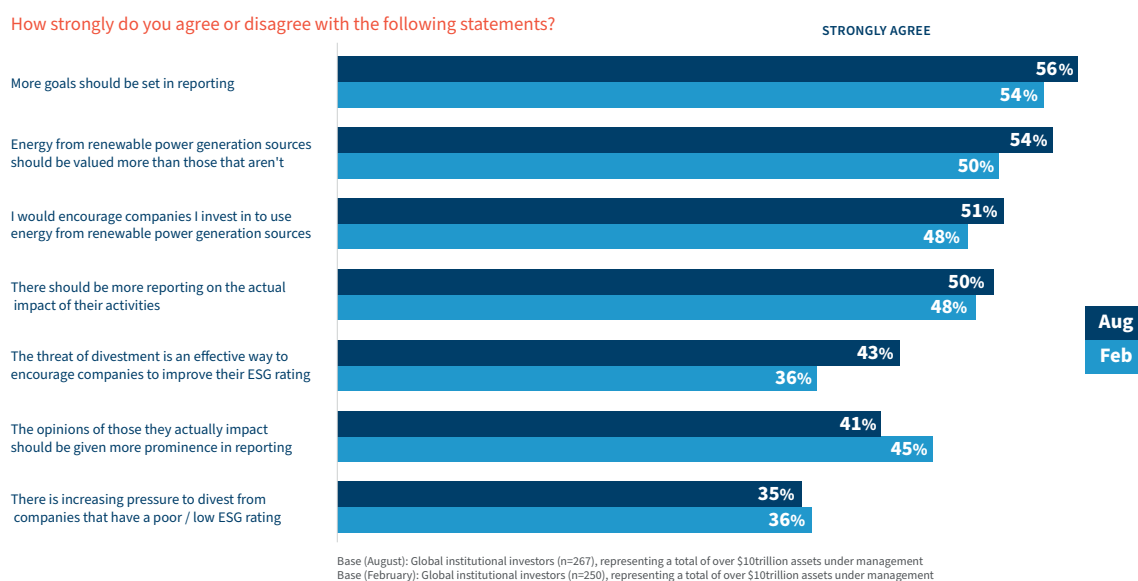
1. Climate has risen up institutional investors' agenda

During 2020, institutional investors increased their understanding of the complex issues around climate change. A total of 95% of those surveyed said they regarded themselves as well informed on the topic, representing a 7% increase in six months. In Europe the increase was greater at 9%, perhaps driven by the ongoing rollout of climate-related policies and regulations in the European Union and United Kingdom.

95% of institutional investors are well informed about climate change, an increase of 7% in six months

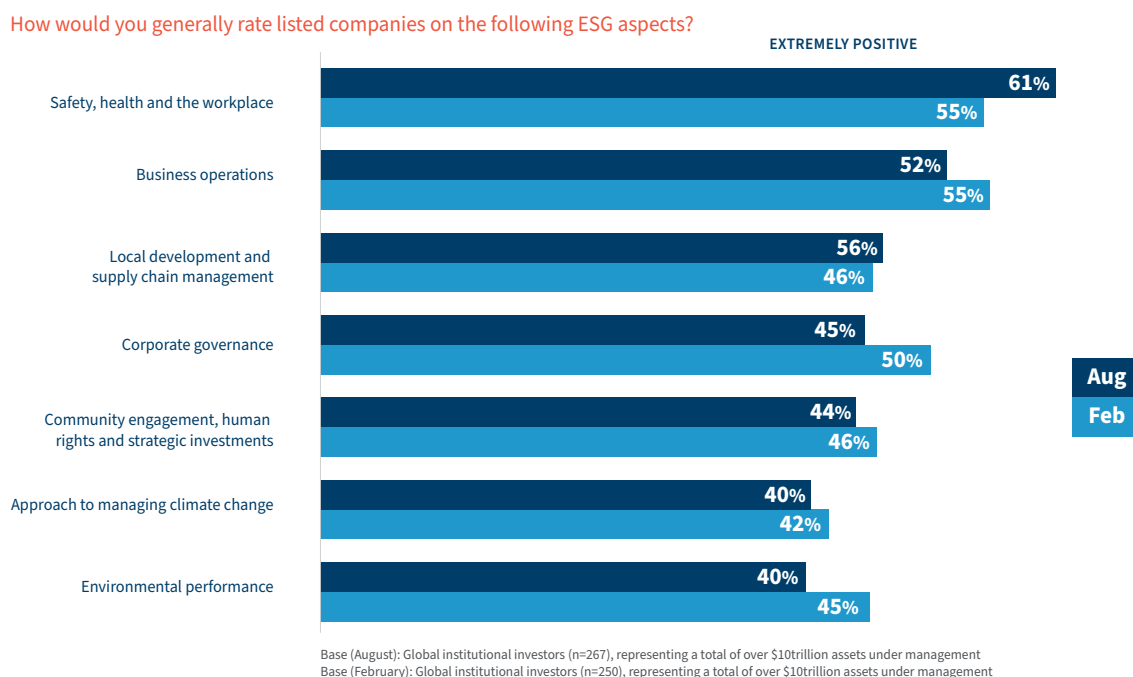
As a result, investors are placing greater value on companies that are acting to tackle the global climate emergency. More than half now say they would encourage companies they invest in to use energy from renewable power generation sources (51%) and that these sources should be valued more highly than nonrenewable ones (54%).

This may reflect that metrics around energy use are frequently requested by ESG ratings agencies, and indicates that companies should be ready to disclose and explain their energy sources. Investors are also looking for greater transparency and accountability from ESG reporting: 56% want to see more goals being set compared with 54% in February.



As investors' personal knowledge around climate change has increased there has been an apparent loss of confidence in businesses' ability to transition towards net-zero. When asked how they felt about listed companies approach to environmental performance, only 40% were extremely positive compared with 45% six months earlier. For climate change, again 40% were extremely positive about listed companies' performance, down from 42% in February. This indicates that companies can expect closer scrutiny from investors around all E metrics, and climate change in particular.

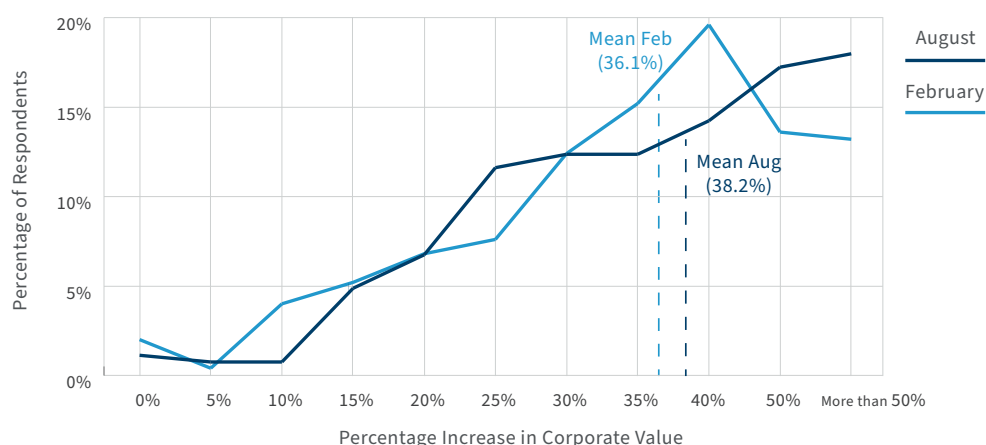
Only 40% of institutional investors are extremely positive about corporate environmental performance, a decline of 5% in six months



2. Companies with a strong overall ESG performance command a higher valuation

Institutional investors are nearly unanimous in seeing a positive correlation between strong ESG performance and high company valuation. A total of 99% of respondents said that a high ESG rating would increase corporate value, while 35% said a high ESG rating would increase corporate value by 40% or more. The mean additional value for a company with a high ESG rating rose by 2.1%, from 36.1% in February to 38.2% in August. This acknowledgement of the importance of ESG and sustainability from investors validates those companies where businesses are showing sustainability leadership. It also underpins how those boardrooms where corporate leaders still need convincing that ESG matters must move quickly to catch up. In either scenario, it is evident that CEOs must pay close attention to the effective implementation of their ESG and sustainability strategies.

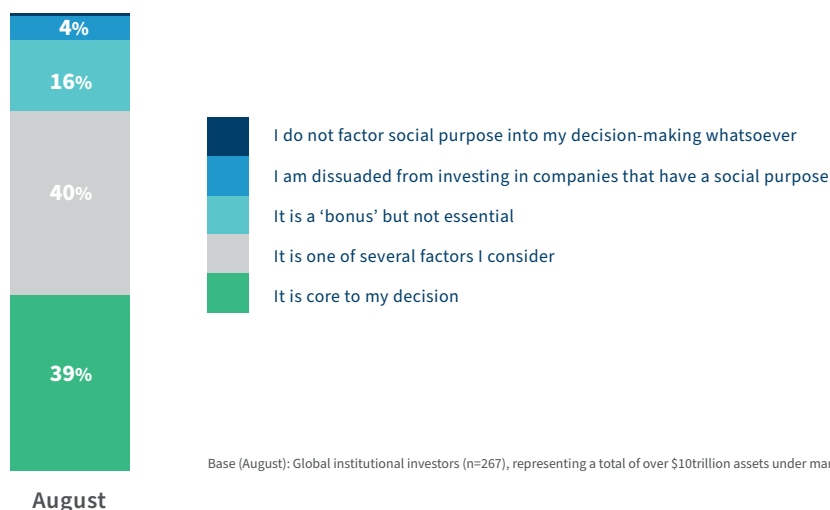
What extra percentage of corporate value would you attribute to a company if they had an extremely positive/high ESG rating?



3. Investors expect CEOs to balance profits with purpose

While institutional investors' top priority for companies they invest in is increased profitability (52%), they also want to invest in businesses whose sense of responsibility extends beyond the balance sheet. Nearly four fifths of respondents (79%) said they actively consider whether a company has a social purpose when making investment decisions. A strong ESG and sustainability strategy is a key foundation of corporate purpose, since it requires companies to consider not just their output and profitability, but overall impact across society and the planet. Frameworks such as TCFD are accelerating the incorporation of ESG into corporate strategy and purpose by placing greater responsibility on CEOs and boards to be accountable for tracking and mitigating climate emissions.

Which of the following best describes the importance you attribute to a company having a social purpose, when deciding whether or not to invest in that company?



Base (August): Global institutional investors (n=267), representing a total of over \$10trillion assets under management

4. Investors want companies to be more transparent about sustainability

Institutional investors are increasingly probing companies on their ESG approach. Three quarters (74%) are actively requesting more information about corporations' sustainability strategy, a significant 11% increase compared to the February sample. Only 4% said they would not seek additional sustainability data from companies. This trend for greater disclosure is set to increase as ESG becomes a bigger overall area of investment, and companies should have the processes and resources in place to respond to these requests in a timely way.

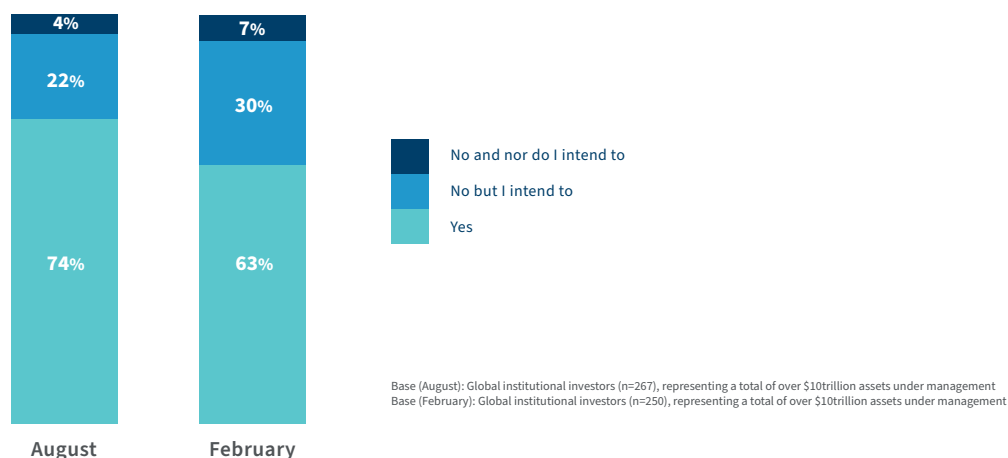
The percentage of global institutional investors asking companies for greater sustainability disclosure increased from 63% to 74% in six months

Investors are concerned that companies are concealing ESG data points for fear of impacting their overall rating. More than half (57%) now believe firms do not report "unfavourable" non-financial information, compared to just 40% in February. The practice of greenwashing is also seen as on the rise, with 100% of institutional investors believing it takes place to some extent. Whereas in February institutional investors estimated 57% of companies were engaged in greenwashing (or overstating their environmental commitment), that proportion has now risen to 59%. Even more starkly, more than a quarter of investors (28%) believe that between 80% and 100% of companies publish misleading environmental credentials.

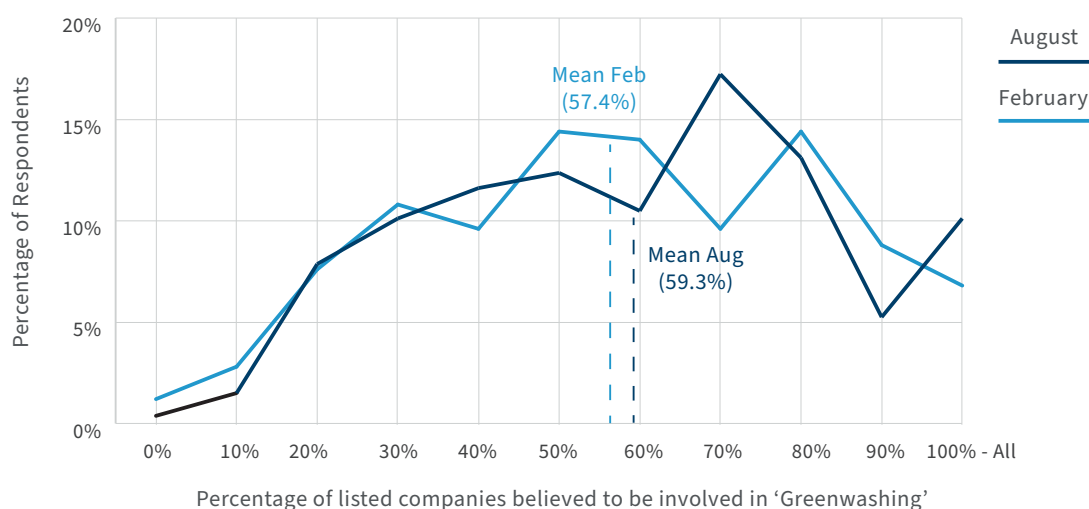
If these suspicions are correct, they point to short-term thinking amongst corporations. A better approach would be to provide context around past areas of ESG weakness, and develop strategies and measurable targets to achieve future improvement – both practices which ESG evaluation encourages.

Another reason why greenwashing and non-reporting are not viable long term strategies is the evidence cited earlier in this report that institutional investors have themselves become more knowledgeable around climate change. That knowledge is fuelling their demand for more information, and their growing concerns over greenwashing and lack of disclosure. In short, investors are engaging more with the ESG and sustainability discovery process, and companies should expect to be able to provide clear responses on both overall strategy and tactical delivery.

Have you been requesting more transparency about sustainability strategy of companies?



What extra percentage of corporate value would you attribute to a company if they had an extremely positive/high ESG rating?

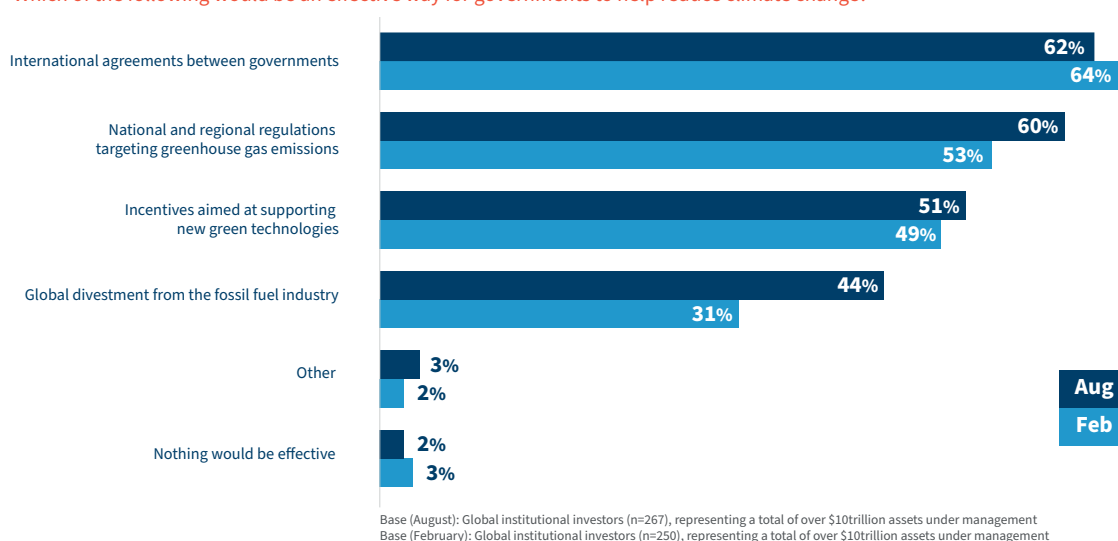


5. Investors want governments to play a leading role in tackling climate change

One of the outcomes of the global pandemic was a decline in greenhouse gas (GHG) emissions, especially carbon dioxide, in the first few months of 2020 as demand for travel, transportation and manufacturing fell away. This may in part explain an upswing in support among institutional investors for greater national and regional regulations to target GHGs: backing for these measures grew by 7% between February and August, from 53% to 60%. Support for global divestment from the fossil fuel industry increased by almost one third in the same period from 31% to 44%. While international agreements between governments to tackling climate change are still seen as the most effective approach, support fell by 2% from 64% to 62% perhaps in response to the Trump administration's stated intent to remove the USA from the Paris agreement. However, the poll was conducted before China's announcement in September that it aims to become carbon neutral by 2060.

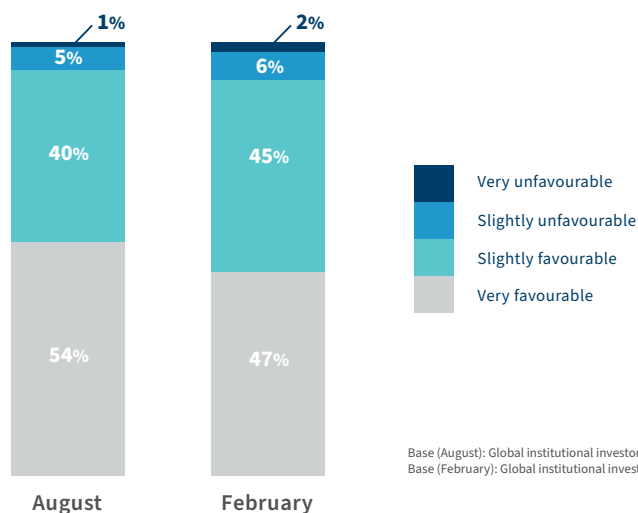
Support for more regulations targeting greenhouse gases rose to 60%, up 7% in six months

Which of the following would be an effective way for governments to help reduce climate change?



Investors also voiced support for the European Commission's Technical Expert Group on Sustainable Finance (TEG). This group seeks to increase standardisation of definitions around sustainable economic activities and Green Bonds, and recently publishing the Sustainable Taxonomy to guide investment decisions. A total of 94% of respondents said they viewed the TEG's efforts favourably, with the proportion saying they had a "very favourable" stance growing by 7% since February, from 47% to 54%. It is likely that formal adoption of the Sustainable Finance Taxonomy in June and widespread discussion of other TEG initiatives since February have boosted support among institutional investors. These findings suggest that investors welcome and will adapt to clear guidelines on ESG in general and climate change in particular. When the rules are clear, and a level playing field is established, it is easier for them to judge corporate performance.

How favourable or unfavourable are you of this European Commission initiative?

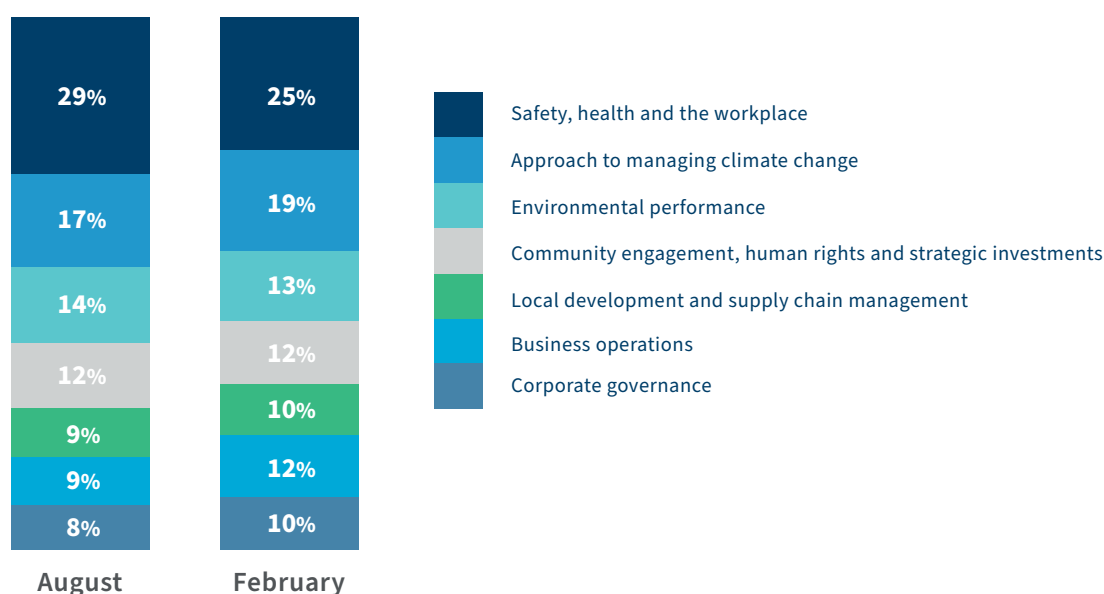


6. COVID-19 has increased the focus on workplace health and safety

In the midst of a global pandemic, institutional investors have naturally paid close attention to the health and welfare of workers. As a result, our research saw a 4% increase in the importance of safety and health in the workplace as a driver of ESG investment decision making, from 25% to 29%. Health and safety had emerged as the primary consideration for ESG investing in February, driven by the human cost, and potentially negative impacts on corporate valuation and reputation, of adverse health and welfare conditions. As COVID-19 continues to spread without a vaccine, health and safety will remain a primary area of concern for investors and companies will be held to account for any failures to protect employees.

Climate change and environmental performance were the second and third most important factors for respondents, and although the percentages may ebb and flow between these three factors they will continue as important drivers of ESG investment decision making for some time.

What weight of importance would you attribute to the following ESG aspects in relation to your investment decision making?



Recommendations on achieving ESG leadership

As FTI's research has demonstrated, institutional investors are becoming more knowledgeable about climate change and other ESG drivers. They want companies to be transparent in their sustainability reporting, and are making investment decisions based on a range of ESG criteria. The overwhelming majority believe businesses that demonstrate both profitability and a strong ESG performance can achieve a higher corporate valuation.

This may sound challenging to corporate leaders already wrestling with the manifold challenges of running a business in the midst of a global pandemic. However, at a fundamental compliance level it is vital that businesses understand the changing expectations around ESG not just from investors but from governments, financial regulators and stakeholders. And there is considerable potential for opportunity too: from straightforward cost savings in reduced resource and energy use, to talent attraction and retention, through to the development of innovative new products, for example tapping into the emerging circular economy.

With this in mind, here are five steps companies can take to achieve leadership in ESG:

1. Know your company's ESG strengths and weaknesses.

The first step towards a resilient sustainability strategy for the future is to understand current performance. FTI's data-driven ESG Compass Model provides companies with insights that can inform future decision-making, and is shown on the next page. (For investors, the ESG Compass Model can prove valuable in assessing different companies and providing a data visualisation of comparative results.)

2. Understand which sustainability topics matter most to your business and its stakeholders.

Best practice ESG reporting includes a materiality assessment that maps a company's priorities against those of its stakeholders (for instance, employees, customers, suppliers, and investors). Finding areas of greatest crossover ensures business strategy and ESG focus areas are aligned.

3. Stay up to date.

Non-financial reporting requirements and policymaking around climate are highly dynamic. Companies can build knowledge and plan for their future by drawing on insights

from industry coalitions as well as public affairs, investor relations, and sustainability experts. Information gained will enable timely decision making

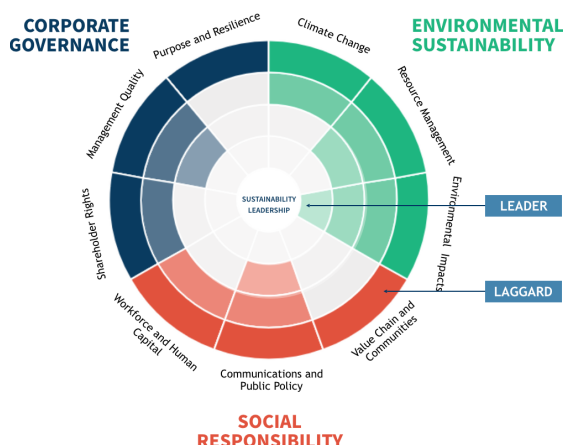
4. Be transparent.

Avoid greenwash. Companies at an early stage of their ESG journey should say as much and then explain how they intend to make progress over time.

5. Embrace change - now.

The global goal enshrined in the Paris Agreement of zero emissions by 2050 may seem a long way off, but there are multiple sustainability-related milestones in the near future. In November 2021 the postponed COP26 meeting takes place in Glasgow, Scotland, and this will keep the topic of climate centre stage; in the UK TCFD implementation is likely to start from 2022; the EU's plans to achieve a 55% in GHG emissions by 2030 will feed into future policy commitments; in California and the UK the sale of Internal Combustion Engine vehicles will end in 2035. Adapting to these and many other transformations requires innovation, which in turn can drive long-term shareholder value.

ESG Compass Model: Data-driven mapping of leadership performance and potential



LEADERS

Top Rank

- ESG policies central to company strategy
- Best-in-class and meaningful disclosure
- Top performers

LATE ADOPTERS

Third Rank

- Partial ESG policies and procedures
- Informative disclosure
- Moderate performance

EARLY ADOPTERS

Second Rank

- Comprehensive ESG policies and procedures
- Informative disclosure
- Good performance

LAGGARDS

Lowest Rank

- ESG based on minimum legal compliance
- Lack of transparency
- Poor performance

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