2022 INTERNATIONAL CLIENT SEMINAR

MARCH 3-6, 2022

WHAT MATTERS TO YOU? TELLING YOUR COMPANY'S ESG STORY

Christen Blackburn
Moderator
LEWIS THOMASON
Nashville, Tennessee
cblackburn@lewisthomason.com

Sheila Kerwin
NILAN JOHNSON LEWIS
Minneapolis, Minnesota
skerwin@nilanjohsnon.com

Environmental Social and Governance: An Overview

Consumer and investor's interest in environmental, social and governance ("ESG") matters has surged in recent years. The current economic, public health, and social justice crises in the past few years have only intensified this focus. ESG, at its core, is a means by which companies can be evaluated with respect to a broad range of socially desirable ends.

ESG describes a set of factors used to measure the non-financial impacts of particular investments and corporate actions. ESG grew out of investment philosophies clustered around sustainability and, thereafter, socially responsible investing (also known as corporate social responsibility). Early efforts focused on excluding companies from investment portfolios largely due to environmental, social or governance concerns, while more recently ESG has favorably distinguished companies that are making positive contributions to the elements of ESG, premised on treating environmental and social issues as core elements of strategic positioning.

ESG metrics have evolved in recent years to measure investment risk as well as opportunity. In his "Dear CEO" letter in 2018, BlackRock Chairman and CEO Larry Fink wrote that:

> [s]ociety is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.
>
> Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world? Are we using behavioral finance and other tools to prepare workers for retirement, so that they invest in a way that will help them achieve their goals?[1]

Other leading business leaders have also supported more expansive views regarding the purpose of a corporation. In August 2019, the Business Roundtable, a non-profit organization comprised of corporate CEOs, released a new Statement on the Purpose of a Corporation (the "BRT Statement").[2] The BRT Statement was signed by the CEOs of nearly 200 leading U.S. companies and identified shareholders as one of five key stakeholders—along with customers, workers, suppliers and communities. The BRT

[1] Larry Fink, Blackrock, "'Dear CEO Letter" (2018), available here.

[2] Business Roundtable, "Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'" (August 19, 2019), available here.

Statement supersedes prior statements that endorsed shareholder primacy (the idea that corporations exist principally to serve shareholders), and "outlines a modern standard for corporate responsibility."

Evidence that businesses are responding to heightened interest in environmental, social and governance issues is everywhere, especially as consumers demand that business play an even bigger role in accelerating progress on ESG concerns. Businesses may have unique concerns but all share some ESG related risks which should be considered and addressed to satisfy consumers, employees, and investors.

The Importance of Developing an ESG Story

Given the increasing interest in ESG factors, it's more important than ever to implement a strategic ESG disclosure and engagement program. Successful companies articulate ways ESG factors impact their long-term strategy and they receive a competitive advantage in doing so. Risks are compounded the longer a company delays. Investors may see a strong balance sheet today, but they want assurance that issuers can sustain that performance into tomorrow. ESG analysis and reporting presents an opportunity for risk mitigation and value creation over the long term.

Communications around ESG present an opportunity to reflect the unique identity of your company. The most effective disclosures focus on traditional financial materiality, while providing context from a culture and values perspective. Though recognized ESG frameworks are useful guidelines, companies should articulate their commitments in a way that shares its progress and builds trust. As society holds businesses to higher standards, understanding Environmental Social and Governance risks and developing an effective and authentic ESG story has never been more important.

ENVIRONMENTAL

While ESG factors are the fundamental framework for measuring a company's sustainability, the Environmental portion of ESG considers how that company performs as a steward of the natural or physical environment. The "E" takes into account a company's utilization of natural resources and the effect of its operations on the environment, both in its direct operations and across its supply chains.

An evaluation of environmental risks considers a company's use of renewable energy sources, waste management program, conservation of natural resource, and treatment of animals. Other possible environmental issues include raw material sourcing (i.e., does the company use fair trade suppliers and organic ingredients?) and whether a company follows biodiversity practices on land it owns or controls. Other examples include ownership of contaminated land, management of toxic emissions, or its compliance with government environmental regulations.

Companies that neglect to consider the effects of their policies and practices on the environment may be exposed to greater financial risk. Without taking appropriate action to curtail carbon emissions or protect against environmental incidents like oil spills or mining explosions, companies can face

governmental or regulatory sanctions, criminal prosecution and reputational damage, all of which risk harming shareholder value.[3]

Environmental concerns can also drive consumer preference. McKinsey research has shown that customers say they are willing to pay to "go green."[4] Although there can be wide discrepancies in practice, including customers who refuse to pay even 1 percent more, McKinsey found that upward of 70 percent of consumers surveyed on purchases in multiple industries, including the automotive, building, electronics, and packaging categories, said they would pay an additional 5 percent for a green product if it met the same performance standards as a nongreen alternative. McKinsey's research reflects that nearly half (44 percent) of the companies surveyed identified business and growth opportunities as the impetus for starting their sustainability programs.[5]

The payoffs are real. When Unilever developed Sunlight, a brand of dishwashing liquid that used much less water than its other brands, sales of Sunlight and Unilever's other water-saving products proceeded to outpace category growth by more than 20 percent in a number of water-scarce markets.

Climate change is expected to increase the frequency of climatic events like hurricanes, floods, heatwaves and wildfires adding an extra layer of uncertainty to the multifaceted framework for measuring a company's sustainability. Climate risk can impose significant financial implications, especially for those companies that fail to adequately plan for the likely impacts of climate change in the form of increasing investment in new sources of energy or technologies.[6]

SOCIAL

An evaluation of Social risk addresses the company's relationship with people. One of the major people relationships is the company's connection to its employees and includes diversity and inclusion efforts. Other relationships include suppliers and corporate involvement in the local community.

While environmental and governance factors have been in focus for a number of years, the coronavirus pandemic, the Black Lives Matter movement, #MeToo movement and campaigns for equal pay, have increased the focus on social factors. As these events unfolded across the globe, companies have re-evaluated and refocused their social initiatives.

A strong Social ESG Initiative can help companies attract and retain quality employees, enhance employee motivation by instilling a sense of purpose, and increase productivity overall. It has long been observed that employees with a sense not just of satisfaction but also of connection perform better. The

[3] SP Global, October 23, 2019, Understanding the E in ESG, available here
[4] McKinsey Quarterly, "Five ways that ESG creates value", November 14, 2091, available here.
[5] Id.
[6] See Uniliver Sustainable Living Plan Scaling For Impact, Summary Of Progress 2014 available here.

stronger an employee's perception of impact on the beneficiaries of their work, the greater the employee's motivation to act in a "prosocial" way.[7]

Some issues to consider when evaluating the Social pillar of ESG:

- Is employee pay fair, or perhaps even generous, compared to comparable jobs or similar positions throughout the industry? What type of retirement plans are employees offered? Does the company contribute to the employee retirement plans?
- In addition to basic wages or salary, what benefits or perks are employees provided with?
- Workplace policies regarding diversity, inclusion, and prevention of sexual harassment
- Employee training and education programs; for example, does your company provide financial support for continuing or higher education and/or flexible working hours for employees pursuing further education; what opportunities exist for employees to be trained in new job skills at the company that will qualify them for higher-paying positions?
- The level of employee engagement with management. How much input do employees have in determining operational procedures within their respective departments?
- The level of employee turnover.
- What's the company's mission statement? Is it socially relevant and beneficial to society?
- How well are customer relationships managed? Does the company engage with customers on social media? How responsive and efficient is the customer service department? Does the company have a negative history of consumer protection issues, such as product recalls?
- Does the company take a public or political stance on human rights issues? Does it donate money to charitable causes?

Most of the issues identified above focus on human capital. Human capital refers to knowledge, experience and skills of employees. Human capital can be evaluated across areas including wellbeing, Diversity Equity and Inclusion, employee experience and operational excellence. Human capital metrics include workforce profile, pay, benefits, careers, hiring, retention, productivity, wellbeing, and culture. Governance and ethical metrics related to human capital include whistle-blower policies, unethical behavior tied to monetary losses, dismissal and incentives against excessive risk-taking. In an increasingly socially and ethically conscious world, organizations must focus their efforts on successful human capital management strategies. The added emphasis on organizational and financial sustainability provides opportunities to outperform the market, manage risk and drive shareholder value.

Investors and customers are paying more and more attention to how companies treat their employees, the diversity of their workforce and company leadership, and whether the company adds

[7] Adam M. Grant, "Does intrinsic motivation fuel the prosocial fire? Motivational synergy in predicting persistence, performance, and productivity," *Journal of Applied Psychology*, January 2008, Volume 93, Number 1, pp. 48–58, psycnet.apa.org.

value to society or preys on customers or suppliers. This scrutiny is expected to intensify in the coming years and will be a difference maker in a company's overall success.

GOVERNANCE

> Governance, in the context of ESG, focuses on the management of the corporation, the role and makeup of boards of directors, and the compensation and oversight of top executives. Some governance risk factors include those related to an organization's ethical and legal management, the transparency and accuracy of company performance, and involvement in other ESG initiatives important to stakeholders. Evaluating these risks involve asking: How well do executive management and the board of directors attend to the interests of the company's various stakeholders – employees, suppliers, shareholders, and customers? Does the company give back to the community where it is located? Does the company avoid conflicts of interest in their choice of board members? Does the company use political contributions to obtain unduly favorable treatment? Does the company engage in illegal practices?

Financial and accounting transparency and full and honest financial reporting are often considered key elements of good corporate governance. It is also important that board members are acting in a genuine fiduciary relationship with stockholders and are careful to avoid conflicts of interest. Another key consideration is whether the board members and company executives are a diverse and inclusive group.

An example of how responsible corporate governance is put into practice can be seen in the policies of the company, Intuit.[8] One of the company's corporate policies that is aimed at helping to ensure that company executives take on a strong vested interest in the company's ongoing success, rather than just in earning some quarterly bonus, is a rule that requires the top-level chief executive officer to maintain stock ownership equivalent in value to ten times their annual salary. In addition, executive bonuses depend on more than just revenue or income – factors such as employee, shareholder, and customer satisfaction are also part of the calculation.

Gender diversity and equity is another high-profile governance issue, with many institutional shareholders demanding better representation of women on corporate boards and in executive ranks, and equal compensation and mobility for women and people of color. More companies are emphasizing the financial benefit of creating inclusive workplaces in an effort to increase diversity and inclusivity. Research has revealed that firms with more women on their boards of directors and in C-Suite positions had greater financial performance than less diverse companies.[9]

---

[8] https://corporatefinanceinstitute.com/resources/knowledge/other/esg-environmental-social-governance/

[9] https://www.spglobal.com/en/research-insights/articles/what-is-the-g-in-esg

The compensation and oversight of CEOs and top executives, in addition to the structure and makeup of boards of directors, is another element of governance. Regulators in the U.S. and U.K. require publicly traded companies to allow shareholders to vote on executive compensation packages at regular intervals. A more recent effort to contain the growth in CEO pay in the U.S. requires companies to disclose the ratio of CEO-to-median employee pay annually. However, many aspects of existing systems for selecting, evaluating and rewarding top executives remain unregulated, leaving boards of directors solely responsible for this key component of a company's corporate governance.

Understanding the "G" in ESG is critical, as governance risks and opportunities will likely increase as social, political, and cultural attitudes continue to evolve.

The Benefits of Improving Your Company's ESG

The most fundamental reason to try to raise your company's ESG performance is that it is the "right thing" to do as human beings. But apart from the moral case, there are very real payoffs for focusing on ESG, including productivity increases due to higher employee engagement, or sales increases due to more loyal and satisfied customers.

1. Improved Resource Sustainability

Companies that focus on ESG see benefits in efficiencies due to resource allocation, employee retention, and regulation in many industries. Many of the costs (and risks) associated with resource consumption – like energy for data processing centers, or transportation costs – can be reduced with ESG-focused resource allocation.

2. Better Risk Management

ESG risk management includes business continuity planning and supply chain management to mitigate the effects of business disruptions large and small. It helps companies act on values such as gender parity in leadership or diversity in board composition, have a ready public response to social justice issues like #BlackLivesMatter, mitigate and prepare for the effects of climate change, and many other risks.

3. Proactive Regulatory Compliance

State and global regulations, and anticipated federal regulations, require increasing amounts of data collection and reporting on ESG issues

4. Greater Profitability

There is a strong correlation between better ESG/Risk Management and higher profitability. In addition, a growing number of investors, consumers, and job seekers are passing on companies that are not responsive to ESG issues. There is risk associated with loss of investment, defecting customers, and an inability to attract and retain top talent.

5. Attractive to Investors

ESG initiatives are attractive to this segment of investors with deep pockets and a consumer mandate to seek out ESG-specific opportunities. If your customers are concerned with ESG and you are not, you are likely to lose your customers.

According to Blackrock's first Global Client Sustainable Investing Survey, $23 billion was invested in ESG companies in 2020, compared to $450 million in 2019. Further, half of the C-suite respondents wished to double their organizations' exposure to sustainable assets within five years. The Dow Jones publication also noted that investment flowing *into* ESG funds was up 102% in 2020 compared to 2019.[10]

It turns out, sustainability is just as good for the bottom line as it is for society and the planet. S&P analyzed 26 ESG exchange-traded funds and mutual funds with more than $250 million in assets under management. From March 5, 2020 to March 5, 2021, 19 of the funds grew between 27.3 percent and 55 percent, outpacing the S&P 500 index's 27.1 percent rise, according to S&P.[11]

6. Employee Retention

Employees have an increasing preference to engage with businesses that prioritize purpose alongside profitability. This is true of both consumer buying habits as well as a company's ability to attract and retain top talent. According to Barron's third annual ranking of America's Most Sustainable Companies, employee turnover is 25-50% lower at sustainable operations.[12]

7. Satisfy Customer and Stakeholder Demands

---

[10] www.nasdaq.com/articles/esg-investments-could-pick-up-momentum-in-2021-2021-01-04

[11]https://www.institutionalinvestor.com/article/b1r9gb5p9k10b4/Here-s-More-Evidence-That-ESG-Funds-Outperformed-During-the-Pandemic

[12] Barron's, *These Are the 100 Most Sustainable Companies in America*, February 7, 2020 (article can be found here)

We have clear evidence that environmental, social and corporate governance criteria influence consumer purchasing decisions. PwC's March 2021 Global Consumer Insights Survey[13] provided the following data about consumer preferences:

- 54% seek out products with eco-friendly packaging or less packaging.
- 56% choose products with a traceable, transparent origin.
- 50% are eating more plant-based foods due to sustainability principles.
- 55% buy from companies that protect the environment.
- 53% are buying more biodegradable, eco-friendly products.

Consumers and employees want businesses to invest in making sustainable improvements to the environment and society, not just comply with regulation, and they're prepared to reward (or penalize) brands accordingly. Overwhelming majorities of both consumers and employees said they're more likely to buy from or work for companies that share their values across the various elements of ESG. While consumers have long said that they value sustainability, the COVID-19 crisis perceptibly shifted consumer behavior and enlarged the pool of conscientious consumers willing to pay more for healthier, safer, more environmentally and socially conscious products and brands.

Conclusion

A robust ESG program can open up access to large pools of capital, build a stronger corporate brand, and promote sustainable long-term growth benefiting companies and investors. Companies that proactively address ESG and make it part of the company's story can set the bar for the entire industry and at the same time help immunize themselves against declining sales, a disinterested workforce, and reduced capital investment.

[13] https://www.pwc.com/gx/en/industries/consumer-markets/consumer-insights-survey.html