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SPOTLIGHT ARTICLE December 2021

Building shareholder value with ESG

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The current focus on measuring the environmental, social and governance (ESG) policies and impact of companies in their business operations reflects a significant mindset shift on what the role of a company as a member of society should be. From major global enterprises to small, local companies, businesses are being challenged to articulate corporate purpose and values, to develop comprehensive ESG strategies and to report and track outcomes in a measurable way.

Nearly 50 years ago, in a controversial essay published in The New York Times, Nobel Prize winning economist Milton Friedman introduced a generation of chief executives and business managers to the notion that the "social responsibility" of companies was to increase profits for shareholders, and that no duty is owed to the public or society. His theory was rooted in the premise that company leaders worked for the shareholders, and what the shareholders wanted was profit and value.

Since then, we have seen a progressive change that has increasingly recognised the impact a company's operations have on its environment, society and markets. This has added valuable complexity to the understanding of profit and value. These considerations encompass the views not only of shareholders, but more broadly of stakeholders – investors, employees, customers, suppliers, communities and beyond – on non-monetary factors such as impact, sustainability and ethics. These stakeholders are now demanding that companies owe a duty to the public and to society as part of the companies' value proposition.

This shift appeared in the early years of this century, with a focus on 'corporate social responsibility'. For some companies, this included earnest efforts to reduce environmental footprints, to increase philanthropy and to improve transparency. In some cases, it entailed additional accountability through reporting to regulators and investors about resource procurement, governance, political contributions and other corporate activities.

Once companies started doing this, regulators and investors took them at their word. If companies touted ESG accomplishments and assets as part of their value proposition, then regulators and investors were entitled to rely on these representations as material elements of their value in many instances, however corporate social responsibility was primarily a 'nice to do' opportunity for companies to raise brand awareness.

In the past few years we have witnessed a full-court press in demands on corporate behaviour driven largely by

increased climate change disruption and a global pandemic. A new generation of stakeholders now weigh intangible ESG criteria equally with financial criteria in making their investment, employment and purchasing decisions. This new generation is seeking accountability, transparency and good citizenship in addition to, and as part of, a company's value proposition.

This push for change is being further reinforced by regulators. In August 2021, Nasdaq issued disclosure standards designed to encourage greater diversity in the composition of corporate boards by requiring companies listed on the exchange to disclose board-level diversity statistics and to have, or explain why they do not have, at least two diverse directors.

And the Securities and Exchange Commission (SEC), which first issued guidance on climate disclosures more than a decade ago, has recently announced the formation of an enforcement division task force on climate change and issued new climate guidance for company disclosures addressing a range of expectations. These include an explanation of the differences between a company's SEC filings, on the one hand, and its corporate social responsibility of ESG report, highlighting local, national or international climate legislation or accords and business trends that materially impact the company's business, and disclosure of past or future capital expenditure for climate-related projects, among other things.

What this means for companies is that they must adapt or revise corporate strategies to ensure that they incorporate robust and demonstrable ESG practices in their business operations and governance.

This is not a straightforward exercise. There is no 'one-size-fits-all' approach. The process involves gathering, testing and incorporating existing data. It also requires a bit of prescience and a good deal of agility to be able to respond quickly to change. The approach will be different for each organisation depending on its products and services, governing jurisdictions, its markets, and the demands of its stakeholders.

There are some helpful guideposts in formulating a strategy. In fact, the questions that a company might start with are similar to the questions one might ask in connection with any corporate strategy. What is the ESG strategy, what are its goals and how is it integrated into the overall corporate strategy? Who has personal responsibility for making the strategy a reality and how does the board have oversight and monitor that responsibility and effort? What is the cost, risk and opportunity associated with the ESG agenda for the organisation? What are the applicable laws and potential liabilities for the company and the board associated with its ESG strategy? How is the impact of the ESG strategy measured? How is the ESG strategy measured and communicated to stakeholders?

The questions are simple. The answers may not be. Take the first question, for example. Significant information gathering must take place, starting with understanding and identifying what ESG elements most resonate with your business. What are your strategic concerns? How are your competitors operating? What is your business sector or industry doing? And what opportunities does your company have to stand out? Equally important is to understand your key stakeholder groups. What do they expect? What impact do they have on your ability to operate? Do your mission statement, goals and values take into account the impact on stakeholders, including shareholders?

This inquiry would also include identifying the existing and anticipated disclosure obligations with which your company is required to comply and regulatory obligations that must be met. It is important to understand the legal risk exposure in relation to current ESG statements and reports your organisation is making or disclosing. Today there is also a tremendous focus on ESG from sources of finance and from stock exchanges. If a company touts that its supply chain is free from labour abuse and exploitation, it not only needs to make sure that is the case, but it also needs to have the data to back up such a claim in the period for which that claim is made.

Next, a wider net should be cast. Has the company undertaken a supply chain risk assessment? How do the answers to the above questions change as the business operates in different markets? The regulatory landscape is not the same everywhere, and the company's baseline and approach for one market might not be the same elsewhere.

In sum, there are many angles that should be considered from new viewpoints that may not previously have been factored into the organisation's strategic planning. After the data is gathered and analysed, the company can define its ESG strategic goals and begin work to integrate them into the organisation's broader strategy. It will be important to make sure cross-team (and, if relevant, cross-market) stakeholders are engaged in the development of the strategy and are ultimately accountable for its implementation.

Equally important, the company leadership must be clear about what will be measured, how it will be executed, how it will be tracked and reported and how it will evolve over time. ESG issues and impact need to be considered in the company's longer-term planning, including launch of new business models, products and services, entry into new markets, and future financing requirements. It is important to think about what is changing in society and anticipate those changes the best you can.

As the strategy is implemented, thought should be given to how it is 'owned' by the business units. One method might be to develop plans by function. For example, an approach to more diverse talent acquisition by HR, supply chain and supplier management by procurement, ESG due diligence protocols for M&A and corporate affairs, and risk screening for corporate communications.

Even with a function-by-function approach, however, leadership must retain oversight to ensure overall consistency in goals and measurement. A reporting or disclosure timeline should be established. As with other strategic initiatives, the organisation might consider aligning executive compensation to success. Finally, ESG updates should regularly be included on the meeting agenda for the board, and ESG-related risks integrated into enterprise risk management protocols. Company

leadership should never lose sight of the ultimate goal of ESG, which is to be a positive force in society.

In a way, this drive to be a positive force in society is not incompatible with more traditional views. The fact that it may, in part, be 'intangible' does not mean that the value cannot be recognised. In fact, regulators and the markets take the position that many ESG-related representations are material. Companies frequently take intangibles into consideration in assessing value – customer goodwill, reputation, intellectual property, brand recognition, to name a few.

All of these contribute to the ultimate bottom line that is the basis for building and measuring the long-term value of a company. As Indra Nooyi, former chief executive of PepsiCo, recently remarked in another New York Times piece: "social responsibility, in the corporate context, is not about depriving shareholders of money earned by the company, but rather [i]t's about how we make money a different way". ■

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