How important are Environmental, Social and Governance (ESG) considerations for UK SMEs?

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At Frazer Hall Corporate Finance we are aware not only of the growing significance of ESG but also its complexity, particularly given the range of measurements involved. Claire Paye, our Communications Director, offers this briefing as a guide to those SMEs seeking to understand what ESG is, what value adopting an ESG approach to business may have, and the increasing ESG reporting requirements that are required of SMEs' end customers: the large corporates.

What are the benefits for UK SMEs (small and medium-sized enterprises) of incorporating Environmental, Social and Governance considerations (ESG) into their businesses?

1. They are increasingly seen as a driver of value creation, ie the process of producing something of value to others, which is therefore of additional value to you.
2. Developing a business plan reflecting a commitment to Environmental, Social and Governance considerations could offer a competitive edge with end customers and procurement managers keen to meet the standards of Corporate Value Chain Scope 3 (outlined in more detail below).
3. ESG metrics are becoming an additional standard by which companies are judged by all their stakeholders, including customers.
4. The expectations that investment decisions are heavily influenced by a target company's ESG policies mean that any business owner looking to access additional finance, or to sell, will need to demonstrate their commitment to ESG considerations.
5. The obligation on large companies to complete a section 172 statement in their annual reports (see below, 'Reporting Requirements') reflects the increasing regulation of companies according to their impact on the environment and their commitment to ethical working practices, as outlined in the ESG metrics. These principles will inevitably reach smaller and medium-sized companies.

Swivelling towards an ESG approach may mean simply reporting common practices already in place within your company, or it could mean taking tough decisions to minimise a company's negative impact on the environment, to raise standards of corporate governance, and to ensure that the well-being of the workforce is placed centre stage. As the importance ascribed to these three issues gains momentum among customers, staff and investors, companies of all sizes are needing to adapt.

Who are the stakeholders with an interest in the ESG policies of an SME?

<u>Employees</u>. In a tight labour market, it may be easier to attract talent if potential applicants know that the company is committed to positive ESG policies. One study showed that 75% of millennials

would accept a smaller salary to work for a company that is environmentally responsible.[1] Another linked high company ESG scores with increased employee satisfaction and attractiveness to talent. [2]

End customers. 62% of Generation Z (born after 1997) prefer to buy from sustainable brands and the majority (54%) will spend 10% or more for sustainability (50% of Millennials (born after 1981) prefer to buy sustainably). [3] Millennials will actively support companies that make a positive impact on society.[4] 80% believe businesses (and the government) need to make greater efforts to protect the environment.

Business customers. Companies are increasingly asked to ensure their supply chains comprise companies which comply with their own ESG policies. A typical consumer company's supply chain accounts for more than 80% of their greenhouse gas emissions and more than 90% of their impact on air, land, biodiversity etc. [5] Companies should therefore try to source their components in a more sustainable and environmentally-positive way, so that they can help their customers meet their environmental obligations.

Investors. Private Equity (PE) firms and large investors are becoming significant adopters of ESG criteria, not least because of an increasing amount of regulation (see below), ensuring they consider ESG factors when investing in, or buying, companies. One third of millennials often or exclusively invest in companies which take ESG factors into account, partly driven by the fact that 76% of older millennials think climate change poses a serious threat to society. [6] NorthEdge, a PE firm, has published its first ESG, Sustainability and Diversity and Inclusion report, stating that they carry out an ESG screen on all new investments, and will discuss ESG risks and opportunities at the beginning of every investment report. [7]

What ESG reporting requirements do UK corporates face?

The movement of ESG considerations to the mainstream has occurred partly because of the new requirement for all UK incorporated companies other than those who qualify as medium-sized or small to include a Section 172 (1) statement in their annual reports. This explains how directors have complied with the requirement under Section 172 of the Companies Act 2006 to promote the success of the company for the benefits of its members as a whole, having regard for, amongst other factors: the interests of the company's employees (Governance) and the impact of the company's operations on the community and the environment (Sustainability and Environment)

A very helpful explanation and assessment of the new Section 172 (1) statement is a paper produced by Deloitte in September 2019[8] This paper outlines the areas the board should consider in order to

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[1] https://www.fastcompany.com/90306556/most-millennials-would-take-a-pay-cut-to-work-at-a-sustainable-company
[2] https://www.mmc.com/insights/publications/2020/may/esg-as-a-workforce-strategy.html
[3] https://www.firstinsight.com/white-papers-posts/gen-z-shoppers-demand-sustainability
[4] https://www2.deloitte.com/ua/en/pages/press-room/press-release/2020/millenial-survey-2020.html
[5] https://www.mckinsey.com/business-functions/sustainability/our-insights/starting-at-the-source-sustainability-in-supply-chains
[6] https://www.cnbc.com/2021/05/21/millennials-spurred-growth-in-esg-investing-now-all-ages-are-on-board.html
[7] https://northedge.com/wp-content/uploads/2021/04/ESG-Report-2020-Long-Form.pdf
[8] https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/audit/deloitte-uk-board-briefing-on-s172-statement.pdf

detail how they have aligned matters of strategic importance with the requirement to act for the good of the company and its impact on the community and environment.

Areas that could be included under the Section 172 (1) statement:

- Employees. Workforce policies and practices, such as the level of investment in the skill levels of employees.
- Suppliers: The relevance of the Modern Slavery Act to supplier terms.
- Community: Does the board recognise the impact of their business in the communities where they have a large presence?
- The Environment: How does the company's strategy take into account its potential impact on the environment and climate change?

This obligation to report on Section 172 extends severally to a group's subsidiaries. They have to produce a separate report detailing their own activities. It is therefore important that the subsidiaries are aligned with the commitments of the parent company. Being aligned with the commitments made by larger companies in their section 172 (1) statement therefore may smooth the way to a possible business sale.

The EU has a similar interest in the reporting of ESG factors, and is developing the Corporate Sustainable Reporting Directive (CSRD), to be adopted by October 2022. 90% of S&P 500 Index Companies published Sustainability, or ESG, reports in 2019. [9]

How are ESG factors measured?

A comprehensive report by Maanch [10] highlights just how convoluted what they call the 'UK ESG Ecosystem' is at the moment, with no single benchmarks and a wide range of global initiatives. It is something of a wild west with competing organisations vying to provide clarity. However, agreement coalesces around the importance of incorporating ESG targets and measurements into business strategy and reporting.

Some of the most widely used approaches are to align a company with:

- The Global Reporting Initiative (GRI)
- The Sustainability Accounting Standards Board (SASB)
- The Taskforce on Climate-Related Financial Disclosures (TCFD)
- The UN Principles on Responsible Investment (PRI)
- The UN Sustainable Development Goals (SDGs)
- The EU Taxonomy Regulation
- The Corporate Value Chain (Scope 3) Standard from the Greenhouse Gas Protocol
    - This has been boosted by the introduction of Streamlined Energy and Carbon Reporting (SECR). This only applies to quoted and large companies in the UK at the moment.

[9] https://www.ga-institute.com/press-releases/article/90-of-sp-500-index-companies-publish-sustainability-reports-in-2019-ga-announces-in-its-latest-a.html
[10] https://updates.maanch.com/2021/03/demystifying-the-uk-esg-investing-ecosystem/

The **Global Reporting Initiative** seeks to set out some comprehensive standards by which activities can be judged, with the option to upload a copy of your report for public viewing. It is an independent international organisation. Their standards are very detailed and are still being developed.
For example, GRI 403 covers Occupational Health and Safety, Disclosure 403 – 2 covers Hazard identification, risk assessment and incident investigation, and asks for a description of the processes used to identify work-related hazards and assess risks. 61% of European sustainability reporters use GRI.

The **Sustainability Accounting Standards Board** focusses on providing investors with sustainability data which could affect their investments. Their standards outline the financial impacts of sustainability measures.

The **Principles of Responsible Investment** are principally designed for investors, but are of great relevance to SMEs who may want to access investment. With over 7,000 signatories in 135 countries, they call themselves the world's largest voluntary corporate sustainability initiative.
The principles include:

1. We will incorporate ESG issues into investment analysis and decision-making processes
2. We will…incorporate ESG issues into our ownership policies and procedures
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest

The **EU Taxonomy** outlines 6 environmental objectives by which companies can be assessed and include:

1. climate change mitigation
2. climate change adaptation
3. pollution prevention and control
4. the sustainable use and protection of water and marine resources
5. the transition to a circular economy
6. the protection and restoration of biodiversity and ecosystems.

The **Greenhouse Gas Protocol** (GHG Protocol) offers comprehensive global standardised frameworks to measure and manage greenhouse gas emissions. Of particular relevance to UK SMEs is the Corporate Value Chain (Scope 3) Standard which measures emissions upstream and downstream in the supply chain, which is where the SMEs are positioned. The majority of total corporate emissions come from Scope 3 sources. [11]
A good example of how the GHG fits with other standards is that company SECR reports may include a comment on GRI 305–3 -'Other indirect (Scope 3) GHG Emissions'. Although at the moment it is only obligatory for large companies to comment on one type of emission (fuel burned during business travel), many companies are future-proofing by reporting on a wide range of supply chain emissions.

The **London Stock Exchange Group (LSEG) guide to ESG Reporting** [12i] has a very clear outline of why ESG factors are important. They state that 'sustainability factors, such as climate change or demography, impact companies' operating environments. It is therefore critical that companies

[11] https://ghgprotocol.org/standards/scope-3-standard
[12] https://www.lseg.com/sites/default/files/content/GReen/LSEG_Guide_to_ESG_Reporting_2020.pdf

provide a clear strategic view on the likely impact of such trends. This will allow investors to understand how they are positioned, and provide confidence that they are resilient and can where possible exploit opportunities from a changing environment'.
The LSEG emphasises the importance of assessing material ESG themes, specifically those which link ESG performance, business strategy and financial and operational performance.
The **FTSE Russell** identifies the following themes as material to the ESG rating:

1. Climate change
2. Environment supply chain
3. Anti-corruption
4. Labour standards
5. Human rights and community
6. Social supply chain[13]

What specific questions could a company consider to meet ESG requirements?

Environmental

- What are the natural resources a company uses in business operations (e.g., energy, water, land use, chemicals and plastics)?
- How does a company's use of natural resources impact the environment or climate?
- Could the company switch to using renewable resources?
- How could we go net zero?
- Could we adopt a circular economy to our activities?

Social

- How are employees (*aka* human capital) treated, taking into account, among other things, well-being, fair and equitable pay, health and safety, talent management, inclusion, equity and diversity?
- What is our supplier dependency? Are our suppliers based in economies where corruption or pollution is common?
- Human rights and labour standards, including the prevention of forced labour, both within a business's own operations and those in the supply chain, and generally keyed to international standards or laws?
- How does our work affect the community?
- Could work with schools and educational institutions help our talent pipeline?
- Data Privacy & Cybersecurity?

Governance

- Board structure and independence?
- Business ethics?
- Executive pay?
- Anti-corruption?
- Accounting practices? [14]

We have a more detailed questionnaire available if required.

Case Study

[13] https://content.ftserussell.com/sites/default/files/esg_scores_and_beyond-part_2_final.pdf
[14] https://www.lexology.com/library/detail.aspx?g=fc291aa9-d900-4fbe-a384-55e20bea00ff

ESG considerations, when linked with a company's strategy, can make good business sense, according to this case study reported in Institutional Investor. [15]For example, Discovery, a South African life and health insurance company, has the stated purpose of making people healthier. This is part of the Social element of ESG. They integrated economic incentives for people to be healthier. Customers received rewards for reaching weekly exercise goals and receive rebates on the purchase of healthier foods through incentives devised by behavioural economists and monitored through wearable fitness devices. These behaviours reduce health care costs and increase life expectancy. As a result, Discovery can offer insurance products at lower premiums whilst sustaining profits tied directly to the social impact of their policies.

Conclusion

ESG is here to stay and its importance is increasing. ESG reporting is likely to become mandatory for SMEs in some way over the next few years. A strong ESG policy can help to recruit and retain talent, and can drive up the value of your business. And if businesses act quickly, before their competitors, it should offer them a competitive advantage in what is a relatively new but increasingly significant field. If you (like us) are starting to feel your way around the issues, then Claire would be delighted to talk to you and share our experiences. Please contact her on claire.paye@frazerhall.com

[15] http://sharedvalue.org.au/wp-content/uploads/2019/11/Where-ESG-Fails-_-Institutional-Investor.pdf