HIGH MEADOWS INSTITUTE

Moral Money Forum

A Deep Dive into Metrics

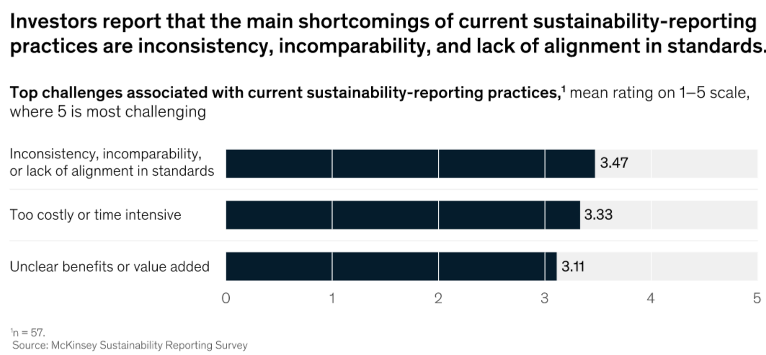
Context: Covering the core developments in measurement, materiality and quantifying the return on investment (ROI) of ESG

Publication: March 2021

1. Reporting & Metrics

Reporting on sustainability gains popularity

- From 2011 to 2018, the proportion of S&P 500 companies reporting on their sustainability efforts, corporate social responsibility activities and ESG performance increased from just under 20% to 86%.
- The global sustainability reporting rates have skyrocketed since 1993: In 2020, the rate for N100 companies was at 80%, following the rate of G250 at 96%, as KPMG reports. It is likely that the N100 reporting rate will continue to climb steadily in coming years.
- **Key issues:**



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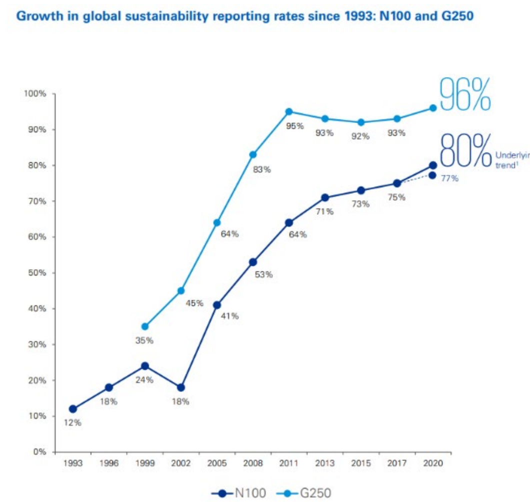


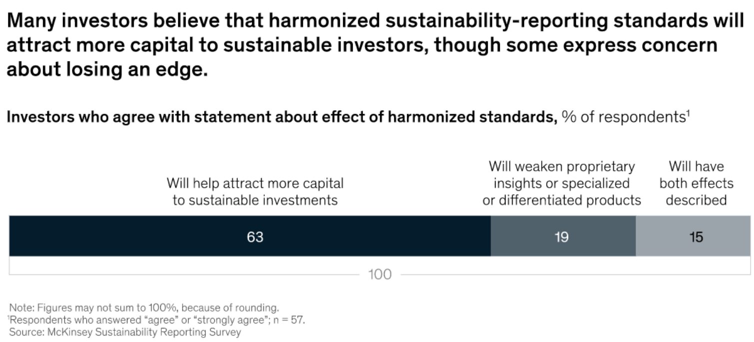
Source: The KPMG Survey of Sustainability Reporting 2020. KPMG (2020).

Reporting guidance

- A range of key organizations are providing voluntary disclosure guidance on sustainability.

	CDP	CDSB	GRI	IIRC	SASB	TCFD
Scope of information / metrics	Environmental	Environmental	Environmental, social, operational, governance and economic	Environmental, social, economic, for physical and knowledge-based assets	Environmental, social and operational governance	Climate
Industry-agnostic / industry-specific	Industry-agnostic and industry supplements	Industry-agnostic	Industry-agnostic and emerging industry-specific	Industry-agnostic	Industry-specific	Industry-agnostic and industry supplements
Approach to materiality	Significant impacts on the economy, environment and people	Enterprise value creation	Significant impacts on the economy, environment and people	Enterprise value creation	Enterprise value creation	Enterprise value creation

- **Key issues:**
    - The lack of standardization in guidance provided (particularly on the metric level) is causing a number of challenges, for example:
        - If companies use multiple different frameworks/standards to guide their disclosures, they may end up with an overly exhaustive list of metrics that they are supposed to disclose against.
        - Metrics and indicators reported by firms are often difficult to compare and can be inconsistent across firms. Zadeh and Serafeim (2018) find that the same ESG issue can have multiple metrics associated with it. For example, there are more than 20 different ways companies report their employee health and safety data.

- **Standardization in sight** → Toward a coherent system for comprehensive reporting
    - In 2020, the Sustainability Accounting Standards Board (SASB) and the International Integrated Reporting Council (IIRC) announced their upcoming merger.
    - CDP, CDSB, GRI, IIRC and SASB published an ambitious joint statement of intent to bring a single, coherent, global ESG reporting system to life.
    - Help has been offered by the International Financial Reporting Standards (IFRS) Foundation, which asked the public to comment on a consultation paper released in September 2020.
    - Further, there have been efforts by the private sector in bringing insights from multiple frameworks together into one succinct guide. In partnership with the World Economic Forum, the Big4 developed a corporate sustainability reporting framework that collates reporting metrics from GRI, IR, SASB, TCFD, the Science Based Targets initiative and more.
    - 

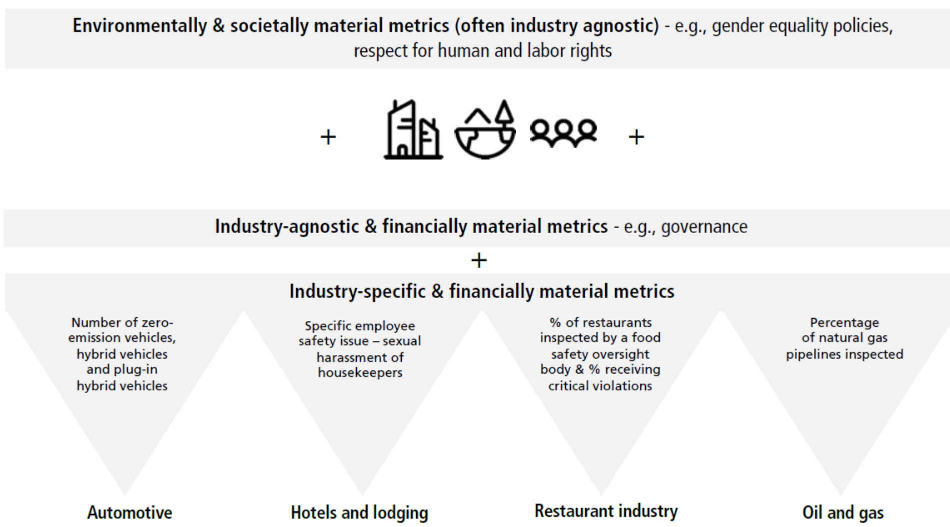
Different types of ESG metrics

<u>Qualitative vs. quantitative ESG metrics</u>

- ESG metrics can be both qualitative and quantitative.
- The value of qualitative disclosure is not to be underestimated.
    - Quantitative reporting in the form of numeric, machine-readable data and raw numbers (rather than ratios) makes disclosures useful for investors. While quantitative data are extremely useful for fundamental and comparative analysis, investors and other users of sustainability information also benefit from a contextual understanding of a firm's operations and strategic initiatives.
    - Reporting guidance should facilitate sustainability disclosure that delivers both quantitative information on performance and qualitative context needed to accurately interpret performance (such as SASB).
- In some cases, qualitative metrics are the best way to provide decision-useful sustainability information. Financial information alone might not provide useful insight into future performance.
- Key issues:
    - Written disclosures are hard to analyze and compare.
    - Quantitative disclosures must be uniformly defined and consistently calculated to allow for accurate comparison.

Industry-agnostic vs. Industry-specific ESG metrics

- Different levels of information can uniquely support investor analysis (while potentially creating additional challenges).
- Reporting standards, frameworks and regulatory reporting guidance facilitate the disclosure of *industry-agnostic information* or *industry-specific information*.
    - ***Industry-agnostic*** metrics can be universally applied to any company (regardless of industry)
        - Reflect certain standards and procedures that all corporations should adhere to.
        - Example: Corporate Governance information → Many companies disclose CG data according to a common set of principles (e.g., in alignment with CG codes).
        - Investors can assess and compare practices equally across industries.
    - ***Industry-specific*** metrics aim to yield data that is relevant to companies in a specific industry.
        - Identified because sustainability issues can drive value in different ways across different industries.
        - Example: Materials Sourcing will affect companies in Water Utilities differently than those in Solar Technology (Water supply resilience vs. supply of critical materials such as polysilicon)
        - Allows investors a way to accurately compare performance across companies in a given industry.



Source: SASB (2021)

2. Measurement

Data providers

- With the growing adoption of ESG amongst investors, the need for ESG data is accelerating.
- ESG data as a commoditized product available to investor started about 10 years ago. Since then, the market has been growing rapidly.
- UBS estimates that the ESG data market is now worth **over $2B** and is expected to grow to **over $5B** by 2025.
- Currently, there are well over 150 different external data providers.
    - More players are entering the sustainability-related products and services markets which is leading to **increased M&A activity** as traditional financial data and research providers and credit ratings providers seek to expand their service offerings by buying up specialized firms.

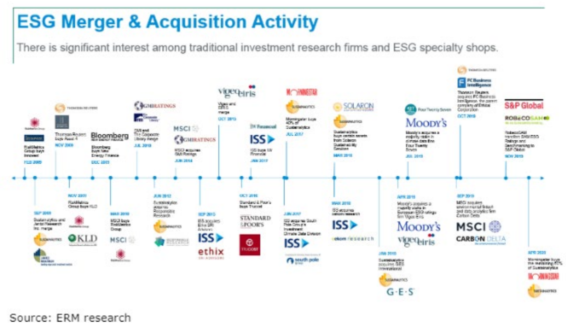


Figure 3: Merger and Acquisition Activity from 2009 to Mid-2020

- **Scope of data varies** from E, S and G, to ESG to issue specific**.**
    - Types of data: peer-adjusted scores, absolute scores, ratings, raw data, monetized impact data.
    - Assessment types: risk management, risk exposure, performance, impact, sentiment, and disclosure quality.
- ESG data providers can be divided into three categories:
    - ***Fundamental data providers***: "Collect and aggregate publicly available data (typically from company filings, company websites, and nongovernment organizations, or NGOs) and disseminate these data to end users in a systematic way" (e.g., Bloomberg, Refinitiv). Do not usually identify whether ESG issue is material or not, and do not provide overall company score.
    - ***Comprehensive data providers***: "Utilize a combination of objective and subjective data covering all ESG market segments." Comprehensive data providers may or may not identify materiality of the ESG issues, and generally provide overall ESG scores as well as E, S and G scores, based on their own ratings methodologies (e.g., MSCI, Sustainalytics and Vigeo Eiris, Truvalue Labs, and RepRisk).
    - ***Specialist data providers:*** "Specialize in a specific ESG issue, such as environmental/carbon scores, corporate governance, human rights, or gender diversity" (e.g., S&P Trucost, CDP and Equileap).
- **Key issues:**
    - Quality and consistency of data: Inconsistencies in methodologies between the providers, which ultimately lead to differences in the ESG ratings between providers: 1) different definitions of materiality, 2) different methods for the normalization of data, 3) varying aggregation methods and weights used for ESG scores, 4) various techniques used for estimating missing data points, 5) different types of metrics produced, 6) benchmarking or peer groups used to determine the ESG ratings, 7) sources of data, and 8) timeliness of the data used as inputs to the ratings.

Asset managers and internal ESG ratings

- Asset managers have been, and continue to be, large consumers of this information provided by ESG data firms.
- However, many are now also developing their own internal ESG ratings. A recent study from SquareWell Partners shows that of the top 50 asset managers, with over $60T in AUM, **over half** have now developed their own, **proprietary internal ratings system**.

Input vs. Impact data

- Disclosure guidance often recommend reporting on input-focused metrics, and rating methodologies from data providers are taking those into consideration.

- There is a change in the notion of what ESG data should be assessing, away from input toward impact → the disclosure of impact-related metrics will become much more relevant:

Evolution of the ESG Data Landscape. Adapted from Richmond Global Sciences (RGS).

ESG 0.0
- Focus on principles
- Immaterial information
- Focus on business involvement

ESG 1.0
- Focus on policies
- Opaque scores
- Focus on firm operations

ESG 2.0
- Focus on impact
- Science-based data
- Focus on products and services

- Innovative solutions to solve blind spots in the way ESG is commonly analyzed:
    - Focus on operations and procurement
    - Data bias towards input metrics
- **Key issue:**
    - Information on **"impact-related metrics"** is much more difficult for companies to collect and disclose.

Impact-Weighted Accounts Initiative (IWAI). Monetization of environmental and social impacts enabling comparability.

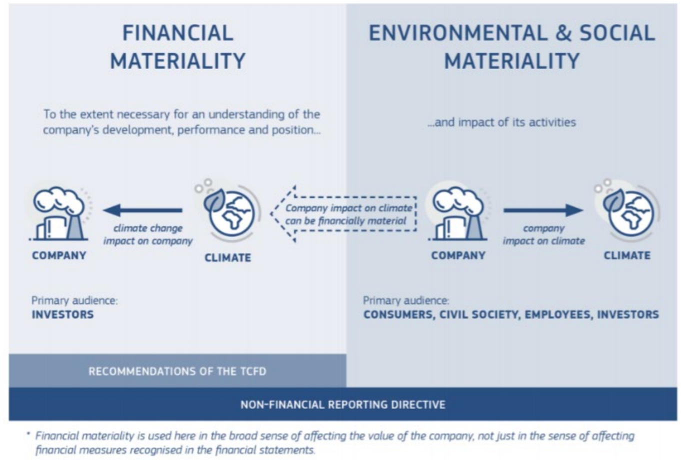
IMPACT-WEIGHTED FINANCIAL ACCOUNTS

This briefing note was developed in collaboration with KKS Advisors.

3. Materiality

The concept of "Double Materiality"

- ESG information can provide insight into traditional financial drivers, such as market share and capital expenditures. ESG information can also provide insight into a company's impact on the economy, environment, and/or people.
  → Depending on the insights provided, ESG information is useful to its users at different levels.
- The concept of "double materiality" introduced by the European Commission has two components: 1) a traditional definition ("financial materiality") and 2) a definition that covers the company's external impacts on the world ("environmental and social materiality")

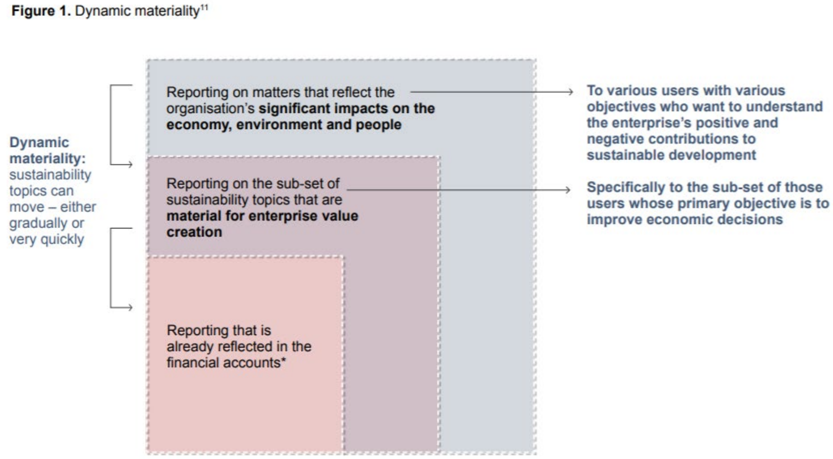


Source: European Commission, "Guidelines on reporting climate-related information" (2019).

The concept of "Dynamic Materiality"

- The market's understanding of ESG information is not static. The materiality of information can shift over time → "Dynamic materiality."
- An ESG issue that is not critical to a company's success may become critical as markets, resource availability, regulation, customer awareness or other factors change.
- Research has shown that particularly in the context of the COVID-19 pandemic, issues previously not necessarily considered as high priority have made it onto the list of material issues for thousands of companies around the world (i.e., Employee health & safety and Labor Practices).

Figure 1. Dynamic materiality[11]



Source: CDP, CDSB, GRI, IIRC, SASB (2020).

- Overall, there is an increased attention to the "S" in ESG: the COVID-19 pandemic and global movement for racial and ethnic equity increased attention paid to health and safety of employees, diversity, and human rights. Investors are demanding disclosure of issue-specific metrics.

4. ESG metrics in the investment process

Integration of metrics across different strategies

- ESG metrics continue to be integrated into investment processes in increasingly diverse and sophisticated ways. In recent years, the strategies presented in the spectrum below have become common practice.
- ESG metrics can be used (also in combination) to:
  - A) Make decisions about exclusionary or negative screening (e.g., avoiding objectionable or low-performing investments such as weapons manufacturers or tobacco companies) and
  - B) make decisions about which investments to prioritize or actively select (e.g., beverage manufacturers that prioritize managing water risk).

Strategy	ESG Integration	Screening			Impact Investing
		Positive screening	Thematic investing	Negative and values-based screening	
Goals	ESG Integration systematically and consequentially integrates financially material ESG factors alongside traditional financial factors in investment analysis and investment decisions.	Investment in sectors, companies or projects is selected for positive ESG performance relative to industry peers.	Investment in themes or assets specifically related to sustainability (i.e., clean energy, green technology or sustainable agriculture).	Exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG factors (i.e., excluding tobacco or weapons industries) or alignment with minimum standards of business practice based on international norms, such as those issues by OECD, ILO, UN and UNICEF.	Targeted investments aimed at solving social or environmental problems. Intended to produce measurable impact outcomes.
Performance spectrum	Value-focused				Values-focused

Linking metrics to channels of financial impact

- ESG metrics are most useful and interesting to investors if there is evidence of potential financial impact.
- SASB, for instance, only includes ESG factors as disclosure topics if the factors might affect the financial condition of a firm through one of these four channels:

Revenue • Market share • New markets • Pricing power	**Assets & Liabilities** • Tangible assets • Intangible assets • Contingent liabilities and provisions • Pensions and other liabilities
Costs • Cost of revenue • Research and development (R&D) • Capital expenditures (CAPEX) • Extraordinary expenses	**Cost of capital** • Risk premium • Industry divestment risk

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