Teneo

The Global CEO Advisory Firm

Teneo Insights:
Is Your Company Being Underrated?
Understanding the Impact of Your Organization's ESG Ratings

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You have heard of ISS. You have heard of Glass Lewis. But have you heard of Sustanalytics? RobecoSAM? RepRisk? These are firms that specialize in rating how companies manage the risks of environmental, social and governance issues. Like better known proxy advisors, these ESG firms can have significant impact on your company. These firms perform a qualitative analysis of a company's exposure to ESG risks and how well it manages those risks relative to peer companies. To date, most ESG ratings have focused on a company's risk exposure to equity holders. Increasingly, credit rating firms are incorporating ESG ratings into a company's overall credit rating. With scrutiny increasing, it is a good time to embrace ESG issues.

What Are ESG Ratings?

ESG ratings firms seek to measure a company's exposure to risks relating to environmental, social or governance issues as well as gauge how well a company is managing those risks. ESG ratings firms perform a qualitative analysis of a company's exposure to ESG risks, based on publicly available data. Companies are then given quantitative ratings that are intended to represent both a company's ESG risk exposure and how well it is managing those risks relative to peer companies. While there are over one hundred ESG ratings firms, the primary firms are MSCI, Sustanalytics, RobecoSam, RepRisk, Bloomberg, and Thomson Reuters. While most ESG ratings have focused on a company's ESG risk exposure to equity holders, credit rating firms are increasingly incorporating ESG ratings into a company's credit rating.

What Is Driving Demand for ESG Ratings?

Asset managers have been under increasing pressure from their clients to incorporate ESG issues into their investment activities. Mandates from institutional clients have resulted in most asset managers signing on to the Principles for Responsible Investment ("PRI") - a commitment to incorporate ESG factors into both their investment and stewardship activities. In addition, millennials have increased pressure on asset managers to consider ESG issues and align their values with investing.

Asset managers themselves are also now being rated on ESG, adding to the demand for ESG research. For example, Morningstar provides ratings for mutual funds that seek to measure how well each portfolio is being managed for ESG risk. The PRI also issues publicly available assessment scores to all asset manager signatories as to how well they are incorporating ESG issues into their investment practices.

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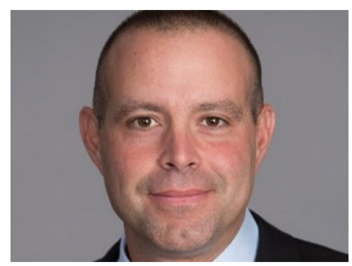

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How Are Investors Utilizing ESG Ratings?

Both active and passive asset managers are utilizing ESG ratings in their investing and stewardship activities. Asset managers are beginning to launch more and more ESG-themed investment products. In fact, more ESG-themed index products were launched in 2018 than non-ESG themed index products. These ESG-themed investment products generally exclude and/or weight stocks largely based on third party ESG ratings. Consequently, ESG ratings are directly impacting the investible universe of these ESG-themed products. ESG ratings are also incorporated into fundamental equity analysis to help investors assess a company's long-term financial risk and, to some extent, identify opportunities to create alpha. Thus, ESG ratings are having a direct impact on a company's valuation by active investors.

Corporate governance teams at both active and passive asset managers also use ESG ratings to supplement their voting and engagement activities. To help investors do so, ESG ratings are now included in the research reports of both ISS and Glass Lewis for most companies.

Even activist investors are utilizing ESG to their advantage. Some activist investors have started ESG-themed portfolios, such as ValueAct Capital and Jana Partners. Activist investors also increasingly utilize ESG ratings to target companies that are vulnerable to ESG risk, leveraging a company's poor ESG track record to bolster their argument for management or board change.

Is There a Standard ESG Disclosure Framework for Companies to Follow?

Despite the efforts of certain shareholder groups, there are no federal or state requirements mandating ESG disclosure. Delaware has enacted legislation that enables companies that voluntarily demonstrate their commitment to sustainability to obtain certification from the DE Secretary of State. In addition, two primary third-party ESG reporting frameworks have emerged in the marketplace. The Sustainable Accounting Standards Board ("SASB") provides an industry specific disclosure framework for material ESG issues, while the Global Reporting Initiative r'GRI") aims to provide a more general self-reporting disclosure framework for sustainability issues. Still others, such as the Carbon Disclosure Project, aim to establish a self-reporting disclosure framework for specific ESG issues. To some degree, ESG research firms incorporate these ESG disclosure frameworks into their rating methodologies.

What Steps Should Companies Take?

1.) Be proactive about better understanding your company's ESG research reports and ratings.
2.) Benchmark ESG disclosures against an appropriate peer group.
3.) Identify short and long-term opportunities to improve your company's ESG rating.
4.) Develop an ESG communication plan with your shareholders and board of directors.
5.) Create a forward-looking framework to help monitor the ESG research and ratings marketplace.
6.) Finally, there are several technology solutions now on the market to help companies with ESG data and access to information.

Conclusion

A poor ESG rating can have a tremendous impact on your company - from negatively impacting the fundamental analysis of your company's stock, to excluding your company's stock from an ESG-themed investment product, or even impacting your company's credit rating. It is therefore critical that all companies review and monitor their ESG ratings on an ongoing basis.

Teneo

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