Part 1

ASSESSING THE ROLE OF INVESTOR RELATIONS IN ENSURING SUSTAINABILITY IS EMBEDDED INTO A COMPANY'S STRATEGIC FRAMEWORK

In the first of a two-part series on Sustainability and IR, we explore the inherent benefits for small and mid-cap issuers in ensuring Investor Relations plays a central role in the development and execution of the Company's sustainability agenda.

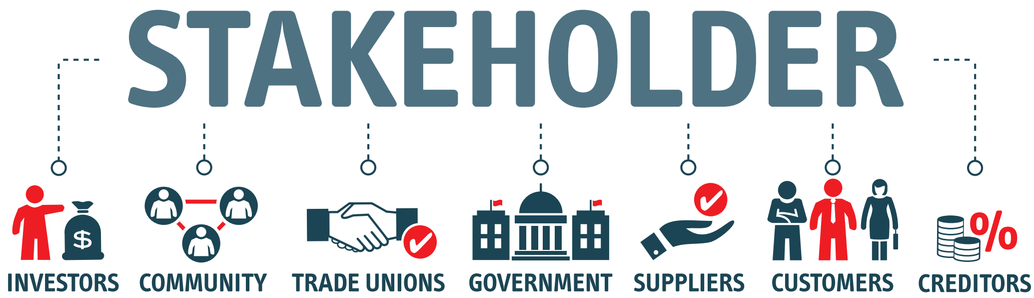
It is clear that the pandemic has crystallised a focus across the spectrum on the importance of sustainability for issuers, investors and regulators alike, and from now on it is likely to be a core guiding principle for a variety of stakeholders either by choice or through external and regulatory constraints.

Despite this drastic change, many issuers find formulating a clear sustainability mission within the traditional ESG framework challenging, given the broad difference in approaches, definitions and concepts across industries and countries. Whilst the mantra of maximising shareholder value at all costs has evolved in recent years to focus more on stakeholder value, in recent months this has further conceptualised into shared values. Issuers that ignore this change will invariably be penalised by consumers, governments, regulators, and investors.

Historically, many issuers have had difficulty in incorporating their corporate responsibility into the Company's strategic framework. This has been largely driven by attention being given to only governance or environmental matters, or in detailed ESG reporting to answer specific surveys, but all developed in isolation allowing no reflection on how sustainability as a whole could benefit the business and its environment. Whilst companies of all sizes have fallen foul to this dynamic, there have been notable exceptions, with some large cap companies playing a pioneering role on this front and establishing many of the best practices aspired to today.

For the majority though, the focus has largely been on ensuring regulatory compliance and the lack of direct accountability internally has resulted in too many interlocutors, leading to weak outcomes. Against this backdrop, Investor Relations has often been a contributor but there was not necessarily a clear rationale as to why IR should be one of the corporate functions best positioned to help drive an integrated approach. However, in today's environment and the varying expectations of a diverse stakeholder base, only an integrated approach will bear fruit in devising, and successfully implementing, a credible sustainability strategy in a timely manner.

It is clear now that the sustainability agenda sits directly with the Board and Management and there is pressure on them to deliver tangible results in an efficient and timely manner. To ensure this, it is critical that the function tasked with coordinating this internally integrates several variables against which this strategy and its outcome are regularly stress tested. Whilst it is important to funnel the input of the various teams and contributors, it will also be critical to assess the impact of these actions within a broader framework that considers the needs of all its stakeholders.



WHY INVESTOR RELATIONS?

Valuation Impact

A well thought-out sustainability approach will lead to value creation in the long term, and is therefore a pivotal component of the equity story – the key pillar of any IR programme.

Whilst it may be difficult to formulate a unique definition of sustainability, it is clear that it begins with responsibility and impact. From a valuation standpoint, at a minimum it offers downside protection against a number of risks and is geared to support a company's resilience when facing disruptions or acute crises. Given the impact of the pandemic on investor mindsets, there will naturally be greater appetite for companies that can prove their capacity to absorb stress by maintaining balance sheet strength, being operationally flexible, embracing technological innovation, managing human capital and broadly limiting downside risks.

By extension, management decisions that improve a corporate's environmental and social footprint and associated risks will be priced accordingly by investors, thus reducing volatility of earnings and the cost of capital in the long run. Given the reduction of risk can positively impact both the cost of equity and debt, sustainability is thus becoming an essential valuation driver alongside the financial and behavioural ones.

Another interesting development is the emergence of dedicated ESG sell side teams, and the integration of the data they generate into the notes published by the more "traditional" research analysts. Over time this will become deeper and stronger and further influence the evaluation of risk and cost of capital overall, as well as the recommendations on the stock.

Investor Engagement

There has been an exponential increase in the volume of thematic ESG and sustainability funds in recent years, with substantial inflows into these strategies. Globally, actively-managed specialist ESG and sustainability funds had an estimated combined global AUM at the end of 2019 of approximately $750 billion, a 50% increase versus 2018, while overall there were around 600 new sustainability fund launches in 2019 alone[1].

In addition, following the adoption of the UN Principles for Responsible Investing, a large and growing number of investors now consider ESG factors in their investment analysis and decision-making processes. By extension, many of these investors also see it as part of their fiduciary duty to engage with corporations beyond financial expectations and returns ("from say on pay to say on sustainability") which places a greater onus on listed corporations, and hence investor relations departments, to understand the dynamics and expectations at play with their various debt and equity investors.

The same considerations also apply to passive investors, with some of the largest asset managers being clear in their disposition to vote against management teams that are not making sufficient headway on sustainability-related issues.

Ultimately, aside from governments it will probably be investors and lenders, more than consumers and customers, that will have the biggest say on supporting or sanctioning companies by opening or closing large pools of capital based on their sustainability approach. Given the significant focus institutional investors are placing on this agenda, understanding trading dynamics, voting patterns and investor expectations – another key tenet of the IR programme – are critical in ensuring support for the Board's and Management's agenda at AGMs.

[1] *Source: Morningstar Research, February 2020: "Global Sustainable Fund Flows"*

Robust infrastructure

IR teams are generally unique in their 'interconnectedness', given the need to engage with a broad spectrum of internal and external stakeholders. IR teams will engage directly with key external market participants as well as internally with departments including finance, legal, corporate affairs, strategy, marketing, operations and corporate communications. As a result, it will often be best positioned to have the necessary "helicopter view" to understand the various sustainability drivers within a company. Given the positioning of IR as a strategic contributor to the C-Suite it can also extend the remit of its upward flow of information to both the Executives and the Board on sustainability within the context of the capital markets.

Market Intelligence

IR teams invariably have a deep understanding of the overall dynamics at play in their sector from a fundamentals perspective. Given the macro environment, sovereign risks and the regulatory environment are all themes that will be strongly impacted by sustainability in the future, IR will invariably need to be knowledgeable about these "new" components in the fundamental valuation drivers in order to develop a robust investment thesis.

Consequently, this knowledge can be leveraged to stress test specific sustainability initiatives from both the up and downside, and improve the development and execution of the strategy.

In addition, due to the necessity of conducting regular market surveillance, IR is also ideally positioned to benchmark the sustainability approach of the peers and customers, another indirect and efficient way to assess the opportunities and constraints that are emerging within a company's ecosystem and refine the company's competitive edge in this regard.

Reporting Collateral & Materiality

The IR department, in conjunction with Corporate Communications, produces the vast majority of a company's publicly available information. IR materials can therefore be leveraged for wider dissemination and the IR section of the website is the most likely avenue for any stakeholder that wishes to get more information about the company.

Most IR departments will also be involved in the production of the Annual Report, for which companies will either have a dedicated sustainability section or adopt the concept of integrated reporting. Any IR officer responsible for the coordination and development of the annual report is naturally geared to have a comprehensive knowledge of the sustainability strategy both from a qualitative and quantitative perspective. This provides IR with a clear understanding of the progress made over time as well as visibility into the challenges that might lie ahead given the key materiality aspects that need to considered for the annual report.

Furthermore, due to the close cooperation required with Financial Controlling as well as the necessity to have auditors sign off on non-financial KPIs, Investor Relations sits at the centre of "data mining". With the rise of ESG rankings and the increasing data requirements, IR will already have access to a large pool of ESG related data, and is the driver behind their integration into controlling reports. As such, similarly to the interpretation of financials and how they relate to strategic ambitions and the execution thereof, IR will have a very good understanding of how to demonstrate progress to external audiences with tangible proof points from a corporate responsibility standpoint. This will be particularly important as the world of social impact accounting will continue to develop and is likely to be fully integrated, over time, into traditional financial accounting measures.

WHAT NEXT FOR THE IRO

Given the recent evidence, it is clear that most companies will increase their efforts to be good corporate citizens, and pay far greater attention to sustainability as a transversal valuation driver, which requires it to be truly integrated into the strategic agenda and not limited to just demonstrating progress against ESG goals.

As mentioned earlier, a number of large companies excel at this, and can really demonstrate a unified sustainability strategy that has been cascaded throughout the entire organisation, and increasingly linked to management incentives. For those IROs in small- and mid-cap companies where there is no such integrated approach yet, the question is where and how to start, as one can be daunted by lack of resources and the scale of the undertaking.

The pragmatic answer is to start simple and build a framework that is easy to understand externally and easy to follow internally. The momentum created in recent times should carry IROs forward and any serious attempt will rally a number of contributors for a process that will be evolving, holistic and take many years to be fully and efficiently implemented.

Critically, from an IRO's perspective, this changing dynamic presents an opportunity to further elevate the IR function into an even more important strategic influencer to Management and the Board than presently.

In part two of this paper, we explore the methodology issuers can adopt in developing a credible sustainability strategy that caters to the needs of an increasingly diverse stakeholder base.

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