ESG, STRATEGY & THE CULTURE IMPERATIVE
Why They Will Still Matter in Our New Reality

A team consisting of risk, investment, legal and business leaders weighs in on the link between environmental, social and governance (ESG) management, strategy and culture in our emerging new reality — and debunk the myth culture is too soft to measure and shape. Gain from the insights of Milla Craig, President of Millani Inc., Stephen Pike, a Partner with Gowling WLG, Richard Arthurs and Mary Larson, both Partners with MNP. Their contact information can found at the end of this piece.

First, can we define what ESG is?

Richard: Businesses and institutions face — and report on — financial risk, as we all know. But there is an array of financially material risks which are equally, if not more, critical to success or failure. These include climate change, business ethics, human rights abuses, operational impact on the environment, employee turnover, discrimination, slavery and child labor and cyber security. These risks fall under the rubric of environmental, social and governance (ESG) management and reporting.

ESG Areas of Focus

Environmental

- Energy efficiency
- Carbon footprint
- Water usage
- Waste management
- Packaging
- Biodiversity management

Social

- Employee attraction and retention
- Diversity
- Pay equity
- Customer data privacy
- Social acceptability of projects / business

Governance

- Climate change
- Cyber security
- Corruption and bribery
- Responsible taxes
- Compensation

Source: Millani Inc.

Why has the topic of ESG become so important in recent years?

Stephen: More than a decade ago, the idea of sustainable or responsible investing began to move into the mainstream, with investors, pension plans, institutions such as universities, boards and CEOs beginning to pay attention. There was (and still is) a lot of “greenwashing” and “greenwishing” going on, however.

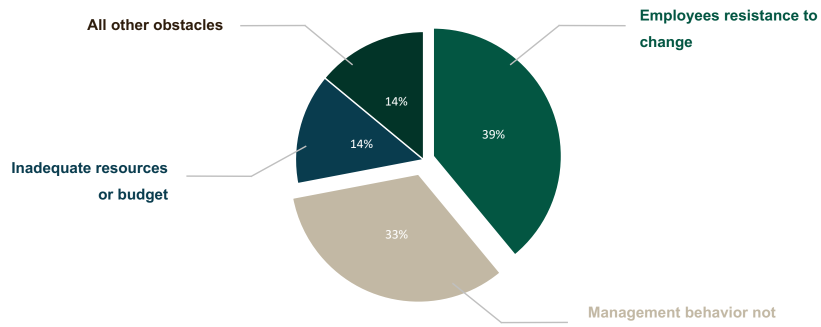
But the realization has gradually taken hold among leading Canadian and global investors that there are very sound reasons to pay attention to these ESG risks: they are financially material and they matter significantly. For example, according to the Canada Pension Plan Investment Board, ”We believe that strong human rights practices contribute to sustaining long-term value.” Cyrus Taraporevala, president and CEO of State Street Global Advisors (US$3+T AUM) adds, “…addressing material ESG issues is good business practice and essential to a company’s long-term financial performance — a matter of value, not values.” (Figures 1A and 1B)

Most recently, finance leaders such as BlackRock CEO Larry Fink have warned CEOs they risk being excluded from their pension fund and other portfolios if they don’t immediately take significant steps to be more resilient to climate and environmental risks. Companies that do not respond “will encounter growing skepticism from the markets, and in turn, a higher cost of capital,” the investment house warned.

In fact, the impact may be even harsher. In May 2020, Norges Bank Investment Management, on behalf of the world’s largest sovereign wealth fund, decided to exclude four Canadian oil and gas companies from its investment portfolio based on “unacceptable levels of greenhouse gas emissions.” (Figure 1C).

Culture Drives Successful Execution of Strategy

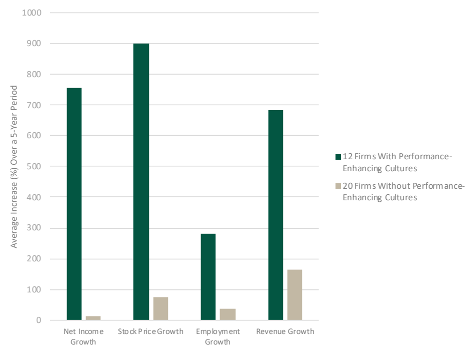
NEARLY THREE-QUARTERS OF STRATEGIC FAILURES ARE CAUSED BY MINDSETS AND BEHAVIORS



Source: McKinsey & Co analysis.

The Importance of Aligning Culture with Strategy

HIGH-PERFORMING CULTURES ARE LINKED WITH BETTER FINANCIAL RESULTS



Source: John Kotter and James Heskett

Why Paying Attention to Risk Matters

Source: MNP

Considering the recent market correction, the global pandemic and the situation many large corporations find themselves asking: does ESG still matter?

Milla Craig: Absolutely. Investors are continuing to pay attention to ESG issues.

As recently as March 27, 2020, the UN Principles for Responsible Investing (PRI) notified its signatories on how "responsible investors should respond to the COVID-19 coronavirus crisis." Their directive was that signatories should "engage with companies that are failing to protect workers' safety and / or their financial security and those prioritizing executives' pay and / or short-term returns to shareholders."

We recently conducted a Canadian institutional Investor ESG Sentiment Study to determine whether if ESG still matters in a post-COVID world. We conducted interviews with 23 of the country's largest investors representing approximately AUM $2.3T. The results were published in mid-May, and what we learned was:

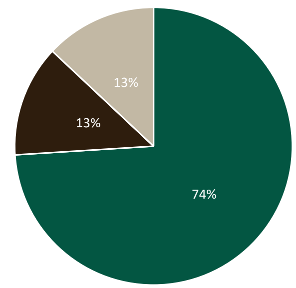
1. Although the focus in the immediate term is on managing the impacts of the pandemic, **we heard repeatedly that ESG is not going away**. In fact, 74 percent of surveyed investors believe COVID-19 will have a positive impact on ESG and sustainable finance. Although there may be a pause to deal with the immediate effects of the crisis, the investors interviewed overwhelmingly felt that in the mid- to long-term, momentum surrounding ESG and responsible investment is too advanced to disappear.
2. **However, it may not be ESG as we have known it**. There will be much more focus on the social issues which are sometimes less obvious and harder to measure and convey, compared to environmental issues. These are human capital issues like worker protection, health benefits, and supply chain sustainability. The value in managing these issues well has been illustrated over the past few months, right before our eyes.
3. **Following a deeper understanding of the connection between social and environmental issues, investors expect that there will be increased analysis applied to governance issues**. How companies have reacted to the impacts of the crisis will be under scrutiny. For example, it was noted a company that had laid people off decided not to pay a dividend and investors advised they will be watching for changes to executive compensation in the midst of mass workforce layoffs. These are governance issues that could affect an organization's reputation, and issues the board needs to closely consider.

Figure 2

74% OF INVESTORS BELIEVE COVID-19 WILL HAVE A POSITIVE IMPACT ON ESG

Q. How will this situation impact the momentum for ESG/Sustainable Finance?

- It will have a positive impact
- It will not have a material impact on momentum
- It will have a negative impact



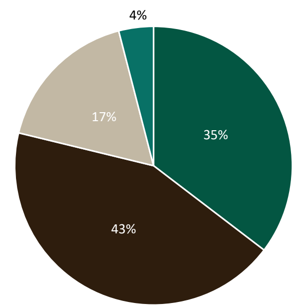
Source: Millani Inc.

Figure 3

78% OF INVESTORS HAVE MAINTAINED OR INCREASED ENGAGEMENT ACTIVITIES DURING THE PANDEMIC

Q. Regarding engagement activities, have you:

- Increased activities
- Maintained activities
- Decreased activities
- No answer



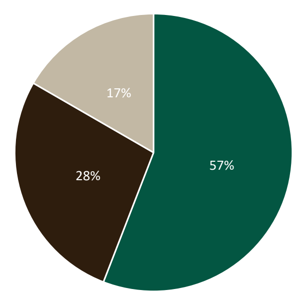
Source: Millani Inc.

Figure 4

ESG PRIORITIES HAVE SHIFTED FOR INVESTORS

Q. Regarding engagement topics, have you:

- Adjusted priorities
- Kept topics the same
- No answer



Source: Millani Inc.

The investor perspective is critical, but what about corporate leaders? What is the level of attention being paid to ESG?

Richard: We are receiving calls every day from CEOs and CFOs, audit committees and internal audit departments. Yes, they are concerned about access to capital, but they are also concerned about the underlying factors: do they face catastrophic cyber risks? Are their employees engaged? Is their culture healthy? Are their strategies clearly understood and being advanced?

The subject of understanding the correlation across strategy, ESG and culture can be overwhelming and hard to quantify. This is leading to significant growth in demand on the part of boards and corporate leaders for using subject matter experts to demonstrate the degree to which a company's culture is helping or hindering its ability to execute strategy — and in giving them the confidence that they are mitigating important risks that can put their strategies in jeopardy.

You mentioned culture just now. How does corporate culture play into the new reality for business?

Mary: If strategy is what you are going to do, then culture is how you are going to do it. One of the characteristics of strategy development going forward is that it will need to consider rapidly evolving trends that will affect the organization's future — and respond with focus and agility. (Figure 5)

We know that culture — a seeming intangible — drives how decisions are made and how risks are addressed, the level of employee engagement, how responsive the organization is to change and the attraction and retention of talent, so there is a very, very strong link across strategy, culture and risk — in particular, ESG-related risk.

No matter what the world of business looks like as we move through the next several months and years, several important trends will remain intact that link directly to ESG.

For one, the shortage of skilled employees will not go away and health and safety issues will continue to be top-of-mind, if not more so. Boards and investors will want to have clear line of sight into the environment in which employees work; they will demand oversight of the treatment and experience of employees / human capital.

Another example: while our skies are clearer now, concerns about climate change, sustainability and the vagaries of "energy independence" will also remain high.

And, finally, social acceptability of projects and business practice will continue to be a front-and-center issue as supply chains and relationships with customers are re-examined. Pricing practices and slave labor are just two concerns among many that will warrant oversight.

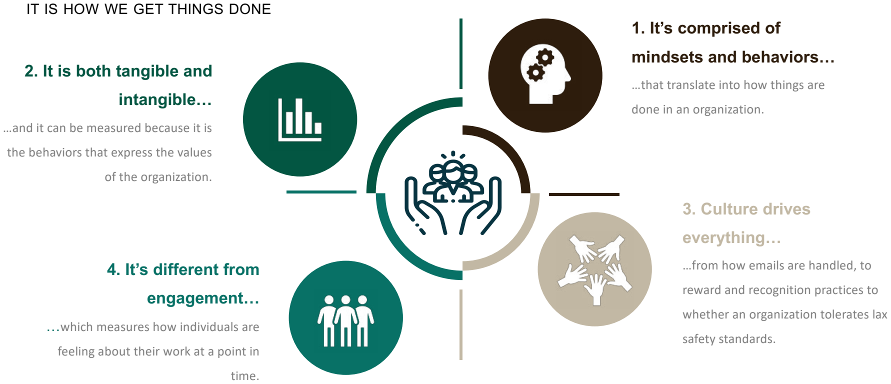
Boards are responsible for ensuring that their organizations' strategies are clear and drive sustainable performance and that any risks associated with the environment, staff, customers, communities and ethical business behaviors are measured and mitigated. They will also want to know organizations have cultures that are agile enough to be able to respond rapidly to emergencies.

This mindset, by the way, is quite distinct from the point of view that prevailed for decades in the wake of Milton Friedman's pronouncement the sole purpose of a corporation was to increase shareholder value. Many notable CEOs and their boards are working hard to define **Purpose: A company's core reason for being**. Larry Fink pointed out: "A company cannot achieve long-term profits without embracing purpose and considering the needs of a broad range of stakeholders."

Purpose really does matter:

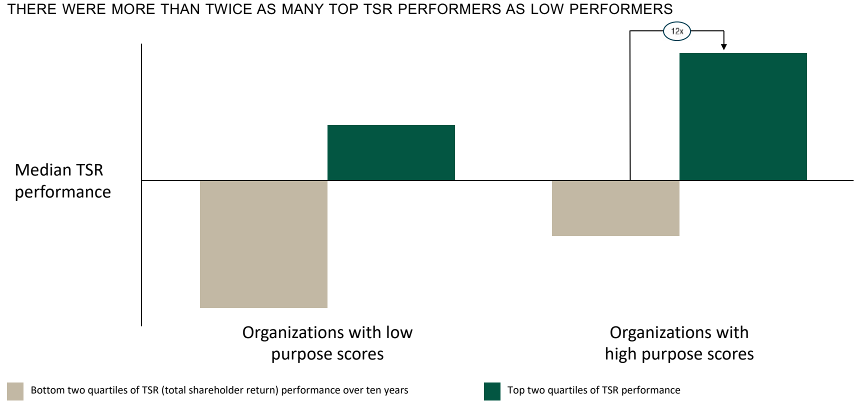
What is Culture?

IT IS HOW WE GET THINGS DONE



Purpose and Performance Are Clearly Linked

AMONG ORGANIZATIONS THAT HAD HIGH PURPOSE SCORES, THERE WERE MORE THAN TWICE AS MANY TOP TSR PERFORMERS AS LOW PERFORMERS



Sources: Brighthouse, BCG analysis

Boards and CEOs appear to sit at the center of this discussion. What do they need to do? From a legal standpoint, what are you seeing?

Stephen: CEOs and their boards are responsible for ensuring the strategy of a company is robust and is being executed. As part of that responsibility, they must also identify and track strategically relevant financial and ESG related risk. And they can and must measure and track organizational culture and the interest of stakeholders.

I was struck by the action and communication from Royal Dutch Shell's (RDS) CEO a few weeks ago.

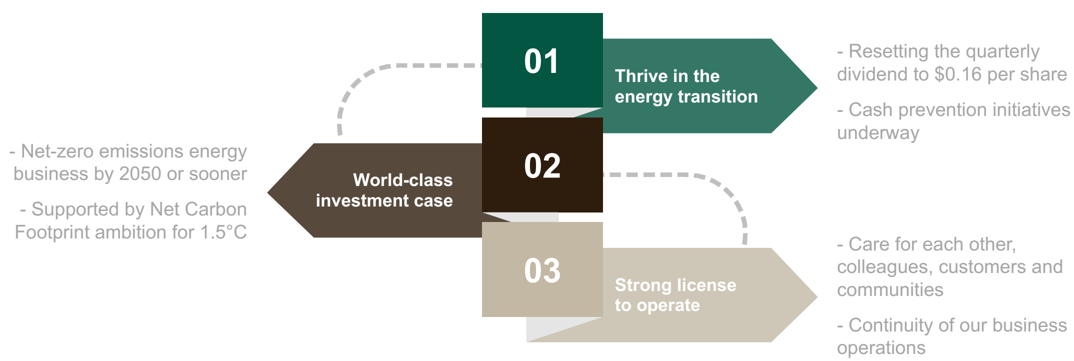
In connection with the decision by RDS to reduce its dividend payment for the first time since the second world war, the CEO reminded shareholders and prospective investors of its strategic ESG ambitions by including "Strong license to operate" and a recognition of stakeholders' interests in his three key messages to shareholders with the Q1 2020 results. RDS had earlier stated on numerous occasions its strategic ambition "to sustain a strong societal license to operate and make a positive contribution to society through our activities."

There is also growing awareness of issues we historically haven't thought or talked about a lot, likely due to the role of the internet and social media. For example, in a well-publicized 2016 Amnesty International report, it described artisanal cobalt mining in the Democratic Republic of the Congo where children as young as seven and adults work in perilous conditions. This report resulted in negative publicity for Apple and resulted in Apple taking steps to re-work its cobalt supply chain and to strengthen supplier sourcing standards to ensure no child labor was utilized in the mining of cobalt for used in the lithium-ion batteries in its products.

In December 2019, Apple, together with 13 other defendants such as Microsoft, Tesla, Google and Dell, were sued on behalf of unnamed plaintiffs, alleging that these companies "are knowingly benefiting from and aiding and abetting the cruel and brutal use of young children in Democratic Republic of Congo (DRC) to mine cobalt, a key component of every rechargeable lithium-ion battery used in the electronic devices these companies manufacture."

Royal Dutch Shell Key Messages

RDS CEO'S COMMENTS RELATED TO DECISIONS TO REDUCE ITS DIVIDEND PAYMENT*



*April, 2020.

With all this in mind, what should boards and CEOs do differently?

There are two levels on which the board and the CEO need to take proactive steps. One is related to business strategy and organizational culture and the other is more programmatic.

Mary: Board members, governance professionals and CEOs must pay special attention as to whether and how their organizations' strategies and cultures support the achievement of these ESG objectives and have explicitly taken related risks into account.

The importance of the board's role in overseeing culture and ESG risks is becoming increasingly apparent to many directors. Last year, we carried out research that was sponsored by ICD, the GPC and Rotman, speaking to over 55 board members and governance professionals from across Canada. We learned there are concrete actions that boards can undertake.

1. When business strategy is defined – or it shifts – the board must be very aware of the need to define – or redefine – the type of culture that will enable the strategy. The strategy could imply cultural norms that carry significant risk, which would cause management and the board to question the wisdom of the strategy. The culture should be measured, using one of the sound tools out there, such as the Barrett Values Assessment, and the board must ensure the CEO and the executive team tackle areas of cultural dysfunction.
2. As one of the board members we talked to said, "ideally, we would have a cultural dipstick or dashboard that allows us to be proactive about culture issues. We would have in it a set of non-financial measures that are aspirational, but not so unrealistic that there would be pressure to under-report."
   Jim Dinning, Chair, Western Financial Group
3. In reviewing the strategy, the board should agree on the types of risks the company is most likely to face, identifying the ones that could do the most damage to the organization. At that point it is possible to identify the appropriate metrics to track and report over time.
4. Establish a regular set of procedures to track and investigate risk, frauds and misdeeds. This may start with carrying out a Strategy and Culture Advisory exercise to pinpoint areas of risk. It can also involve putting in place an ombudsperson, defining whistleblower policies, or ensuring that the organization's code of conduct is adhered to. This code of conduct should clearly articulate the values and behaviours needed to achieve the organization's strategies; regular pulse surveys can be used to track employees' views regarding adherence to the code.

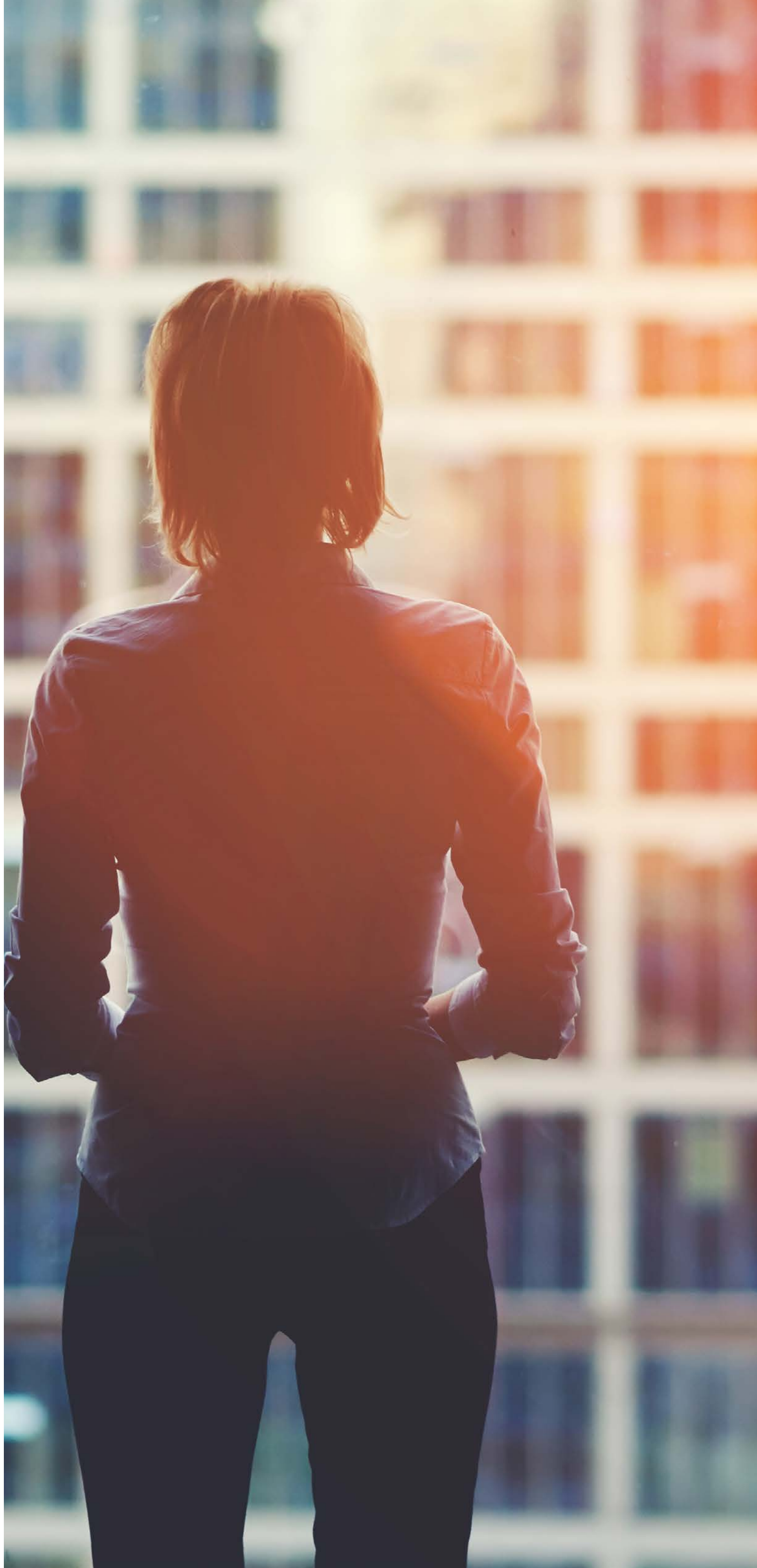
Milla: To build on this, with respect to risk identification and tracking, it is critical for the organization to clearly define their "financially material" ESG risks. Typically, there are a handful that matter to your financial stakeholders, which ultimately will influence either your cost of capital or your ability to access capital. As such, the organization should go do a financial stakeholder materiality assessment. This then allows the CEO and board to set a course to manage these risks. Once the issues are determined, the next step is to set clear metrics and targets that can be consistent and comparable to others in the marketplace. This is where these issues need to be operationalized, with metrics and targets being implemented and added to the organization's risk management analysis and processes. Going forward, regular updates must be provided to the board.

Resources are required today to manage these issues well both from an internal operational standpoint, as well as a communication standpoint for the disclosure of this information to the marketplace. Strong communications planning is required to determine what and when to disclose as well as a strong engagement strategy to ensure proper communication of these issues to your various financial stakeholders.

For example, if the issue is climate change, then the organization needs to determine if this is "financially material" to their business – not just from a carbon foot printing standpoint, but from the standpoint of what the physical and transition impacts of climate change will be on their business. If it is determined that the answer is yes, then the organization should take steps to do scenario analysis, the outcomes of which would be presented to the board for consideration, metrics and targets would be determined and then communicated to the marketplace in multiple communication channels like roadshows, investor days, or climate reporting.

Richard: The role of internal audit is also shifting to place more emphasis on proactive advisory. Internal audit is no longer seen as the "third line of defense" but rather as being on the front lines of providing evidence to the board, investors and other stakeholders that the company is doing everything reasonable to identify and mitigate risk.

This is not surprising, given the pace of change we are all dealing with, driven by technology innovation and threats ranging from pandemics, political instability, regulatory change, and sizeable shifts in concerns around climate change, sustainability, and cyber events. The audit committee sees internal audit as a means to anticipate risk and recognizes that risks are exacerbated by negative cultures.



Conclusion

The long-term benefits of aligning culture with strategy are significant. First and foremost, the likelihood that the strategy will be accomplished are significantly improved if the culture is aligned with strategic direction. Sound cultures also drive decisions and behaviors that reduce financial, regulatory and legal risk and create lasting value along ESG dimensions.

For more information, please don't hesitate to reach out to any of our panelists:

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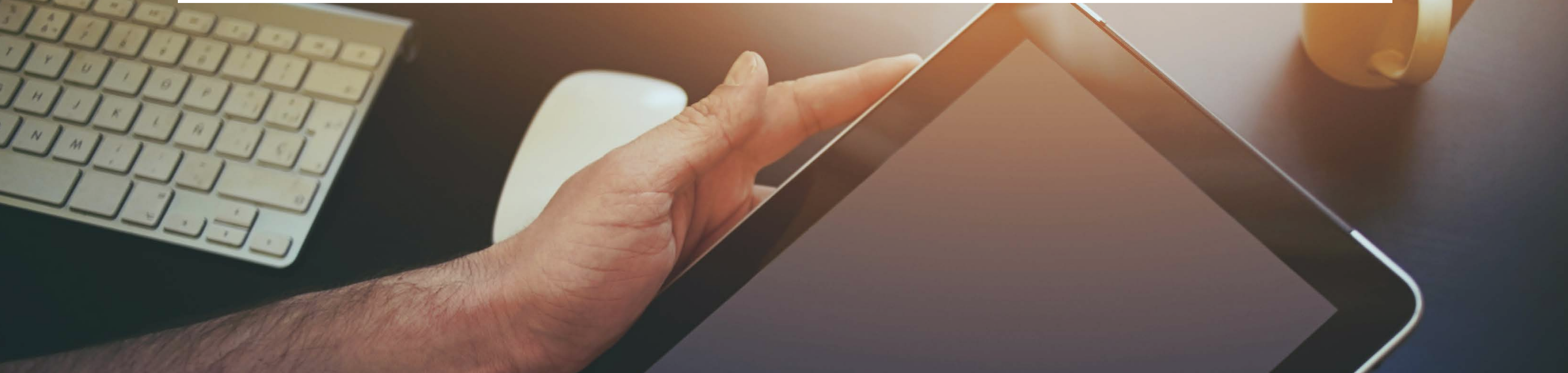

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