ESG Rating Agencies Are Here to Stay

In today’s socially conscious market environment, understanding and working with ESG rating agencies is essential. Learn how to ensure your company is getting the credit it deserves.

BY ALEXANDRA WALSH
Jamie Dimon made this comment in conjunction with the Business Roundtable’s late summer 2019 announcement that it had released a new “Statement of the Purpose of a Corporation.”

Each version of the document issued since 1997 had endorsed principles of shareholder primacy – that corporations exist principally to serve shareholders.

The new statement supersedes previous statements and outlines a modern standard for corporate responsibility.

The revised statement was signed by 180 of Dimon’s fellow CEOs who committed to lead their companies for the benefit of all stakeholders – customers, employees, suppliers, communities, and shareholders.

**Battling Cynicism**

Much of the media coverage following the Business Roundtable’s 300-word statement leaned towards the cynical. *The Washington Post* noted the statement offered sparse detail and wondered how success might be measured in a stakeholder-driven approach to capitalism.

One truth is certain and beyond cynicism – there has been a significant development of sustainable and responsible investment during the past 10 years.

Investors, shareholders, government agencies and ratings firms are requesting detailed information about financial performance and about environmental, social and governance (ESG) aspects of companies, which has become part of their competitive strategy.

**Rise of ESG Rating Agencies**

These factors have given rise to the inevitable appearance, and now growth, of ESG rating agencies.

ESG rating agencies scrutinize businesses and assess corporate sustainability performance by using their own research methodologies. This expertise has turned the agencies into a key reference for companies, financial markets, and academia in terms of corporate sustainability assessments.

Consequently, the sustainability rating market has also grown considerably during the past decade.

**Investors Driving Change**

At this juncture, it might be considered a moot point how an American CEO really feels about no longer putting profit ahead of all other stakeholder interests because investors are increasingly taking a broader view of what drives corporate success.

Jonathan Bailey, head of ESG investing at Neuberger Berman, notes that in 2015, about 5 percent of inquiries pertained to ESG – last year it was closer to 50 percent.

“We’re still getting fewer ESG inquiries from U.S. investors than European or Australian investors, but those markets exist in a different regulatory and political climate,” Bailey points out. “Now most of the investment consultants who advise funds are asking about ESG – there are changing expectations that go far beyond whether a fund is being labeled sustainable or not.”

“There is a fast-growing demand for the product because companies that have ESG integration are asking for it,” says Elizabeth Saunders, partner, Clermont Partners, LLC. “Demand is coming from external clients requesting portfolios be created for them that are sensitive to ESG issues.”

Saunders says if an investor has an option to invest in an ESG fund with the same Morningstar Rating as another fund, they’ll pick the ESG fund.

“These investors believe a company with stern ESG protocol is a safer/lower risk investment and believe returns in these integrated funds are the same as ESG funds,” she notes.

**CEO Attention to ESG**

Every CEO should be paying attention to ESG, says Dan Nielsen, head of ESG and responsible investing and senior portfolio specialist at Great Lakes Advisors.

Nielsen argues that when ESG ratings are based upon an assessment of material ESG issues – that is, the non-financial issues that might have a financial impact on the company’s bottom line – CEOs should absolutely be aware of their company’s ESG rating.

“For investors, there is a strong business case for incorporating an assessment of material ESG issues into an investment analysis,” he declares. “Doing so can yield additional insights that help improve investment decision-making with the aim of improving risk-adjusted returns.”

“"The American dream is alive, but fraying. Major employers are investing in their workers and communities because they know it is the only way to be successful over the long term.”

*Jamie Dimon, Chairman and CEO of JPMorgan Chase & Co. and Chairman of the Business Roundtable*
“For CEOs, managing material ESG risks and opportunities can create competitive advantages by lowering costs, improving efficiency and productivity and generating new sources of revenue, all issues that CEOs should be focusing on.”

**Competing ESG Rating Agencies**
With a proliferation of ESG rating agencies, how does an IRO know which agency to follow or whose data to track?

Beau Daane, a sustainability professional for 15 years, says the ESG rating agency an IRO should follow depends on their own company’s industry sector. As an example, he notes that the rating agency CDP is laser-focused on energy and water use.

Daane’s list of ESG rating agencies that he considers the most influential data providers is shown in the sidebar in this article.

“Evaluate what your peer companies are doing, what issues they identify as material, and how they are communicating strategies and performance on those issues,” Nielsen recommends.

He also advises that if they haven’t already, IROs should familiarize themselves with SASB (Sustainability Accounting Standards Board), founded in 2011 to develop and disseminate sustainability accounting standards. (See the diagram in this article for SASB sustainability topics.)

“Unlike financial accounting standards, which can be uniform for all companies, sustainability accounting standards need to recognize which ESG issues are relevant, which varies across industries. That is why SASB created a unique list of material ESG issues for each of 77 industries,” Nielsen notes.

Gregg LaBar, senior managing director, sustainability communications at Dix & Eaton, suggests that IROs start by asking their largest investors who they rely on for ESG data and by paying close attention to the what questions are submitted to their IR and corporate governance teams.

**Correcting Errors**
Saunders points out that two of the most influential rating agencies, MSCI and Sustainalytics, both provide companies they cover with a free full report.

“Start there – get a copy of that report and figure out if there are errors, perhaps updates you provided that the agency didn’t catch,” says Saunders. “Identify those ESG areas where the company is weakest and begin an internal dialogue at your company to decide what the fix will be.”

Saunders says that fix might simply be making the right internal report public. “The customer service teams at the rating agencies will correct errors, but they don’t always work quickly, so you have to create a space in a public forum that disproves the error.”

Bailey says most ESG rating agencies will send a summary of the information they are working from to determine a company’s ratings to the company in question.

“Some aspects of the report might seem a little subjective – is there a safety plan or not, have there been safety incidents or not,” Bailey explains. “But when it comes to elements like products and services aligning with clean technology for instance, your company might be producing a component essential to a product aligned with clean technology but it might not be easy to see that ball bearings can be applied in that way.”

Bailey says you have to show the path and tell the story and ensure that the information is updated in your earnings report and on your website.

Nielsen says most companies are not aware that Sustainalytics and MSCI will make reports available to the company they cover every time the report is updated.

“There are a lot of reasons companies might not know who will see their report: it might not be getting to the right person or isn’t being recognized for what it is,” Nielsen suggests.

Nielsen points out that most ESG rating firms rely only on...
publicly available information. When information is not available, some raters will penalize a company while others might assign an industry average score. And, there are instances when companies determine that the sought-after information cannot be publicly disclosed.

“The company might disagree with the rating agency’s methodologies, such as what issues the agency thinks are relevant, but the information populating that methodology can be corrected if mistakes are found,” Nielsen says.

LaBar adds, “Ratings organizations are generally doing a good job, but they’re conducting a relatively quick scan of your information and you know your company much better than they do. If you care about your company’s ratings, you should be engaging with the raters to get the information right – or accept the consequences if the information is inaccurate or unavailable.”

“Don’t fixate on errors in the data the agencies are reporting,” Saunders warns. “Typically, if an agency gives a company a failing grade, it’s because the company chose to not make certain informa-

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**Starbucks Issues Third and Largest Sustainability Bond**

In May 2019, Starbucks issued a $1 billion Sustainability Bond, the largest the company has issued to date. It follows two previously issued Sustainability Bonds in 2016 and 2017.

As with the other two Sustainability Bonds, funds will support Starbucks ethical coffee sourcing and its Greener Retail initiative.

A portion of the funds will also support Starbucks’ partnership with responsAbility Investments AG, an asset manager in development investments, on a $20 million investment to provide debt financing to coffee producer organizations in Latin America, Africa, and Asia to support the operations of coffee farmers.

Starbucks reported that its latest Sustainability Bond attracted significant investor interest and was oversubscribed.

The company noted the bond illustrates a trend toward heavier interest from investors in its socially and environmentally focused projects – in this case supporting coffee farmers and leading in green retail – and added that Starbucks’ leadership in social and environmental responsibility is a defining element of who the company is.

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The Path to Better Ratings

Nielsen believes disclosure is always the best practice for a company. "I want to hear from the company what they identify as material ESG issues, how they are impacted by those issues, what initiatives and strategies are underway to manage those issues, and what has been the performance of the company in implementing those initiatives."

Nielsen notes that when a company doesn't disclose ESG information that investors think is material, they will go to other sources. "It's always good for a company to tell its own story. When they don't, we have to incorporate more assumptions into our analyses, which makes the investment riskier."

Nielsen warns IROs not to let perfect be the enemy of good. "Not getting it right 100 percent of the time is better than no disclosure at all. I'm looking for evolution in a company's ESG reporting – a company gains credibility for beginning to report on ESG issues and expanding that reporting over time."

To ensure the company is fully disclosing all ESG data, Nielsen suggests starting with the company's sustainability department, if there is one, to see what the company is already doing.

"The relevant data may not be framed in such a way that makes it easily recognizable to investors – the company might be promoting a whole list of initiatives targeted at a large group of stakeholders when, as an investor, I'm only interested in the financial performance of the company and the ESG issues impacting that performance," Nielsen explains.

Bailey says IROs need to distinguish between what investors are looking for and what ESG rating agencies are looking at. "Many active managers, such as Neuberger, build our own ESG capability evaluation and what we're looking at might be very different from rating agencies – IROs should ask active managers what are the most important ESG issues to them and what they would like to see disclosure on."

LaBar recommends starting with a gap analysis that examines what data the company is tracking and what metrics might be missing that could hurt the company's score. "Make sure you have relevant KPIs that are measurable and that you're reporting in the correct units."

"Also look at what your industry peers are doing and examine how they cover ESG in their annual or CSR report," LaBar adds. "And make sure you fully understand what institutional investors are looking for and asking about in your space and what it will take to get that information."

LaBar advises IROs make sure they understand shareholder proposals related to ESG, if there are any. "A lot of governance issues should already be addressed on your website so if that part is missing, just provide links to where investors can find the information."

Bailey recommends making sure health and safety metrics are right up front on the company website, annual or CSR report. "It doesn't have to be a 40-page report – it can be one table with the right data points that sends an immediate signal without the need to collect a whole lot of new data."

Bailey also suggests going to SASB for advice. "They're a great team of people, they understand what investors are looking for in terms of ESG best practices, they'll help companies focus on what's material and also recommend different approaches to improve disclosure, whether that might be a standalone table, woven into a 10K or in a sustainability report," Bailey says.

He also urges IROs to join the SASB Standards Advisory Group that pertains to their industry as a way to learn from peers more about framing ESG issues.

LaBar adds, "You need to address the topics that matter most to your company, your investors, and your stakeholders. A materiality assessment, using the SASB or GRI (Global Reporting Initiative) framework, may ultimately be necessary."

Why It Matters

Daane believes there is more money chasing companies practicing sustainability than there are companies to invest in, and the challenge for IROs is differentiating their company to show they are worthy of that capital.
As an example, he points to the issuance of Starbucks’ recent $1 billion sustainability bond, which was oversubscribed and brought in dozens of new investors for the company. (See sidebar on page 21).

And, Nielsen adds, “When IROs can articulate to CEOs that investors are making decisions based in part on ESG, it’s likely that IRO team will receive additional resources.”

“At the end of the day, an investor is going to look at what will move stock and improve company performance. At best, investors are using some of the underlying data from ESG rating agencies but most are concerned more about the substance of what you’re doing, rather than the ratings,” Bailey says.

The Rating Outlook
Daane notes there is a wealth transfer aspect to the ESG investment movement.

“From the boomers to Gen X to millennials, each generation has become increasingly concerned about companies’ environmental and sustainability track records. IROs are only going to see more and more investor questions about ESG.”

Daane adds that’s also why ESG is such a hot draw in recruiting, retaining and developing young talent in the tight job market. “Increasingly, employees rank the ESG record of a prospective employer as one of their highest priorities.”

“Right now, the ‘G’ in ESG continues to be the most important factor to investors and has been since all the studies came out discussing how important governance is,” Saunders says. “And while there’s no denying the ‘E’ and ‘S’ are becoming increasingly relevant, when, or whether, they become as equally important as ‘G,’ remains to be seen.”

Saunders also notes there are some inconsistencies in data between agencies, which is leading some institutions that have to integrate ESG to become increasingly uncomfortable with their performance being rated out of house. But Saunders warns, “The bar will be higher for institutions than rating companies.”

“We conduct our own ESG analysis on companies in our portfolios, and we do our own materiality assessment,” confirms Nielsen. “It’s a risk assessment tool – if a company gets a low score it reduces how much we’re going to invest because it’s a riskier investment. And if the score is high, so is our willingness to invest more.”

Nielsen says they’ve been formalizing the company’s ESG integration process since 2008, and it has continued to evolve and expand. “Certainly there is increasing interest in the marketplace for ESG, but our primary driver is to incorporate it into our investment analysis because of the impact on risk-adjusted returns.”

“IROs should embrace the opportunity to advance the ball in this ESG space,” Daane contends. “In the long run, the company that manages its ESG data well is generally going to be better managed, think beyond quarterly results and be a stronger investment.”