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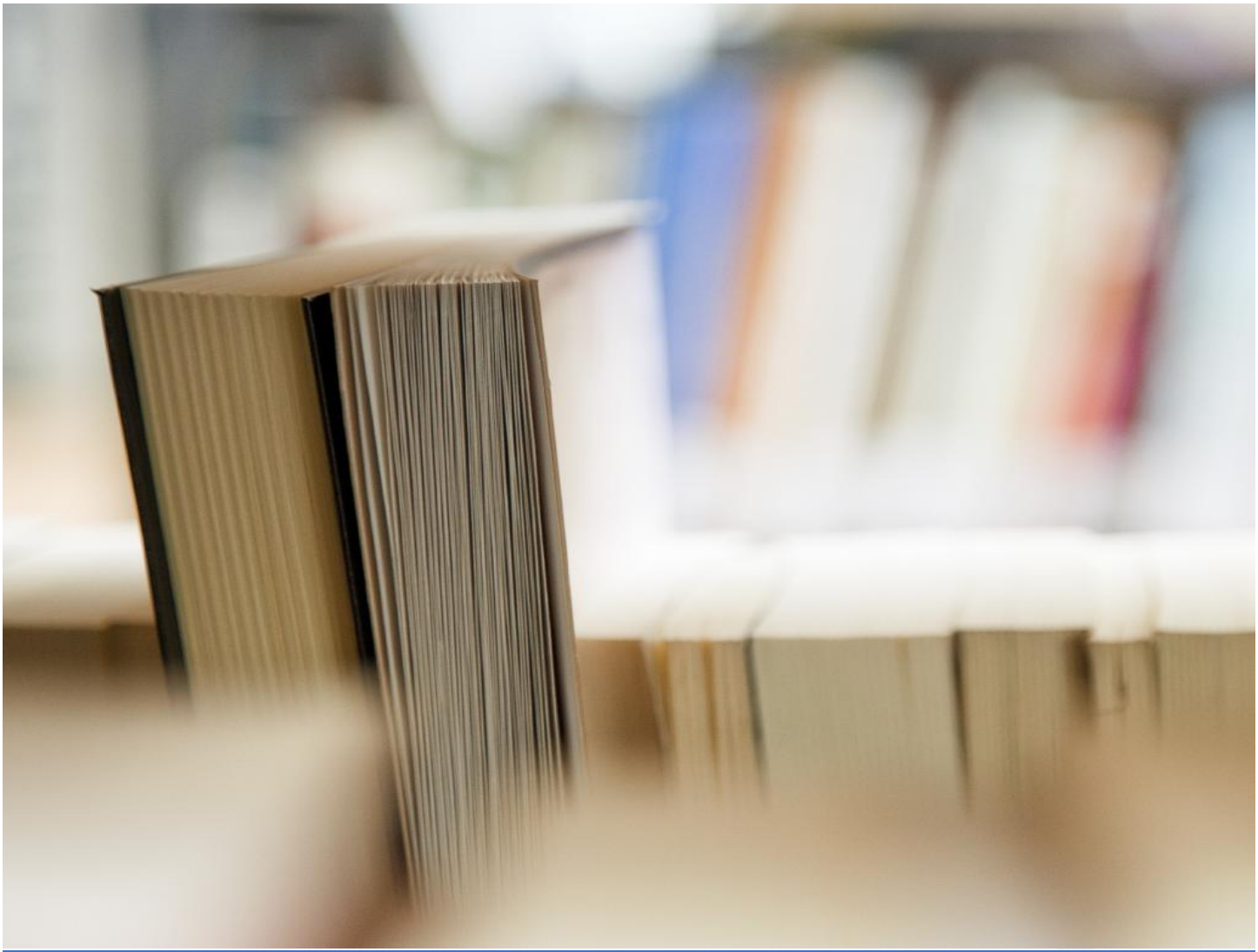

ESG Integration Assessment Stages in the Investment Process: (Research and Idea Generation)

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ESG Integration Assessment Stages in the Investment Process: (Research and Idea Generation)

Investment institutions and investment groups may not incorporate ESG factors into their investment philosophy but still use ESG techniques in their investment process. These techniques may run alongside financial analysis or include aspects that are integrated into the analysis.

The three stages are typically: research, valuation, and portfolio construction to make investment decisions.

Each of these stages will be considered in more detail in later articles.

Research and Idea Generation Stage:

Gathering Information:

Investors gather financial and ESG information from a variety of sources, often a combination of company reports, third-party research, and primary research, and the data can be qualitative or quantitative, or both.

For example, qualitative data might include company questionnaires and management

Materiality Assessments:

The research phase typically includes a materiality assessment to identify ESG issues that are likely to impact a company's financial performance. Materiality is typically measured in terms of both likelihood and magnitude of impact.

Materiality is considered important because evidence shows that immaterial factors do not impact a company's financials, valuation, or business model. It differs from some exclusionary socially responsible investing strategies, which may also consider immaterial factors (e.g., excluding investments in pork with a particular religious affiliation) that a typical investor would not consider to be material ESG factors.

Investors primarily view ESG analysis and ESG integration as a way to improve their investment processes by focusing on ESG issues that they consider financially material (i.e., factors that they believe may have a future financial impact, positive or negative). As of 2021, there is ongoing debate about the classifications and definitions used around ESG and Sustainability. For example, the EU is proposing a taxonomy for sustainable investing. Additionally, some investors label their strategies as "ethical" or "impact." Such ethical strategies may consider issues that ESG-integrated investors do not consider material.

Tangible and Intangible; Different Forms of Capital:

Tangible assets (or hard assets) are physical assets, while intangible assets are non-physical assets that are difficult or impossible to physically touch.

Examples of tangible assets:

- Land
- Manufacturing plant

- Inventory
- Furniture
- Machinery

Examples of intangible assets:

- Goodwill
- Patents
- Copyrights
- Intellectual property and know-how
- Software assets and innovation
- Corporate culture
- Incentives
- Employee productivity
- Other forms of social and relationship assets

Assessing Different Forms of Tangible or Intangible Elements:

A framework for assessing different forms of "capital" or tangible or intangible elements has been developed by the International Integrated Reporting Council (IIRC).

The IIRC framework (which some companies use to report) describes capital (both intangible and tangible) as follows:

Financial capital - Capital available to an organization for use in producing goods or providing services and is obtained through financing, such as debt, equity, or grants, or is generated through operations or investment.

Manufactured capital - Manufactured physical objects (as opposed to natural physical objects) available to an organization for use in producing goods or providing services, including buildings, equipment, and infrastructure (e.g., roads, ports, bridges, waste, and water treatment plants). Manufactured capital is typically generated by other organizations but includes assets produced by the reporting organization for sale or when they are retained for its own use.

Intellectual Capital – Knowledge-based, organizational intangible assets, including intellectual property (e.g., patents, copyrights, software, rights, and licenses) and "organizational capital" (e.g., tacit knowledge, systems, procedures, and protocols).

Human capital – People's capabilities, capabilities, experience and their drive for innovation, including:

- Their alignment with and support for the organisation's governance framework, risk management approach and ethical values
- Their ability to understand, develop and implement the organisation's strategy
- Their commitment and motivation to improve processes, goods and services, including leadership, management and collaboration

Social and relational capital – The institutions and relationships between communities, stakeholder groups and other networks and the ability to share information to enhance individual and collective well-being. These include the following:

• Shared norms, values and behaviours

• Intangibles associated with the brand and reputation that an organisation has developed

• An organisation's social licence to operate

Natural Capital – All renewable and non-renewable environmental resources and processes that provide goods or services that support the past, present or future well-being of an organization, including air, water, land, minerals and forests, as well as biodiversity and ecosystem health.

Clearly, not all forms of capital (intangible or tangible) are material or relevant to all companies; however, determining this may require an assessment of materiality. Many non-financial sources of capital will be considered under ESG criteria, with a large number also being intangible. Qualitative identification and assessment will be considered a form of qualitative approach to ESG.

We will now briefly consider how some of these forms of capital can be assessed using some examples of company constituents, such as regulators, customers, employees and suppliers.

A positive relationship with regulators can lead to less friction and litigation. Examples of industries that might include:

• Social media and advertising companies,

• Pharmaceutical companies,

• Airlines,

• Financial services, and

• Any company that is particularly sensitive to regulators, which can be found in many industries.

The relationship between the regulator and the company will be considered an intangible asset (or liability if the relationship is negative). A negative relationship is more likely to result in litigation, which adds costs and may result in penalties, both of which impact the company's cash flows.

The amount of capital that banks and insurance companies are required to hold may depend on the investment analyst's view of their relationship and reputation with regulators and the public. This in turn may affect estimates of return on capital, cash flows, and valuations.

Pharmaceutical companies with positive reputations and products that previously met a medical need may have a faster or more certain path to regulatory approval. This can be measured by different estimates of the probability of future product success. For example, the probability of success may decrease from the industry average of 70% to 60% for a company with a poor reputation, or it may increase to 80% for a company with a positive reputation. This adjustment will affect the calculation of the risk-adjusted discounted cash flow (DCF): Faster approval of licenses will have a positive impact on cash flow, so reputation and brand are intangible assets.

Customer service, perceived brand value, and overall customer satisfaction can be inputs into determining future revenue growth and thus cash flows. Different growth rates can be influenced by investors' views of reputation and brand value for both positive opportunities and negative risks. A company with high customer satisfaction or a strong brand reputation can be expected to grow revenue faster than the industry average according to investors' estimates.

High employee satisfaction can also influence investors' estimates. For example, a hotel group with high employee satisfaction may find it easier to recruit new talent and may be perceived as delivering a better customer experience, which may lead to higher repeat revenue in the eyes of investors or by investors being prepared to assign higher valuations (e.g., willing to buy stocks with higher P/E ratios or bonds with lower credit spreads).

Poor supply chains or poor relationships with suppliers may lead to lower investor forecasts or lower valuations, such as in the supermarket food supply chain where poor supply chains led to the recent case of horsemeat in Lasagna food products in Europe. This can also be seen in the question of sustainable sourcing of supply chains. On the other hand, strong supply chain management in managing inventory quickly and flexibly from short and strong supply chains can bring a more positive view from investors. These factors can intersect. For example, poor supply chains and labor practices can be negatively affected by modern slavery laws or regulations, which can combine both regulatory assessments and supply chain assessments from investors.

Idea Generation:

Investment ideas can be generated from the data. Some investors begin this phase by using a valuation or fundamental screen, which may incorporate ESG factors – perhaps a combination of positive (looking for high G), negative (avoiding low G) or momentum (looking for rising G or avoiding falling G) – to create an attractive investment horizon. This is often referred to as "positive" or "best-in-class" screening.

Investment ideas can also be generated by themes related to specific ESG megatrends. For example, an ESG thematic opportunity might be to improve access to clean water or clean energy services. This approach is often referred to as "thematic" investing.

At this stage, checklists – either internally or externally sourced – can "red flag" companies and be used to narrow the investible pool. For example, a low Governance (G) score may be acceptable, or an unacceptable number of ESG controversies (real-world ESG events that are contested by various stakeholders or have a social impact, such as a dam failure). Red flagging techniques can also be used in later stages.

These risks can be ESG risks assessed on an absolute hurdle basis, or assessed on what can be "priced into the asset".

A material negative assessment of a particular ESG factor or set of factors may lead to a decision that the investment does not meet a particular hurdle/criterion. For example, an incentive structure that is deemed inappropriate according to the assessment in pillar G may eliminate the investment possibility and the assessment will trigger a "sell" or "do not invest" signal.

This assessment can be quantitative (e.g., Company A's carbon intensity is too high relative to the benchmark to meet the investor's investment criteria) or qualitative (e.g., the

management team's experience in managing environmental risks and lack of published policies may indicate that the risk is too great for the investor on a qualitative basis).

To learn more about ESG and sustainability-related models, please contact **YTT Consulting**!