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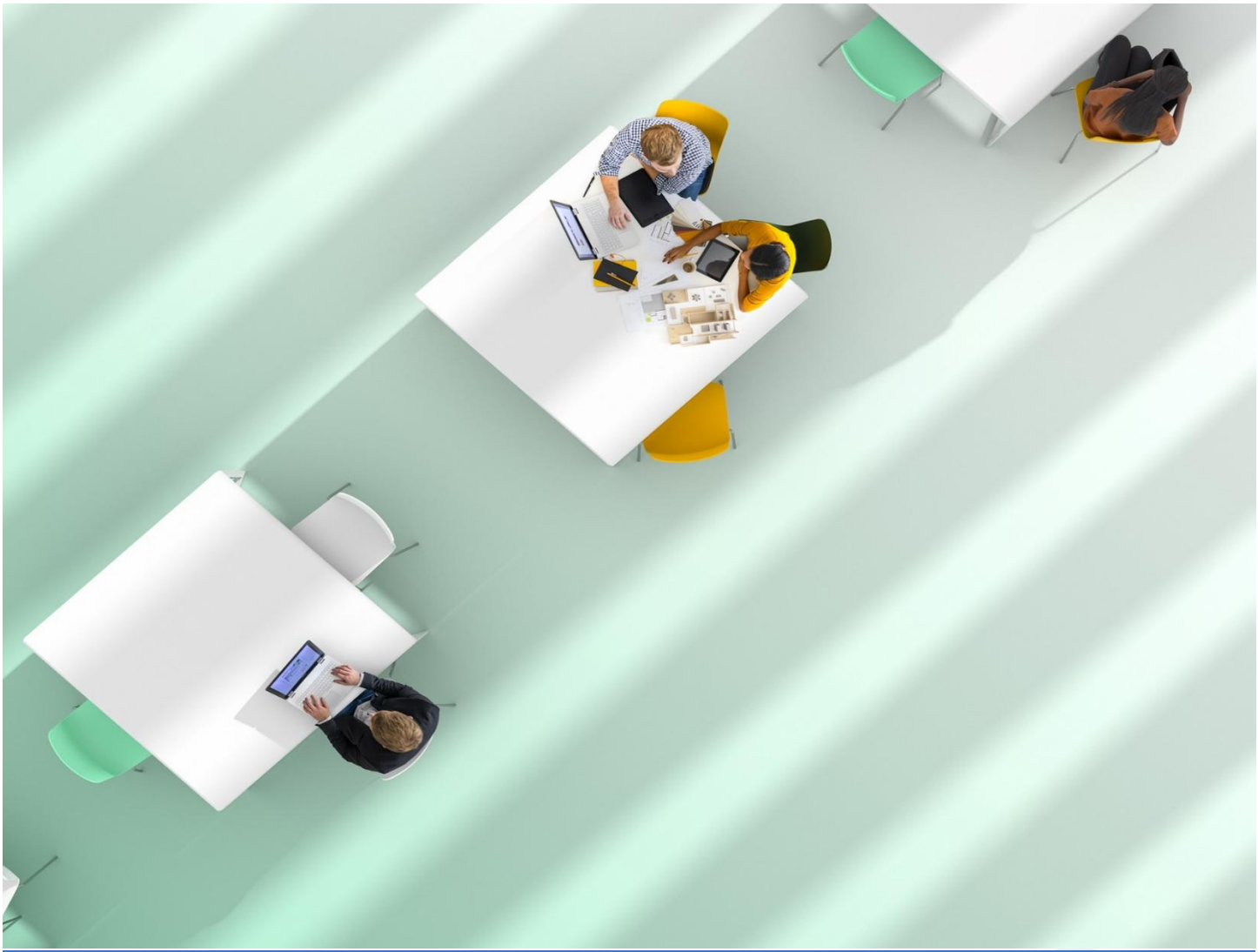

Stages of Integrated ESG Assessment Within Investment Processes: Research and Idea Generation

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Stages of Integrated ESG Assessment Within Investment Processes: Research and Idea Generation

Firms and investment teams might not have ESG factors embedded in their philosophy but still use ESG techniques within investment processes. These techniques can run alongside a financial analysis or have integrated aspects to the analysis.

The 3 stages typically are research, valuation, and portfolio construction, which leads to investment decisions.

Each of these stages is considered in further detail in the following articles.

Research and Idea Generation Stage:

Gathering Information:

Practitioners gather financial and ESG information from multiple sources, typically a mix of company reports, third-party research, and primary research, and the data might be qualitative or quantitative, or both.

For example, qualitative data might include company questionnaires and management interviews, whereas quantitative data might include environmental emissions data.

Materiality Assessments:

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

The materiality assessment is considered important because evidence shows that nonmaterial factors do not affect financials, valuations, or company business models. It is distinguished from some exclusionary socially responsible investing strategies, which might also consider nonmaterial factors (e.g., exclusion of pork-based product companies for certain religious stakeholders) that a typical investor would not deem a material ESG factor.

Investors who primarily see ESG analysis and ESG integration as a way to enhance investment processes are likely to focus on ESG issues they consider financially material (i.e., a factor that they consider likely to have a financial impact in the future, either positive or negative).

As of 2021, debates are ongoing about the taxonomy and definitions to be used surrounding ESG and sustainability. For instance, the EU is proposing a taxonomy on sustainability investments. Also, some investors label their strategies as either "ethical" or "impact." Such ethical strategies might consider issues that an ESG-integrated investor does not deem as being material.

Tangible versus Intangible Factors; Different Forms of Capital:

A tangible asset (or a hard asset) is a physical asset, whereas an intangible asset is a non-physical one that is difficult or impossible to touch physically.

Examples of Tangible Assets:

- Land

- Manufacturing plants
- Inventories
- Furniture
- Machinery

Examples of Intangible Assets:

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

Evaluating Different Forms of Tangible or Intangible Factors:

One framework for evaluating different forms of "capital" or tangible or intangible factors was developed by the International Integrated Reporting Council (IIRC).

The IIRC Framework (to which certain companies report) describes capitals (both intangible and tangible) as follows:

Financial capital — the pool of funds that is available to an organization for use in the production of goods or the provision of services and that is obtained through financing, such as debt, equity, or grants or generated through operations or investments.

Manufactured capital — manufactured physical objects (distinct from natural physical objects) that are available to an organization for use in the production of goods or the provision of services, including buildings, equipment, and infrastructure (e.g., roads, ports, bridges, and waste and water treatment plants).

Manufactured capital is often created by other organizations but includes assets manufactured by the reporting organization for sale purposes or when they are retained for their own use.

Intellectual capital – organizational, knowledge-based intangibles, 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 competencies, capabilities, and experiences and their motivations to innovate, including the following:

- Their alignment with and support for an organization's governance framework, risk management approach, and ethical values
- The ability to understand, develop, and implement an organization's strategy
- Their loyalties and motivations for improving processes, goods, and services, including their ability to lead, manage, and collaborate

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

- Shared norms and common values and behaviors

- Intangibles associated with the brand and reputation that an organization has developed
- An organisation's social license 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 prosperity 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) would be material or relevant to all companies; however, determining this might require a materiality judgment.

Many of the nonfinancial capitals would be considered under ESG, with a large number also intangible. A qualitative identification and judgment would be considered a form of qualitative approach to ESG.

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

A positive relationship with regulators could lead to less friction and litigation. Examples include:

- Social media and advertising companies,
- Pharmaceutical companies,
- Airlines,
- Financial services, and
- Any company that has a significant regulator, which could be found in many industries.

The relationship between a regulator and a company would be considered an intangible asset (or a liability if the relationship is negative). A negative relationship might be more likely to lead to litigation, which adds to costs and could lead to penalties, both of which affect cash flows.

The amount of capital that banks and insurers are required to hold might depend on an analyst's view of their relationships and on their reputation with regulators and the public. This in turn could affect return on capital metrics, cash flows, and valuation estimates.

Pharmaceutical companies with a positive reputation and products that meet previously unmet medical needs might have quicker or more certain regulatory approval pathways. This can be assessed by differing estimates of the probability of success for future products. For example, the probability of success might be lowered from an industry average of 70% to 60% for a company with a poor reputation, or it could be raised to 80% for a company with a positive reputation. This adjustment would affect risk-adjusted discounted cash flow (DCF) calculations: Faster approval positively affects cash flows, so reputation and brand are intangible assets.

Customer service, perceived brand value, and overall customer satisfaction can be inputs to determine future sales growth rates and therefore cash flows. Differing growth rates might be affected by an investor's view of reputation and brand value for both positive opportunity and negative risk. A company with high customer satisfaction or strong brand reputation might be expected to grow revenue faster than the industry average in investor estimates.

High employee satisfaction might also affect forward estimates by investors. For instance, a hotel group with high employee satisfaction might find recruiting new talent easier and

might be assessed to provide a better customer experience, which could lead to higher repeat revenue modeled by investors, or by investors prepared to assign higher valuation ratios (e.g., prepared to buy stocks with higher P/E ratios or bonds at lower credit spreads).

A poor supply chain or a weak relationship with suppliers might lead to a lower forecast by investors or lower valuation ratios, for instance, in food supply chains for supermarkets when a poor supply chain has led to instances of horse meat in lasagna food products. Alternatively, this could be seen in the questioning of the sustainable sourcing of supply chains. On the other hand, strong supply chain management in agile, fast inventory management from short robust supply chains might lead to a more positive view from investors.

These factors can be intersectional. For instance, a poor supply chain and labor practices might be negatively affected by modern slavery laws or regulation, which might incorporate both a regulator assessment and a supply chain assessment from investors.

Generating Ideas:

Investment ideas can be generated from the data. Some practitioners begin this stage using a valuation screen, or fundamental screen, which might incorporate ESG factors—perhaps a mix of positive (seek high G), negative (avoid low G), or momentum (seek rising G or avoid declining G)—to create an attractive investment universe. This is commonly referred to as "positive" or "best-in-class" screening.

Investment ideas can also be generated by themes associated with specific ESG megatrends. For instance, an ESG opportunity theme might be to seek improving access to clean water or to energy services. This approach is commonly referred to as "thematic" investing.

At this stage, checklists—internal or externally sourced—might "red flag" companies and be used to narrow the investable universe. For instance, an acceptable low governance score or an unacceptable number of ESG controversies (real-world ESG events that are contested by different stakeholders or that affect society, such as a dam failing). Red flag techniques can also be used in later stages.

These risks might be ESG risks judged on an absolute hurdle basis or judged against what can be "priced into the asset." A materially negative assessment of a particular ESG factor or collection of factors could lead to a decision that an investment fails to meet a specified hurdle. For example, an incentive structure deemed to be poorly aligned under a G assessment might disqualify a possible investment and, the assessment triggers a "sell" or "do not invest" signal.

This assessment could be either quantitative (e.g., the carbon intensity of company A is too far above an index benchmark to meet a practitioner's investment criteria) or qualitative (e.g., the experience of the management team in managing environmental risk and the lack of disclosed policies might indicate risks too great for an investor on a qualitative basis).

To learn more about ESG and sustainability-related models, don't hesitate to contact **YTT Consulting**!