ESG MOVES 'OFF-BROADWAY' AND INTO THE MAINSTREAM

KPMG Board Leadership Centre event

May 2021

The nation's boards are becoming increasingly aware that social purpose equals profit

Chief Executive of AustralianSuper, Ian Silk, says Environmental, Social and Governance (ESG) issues are "front and centre" in the giant superannuation fund's investment process.

Silk was speaking on a panel examining the rapid rise of ESG in business as part of KPMG's Board Leadership Centre's (BLC) monthly event series which aims to provide support and specialist expertise to Australia's non-executive directors.

According to Silk, ESG has moved from "an off-Broadway consideration to a mainstream part of the investment process".

"While we hear the term social license thrown around a bit, ESG issues have as big an impact on social license as traditional economic drivers," he told the panel held in Melbourne recently, moderated by KPMG's National Chairman Alison Kitchen.

Creating value not just profits

Fellow panellist, Karen Wood, Chair of resource mining and metals company South32 agreed, saying ESG considerations reflect a fundamental change in how we think about value in an organisation and "what creates value and at what cost".

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Chair, South32

It would seem we have come a long way since the economist Milton Friedman said in 1970 that the only responsibility of business was to increase its profits.

Put bluntly, Friedman's philosophy around corporate social responsibility was, if it didn't add to the bottom line, it was not worth thinking about.

The idea of letting business maximise return and allowing shareholders do what they want with their money — has until recently dominated not only the corporate world but also the asset management industry.

In a 2017 paper titled Companies Should Maximize Shareholder Welfare Not Market Value by Harvard University's Oliver Hart and Professor Luigi Zingales, who hails from Friedman's alma mater the University of Chicago Booth School of Business, they pointed out the many flaws in Friedman's argument.

For instance, in regard to the environment they found "it is often cheaper for society as a whole not to pollute, for example, than to pollute and then clean up".

Moreover, they argued that money-making and ethical activities are often inseparable.

Ethical activities create profit

This was a point made by CSL's Company Secretary and Head of Corporate Governance, Fiona Mead, at the BLC event who pointed out if you see a company doing ESG well, then they're probably also doing other things well."We've seen recent examples where a company has not done ESG well, and it's led to a broader questioning of the management team and the governance and the culture - it's more and more intrinsically linked with how a company is being run."

Mead's advice is that companies and boards need to make sure ESG considerations are tailored to their business needs. She said it goes beyond ticking boxes on environmental concerns.

"You need to think deeply about your company and what your (ESG) drivers are and make sure that is how you drive your strategy, because that's how you'll win the hearts and minds of your management team and your stakeholders."

It's then a question of communication and "the board and the management know the company better than anyone else, so it's about them telling that story and having it understood instantly".

South32's Wood said companies looking to improve their ESG credentials should look to how they've evolved their businesses in the past.

"Perhaps unsurprisingly for a natural resources company, we always start with health and safety. Because it's fundamental to our business.", she said.

"When the board looks at the journey the resources sector has taken on improving health and safety issues across every facet of its operations, it's a similar journey when it comes to ESG. Everyone needs to be heading in the same direction right across a company," she said.

"And so, as we think about some of the critical environmental issues, for example, we're thinking about how we made that shift in the health and safety arena and how we can deploy that going forward," Wood said.

Assessing an organisations ESG credentials

Panel participant, Adrian King, who leads KPMG Australia's Climate Change & Sustainability practice, said ESG is an enterprise focus on all of the environmental and social attributes impacting an organisation.

At ESG's core is a close alignment to the United Nations' 17 Sustainable Development Goals but it's not intended to push every company to adopt everything, it's about pushing everyone in the same direction to "achieve some outcomes".

"ESG is a subset of sustainability and is typically used as the term focusing on enterprise value as opposed to economic value and it is largely being used by investors," King said.

"It's not one thing, it's 50 things and depending on your organisation, you have to nominate which of those 50 are most relevant to you and you can have an impact on."

As for investors examining a company's ESG credentials in terms of their investment decisions, King said the hard thing was navigating those 50 things "or the top 10 things and how best to factor those into investment decisions".

When it comes to identifying those top 10 things, King said the current top of the pops in the community is mitigating against climate change and most people believe this is the responsibility of organisations and by expansion, the responsibility of directors and boards.

AustralianSuper's Silk agreed, saying: "If boards aren't attuned to those issues and managing them properly, then they're as responsible as they would be for mismanaging or ignoring any other material issue that may impact on the economic success or viability of the organisation."

He said AustralianSuper as an investor focuses on eight themes in the ESG space.

"The four main ones are climate change, gender diversity, First Nations issues, and modern slavery while the others are board effectiveness, executive remuneration, data security and circular economy," said Silk.

"It's a pretty broad sweep and we're just one investor although we're the largest or second largest active Australian shareholder in every listed Australian company where we invest. So, we've got some clout, but we're conscious of the responsibility that comes with that."

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Moreover, he said the eight don't apply to every company because some of those are not relevant to some companies but, "it will usually be two or three of those that we will focus on, depending on our view of how the company is proceeding in any of those".

Increasing the boards ESG knowledge

Bearing this in mind, King said Australian boards differ on their ESG knowledge significantly and those differences can vary wildly within the same company and/or industry.

He said the mining sector has been focused on many of the issues associated with ESG performance for 20 years while the banks have picked up their game since the Hayne banking royal commission.

"It also depends on (board) exposure to overseas markets. Australia is not the leader in this space. Europe has probably been doing this 10 years longer and so organisations in Australia that have had exposure to global markets are much more advanced," King said.

According to South32's Wood, boards need to be focused on ESG issues because they have a significant impact on risk going forward and "unless we're focused on them, we're going to make decisions that don't stand the test of time".

In terms of M&A activity and capital allocation, Wood said, it's imperative boards now take ESG into account because they need to understand whether decisions are going to enhance or detract from the way in which their company is seen in the long term.

As for getting ESG right and formulating a set of standards that govern every company, Silk said it's a huge challenge but the present situation is best summed up by Churchill's comment about democracy, "Democracy is the worst form of government, except for all the others".

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April 2022.789206282FIRM