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ESG: A moat around the castle

17 May 2021

Moat - Wikipedia

In the medieval times the castle was protected by a moat. Using this analogy, Environmental, Social and Governance (ESG) awareness, readiness and reporting could amour your business for the future. The castle being the business and ESG readiness being a moat protecting your business.

This write-up is intended to create awareness in support of the previous write-up, with the subject “Who Knew?”, and ultimately to encourage action. It is not intended to give the full insight and comprehensive unpacking, but to rather demystify the picture somewhat, as it could be intimidating when one start researching the subject of ESG.

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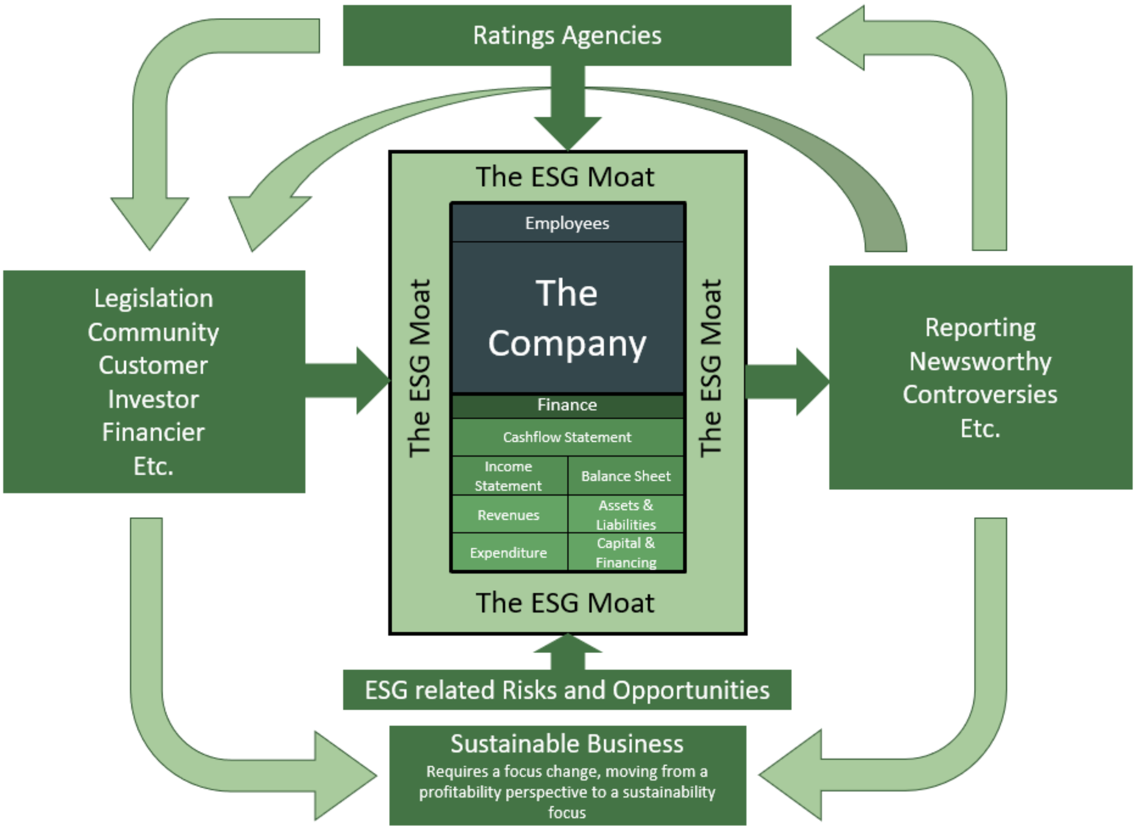
Change the focus

The focus of businesses should <u>move from a profitability perspective to a sustainability focus.</u> "Sustainability focus" as quoted above is not referring to the *"green"* things, it is inclusive of the bigger theme, talking to all the factors that will result in sustainable circumstances for people, planet and prosperity. If the complete value chain is not accounted for, the business and ultimately humanity will simply not survive the already changed world; and changes are now introduced at an exponentially growing pace.

If we do not move with it, we are going to miss the proverbial (and already delayed) bus as it will have to depart and sacrifice some for the survival of many.

What is the ESG Moat about?

The following figure aim to demonstrate the movers and shakers and how they interact.



We should realise that the ratings agencies are using the public data available like the annual integrated reports, carbon disclosure ([Home - CDP]()), publicly available data (i.e. articles in papers and publications, controversies, SENS announcements, etc) and includes company sourced information, publications and websites. Whether or not your company is publicly disclosing this information, your company is likely to be reviewed for the ESG KPI's to feed this information to investors and finance houses. This fact is important if we want to adapt to the changes and in the process access finance; amongst others the funding pool as discussed under the heading *"Finance"* in this write-up.

At the base one will find that the building blocks for the ESG moat is in the understanding of the risks and opportunities that needs to be unpacked to influence the changes in business strategy required. The investor and financier are also getting educated about the changes coming and how these will influence the future of the business, resulting in these entities viewing a *"good"* investment for the future different from how they used to look at it. Due to this focus change, the investment and financial worlds realised that special vehicles had to be created to finance the required adjustments and the "Finance" section below give some insight into the magnitude of what is happening in this realm.

High level indication of risks and opportunities:

Market and Technology Shift

Develop and implement aligned policies and investments to deliver a low carbon economy.

Consider the following:

- Reduced market demand for carbon intensive products or commodities
- Increased demand for energy efficient or low-carbon products and services
- New technologies that disrupt

Reputation or Brand Value

Growing expectation for responsible conduct from stakeholders, amongst others; investors, lenders supply chain and consumers.

Consider the following:

- Opportunity to enhance reputation and brand value
- Risk of loss of trust and confidence in management

Policy and Legal

Evolving requirements from an international, national, regional and local level.

Consider the following:

- Increased cost to operate due to carbon intensive activities
- Threat to secure or maintain license to operate due to carbon intensive operations
- Concern about liabilities and litigation actions

Physical Risks

Chronic changes and more frequent and severe extreme climate events.

Consider the following:

- Increased business interruption
- Damage across operation, supply chain and the customer
- Consequences on revenue, assets, value chain and insurance

Aligned with the TCFD

Finance

To meet the significant investor demand, asset managers are creating ESG funds at a rapid pace, up more than 30% from 2019 to 2020. Assets under management in ESG funds have increased to $1.05 trillion at the end of 2018 from $655 billion in 2012, according to Morningstar. Demand for ESG products has boomed in recent years and shows no signs of slowing down. Goldman Sachs alone committed on their own investment portfolio the value of $750 billion from now to 2030 (Goldman Sachs | Sustainable Finance). Standard Bank, Nedbank and First Rand for instance stopped financing of coal fired power stations (Standard Bank joins banks not financing 'dirty' coal-fired power plants | The Citizen); and when researched, a number of similar events already happened and will happen in future. Netcare recently concluded a R1 billion deal in ESG financing with Standard Bank to prepare for the changing business environment (https://greeneconomy.media/netcare-and-standard-bank-launch-africas-first-sustainability-linked-bond).

The board and C-suite of any business should take note of this as it is intended to support business at large to adapt and survive, in the process supporting the UN 2030 Agenda, specifically talking to people, planet, prosperity, peace and partnerships. (21252030 Agenda for Sustainable Development web.pdf (un.org))

ESG pillars

ESG stands on three pillars, namely Environmental (also referenced as Climate Change), Social and Governance. Two of the prominent ratings agencies I have been exposed to are MSCI (ESG Investing: ESG Ratings - MSCI) and Sustainalytics (Company ESG Risk Ratings – Sustainalytics).

Sustainalytics covers the ESG scope through 21 material issues whilst MSCI breaks it out in 10 themes and 35 key issues under the themes. At the moment reporting and reviews focus on 5 themes per ESG pillar and one can see that this might not adequately cover all the issues.

The reality

There is still a lot of work required to align all the reporting standards and those that are in development to specifically address ESG, however we must start somewhere (and soon if we do not want to be left behind). To really unpack this realm of reporting is impossible through a short write-up like this, it can give a glimpse of the task required to do this properly and can at best create awareness to the fact that action is required if we want to stay relevant.

We must also realise that reporting is the output of the work, the real work rests in the identification of risks, mitigation strategies and opportunities, ideally using scenario analysis methodologies and through this clean up the "castle" and get the response in place through strategy development and putting it into action. Through my research to enable proper guidance the one thing I have realised is that ESG reporting is here to stay until we get traction and if we do not comply, we will become irrelevant over time.

We have no option, but to act and act swiftly as the generations after us will know we knew.

A humble attempt to call for action – look out for a follow-up in the next couple of weeks.

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