Looking inside the investment "BLACK BOX"

Mainstream investors are becoming more sophisticated in the way they integrate environmental, social and governance (ESG) information in their investment process. But they are often failing to explain to companies what information matters most to them, how it relates to their broader financial analysis and how it impacts investment decisions. Here are some insights.

By Cécile Biccari

A growing number of mainstream investors are committing to "ESG integration". In practical terms, this means they seek to enhance their investment decisions by systematically incorporating material ESG issues into fundamental analysis and valuation models. Why? Because this information enables them to gain a more complete understanding of a firm's competitive positioning and its ability to maintain its competitive edge over time.

Materiality is in the eyes of the beholder

The concept of "financial materiality" is an important starting point as it aims to identify issues with the greatest potential impact on the company's long-term competitiveness and prioritise these issues when communicating with investors. Sector guidelines exist, but it is the responsibility of the management teams to determine what issues are most relevant to their firm given the company's business model, its current operations and corporate strategy. They must retain ownership of this process because every firm is unique and investors will continue to have different views on what ESG information they consider most material, just like they pay varying attention to different aspects of the execution of the business strategy and quarterly results announcements. Whilst "materiality analysis" and "stakeholder engagement" exercises can be informative, management teams should try to embed this analysis in their established long-term planning, risk factors and capital allocation discussions.

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Actionable, forward-looking information required

Once a company has identified the most material issues for its business, it needs to package this information in such a way that it will reach its ultimate target audience, i.e. the analysts and portfolio managers making investment decisions, and preferably those who take a long-term orientation in managing assets. This group expects actionable information, typically:

1 stly a strong narrative (usually found in the "management discussion" section of an annual report) that qualitatively outlines the most compelling macro trends impacting the industry, how these create risks or opportunities for long-term value creation, and how the company is positioned to capture these opportunities and manage these risks. This should be contextualised within the broader corporate strategy and management should make clear links to future revenue streams or potential cost-savings wherever possible.

2 ndly a limited number of data points and KPIs about the company's past performance, as well as its strategic investment in key areas (e.g. Capex figures). Where possible, it should also indicate expected return on these investments, both in terms of reaching pre-defined ESG targets but also with regard to potential impacts on future costs and revenues, and how this is reflected in management forecasts.

Comparative analysis matters ...

Armed with this information, investors will look for evidence of alignment within the firm (e.g. are the strategic priorities identified at group level supported by appropriate resources and incentives within business units?), of scale (e.g. is this done throughout the business?) and of a positive trend (e.g. has the performance improved over time?). This analysis will enable investors to strengthen their overall opinion of the company's financial performance, the quality of their management team and the robustness of its corporate strategy. Investors will typically also use this data in comparative analysis, benchmarking companies' practices and performance against a small peer group or broader industry averages, to determine whether they are likely to be at a competitive advantage in the way they manage specific ESG risks and opportunities. Where possible, they will also use quantified data as input into their valuation models, adjusting revenues expectations, costs or Capex needs; and reflecting their opinion of the overall risk profile of the firm on the discount rate being used to calculate the company's fair value.

... but integrated analysis is not yet the norm

Ultimately, this should enable investors to construct a better-informed investment thesis and to unveil some issues of concern about the company's ability to create sustainable value, which they can then discuss with management teams. But because investors have been slow to implement this type of integrated analysis, companies should also proactively identify those who are already systematically applying this approach and prioritise them in their outreach efforts. By engaging with them, companies can progressively build a core group of shareholders who are likely to invest for the long-term.

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