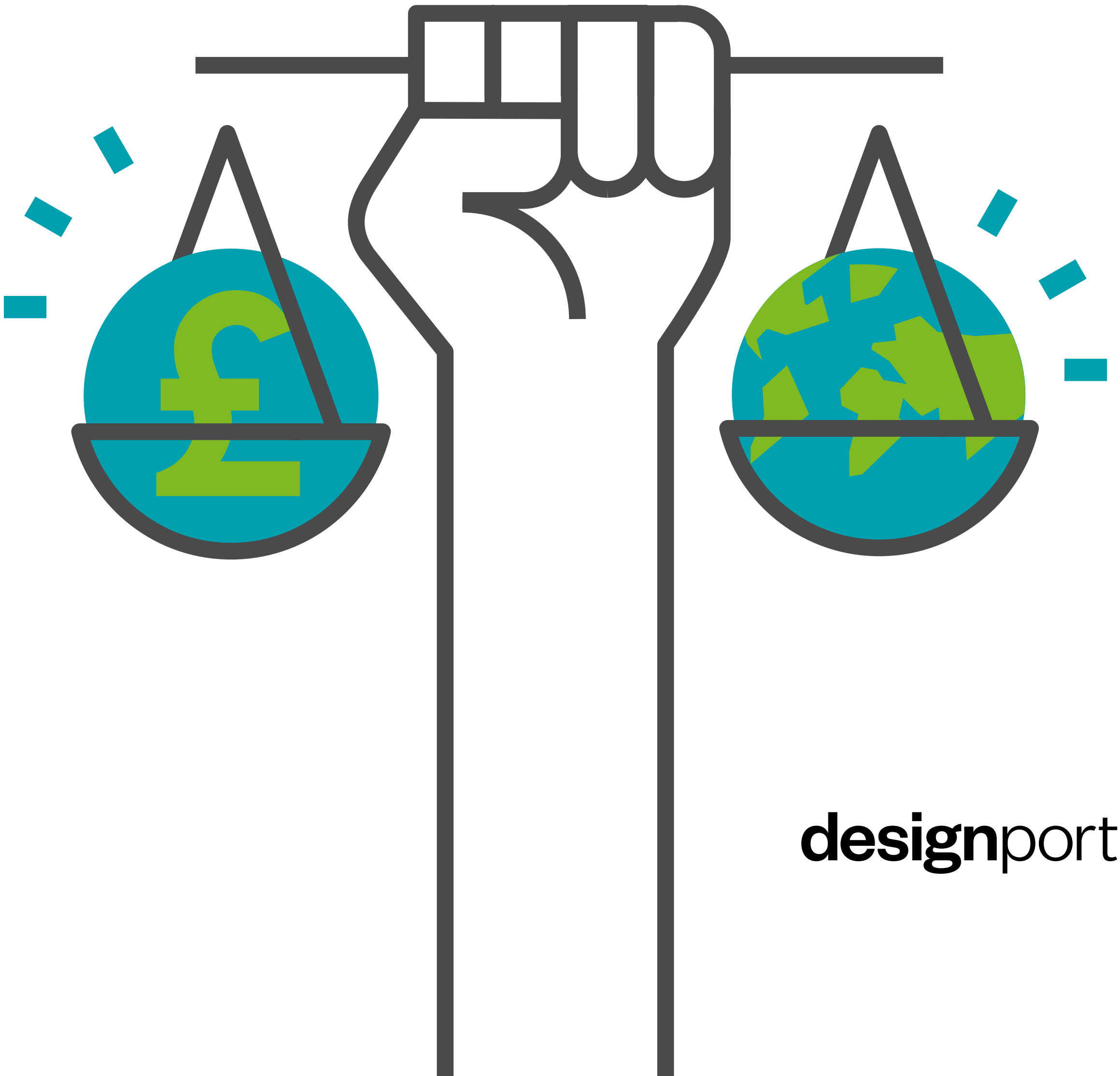
A Design Portfolio guide to ESG reporting 2017

"It's not about making ESG a priority, it's about making it the norm."



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What is ESG?

Interchangeable with other terms such as sustainability, ESG encompasses the broad set of environmental, social and governance considerations that can impact a company's ability to execute its business strategy and create value.

This is an area of reporting which has faced a number of developments, regulatory changes, guidance and focus. Recent examples include the launch of the London Stock Exchange's "Guidelines on ESG Reporting" which encourage all issuers on the London Stock Exchange to be more aware of the importance of providing high quality ESG information and engaging investors on sustainability-related issues.

Five main takeaways

1. Integrating ESG information into investment decisions has become standard for long-term investors who care about sustainable value creation.

2. Effective management of ESG issues and opportunities can lead to commercial successes.

3. Linking ESG to strategy, the business model, risk management and governance provides important benefits in relation to internal efficiencies and stakeholder confidence.

4. It is imperative that companies demonstrate how they have identified material ESG issues.

5. Business success in the 21st century will be defined by more than financial profit. Ethical issues impact economic outcomes.

Why is ESG important?

Recent scandals and corporate failures have led to a loss of public trust and show the considerable impact that poorly managed ESG issues can have on financial performance. It should be of no surprise that ESG reporting has become an area of such scrutiny.

Furthermore, despite still being in the first quarter of 2017, the issue of ESG reporting is at the forefront of discussion. In no way has this been made more apparent than through the publication of the Department of Business, Energy & Industrial Strategy's Green Paper on Corporate Governance.

The Green Paper announced a review of the UK Corporate Governance Code and whilst at the time of writing this paper we are far from knowing the final outcome, it's clear that the importance of stakeholder engagement is now recognised as essential to rebuilding trust and ensuring long-term sustainability in business.

It is this very stakeholder accountability which is fundamental to identifying ESG themes and ensuring sound ESG performance.

What are the benefits of reporting material ESG management?

Business success in the 21st century will be defined by more than financial profit. Identifying material ESG themes goes beyond simply classifying key sustainability issues. If properly executed, it can result in better commercial performance within the business. Linking ESG to strategy, the business model, risk management and governance provides important benefits in relation to internal efficiencies and external support. These benefits are addressed in more detail overleaf.

Who cares about ESG?

Investors do. Fundamentally this is supported by the findings in the "Global Sustainable Investment Review" (The Global Sustainable Alliance 2014), which show that throughout the period of 2012-2014 investors who considered ESG factors in their portfolio selection and management grew by 61%. This number grew by a further 25% in the period up to 2016.

Additionally, growing signatories of the United Nations supporting "Principles for Responsible Investment" and vocal support for socially responsible investing from leading figures such as the Governor of the Bank of England clearly show that investor interest in ESG factors is a growing and influential trend.

An increasing number of reports and research have been published to demonstrate the links between quality ESG management and strengthening financial performance. One such study was conducted by Morgan Stanley's Institute of Sustainable Investing in 2015, examining performance data from a number of open-end mutual funds and separately managed accounts over seven years. The report concluded that investing in sustainability usually met, and often exceeded, the performance of comparable traditional investments. This was the case on both an absolute and a risk-adjusted basis, across asset classes and over time.

So, what should companies do?

Before reporting on any ESG performance, management or opportunities, relevance and materiality should be addressed. This is arguably the most important stage. Materiality, or "material aspects", are those issues which are crucially important to stakeholders as well as the business itself. Guidelines, principles and frameworks from professional bodies such as the International Integrated Reporting Council, the London Stock Exchange, the Climate Disclosure Standards Board, the Global Reporting Initiative and the Sustainable Stock Exchange Initiative (to name just a few) all refer to the importance of materiality when addressing ESG issues.

Critical to any stakeholder's trust in a company and investor confidence in a company's ability to generate future sustainable value is an understanding of the internal processes and assessments the company has undertaken to manage ESG issues. Companies must ensure that the ESG issues they are managing are the most critical to strategic performance and the business model. This is called the materiality assessment.

So, what does a materiality assessment look like?

A materiality assessment is an exercise in stakeholder engagement designed to gather insight into the relative importance of specific ESG issues. Communicating this exercise clearly is integral to building stakeholder confidence.

Despite the plethora of matrices out there, there is no "right" format for conducting and presenting materiality assessments. The key lies in defining the best process for your company and communicating it effectively, whether this is through stakeholder consultations, staff surveys, interviews with the C-suite, external and internal workshops, or the support of a third party facilitated process. Once material ESG issues are identified, it is best practice to disclose specific performance indicators to demonstrate progress.

A great example of a clearly communicated and designed materiality process can be seen in the **Coca-Cola Hellenic** example provided. The results of this materiality assessment go on to define the structure and design of the sustainability discussion, whilst reassuring investors that the rigorous internal processes the company has in place will protect its capital and ensure sustainable value creation.

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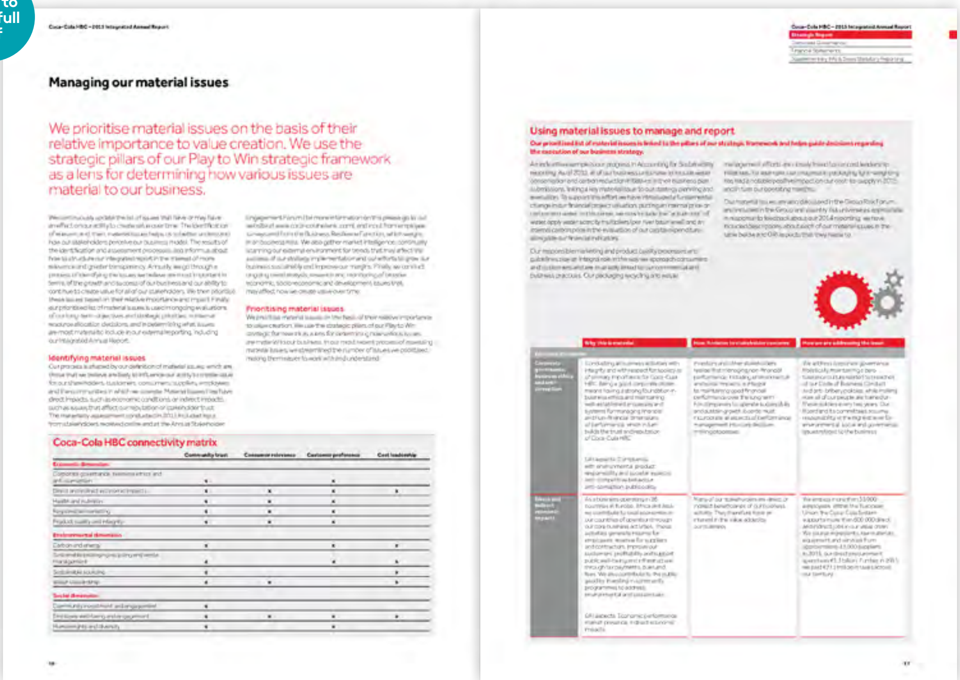
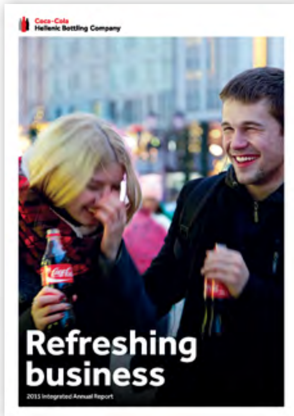

Managing our material issues

We prioritise material issues on the basis of their relative importance to value creation. We use the strategic pillars of our Play to Win strategic framework as a lens for determining how various issues are material to our business.

Coca-Cola HBC connectivity matrix

Using material issues to manage and report



Coca-Cola Hellenic plc
Annual Report 2015
Pages 16 and 17

Coca-Cola Hellenic clearly outlines how material issues are identified and prioritised. An innovative matrix is provided to highlight the connectivity between material issues and the pillars of the company's strategic framework. Furthermore, for each material issue Coca-Cola Hellenic explains why it is material, how it relates to stakeholder concerns and how the issue is being addressed.

Business model

The business model is the lifeline of a company and the heart of an annual report. This one area of reporting can be used to address so many different elements of the business, such as key differentiators, supply chain, organisational structure, business activities, values and size. However, without the intangible (as well as tangible) assets and non-financial resources that ensure all of these elements function, the business is redundant and ineffective.

The value of intangibles (such as people, brand, customer relationships and software) and non-financial resources (licence to operate and environmental processes) has grown enormously in recent decades. Demonstrating good ESG performance and management through a stringent materiality assessment provides confidence that imperative intangibles and non-financial resources will be protected. Ultimately this demonstrates that the company's business model will be sustainable in the long term, ensuring stakeholder and investor value creation. **Taylor Wimpey** demonstrates a good example of how ESG issues are integrated into the business model and how this defines the structure of the group's performance reporting.

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Our Business Model

We create value and deliver quality across the housing cycle

Our Business Model is based on a value cycle and each component of the value cycle is important in order to achieve our strategic objectives. This is presented at UK level only as most of the metrics do not apply to our Spanish business.

Focus on customer service

Integration of sustainability

Delivering customer service | Selecting land | Managing the planning and community engagement process

Getting the homebuilding basics right | Our people

Our sustainability strategy

Our Business Model

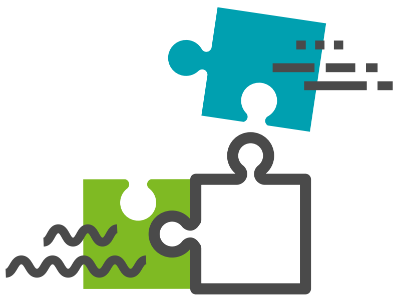
Optimising value for our stakeholders

Selecting land | Planning and engagement | Delivering customer service | Our people | Homebuilding basics

Our cultural principles

Taylor Wimpey
Annual Report 2015
Pages 18 and 19

Taylor Wimpey specifically explains how sustainability is integrated into the company's business model. The business model addresses intangibles such as community engagement and people whilst being supported by strategic commitments that relate to ESG. Moreover, the company highlights the cultural principles that drive the business model and sustain competitive advantage.



Strategy

Once key ESG themes have been identified, the group strategy must demonstrate how the company is responding to these themes to ensure growth. If, for example, a recruitment company is looking to expand, it must clearly identify the material ESG issues that will ensure its business is successful (for example, retention of the best people, client retention and customer satisfaction).

The strategy needs to address these key ESG issues and explain (in this instance) how the company's approach to social and governance issues will ensure these goals are achieved. **Petra Diamonds** provides a good example of integrating ESG commitments into the group's strategy. The consequence of operating without adhering to ESG guidance would negatively impact commercial success and jeopardise its licence to operate.

Additionally, the LSE's ESG guidance mentions that a number of the world's largest investors are actively allocating additional capital to companies with higher green revenue exposure or those that are better equipped to fulfil sustainable goals. Consequently, it can be beneficial for a company strategy to address potential new revenue streams generated by green and socially beneficial products and services. Embracing ESG in the strategy can drive value for the organisation (growth, cost reductions and consumer support), as well as provide social and environmental solutions.

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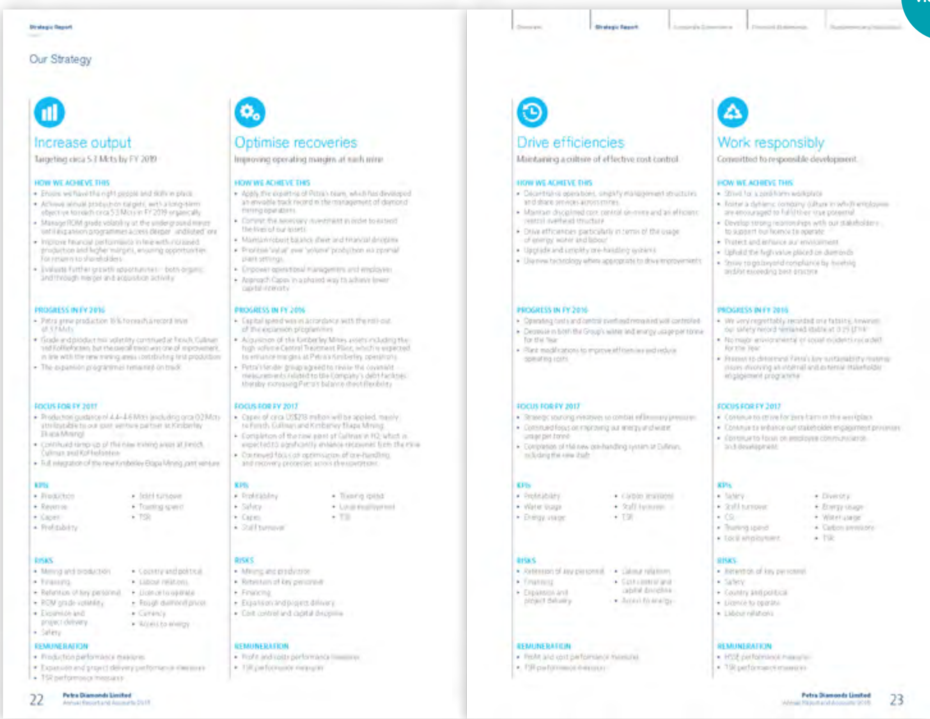
Petra Diamonds
Annual Report 2016
Pages 10–13



Petra's strategic objectives include priorities for the next financial year and an update on progress for the current one. The company links each objective with KPIs, risks and remuneration, ensuring a holistic approach to the annual report by including its commitment to responsible development as a strategic objective. This paves the way for the sustainability section of the report, with an insight into the company's material issues ensuring its licence to operate.

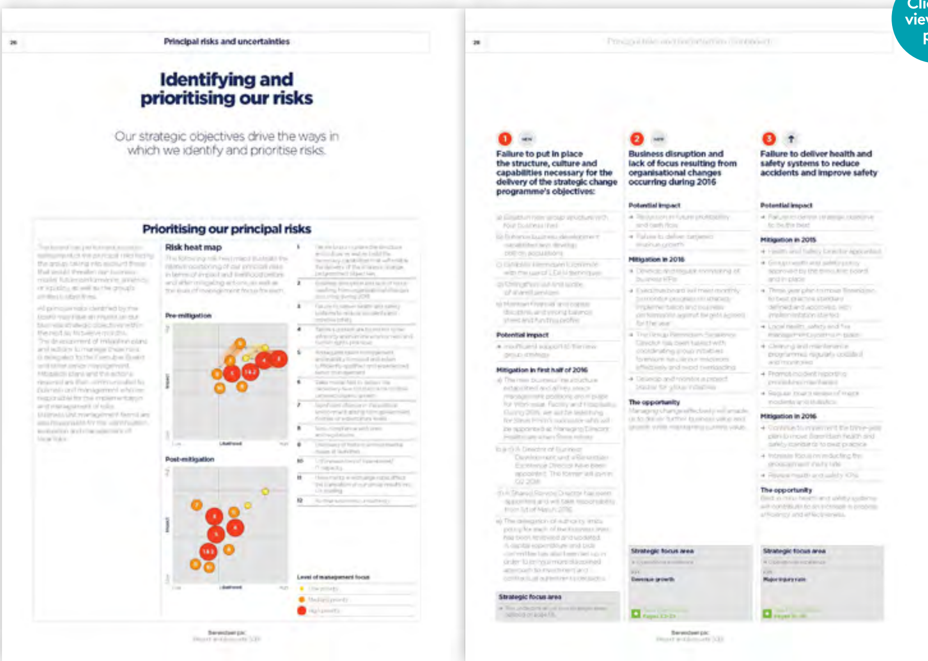
Risk

As with the business model and strategy, it is becoming more and more important that companies integrate ESG into their risk management discussion. It is important for companies to go beyond generic financial risk reporting and demonstrate how material ESG issues have been embedded into the risk identification process, helping to safeguard security, governance, ethics, licence to operate and environmental matters.

Risk reporting does not necessarily have to focus on setting future targets but it does need to plan for the future. Robust integration of ESG themes can project a calculated and risk-adverse journey ahead for any company.

Materiality of risk is just as important as materiality of ESG issues. Demonstrating the opportunity each risk presents can be an effective way of outlining why each risk is principal to the business. Opportunity reporting is simply linking the risk to strategy and saying "we are taking this risk as we see this as a strategic opportunity". **Berendsen** provides a good example of how both ESG issues and opportunity can be communicated in a risk section.

Berendsen plc
Annual Report 2015
Pages 26–28



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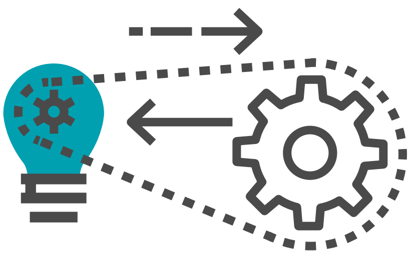
Berendsen goes well beyond generic financial risk reporting to demonstrate how ESG management has been integrated into the risk identification process. Principal risks, which include culture, health and safety and talent management, are supported by an insight into the relation to strategy and KPIs and the opportunity present for the business.



Governance and culture

Following publications from a number of influential bodies, including the UK government with the Corporate Governance Reform Green Paper, culture and governance have really been in the spotlight. As governance makes up the "G" of ESG, it should be of no surprise that this is a critical area of value creation for a company.

Good governance enhances value and performance through balanced relationships and improved decision making, so transparent disclosure in this area is critical to providing stakeholders with assurance that the organisation has a clear strategic direction, embedded through culture and values and driven by a strong leadership team.

Reporting on how culture is managed, lived, driven and protected by the board can have many benefits for a company. It enables strategy, it gains confidence and trust from stakeholders, and it provides transparency. Research has shown that companies with a weak culture and toleration of poor ethics face more issues and upsets, such as fines and failures. This correlation is becoming more and more evident as a result of many recent scandals and corporate catastrophes in the media which have shown the impact of poorly communicated culture, ethics and values. If a company focuses only on growth and profit it raises red flags amongst the savvier investors out there, particularly those investing the money of others.

It is essential for a governance team to clearly describe its values, as well as the desired culture adopted by the board, engagement with key stakeholders and the behaviours expected of its employees. **SEGRO** provides a great example of how this can be achieved by outlining the importance of promoting and defining purpose at board level and communication between employees and the C-Suite.

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SEGRO plc
Annual Report 2015
Pages 72 and 73

SEGRO's sustainability section includes discussions around the company's purpose, how the company is focused on its people and the reason SEGRO exists, beyond delivering shareholder value (Purpose), and how this is strengthened by its shared values and culture (Values). Furthermore, the governance report makes clear that SEGRO believes that it is vital for the board and the executive committee to work together to set the values and standards of behaviour for the business and to make sure that these are maintained in order to ensure long-term value for shareholders.

Conclusions

Encouragingly, year on year companies have really begun to embrace ESG themes in their reporting and have demonstrated materiality in this process. A number of Design Portfolio clients, including Tullow Oil, Just Eat, ZPG and Countrywide, have pushed on their reporting in risk, governance and performance to demonstrate the integration of ESG factors.

This encouraging trend has been accelerated through investor activity and the recent focus on stakeholder accountability.

The absence of ESG performance information is a warning sign for investors and can lead to the withholding of funds. Lack of clear stakeholder engagement can lead to a loss of trust and can really damage commercial performance. This is why it is not about making ESG a priority, it’s about making it the norm.

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