SIFA STRATEGY

ESG MOMENTUM IS BUILDING FOR MID AND SMALL CAP COMPANIES

UK COMPANY ESG REVIEW

October 2021

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FOREWORD

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Through our work with companies and our ongoing dialogue with many different parties who touch on the ESG debate, we felt there was an information void. There are multiple case studies and insight into how ESG has been implemented by the large, global companies - many of whom identified the importance of ESG a number of years ago and have had the necessary resources to build it into their business models. However, there is very little evidence on how other UK companies, who make up the backbone of our economy and stock market, are dealing with this step change in the relevance of ESG.

The information and stories from larger companies provide an extremely useful roadmap into their ESG journey, but for the vast majority of mid and small-cap companies it is not a fair benchmark with which to gauge their own progress.

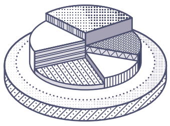
This first annual UK Company ESG Review is for those companies who want to understand how their ESG strategy and programme can be improved. It provides insight into how companies are developing their approach to ESG and their plans and ambitions for the years ahead. We also provide, where possible, suggestions as a guide to best-practice.

Our intention is to repeat this research each year to enable companies to build a greater understanding of how the influence of ESG is changing over time; the best practices being adopted; and the direction of travel. If you have any views on the findings, please do not hesitate to be in contact and we can look to build your comments into the research in the future.

We hope this report furthers your understanding.

HIGHLIGHTS

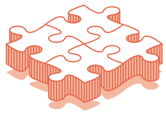
56%



of companies see ESG as being ever more closely aligned with shareholder returns.

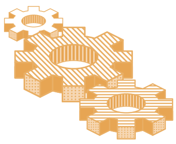
This is significantly stronger than two years ago. As a result, the capital markets are seen to be placing the most demand on companies to implement ESG successfully.

26%



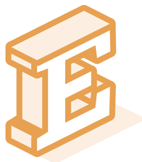
of companies have only just started to look at ESG within their business while an equal number believe that it is now a key part of their strategy.

74%



of companies intend to have ESG fully emersed in their business model and management processes within five years, in a sign of ESG's increasing influence.

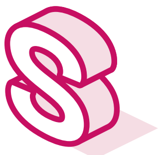
40%



of companies have started to implement the recommendations of TCFD.

This is relatively low given environment and climate change are regarded as one of the critical issues which will have a potential impact on the value and performance of a company over the next decade.

51%



of companies see social issues as becoming increasingly important.

Many expect it to have the same potential impact as the environment in the future.

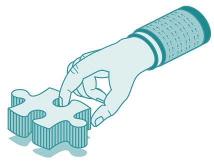
HIGHLIGHTS CONTINUED

>75%

of companies believe purpose, values and culture help drive their business.

This is especially the case when they have recently been reviewed as part of the company's strategy.

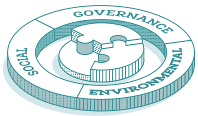
77%



of Boards now include ESG on the Board agenda.

The breadth of ESG being discussed, the regularity and the level of detail varies considerably.

6%



of companies believe they have ESG fully embedded within the business.

This compares to **8%** of companies who haven't started to embed it at all, and **29%** who believe they are halfway there.

57%

of companies don't yet have KPIs relating to ESG and for those that do, few have evolved to set targets as part of their performance monitoring.

26%

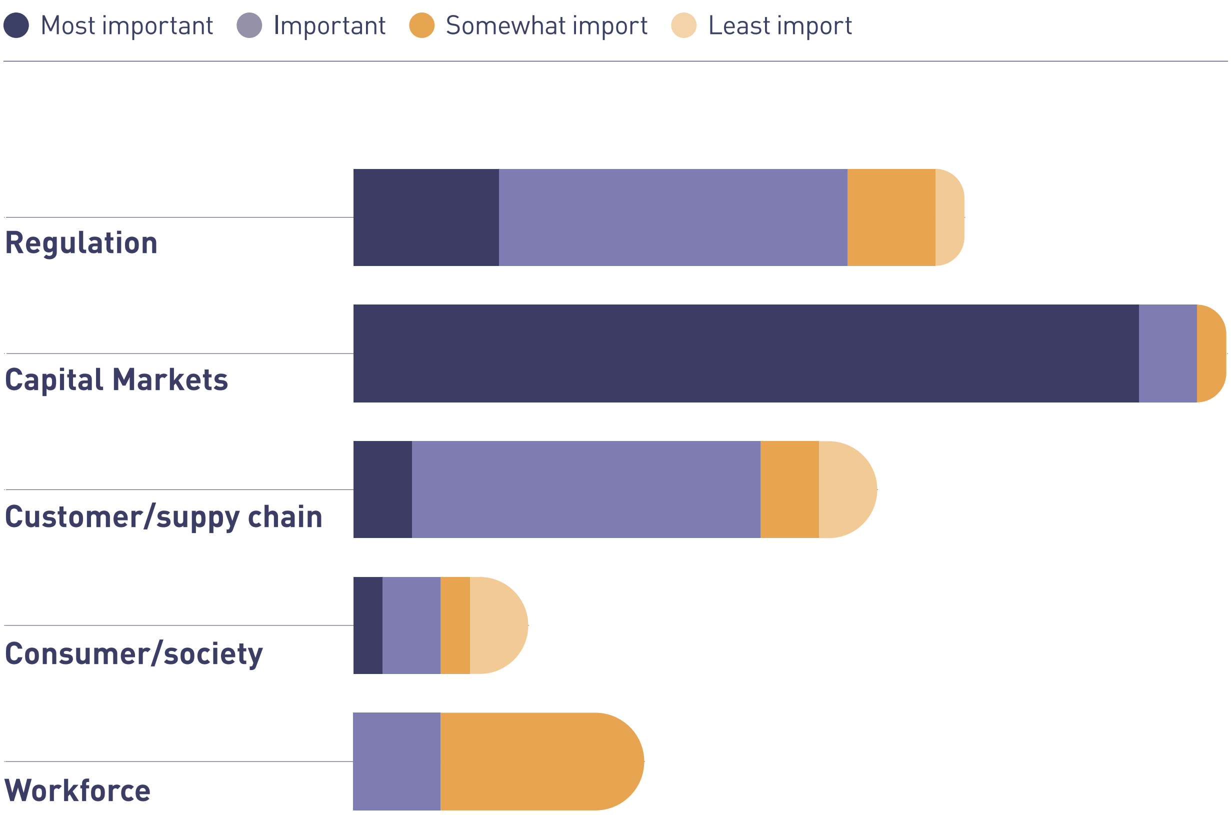
of companies have established a link between ESG performance and senior management remuneration.

This is expected to increase as the capital markets continue to demand more from corporates in this area.

CONCLUSION

ESG, financial returns and reputational value are going to become more and more closely entwined, with greater demands on data and insight to support the internal management process, external stakeholder analysis and corporate narrative. Please read page 32 for more detail.

WHICH ISSUES BEST REPRESENT WHERE YOU FEEL THE MOST DEMAND/ PRESSURE TO IMPLEMENT ESG?



77%

of interviewees label the capital markets as the 'most important' driver for implementing ESG

CAPITAL MARKETS LEADING THE CHARGE

The increasing scrutiny from the capital markets is the primary driver of ESG adoption, followed by regulatory pressures, with 77% of interviewees labelling the capital markets as the 'most important' driver for implementing ESG.

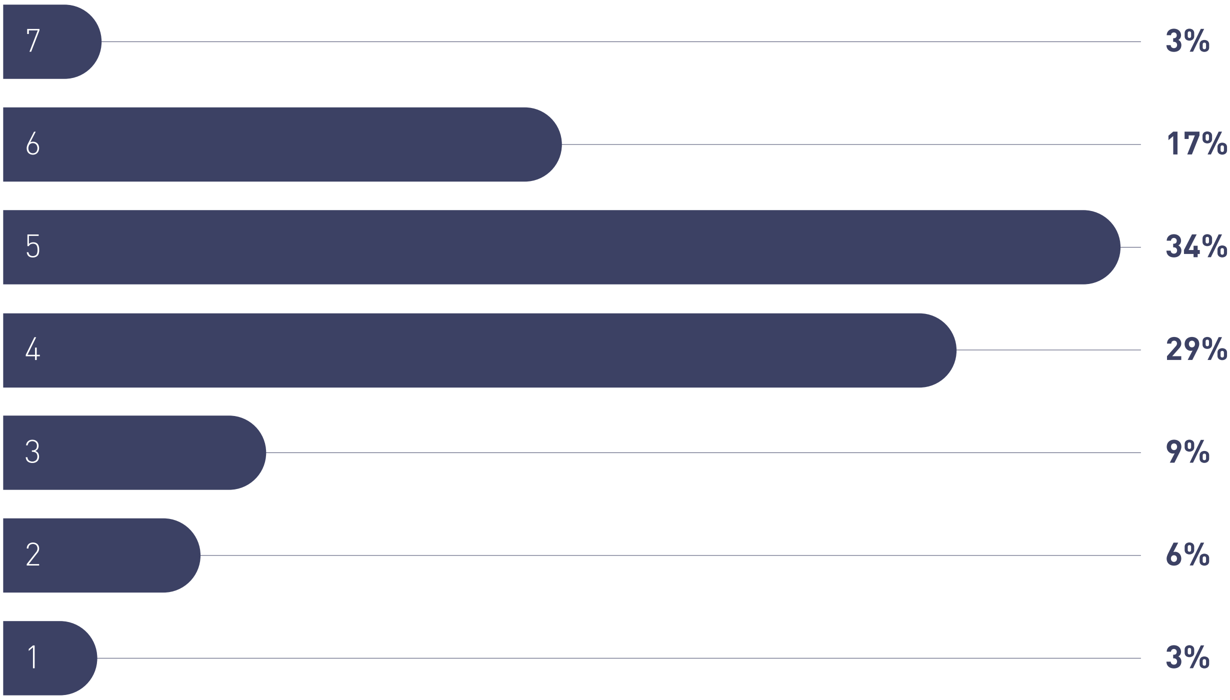
This is not a surprise to us. In 2018 we undertook research amongst some of the UK's leading fund managers. The findings, published in **SIFA Strategy: Culture, Behaviour and Stakeholder Engagement – Moving up the Investor Agenda**[1], showed the increasing interest these asset managers had in the drivers of ESG and the level of detailed questioning they were going to be putting to leadership teams and the Board. This research shows that nearly all corporates recognise that the demands and oversight from both capital markets and regulators, as well as other interested stakeholders, are only going to continue. This is most likely just the tip of the iceberg, as ESG and financial reporting become more closely interlinked.

It is also clear that broader stakeholders are now also being taken into account as drivers of ESG. There is growing recognition of the important role that the business customer, the supply chain, the workforce and the consumer play in the long-term performance of a company. In particular, the supply chain and customer are showing a growing level of influence over ESG demands on corporates with 23% of interviewees marking it as Very Important or Important. While the materiality of stakeholder perceptions will depend on the sector and business model, it is positive that these views are appearing within the ESG spectrum. For UK companies this will have implications on how they approach Section 172 of the Companies Act 2006 and, as we discuss later, drive a more structured approach to stakeholder engagement.

1 https://sifastrategy.com/our-thinking/culture-behaviour-and-stakeholder-engagement-moving-up-the-investor-agenda

HOW WELL ALIGNED IS ESG TO MAXIMISING SHAREHOLDER RETURNS?

7: Fully **1:** Not at all



83%

of all interviewees scored ESG alignment at 4 or above

GROWING RECOGNITION OF ESG'S IMPACT ON SHAREHOLDER RETURNS

The belief amongst Boards that ESG was a fad, and that capital markets interest would return to the primacy of the shareholder is disappearing, as the recognition grows that ESG is closely aligned to shareholder returns. ESG is increasingly being viewed as a factor of financial materiality – be that from a risk management or business opportunity perspective.

This drive to materiality will have many implications as to how ESG will evolve in the future with ever greater demands on data and insight and the closer correlation to financial and commercial performance. We will see ESG become much more a blend of quantitative and qualitative reporting and measurement, which will create challenges for companies to ensure their approach is fully embedded in the management system, supported by metrics, targets and narrative.

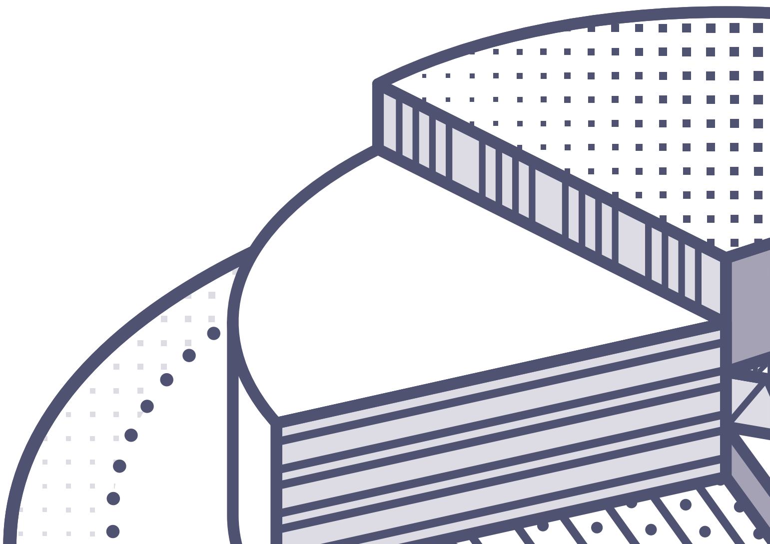
It is important to highlight how quickly this has changed. A significant number of participants added in their dialogue that only two years ago they would have scored ESG alignment to shareholder returns as a "1" or a "2" and are now scoring at a "4" or above, with 83% of all interviewees scoring at or above this level. This closer link to financial materiality marks how ESG differs from the more traditional form of CSR which is often perceived as being more narrative based.

As one participant summarised:

> *" ESG forces you to think about the sustainability of your business model and to think longer-term. ESG is asking a bigger question about long-term viability, when CSR was all about narrative.*

Such an understanding on the potential impact on financial performance has many implications as to how ESG should be approached within the company; how it should be measured; and how it should be championed by the Board and leadership team.

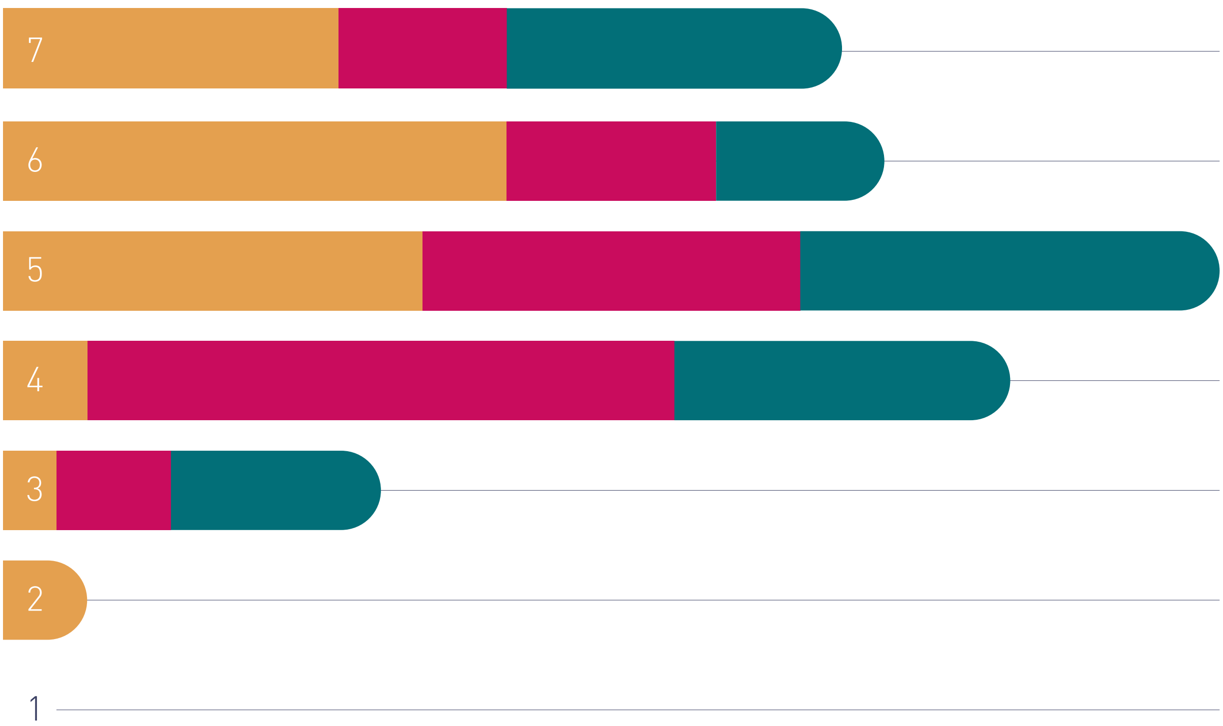
Finally, it is indicative as to how nascent ESG remains by the breadth of responses to this question, with nearly 20% of companies still seeing ESG as having little or no alignment to shareholder returns.



THE IMPACT OF ESG ON VALUATION AND PERFORMANCE OVER THE NEXT DECADE

7: Very significant impact **1:** No impact

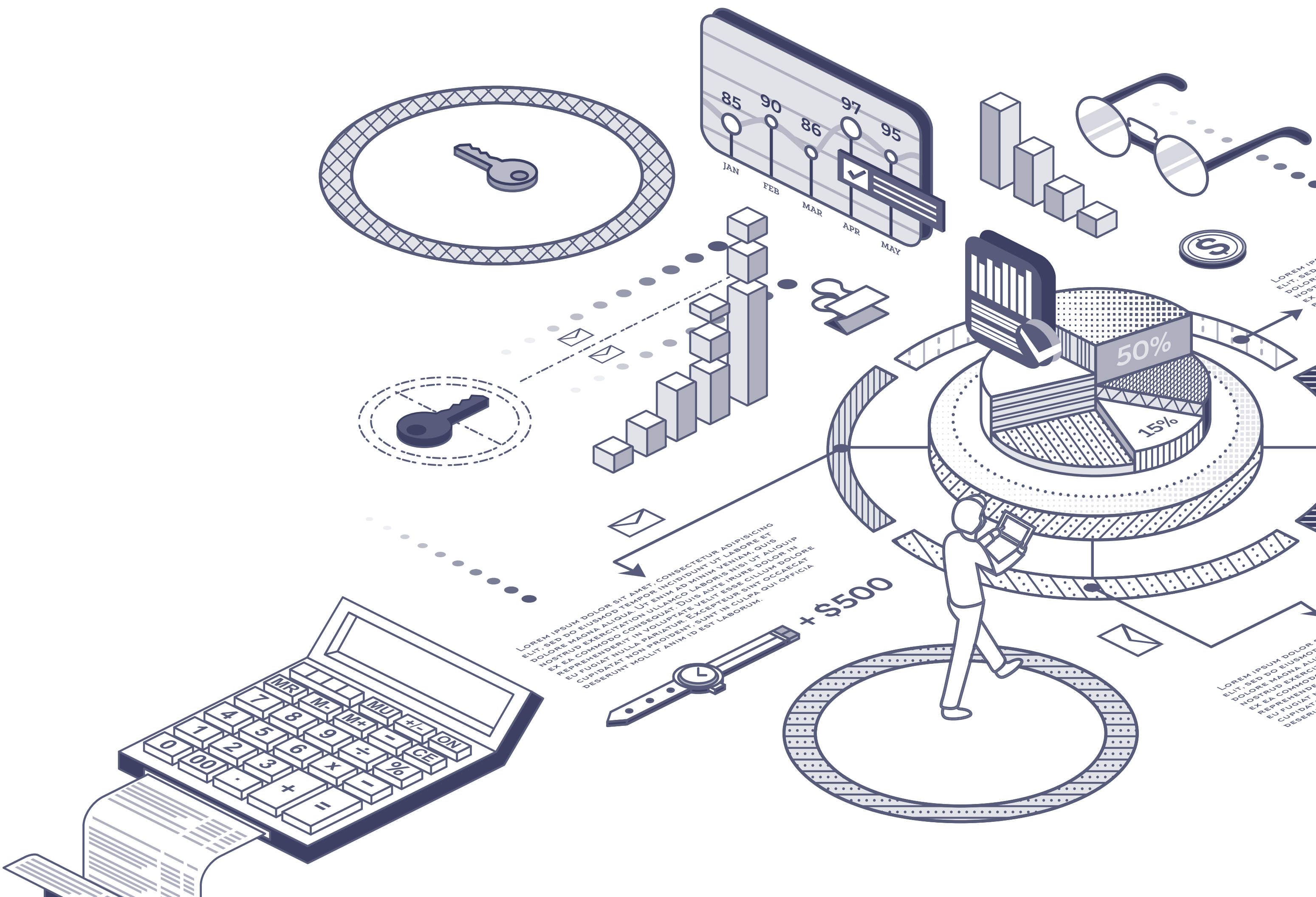
Environmental Social Governance



INCREASING PRESSURE TO ANSWER QUESTIONS ON ESG

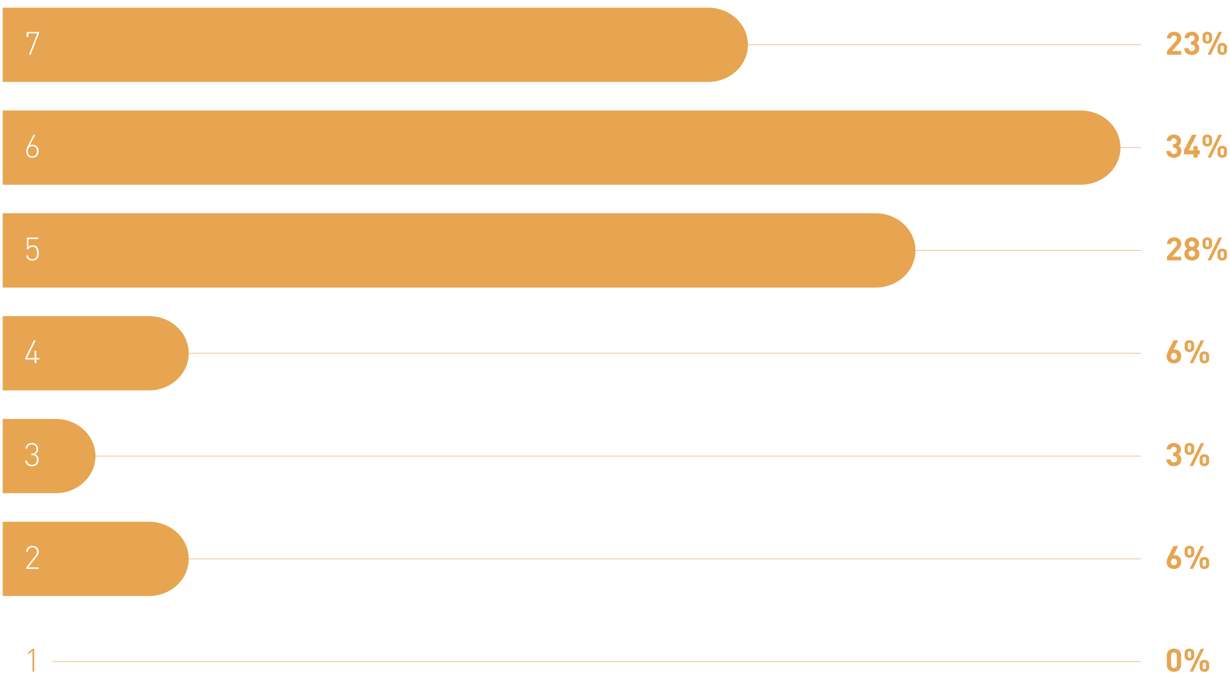
While the environment often carries much of the headlines in terms of ESG and is clearly a dominant issue, social issues have gained in recognition and are beginning to carry increasing weight within organisations. Governance and leadership continue to be seen to have impact on future corporate valuation and performance.

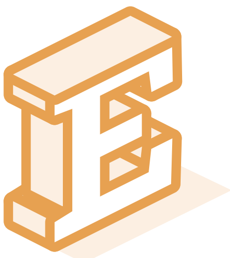
We look at each of these drivers in more detail in this next section.



SCORE THE IMPACT OF ENVIRONMENTAL ISSUES ON THE VALUATION AND PERFORMANCE OF YOUR COMPANY OVER NEXT DECADE

7: Very significant impact **1:** No impact





57%

of interviewees said that Environmental issues have a very significant or significant impact

ENVIRONMENTAL ISSUES TO TOP ESG AGENDA OVER THE NEXT DECADE

The environment is an immediate issue for the majority of organisations, with 57% marking it as having a very significant (score: 7) or significant (score: 6) impact on valuation and performance.

This pressure has also increased significantly over the last couple of years, even for those businesses who have been considering environmental impacts for a long time. There is little doubt that this is primarily being driven by growing stakeholder awareness of the environment as a material risk to business, be that from a physical perspective (flooding, wildfires, extreme heat, rising sea levels etc.) or from a transitional one (increased carbon pricing, more aggressive legislation etc.). With the recent report from The Intergovernmental Panel on Climate Change ('IPCC') confirming the direct effect of human/business activity on the growing climate crisis, the potential impact of the environment on the global economy and business is only going to increase.

In contrast to this, just under 9% of respondents noted environmental issues as having very little or little impact on valuation and performance. However, even for these companies with the potential for a relatively low environmental impact, it has still become a key area of stakeholder interest. The move from the publication of Scope 1 & 2 emissions to the increasing expectation that companies publish their Scope 3 emissions and set out a clear carbon reduction plan leading to a Net-Zero strategy is creating stress on data collection systems and management processes.

“We are receiving ever greater level of questioning from investors on our environmental plans. I am not sure investors realise the massive investment required and what this could mean to our business and profitability.

At the same time, it is also noticeable the number of companies who are reaching a position of viewing the environment as both a threat and an opportunity for their business. As environmental issues are becoming part of the public debate and a factor within customer/consumer decision-making, some companies are looking at how their role in the environment provides both business, product and brand potential.

“The environment is the key factor and how we treat it within our business is critical. It is both our biggest threat and our biggest opportunity.

“We are only just beginning to look at the environmental side and how our business model can reduce its overall environmental impact and what this can mean for our customer proposition.

Overall, the interest in the environment is forcing companies to deliver greater clarity on how they are addressing this issue. This demand for greater transparency is moving beyond narrative to include clear metrics and targets as part of their ESG and business strategy.

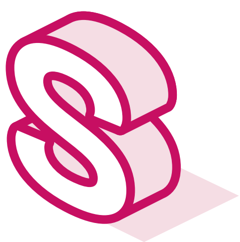
The other major impetus behind the materiality of the environment for all companies is the growing interest in the Task Force on Climate related Financial Disclosures ('TCFD') and the requirement for all premium listed companies to adopt its recommendations as part of their reporting from 2022. This shift for leadership teams to not only consider their impact on the environment but also now to formally consider how climate change could impact on their business and finances in the medium to long term is prompting a very different approach within companies. Environmental considerations are now being led from the top and are not being treated as a separate, risk reporting activity within the company.

RECOMMENDED BEST PRACTICE

- Formal analysis and clear narrative outlining how the Board and leadership team have considered the environment from a risk and opportunity perspective on the business, either within the Risk Management System and management processes or in specific business model/ product/ service lines. This includes reference to how the business manages its own environmental impacts.
- Publication of Scope 1, 2 and 3 emissions, together with details on how the business will reduce these emissions over time, where possible based on Science Based Targets. These details will include a Net-Zero emissions target to be delivered by 2050, if not earlier and shorter term targets for phased emissions reduction.
- Detailed reporting on potential future impacts of climate change on a business, using the TCFD methodology.

SCORE THE IMPACT OF SOCIAL ISSUES ON THE VALUATION AND PERFORMANCE OF YOUR COMPANY OVER NEXT DECADE

7: Very significant impact **1:** No impact



26%

of interviewees said that Social issues have a very significant or significant impact

EXPECT SOCIAL IMPACTS TO BECOME A KEY ISSUE

Alongside the environment, social has also seen a marked increase in the potential impact on business performance and valuation, in terms of the way a business behaves and interacts with its employees, suppliers, customers, consumers, communities and the wider society. 26% of corporates said that social issues have a very significant (score:7) or significant (score:6) impact on valuation and performance.

Without a doubt, the COVID-19 pandemic has accelerated the understanding and relevance of stakeholder wellbeing in particular for employees. Meanwhile, the movement catapulted by the George Floyd tragedy in the US has been one of several catalysts to highlight the need to address social inequality. For some businesses, the social elements of ESG are now on an equal standing to managing the environment, and in certain sectors even more important.

" The last 12 months has shown how important the social side is and will be more so going forward.

" Ensuring that our supply chain understand and manage their responsibility in respect of incidents of modern slavery will be a challenge for us.

" Over the longer term the environment will be a key issue; however within five years we expect social to be at the same level.

Just as there are businesses who believe that the environment will have little impact for them, there are businesses who believe that the potential social impact on their business is low, and is not yet a key consideration for management teams. 49% of interviewees said social issues only had little (score: 3) or some impact (score: 4), reflective of the challenge corporates feel about how to best understand and quantify social impacts. We would caution that this view fails to recognise the changing trend. Just as low carbon emitters will be required to set a carbon reduction / net-zero strategies, those businesses who believe they have a low social impact will still be expected to provide clarity on how social issues and their influence has been considered by the Board and throughout the organisation.

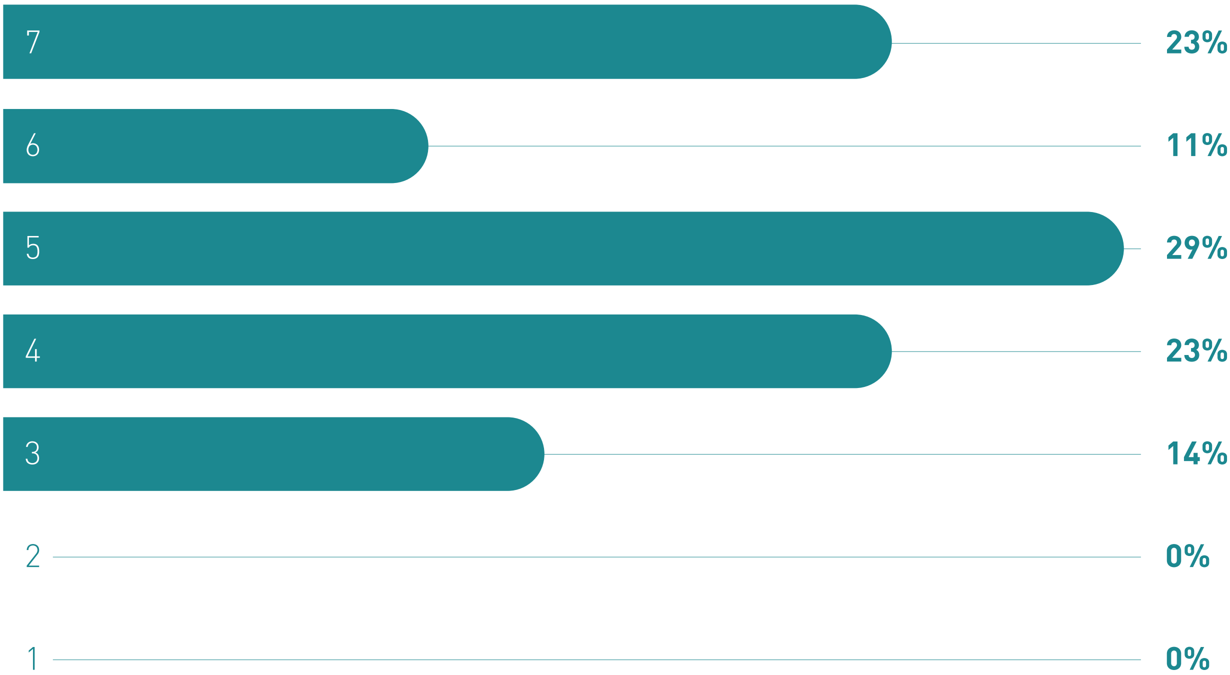
Many companies struggle with the social elements of ESG, as they tend to be more subjective and are less developed in terms of identifiable metrics. However, this will change over time. Large companies are already expected to have considered their social responsibilities in line with their strategy and to demonstrate the progress they have made. This will flow down to the mid and small-cap companies within the next few years, as the social aspects of ESG becomes more quantifiable and more closely correlated to financial performance.

RECOMMENDED BEST PRACTICE

- Have defined and communicated policies for areas such as gender pay, modern slavery, health & wellbeing, supply chain management, diversity & inclusion etc.
- Clear understanding and communication of the role and impact of the business in society, including areas where the business has the ability to either negate or enhance its social impact and how this links to corporate strategy.
- Consideration of the United Nations Sustainable Development Goals and how any of the 17 goals and underlying 169 targets can be enhanced and influenced by the company's actions.
- Identified metrics and targets to demonstrate the direction of travel and progress that the business has the ambition to achieve in terms of its social impact.
- Social elements aligned with the purpose, values and expected behaviours of the organisation and linked with the brand and narrative of the business.

SCORE THE IMPACT OF GOVERNANCE ISSUES ON THE VALUATION AND PERFORMANCE OF YOUR COMPANY OVER NEXT DECADE

7: Very significant impact **1:** No impact



23%

of interviewees said that Governance issues have a very significant impact

THE IMPACT OF GOVERNANCE IS WELL UNDERSTOOD

Governance needs to be looked at in two ways. Firstly, how strong the Governance is of the business and secondly the actual Governance of ESG itself.

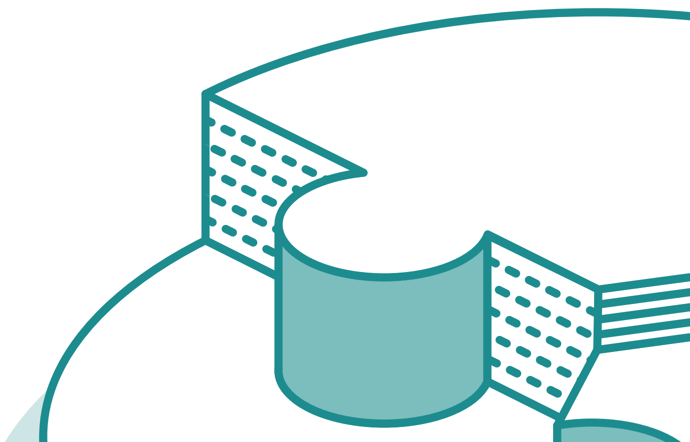
34% of interviewees referenced Governance issues as having a very significant (score: 7) or significant (score: 6) impact on valuation and performance. It is of little surprise that Governance scores highly as this area has been exposed to extensive changes and scrutiny over many years, with the Cadbury Report (1992) noted as a milestone event. At the same time, there are numerous examples of where Governance failure has led to a significant loss of value and reputational damage, often irreparably. With the level and detail of questions that Boards and senior management receive from shareholders, debt providers, regulators and rating agencies, Governance is by far the most understood concept within ESG.

The governance of ESG itself is different and an area that we look at later in this report. How a company governs its environmental and social responsibility is less developed and there are considerable differences across companies.

RECOMMENDED BEST PRACTICE

Given governance best practice is well defined and regulated and subject to continual review, we have chosen to concentrate on the governance of ESG in this section:

- A formal ESG Committee, or similarly termed, reporting to the Board on a regular basis, with ESG as a formal part of the Board agenda. The ESG Committee is often chaired by a Non-Executive Director and is supported by an ESG Working Group.
- A clear stakeholder engagement strategy with clear reporting/disclosure regarding the actions emerging from such two-way dialogue and the subsequent actions taken by the Board.
- Implementing an ESG strategy based on materiality to the business and strategy, supported by a growing range of data sets enabling measurement, target setting and performance management. These KPIs are well understood throughout the business as part of the management discipline and are linked to part of the remuneration and performance review process.

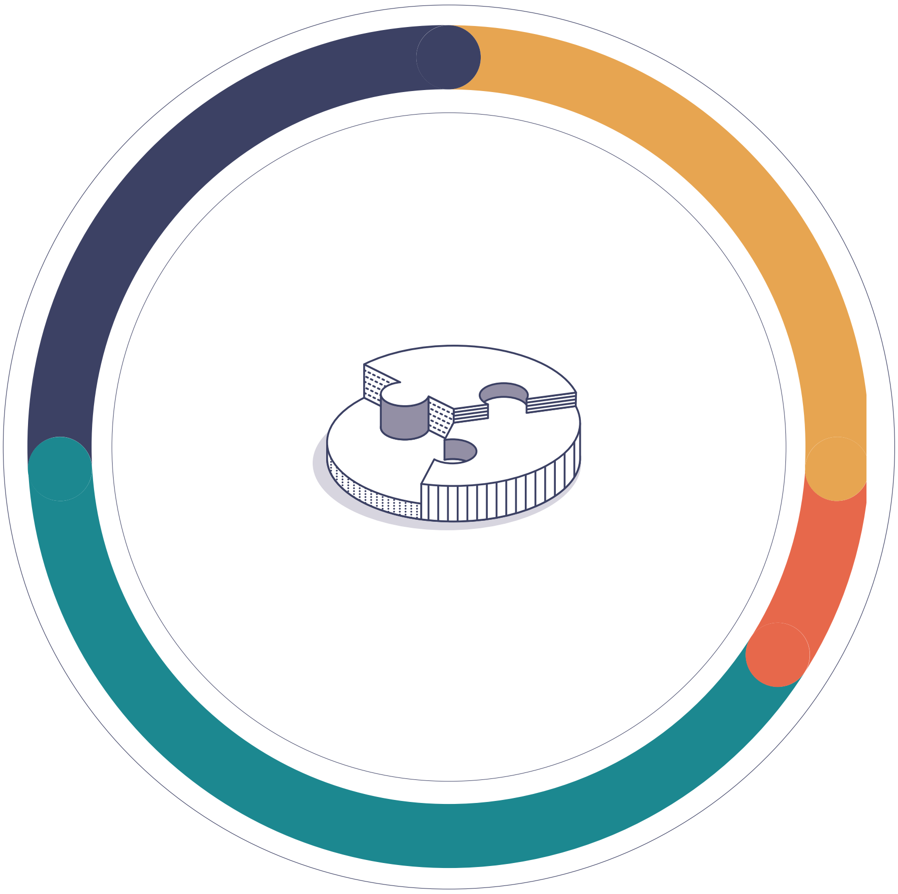


HOW WOULD YOU DESCRIBE YOUR FIRM'S CURRENT APPROACH TO ESG?

No management process	**0%**
Just being looked at	**26%**
Reporting requirement	**8%**
Desire to act responsibly	**40%**
Embedded	**26%**

74%

of companies intend to have ESG fully emersed in their business model and management processes



COMPANIES IN VERY DIFFERENT STAGES OF ESG ADOPTION

The results are evidence of the evolution of ESG over recent years and the growth in its influence. There is effectively a timeline of progression for companies from starting to look at ESG; treating it as a reporting requirement; to a desire to act responsibly; and to finally becoming fully embedded. Companies are at different stages of their journey.

The challenges of ESG also evolve as a company progresses. The initial difficulty for those who are looking at ESG for the first time is where and how to start. In our research this represented 26% of those we spoke to. This is particularly difficult if ESG is not already part of the Board agenda and being led from the top in terms of strong governance. The challenge then progresses to having certain elements of ESG being part of the business but needing to expand ESG coverage to a more developed and holistic approach. This requires the business to understand the additional material areas of ESG both internally and from the perspective of multiple stakeholders.

> " *Certain areas of ESG have been part of our business and been embedded for a while, food waste for example. Other areas, in particular on the social side, are only just starting to be looked at and will be embedded in the future.*

> " *The need for embedding the environmental discipline was placed on us by our customers. The social side, for example on diversity and inclusion, needs to be improved.*

The final stage is to ensure that a company's ESG ambitions and initiatives are understood and accepted across the business as part of the management discipline and performance process.

> " *For us, ESG and financial reporting are nearly one and the same. ESG now sits within our business, core brand and reputation.*

We can expect this evolution of ESG to accelerate over the next five years. 74% of respondents stated that they expected or hoped that ESG will be fully embedded in their business within that time frame, no matter their current status. Best practice will evolve considerably during this time as management teams become more aware of the ESG drivers to their business; and more comfortable with the validity of measuring it and using these metrics as part of their performance criteria and remuneration. We will also see ESG reporting standards and frameworks converge to create more consistent reporting.

> " *ESG will be fully embedded and be completely integrated into our strategy.*

> " *I believe ESG will be firmly embedded within our business and strategy. ESG reporting will be treated as a standard report, much like our financial statements are today.*

> " *The Board wants ESG to be embedded within the business so that it can add value.*

RECOMMENDED BEST PRACTICE

- ESG firmly on the Board agenda and fully embedded in corporate strategy, with supportive governance structure.
- Management treating ESG as a factor of financial materiality from a risk management and business opportunity standpoint.
- Detailed and tailored materiality assessments covering a broad range of stakeholders, informing sustainability strategy and reporting, as well as strategic planning, operational decisions and capital investment.
- Regular and rigorous engagement with stakeholders around ESG targets and commitments with link to Board and senior management decision-making and strategy.
- Prioritisation of material activities with clear KPIs and targets closely linked to Board and senior management remuneration.

INCREASING DEMAND FOR DATA & INSIGHT AND THE NUMEROUS STANDARDS AND FRAMEWORKS FRUSTRATE COMPANIES

The lack of uniformity in various industry standards, as well as increasing data and information requests from different parties regarding ESG elements are the dominant frustrations. This was cited by nearly all participants in their responses, with particular emphasis placed on the different approaches and rankings adopted by investors, proxy agencies and rating agencies.

This lack of consistency and clarity causes confusion and for many companies can take up a significant amount of time and resource in an attempt to answer the growing demands and range of questions. In particular, this is felt in the mid and small-cap sector where often there is little or no engagement from rating agencies.

❝ The non-engagement black-box approach of some of the ESG rating agencies is unhelpful.

❝ The proliferation of different voluntary or non-binding standards that aim to deliver compliance with regulations makes it difficult for businesses to determine which standards are most applicable to them and therefore align their strategies to. It fuels indecision and lack of progress.

❝ The box-ticking approach of proxy advisers rather than considering a more holistic view.

❝ Too many frameworks to follow due to divergence in preference from investors.

❝ The use of "ESG" as a blanket term. The "tick box" approach. Lack of serious engagement from asset managers. Too many regulators/ESG scoring and rating systems/sets of metrics.

Also mentioned is the growing frustration in supply chain sustainability, in particular for those companies that sit within large global supply chains and are receiving increasingly detailed questionnaires.

❝ We have customers just throw questions and forms at us!

❝ The level of questioning from our customers continues to grow. In some cases, our contacts within these customers don't even know why we are being asked, it is just part of the required form filling.

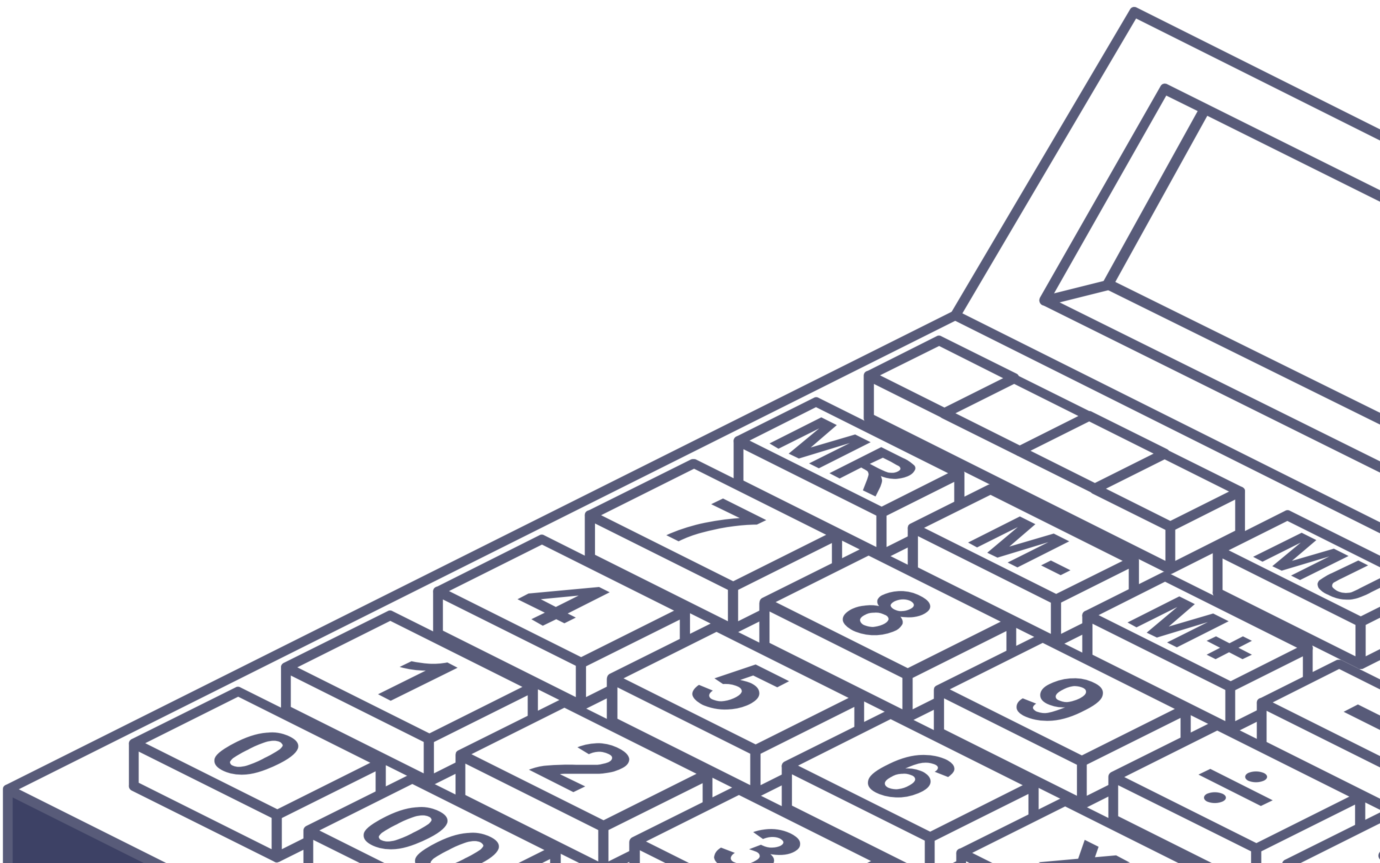
This lack of agreed, uniform, core data and reporting sets is a recognised challenge in ESG. We are already seeing many proposed solutions to this challenge coming to the fore; for example, the International Integrated Reporting Council ('IIRC') and Sustainability Accounting Standards Board ('SASB') forming The Value Reporting Foundation and working more closely with the Global Reporting Initiative ('GRI'). There is also work underway to create an International Sustainable Standards Board ('ISSB') to set International Financial Reporting Standards ('IFRS') sustainable standards. The reality, however, is any such standardisation of data will take some time. Also, it should be recognised that individual asset managers are most likely to continue to develop their own ESG demands as such information will be part of their own analysis and performance differentiation in search of higher returns on their investments.

INCREASING DEMAND FOR DATA & INSIGHT AND THE NUMEROUS STANDARDS AND FRAMEWORKS FRUSTRATE COMPANIES CONTINUED

Not all this frustration is the fault of a lack of uniformity, frameworks, rating agencies and form filling. The blunt truth is that the source of some of the frustration is that many companies do not have the basic and necessary ESG data within their own organisations, or the systems to collect it. As ESG develops and the demand for information on all companies increases from different stakeholders, the data gathering adopted by companies will have to change just as it has done under IFRS over the years.

RECOMMENDED BEST PRACTICE

- Management and presentation of detailed ESG materiality assessments with a clear reference to established frameworks.
- Analysis of rating agency and reporting frameworks to provide more standard data demands, for example Scope 1,2 and 3 emissions and social policies (gender, health & safety, modern slavery etc).
- Clear narrative and communication in the Annual Report, website and other ESG collaterals to highlight measurement, ambitions and strategy.



TO WHAT EXTENT DO YOU BELIEVE PURPOSE, VALUES, CULTURE HELP TO DRIVE YOUR BUSINESS?

7: Fully **1:** Not at all

54%

of interviewees scored purpose, values, culture at 6 or above

PURPOSE AND VALUES DRIVE ESG BUT ARE HARD TO MEASURE

Overall, corporates agreed that culture, purpose and values were important driving forces for the business, with 54% of interviewees scoring it at a 6 or above and over three quarters of all respondents at 5 or above.

It was interesting to note the correlation between purpose and business performance was often scored highest by companies who had recently reviewed their purpose and values.

" 18 months ago, we didn't have an identified purpose or values, but we are now pushing it along with sustainability. (Note: This company scored a 7)

Those respondents who scored lower – 12% scored a 3 or below – mostly admitted that this was an area that required attention with many companies also highlighting the challenge to identify metrics that are clearly representative of the purpose and values of the organisation.

For some respondents, purpose has been core to the business for a long period of time or since inception.

" Our purpose has not changed once in 50 years. It has been central to our history as a Quaker company.

" We are very purpose-led and have been from the beginning. It is becoming even more important as we grow.

Purpose and values have historically been managed and communicated qualitatively and as external stakeholders demand more management and measurement across these important social drivers, quantifying purpose and values and attaching appropriate KPIs will create challenges. Even the more advanced purpose-driven companies admit to the difficulty in identifying core metrics that can best represent how the purpose, values and culture of the business are managed through the business.

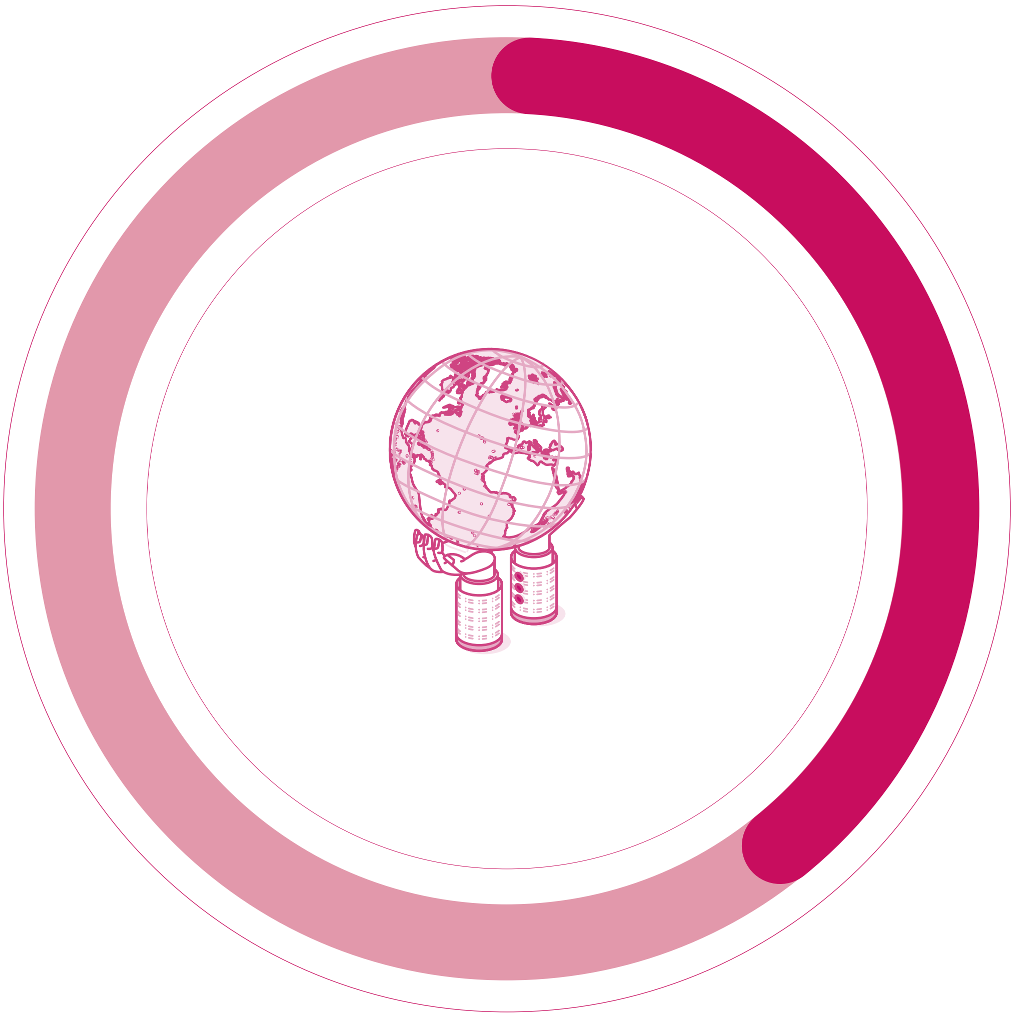
" We have a strong culture but are we pushing it for performance – then no.

RECOMMENDED BEST PRACTICE

- Most employees do not work for a company whose sole purpose is to make money: consult with employees, as well as other key stakeholders, to ensure that environmental and social considerations have been discussed when defining a company's purpose. A company's purpose should focus on the medium to long term.
- Values should support a company's purpose and should not simply be hygiene factors which provide no direction. Values are not purely for reporting but should feature prominently in the company's business planning and narrative.
- Values should be incorporated within a company's performance process and should be regularly reviewed to ensure relevance.
- Companies should have a well-defined purpose and should be able to demonstrate progress towards achieving it.

ARE YOU CURRENTLY IMPLEMENTING TCFD?

Yes	**40%**
No	**60%**



CLIMATE CHANGE IMPACTS BEGINNING TO BE CONSIDERED

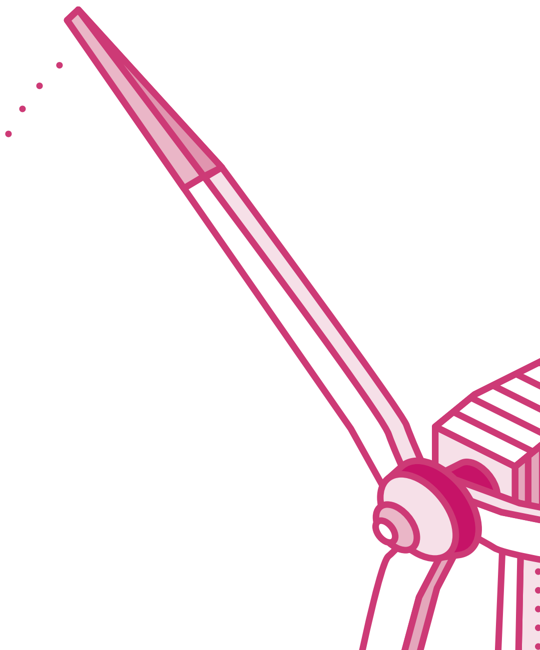
The Task Force on Climate-Related Financial Disclosures ('TCFD') framework is gaining traction with 40% of companies responding that they have already started to adopt its recommendations prior to the mandatory requirement on a "comply or explain" basis as a Premium Listed company.

The majority of companies who haven't yet implemented TCFD intend to do so in the near future, so we can expect it to be fully integrated into a company's management and reporting processes soon. This will especially be the case should the expected outcome from the Financial Conduct Authority ('FCA') consultation result in TCFD becoming mandatory for all standard listed companies.

While the recommendations were first published in 2017, 2021 will be marked as the year when TCFD became part of the senior management lexicon for most UK companies. As such, it is too early to make an interpretation of best practice. However, those companies that are starting correctly are not delegating the TCFD process into the organisation but are addressing the key governance and strategy elements of TCFD from the Board downwards, ensuring that climate change is addressed as both a risk and an opportunity to the business. Most advanced companies are forming a TCFD working group which either has Board representation or has a direct reporting line to the Board for updates as the in-depth analysis and climate scenario planning is completed. The reporting season for 2021 / 2022 will start to mark the winners and losers in the approach and transparency in terms of the assessment and disclosure of climate change impacts.

RECOMMENDED BEST PRACTICE

- Establishment of a TCFD working group with Board representation or access.
- Ensure a holistic and connected view of the eleven required disclosures across the four core elements considered under TCFD, to effectively describe how a corporate is managing and considering climate-related risks and opportunities.
- Comprehensive assessment of the governance and material risks linked to climate change. Analysis of at least two future scenarios (including alignment to Paris Agreement global warming of 1.5-2 degrees centigrade), considering transition and physical risks and opportunities. Transparent disclosure and reporting, with reference to potential business/ financial implications.



IS ESG PART OF YOUR BOARD AGENDA?

Yes	77%
No	23%

ESG IS BECOMING A REGULAR BOARD ITEM

77% of companies now have ESG on the Board agenda. While positive, this is slightly misleading as the approaches taken and the level of detail and breadth of ESG issues covered vary greatly from company to company.

Many respondents admitted that having ESG on the Board agenda was a very recent development and, in some cases, it only appeared once or twice a year, while others showed a more established and consistent approach to understanding and managing ESG at Board level.

❝ Climate change has been discussed at the Board, while broader social issues are covered at the committee level and sustainability is an operational management issue.

❝ ESG is a bi-annual report to the Board, otherwise there is a working group that reports to the CFO.

❝ We had our first ESG report to the Board this month, but the areas covered are limited.

❝ We have set up an ESG committee that is chaired by the CEO, and this is the reporting channel to the Board.

These different approaches are not a surprise considering the relative speed that ESG has become a Board issue and how relatively young it is as a management discipline. If this same question had been asked only a couple of years ago, we are confident that the response would have been very different with few businesses identifying ESG as a Board or even senior management issue (excepting those businesses more exposed to the environment and social issues due to their business model).

We expect over the next five years nearly all companies will have created ESG as a formal Board agenda item, with a recognised reporting structure run through the business, via the senior management team to the Board.

RECOMMENDED BEST PRACTICE

- Creation of an ESG management working group integrated across the business that reports to an ESG Committee (or similarly named – Sustainability Committee, Sustainability & Ethics Committee etc.) which either reports to the Board or has Board representation through the Chair of the Committee.
- The regularity of ESG appearing on the Board agenda tends to be driven by the level of ESG materiality to the business.

DO YOU HAVE KPIs AND TARGETS FOR ANY DRIVERS OF ESG?

Yes	**43%**
No	**57%**

MAJORITY OF COMPANIES ARE YET TO DEVELOP KPIs AROUND ESG

In line with the early-stage adoption of ESG for many companies, the majority have not set KPIs around ESG as a formal programme for the business.

We attribute this to how undeveloped ESG is as a holistic strategy for many companies and instead individual areas such as emissions, gender diversity or health & safety are still being treated in silos for reporting purposes.

“ We have no identified KPIs for the business at the moment which are recorded at the EXCO or Board level.

“ We have the data for areas such as gender diversity, training days and emissions but it would be wrong to list them as core KPIs at the moment and we have not got so far as to properly consider targets for them.

Other companies are more evolved and have identified a number of KPIs that are core to the long-term success of the business. However, as yet, they have not been able to develop these to the next stage of setting acceptable targets, mirroring the level at which ESG is embedded within the management process. The more an ESG strategy is developed, the more advanced are the KPIs and targets.

“ Our key priority for this year is to identify KPIs and targets that are in line with our strategy and our way of doing business.

“ We have headline targets, and these will be strengthened and shortened over time.

In general, companies are finding it easier to start their KPI programme with the environment. With the growing pressure from stakeholders and the adoption of TCFD, companies are beginning to set carbon reduction targets leading to Net-Zero. This accepted approach on emissions calculations, supported by the Science Based Targets Initiative ('SBTi'), make it an easier model to follow. It is the social drivers that companies find harder to define and where the lack of accepted uniform measurements is making it confusing.

“ We had to address our environmental footprint and have KPIs and targets as this was demanded of us by our customers. It is in the social area that we need to improve and understand what is important to us.

The most evolved and the current leaders have identified their core KPIs linked to the business and have targets for them. These are clearly communicated throughout the business and reported to stakeholders alongside financial performance.

“ We have five Total Commitments and have set clear targets for each.

“ We have identified the areas that we and our stakeholders believe are important to us and we are setting targets for them across the business.

“ We have our environmental targets and also targets in line with our social values. These social targets are continually refined as we develop our framework.

“ We have currently identified five areas from the environment through key social areas to our customer support that we have KPIs and targets for. We keep these continually under review.

HOW EMBEDDED IS ESG WITHIN YOUR BUSINESS?

7: Fully **1:** Not at all

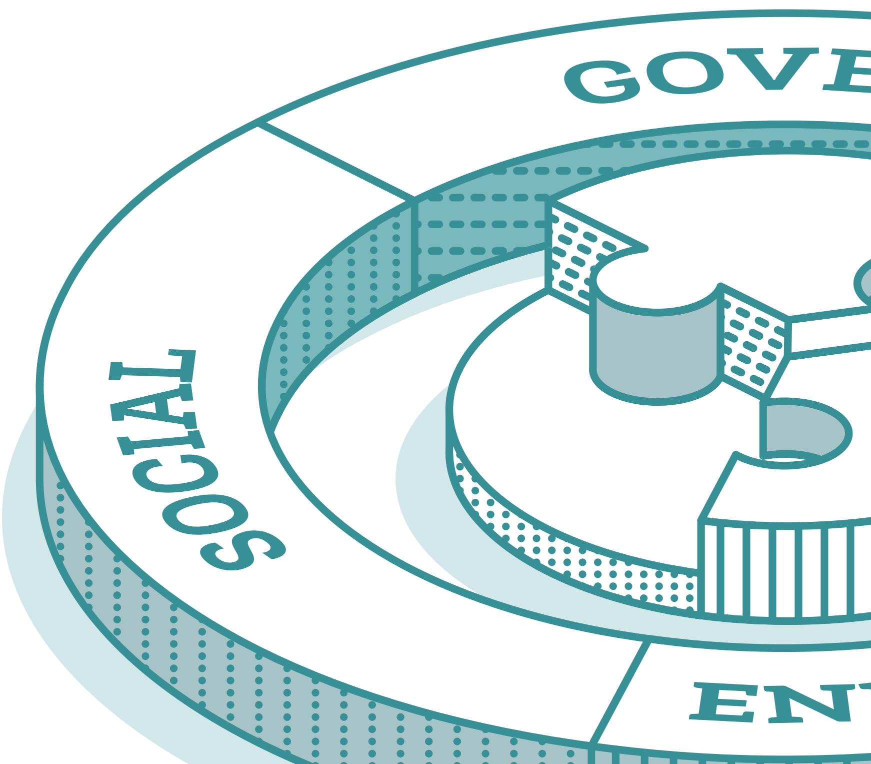
42%

of corporates are at a much earlier stage of their ESG journey

FEW COMPANIES HAVE FULLY EMBEDDED ESG, BUT AMBITIONS ARE HIGH

With the exception of a few companies, ESG is still too young a discipline with only 6% of corporates confirming ESG as fully embedded in the business and management process. 42% of corporates are at a much earlier stage of their ESG journey and scored at a 3 or below. Notably, the vast majority of the companies we spoke to have the ambition of ensuring ESG is fully embedded within their business within five years.

It requires a cross functional approach that uses both quantitative and qualitative disciplines. Beyond ensuring that ESG is aligned with the purpose, values, behaviours and culture of the business, it is also important that it is measurable through accepted KPIs and targets. This combined approach must then be continually promoted through clear communication internally and externally via corporate materials and reporting, where ESG metrics are correlated to commercial and financial performance. The ESG strategy must be driven from the Board downwards and the key litmus test for the level of how embedded ESG is within a business is how it is linked to remuneration. To embed ESG within a business takes time, firstly for it to be understood throughout a business, linked to its values and then accepted to the level that the workforce sees it as a valid part of their performance criteria.



IS YOUR LEADERSHIP TEAM REMUNERATED AROUND ESG PERFORMANCE?

Yes	**26%**
No	**74%**

ESG REMAINS TOO EARLY STAGE TO BE LINKED TO LEADERSHIP REMUNERATION

It is noteworthy how few companies have reached the level of including elements of ESG within the remuneration policies of the leadership team.

This shows how far companies are from fully embedding ESG within their business and also the low level of acceptance given to non-financial KPIs and targets. ESG is a relatively new issue for many companies and it will take time for it to be accepted as a financial influence.

Unlike the near universal intention to have ESG embedded within the business, this is not the case when linking it to pay, with some companies unconvinced as to the validity of the concept.

“ The remuneration committee regularly reviews whether or not to incorporate ESG metrics into the annual bonus and LTIP awards.

“ We are unsure. There are a lot of arguments against using ESG targets as part of Rem targets. Also, if fully embedded, then ESG targets will become commercial targets in any case.

However, for the majority of respondents it is the intention to develop a link between remuneration and ESG.

“ We have pay linked to gender targets, and beyond that we have ongoing discussions on how we could broaden it.

“ We expect that within five years up to 30-40% of targets will be non-financial in which ESG will play the biggest part.

For many this is a response to growing demands from shareholders who want to see ESG and related non-financial targets linked to remuneration – either via bonus or LTIPs or both.

“ We don’t have links to pay at the moment, but we are very aware that is the recommendation from our shareholders. They are challenging us on how we will implement it, and which targets we will set.

Though it is still early days in the link between ESG and remuneration, we expect this to change quickly over the next few years. In our dialogue with asset managers, they indicate that remuneration should be based on two criteria. Firstly, an element of pay should be set against clear KPIs under which the management team can have an influence, as opposed to more macro indicators. Secondly, remuneration should be judged against stretched targets, as opposed to targets where the business would be expected to achieve the result under normal conditions.

RECOMMENDED BEST PRACTICE

- An element of the bonus or LTIP scheme is allocated for ESG performance.
- The level of detail on the KPIs and targets provided are clearly set out.
- Remco clearly reporting on process and engaging with shareholders to meet their growing demands for improved levels of detail and transparency in particular on environmental and social targets.

CONCLUSION: ESG MOMENTUM IS BUILDING

ESG is starting to have an accelerated influence on management thinking and corporate behaviour.

As our research shows, the Board of every UK listed company must now be prepared to take on greater responsibility and accountability for a corporate's impact on the environment and its licence to operate, as well as deliver a return to shareholders. It is now recognised and understood that there is a closer alignment between profit and corporate behaviour. This is placing a fundamentally different demand on corporate strategy and engagement, and is creating a marked change in how corporates should tackle ESG compared to how they have treated this area in the past.

For many companies, ESG has been expanded from the more traditional areas of corporate affairs and corporate social responsibility ('CSR'). This is not a criticism; however, what it has encouraged is a more descriptive approach where narrative has often been used in place of clear strategy and measurement. This research demonstrates that ESG is quickly developing a direct link between non-financial items, performance and valuation. For corporates, ESG will increasingly be measured against commercial and financial performance as well as the level of trust and engagement with stakeholders.

From whichever angle it is looked at, ESG must now be an important part of the management tool box – be this in response to the sudden growth in ESG-based funds with significant assets under management; the regulatory standpoint with the implementation of requirements such as the Task Force on Climate-related Financial Disclosures ('TCFD') and the Streamlined Energy and Carbon Reporting ('SECR'); expected reporting frameworks from the International Accounting Standards Board ('IASB') and the International Sustainability Standards Board ('ISSB'); or the growing impact ESG has on corporate reputation and brands, impacting employee retention and customer attraction. ESG now needs to be understood, measured and embedded throughout an organisation and used to maximise competitive advantage and ensure long-term success.

This is an important point for any company going forward. Firstly, ESG can no longer be addressed solely through narrative but must be supported and understood from a quantitative perspective, with the setting of performance indicators and targets. Secondly, there is no set way to achieve this that can just be taken off the shelf. An ESG programme has to be tailored and implemented within each company's own processes, strategy and economic reality and remain closely aligned to financial returns. It must be recognised that ESG is a young discipline and one that will continually evolve. This means ESG is not something that can be achieved in a year and filed with annual accounts.

This research highlights that Boards recognise that there is clear momentum behind ESG, and they are planning for its long-term influence. ESG, financial returns and reputational value are only going to become more and more closely entwined.

ABOUT SIFA STRATEGY

SIFA Strategy has established a team of experienced specialists who enable a management team to embed environmental, social and governance aspects into the heart of the business model, recognising the capital markets and other stakeholder demands.

SIFA Strategy focuses on providing holistic ESG support for companies where the team is equally comfortable advising Boardrooms and Leadership teams on implementing their broad ESG strategy and governance; undertaking materiality assessments; establishing KPIs and targets; defining social purpose; driving cultural change; analysing stakeholder engagement; assessing climate change risks and environmental impacts; providing tailored ESG training; or ensuring that the narrative and reporting reflects their ESG journey.

SIFA Strategy's core purpose is to support businesses to be both successful and sustainable.

METHODOLOGY

SIFA Strategy conducted research with 35 publicly-listed companies with representatives from the FTSE 100, FTSE 250, FTSE 350 and AIM, operating across multiple sectors. The research was based around conversations with CEOs, COOs, CFOs, Company Secretaries and senior management with direct responsibility for ESG. The aim was to understand how companies are developing their approach to ESG and their ambitions for the years ahead. Over 80% of the research was conducted through in-depth interviews, conducted on a non-attributable basis covering both quantitative and qualitative elements. The remainder was completed with participants completing a detailed questionnaire. The research was undertaken between April to August 2021.

SIFA STRATEGY

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