Capital League
PRIVATE WEALTH MANAGEMENT

ESG INVESTING

Growing Sustainably

Knowledge Series

Paper 2

What is ESG?

The three components of ESG are environmental, social, and governance.

The environmental aspect focuses on how a business minimises its impact on the environment. It covers the business's products/services, the supply chain and operations.

The social aspect focuses on how a business impacts wider society and workplace culture. Equality and fairness are at the heart of this aspect.

Governance refers to the processes of decision-making, reporting, and the logistics of running a business. It also looks at the business's ethical behaviour and its transparency with stakeholders about its activities.

What is ESG Investing?

ESG investing, also often interchangeably known as 'Socially Responsible Investing,' 'Impact Investing,' 'Ethical Investing,' and 'Sustainable Investing', refers to investing which prioritises optimal environmental, social, and governance (ESG) factors or outcomes. ESG investing is widely seen as a way of investing 'sustainably' - where investments are made with consideration of the environment and human wellbeing, as well as the economy. It is based upon the growing assumption that the financial performance of organisations is increasinglvy affected by environmental and social factors.

In the last few decades, the ESG movement has grown from a corporate social responsibility initiative launched by the United Nations into a global phenomenon.

Does ESG Investing Add Value?

All stakeholders (investors, customers, regulators) are getting more sensitive to ESG related issues. Businesses are getting increasingly impacted by non - financial factors as weak ESG practices increase business risks. For instance:

- **Environmental:** A firm generating high levels of pollution may suffer from a future tax
- **Social:** A firm that poorly treats its employees or suppliers may be boycotted by the consumers
- **Governance:** A firm with poor governance may be heavily fined by the regulator

These events can have a meaningful impact on the value of the firm.

ESG Aligned Companies Attract Investors And Lenders

The inclusion of ESG reporting in earnings reports is increasing among businesses. Investors and lenders are becoming attracted to organisations that invest in ESG and use ESG disclosures to shed light on their sustainability efforts.

Public concerns caused by the pandemic, climate change, and misuse of natural resources are forcing lenders to shift their lenses toward sustainable businesses and weed out the ones with outdated practices - such as unfair wages, investments in fossil fuels, unsustainable agriculture methods and the manufacturing of non-recyclable products.

Does ESG Add Value For Investors?

Sustainable businesses can generate sustainable growth.

Sustainable companies

- Run for the long term
- Take into account impact on all stakeholders
- Maintain structural growth
    - Deliver compounding returns to shareholders
    - Have a lower cost of capital
    - Command premium valuation
    - Have a lower volatility and reduced drawdown risk

Status in India

In recent years, India has been at the forefront of fighting climate change, advocating a sustainable lifestyle, and supporting renewable energy (founding and leading the International Solar Alliance). This perspective now reflects in the evolving ESG ecosystem in the capital market.

Governance

Keeping in line with the global evolution of ESG-related reporting, SEBI, through a notification dated 5 May 2021, mandated companies to use a new reporting template based on ESG parameters, called Business Responsibility and Sustainability Report (BRSR). The report notes the following:

- Top 1,000 listed companies by market capitalisation, to mandatorily report in BRSR format for FY22-23
- For FY2021-22, voluntary disclosure by the top 1,000 listed companies by market capitalisation in BRSR format
- Listed companies beyond top 1000, have an option to submit BRSR in place of BRR, effective FY2021-22 onwards

ESG Rating

Different rating providers have put together a methodology for measuring ESG risk and performance factors. A few better known ones are - S&P DJI ESG Scoring, Morningstar's Sustainalytics, and Crisil's ESG scoring. The S&P BSE 100 ESG index measures securities that meet sustainability investing criteria while maintaining a risk and performance profile similar to the S&P BSE 100.

To establish a common foundation and contextual evaluation parameters, SEBI has introduced guidelines in its Master Circular for ESG rating providers.

ESG – Mutual Funds

SEBI permits mutual funds to launch multiple ESG-oriented funds, each focusing on specific strategies such as exclusion, integration, best-in-class, positive screening, impact investing, sustainable objectives, or transition investments. These funds must allocate at least 80% of their corpus to the chosen strategy, paving the way for a more nuanced ESG-conscious investing ecosystem. Various MF houses (SBI, Axis, Kotak, Aditya Birla, etc.) already have running ESG funds. The total assets under management is now 10000 cr across 12 schemes and over 100k investors.

With improved ESG-focused disclosures and a well-established ESG ratings framework, the next step involves raising awareness in the investing ecosystem. If the mutual fund industry's efforts are any indication, we are on the right path.