Sustainable Value Governance

Integrating ESG into long-term strategy

Sustainable value is the aspiration- meeting the market's ESG demands can help build it

The first step in getting ESG (Environmental, Social, Governance) strategy right is understanding what ESG really is. ESG is a label for a fundamental shift in demands coming from current and potential employees, customers and investors. A recent PwC survey confirms that more than 86% of people want to work for and buy from companies that align with their personal values.[1] That percentage goes up as age goes down. And the fastest growing segment of the investment fund industry is in ESG focused funds, which total more than $18 trillion as of 2021[2]. Over the next 15-30 years, the group of values-alignment investors driving that growth will be on the receiving end of the biggest asset transfer in human history, as the baby boom generation passes its wealth to other generations. This group of stakeholders has an elevated focus on the importance of climate, social justice, human rights, income equality, fair treatment of workers, cybersecurity, responsible use of data, responsible stewardship of the social media commons and more. ESG isn't an agenda. It is a market force.

The strategic challenge is to respond to the market demands labeled as ESG in ways that produce *sustainable value* for the company.

> Sustainable and value are not separable terms. A sustainable business strategy has value - value that can last over time - a goal every business leader is striving to meet.

The key insight we take from our market experience is that "sustainable" and "value" are not separable terms. It is very hard to sustain any business strategy if it doesn't add value. And a strategy that can't be sustained over time is unlikely to be the best path toward adding value.

ESG demand will be different for different companies. To create sustainable value, leaders should engage with the community of stakeholders who create and sustain the company and give them a voice in setting ESG goals. Building trust with stakeholders through engagement, communicating a clear strategy and being transparent about progress can create resilient stakeholder relationships, attract and retain talent, build brand strength, drive revenue and reduce capital costs.

PwC's Sustainable Value Governance framework helps leaders set a strategy that responds to their stakeholders' specific ESG demands in a way that helps create sustainable value. The framework helps management: (1) synthesize information from across the organization to identify ESG actions that can drive sustainable value; (2) develop a strategy that sets long term goals and shorter term milestones; (3) communicate a clear, concise strategy narrative across the organization; (4) provide a feedback loop of performance data to senior management; and (5) document the entire process.

1. PwC's Consumer Intelligence Series June 2, 2021.
2. PwC Global ESG and AWM Market Research Centre analysis, Lipper, Preqin, ESG Global

How companies can develop an ESG strategy to builds trust and long-term value

In PwC's *2022 Annual Corporate Directors Survey*, only 57% of respondents said that ESG is linked to their company's overall strategy. Only 45% see a connection between ESG issues and financial performance.[3] This isn't surprising. We've seen that even where ESG efforts are more mature, the data and knowledge necessary to integrate relevant factors into company strategy and provide proper oversight often aren't reaching senior management and the board in useful form. The survey found that less than two-thirds of directors say their boards understand the internal processes and controls around ESG.

Much of that data and knowledge often exists, but it is often scattered across different organizational functions, departments and systems at the company. Companies should have a clear process that draws ESG information together and connects ESG data (such as GHG emissions, DEI, fair treatment metrics, etc.) to long-term value data (revenue growth, cost reductions, brand health, cost of capital, talent attraction and retention, customer loyalty, etc).

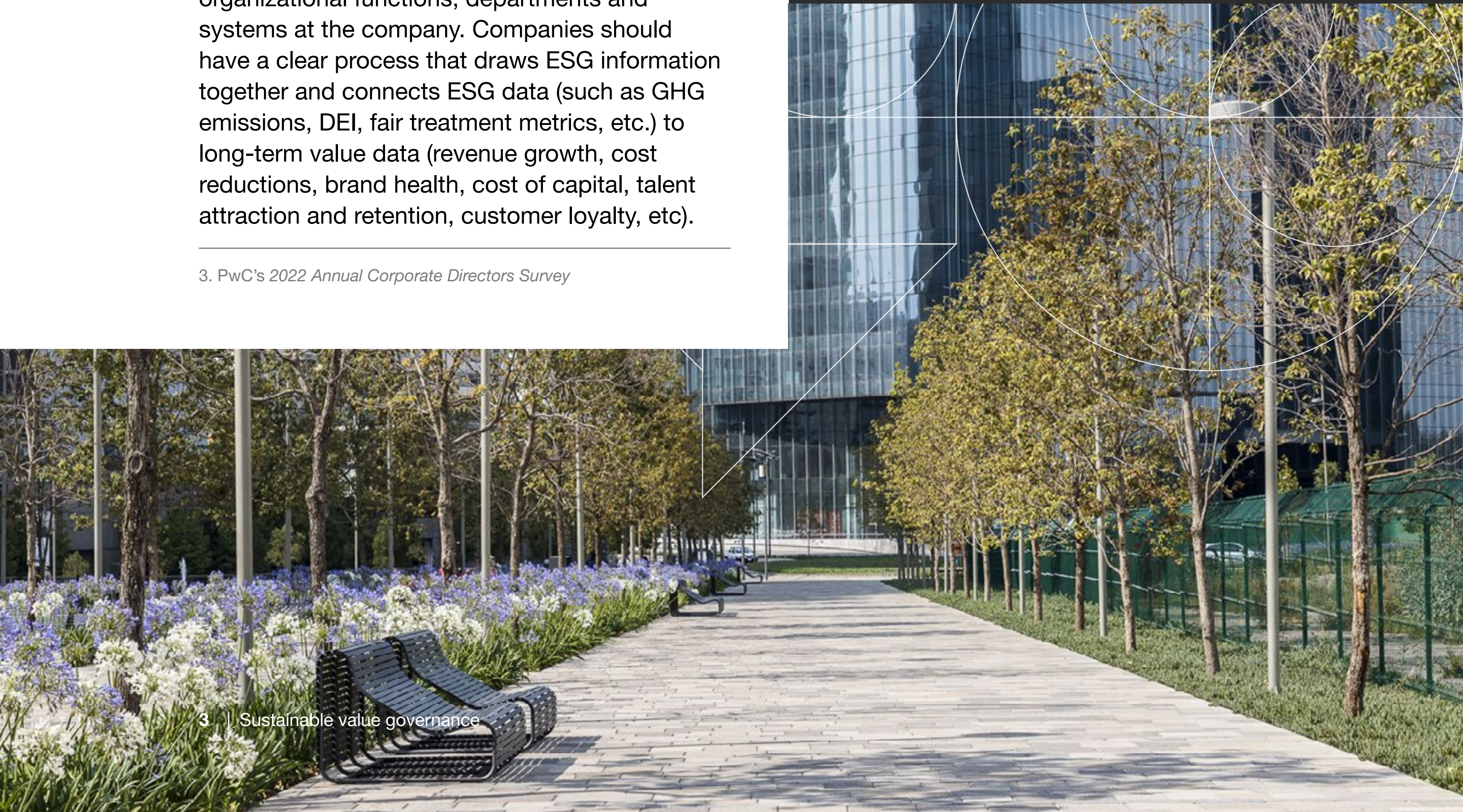
3. PwC's *2022 Annual Corporate Directors Survey*

Board oversight process solidifies, perspectives change

Percentage of directors who agree with the following about ESG issues:

	2021		2022
Regularly part of the board's agenda	52%	▲	55%
Linked to company strategy	64%	▼	57%
Impacts company financial performance	54%	▼	45%

Q19. With which of the following statements do you agree about ESG issues? (select all that apply)
Base: 788 (2021); 636 (2022)
Sources: PwC, *2021 Annual Corporate Directors Survey*, October 2021; PwC, *2022 Annual Corporate Directors Survey*, October 2022.



Why is more governance around ESG issues needed now?

A number of factors are coming together to require more integrated governance of ESG issues.

- **Cost of capital/debt.** Investors are increasingly focused on a company's ESG performance. Large pools of capital have formed that are available for investment only in equity or debt of companies that meet certain ESG performance criteria. Commercial banks are moving to reduce their "financed emissions." That may raise borrowing costs for companies that are not setting and meeting GHG targets.

- **Rapidly evolving regulatory and compliance environments.** In both the U.S. and the E.U. regulators are setting disclosure requirements for one or more ESG issues. As these requirements evolve, companies should be prepared to include in their disclosures descriptions of their sustainability strategies and of the board's oversight of these issues.

- **Reputational threats.** A lack of response to or empathy for emerging societal issues can present reputational risk to companies. In addition, ill-prepared or reactionary responses can consume board and management attention and can be seen by stakeholders as potentially inauthentic, eroding trust. Certain investors and other stakeholders are questioning the value to shareholders of ESG commitments. Setting ESG goals and strategy that create sustainable value for the business can help companies navigate these pressures and set a framework to clearly set and pursue aspirational goals.

- **Talent attraction, training and retention.** Attracting and retaining talented employees is critical to nearly every business. As PwC's Consumer Intelligence survey shows, 86% of employees want to work for companies that align with their personal values[1]. Companies can build trust by engaging employees in goal setting and by providing transparency about execution on ESG priorities. Building employee relationships that are more than just transactional is a powerful way to create trust and resilience - key components of building long-term value.

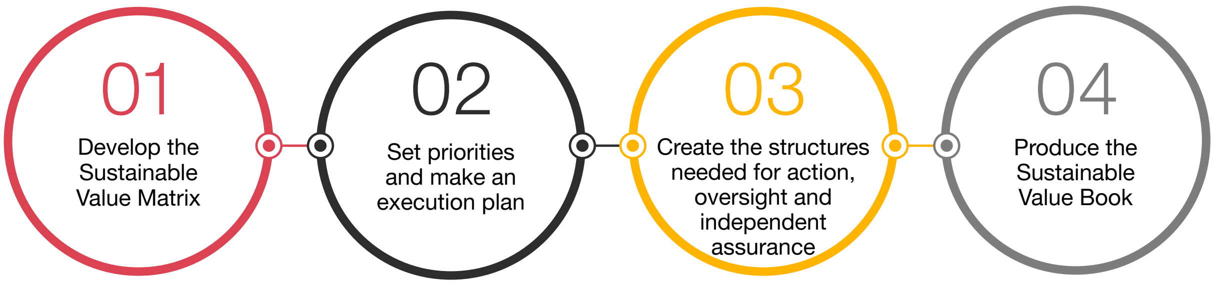
- **Proxy pressure and investor activism.** Asset managers, proxy advisors and activist investors are increasingly willing to support shareholder proposals that call for greater disclosures of ESG issues such as climate change and diversity. At the same time, there are activist investors and others who are taking anti-ESG positions. Both groups are making increasing use of the proxy process, aided by the shift to a universal proxy. Shareholder resolutions on ESG related issues are increasingly sophisticated and more likely to demand specific actions than in the past.

- **Macroeconomic shifts and civil litigation risk.** The pressure created by all of the above issues raises the potential risk of derivative litigation for boards in relation to oversight of ESG issues. Securities litigation risk over alleged mismatches between ESG promises and performance is also likely rising.

- **Increased political attention.** ESG is increasingly becoming part of the polarized political environment in the U.S. There is a growing movement opposing investor and corporate commitments to ESG. While on the other side of the political spectrum, they are increasing their demands for ESG commitments. Investors are responding to this pressure with increased demands for transparency and a connection between ESG investments and long-term value. This pressure is unlikely to abate and for many, cannot be avoided.

What is Sustainable Value Governance?

Your employees, customers, investors, regulators and communities care about the planet and the health and well-being of the societies in which they live. They want corporate leaders to be accountable for responding to those concerns. The sustainable value governance solution helps companies do that in four steps:



01

Develop a Sustainable Value Matrix. In this step, companies bring together data and knowledge about ESG efforts across the company to develop a thorough understanding of how ESG issues relate to the company's value chain. Using that information, leaders can assess the potential risks and opportunities associated with the identified issues from relevant perspectives, including reputation, brand, talent attraction and retention, revenues and cost, financial statement materiality and evolving regulatory standards. The end result of this process is a matrix that places ESG issues in context with the business strategy, shows how those issues interact with each other and provides a framework for determining their relative importance to the company. This matrix is the basis for the remaining steps of Sustainable Value Governance. The initial "top down" matrix described here is also the basis for the "bottom up" process of stakeholder engagement (discussed below) through which Sustainable Value Governance can provide even more value.

02

Set priorities and make an execution plan. Based on the Sustainable Value Matrix, company leaders choose the issues on which the company should take action. Working with specialists and teams, companies conduct an industry-leading practices review and benchmark themselves against peers. They should set concrete long-term goals and interim milestones and put in place a strategy to achieve those goals. The purpose of this process is not to centralize operational decision making; how operational decisions are made will vary by company and will reflect an organization's unique culture. Rather, the purpose is to set clear goals and communicate them through the company. This will help decision making and encourage appropriate risk taking.

03

Create the structures needed for action, oversight and independent assurance: Companies need to create the required measurement, data quality and reporting structures to enable effective management of the execution plan. These structures should be built recognizing that the information they produce can also be used for public reporting. Sustainable Value Governance is designed to be an incremental process. It builds on existing data structures and prior ESG materiality analysis, goal setting exercises and data projects. This process is likely to find ways to continue to improve the data flow. But it isn't starting from scratch.

04

Produce the Sustainable Value Book. The book documents the process and provides a concise picture of strategy and progress to the senior management team. The final structure of the book will vary by company, but the basic content should include the following four sections:

- A 3-5 page narrative describing the company's ESG priorities, the concrete goals the company aims to pursue to put those priorities in action, the interim milestones that measure progress, how the goals and milestones were set, why reaching the goals and milestones will be accretive to long-term value and why leadership (and everyone else) should be confident that its ESG data is accurate.
- Dashboards and benchmarks showing at a glance each of the goals and milestones and the status of each.
- A table tracking all the public statements the company has made about ESG, where each statement appears, who made it, whether it is accurate, and who is responsible for the statement's accuracy.
- A data appendix: Each operational group within the company that is taking action on ESG can provide a data package with expected details to support the discussion and conclusions in the first three sections.

The Sustainable Value Book is a management document. Our suggestion is to produce the book annually, but the right frequency will depend on the company. The executive leadership team, in consultation with the board, can use the Sustainable Value Book as the basis for reporting to the board and appropriate committees on ESG. We also suggest that the owner of the book be a member of the executive leadership team.

Creating Opportunities through Stakeholder Engagement

Sustainable Value Governance helps companies respond to the market demand that's been labeled ESG in ways that produces long-term value. The process can provide high-quality data to meet investor and lender demands and growing regulatory requirements. It can also help reduce the risk of a mismatch between promises and performance, reducing regulatory and litigation risk. Sustainable Value Governance also provides a basis for a disciplined response to political pressure and activists.

The final step in Sustainable Value Governance - the "bottom up" element of the Sustainable Value Matrix - offers an opportunity to create even more value by deeply engaging stakeholders to align ESG efforts with their personal values. This can help build trust and resilient relationships with the community of people who ultimately create and sustain the value of the company: employees, customers, investors and the people who live near and are affected by company operations. Deep stakeholder engagement helps give a meaningful role in setting ESG priorities to that corporate community.

The stakeholder engagement process will be different for different companies. To be effective, it should be robust.

The stakeholder engagement process will be different for different companies. To be effective, it should be robust: thought of more as a stakeholder democracy, not just sporadic focus groups or surveys. A result of the process will be a Sustainable Value Matrix that respects the wide array of concerns and values of the company's stakeholder community.

As it becomes more advanced, Sustainable Value Governance may also provide a useful response to reputational risks from emergent issues as well as pressure from activists, political actors and regulators. The established framework can not only help mitigate potential risks and take advantage of opportunities; but also offers a principled way to say "no" to outside pressures. In this way, your company can engage your stakeholder community and decide together how to respond, further distinguishing your organization from your peers and adding long-term value.

For more information and to talk about what Sustainable Value Governance looks like for your organization, please contact:

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