

Sustainable Value:

How Emerging Public Companies Can Deliver on ESG Expectations

Executive Summary

The momentum driving corporate action on sustainability has reached a point where emerging public companies risk limiting their value potential if they do not embrace environmental, social and governance (ESG) management and disclosure. Pressure is growing on companies to manage ESG risk and harness related opportunities from across the investment value chain. Half of U.S. individual investors now practice sustainable investing,¹ while 80% of institutional asset owners integrate ESG considerations into their investment process.² Three quarters of asset managers have adopted sustainable investing and nearly 90% plan to devote more resources to sustainable investing over the coming years.³

The turbulent events of 2020 have further heightened ESG expectations for companies, delivering a clear demonstration of how sustainability considerations can impact their stakeholders, including employees and communities. C-suites face intense scrutiny as they respond to social concerns ranging from maintaining employee health and managing a rapid shift to remote work to addressing systemic racial inequity, including in corporate hiring policies.

Three Building Blocks for Realizing the Value of Sustainability

This brief aims to help emerging public companies better manage sustainability risks and leverage related value. Our guidance first identifies two critical gaps that can hold back companies during financial transition. The first is the **Value Gap**—when companies that lack a sustainability strategy or proper management of related issues may be unable to access the growing pool of capital that takes account of sustainable

investing considerations. The second is the **Expectations Gap**. This occurs when companies accessing public markets are unprepared to face stakeholder scrutiny on sustainability issues, especially from a new slate of investors.

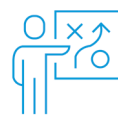
To bridge these gaps, the brief outlines three key building blocks for integrating sustainability into firm strategy to help reduce risk and create long-term value.

This guidance is designed to assist companies addressing the ESG aspects of accessing public capital markets. High-growth private companies going public for the first time may be naturally positioned to implement the building blocks outlined below, however, this guidance is also relevant for a broader set of companies on the path to integrating sustainability into firm strategy. Material¹ sustainability considerations may differ based on geography, market capitalization and exit strategy, but there is universal applicability of a well-conceived sustainability strategy that can be shared across all businesses.



BUILDING BLOCK 1

Articulate corporate purpose to help drive valuation, sustain capital and attract and retain talent



BUILDING BLOCK 2

Identify potential ESG-related risks and build a strategy to manage them



BUILDING BLOCK 3

Communicate an authentic approach to ESG-related risks and business opportunities

¹ Sustainability issues likely to affect a company's financial condition or operating performance.

The Growth of Sustainable Investment

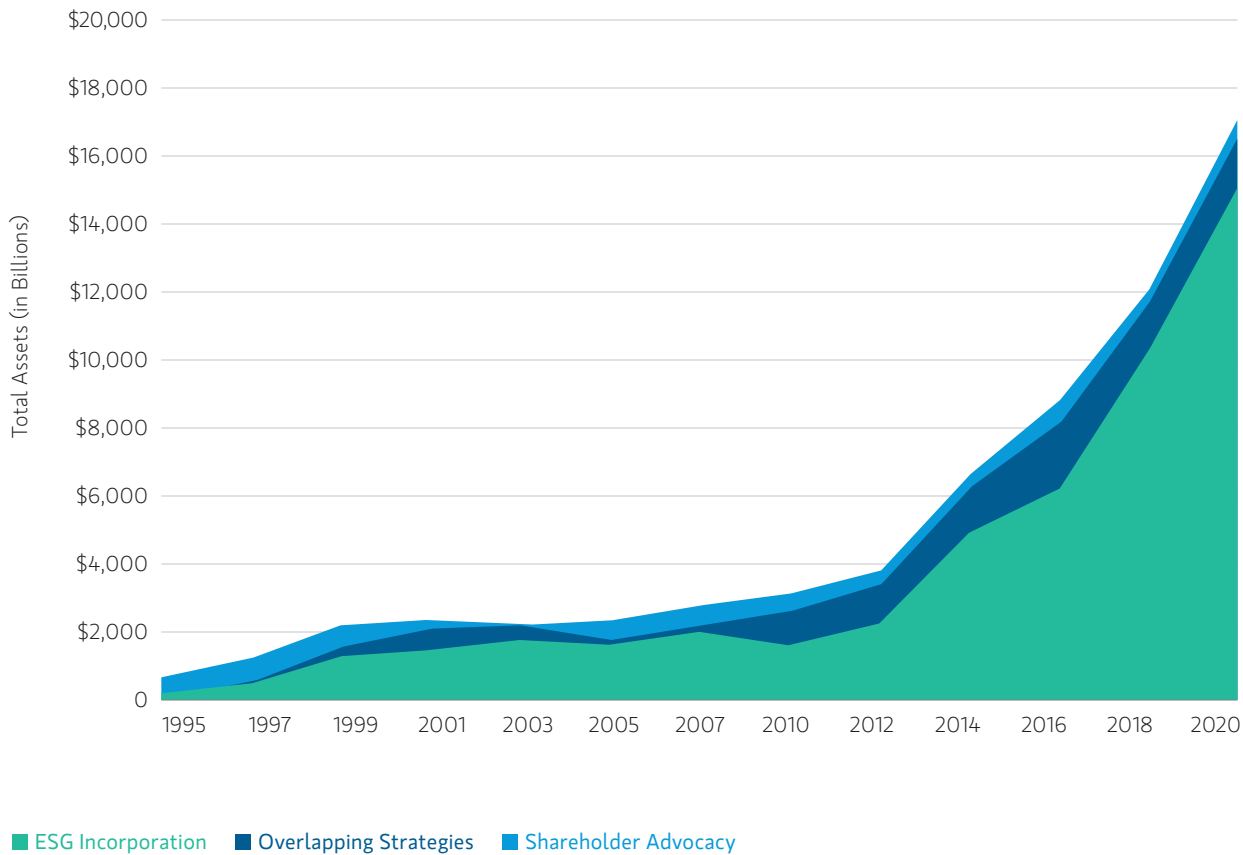
Companies going public have significant incentive to embrace sustainability. First, sustainable investing is now firmly in the mainstream with investors increasingly looking to allocate capital in ways that align with their values. Second, there is growing evidence that a strong focus on ESG issues drives value for corporations.

Investors are increasingly incorporating ESG factors into investment decisions and support active ownership to create sustainable long-term value. As of January 2020, investorsⁱⁱ representing \$17.1 trillion in US-domiciled assets have adopted a sustainable investing strategy, a nearly 43% increase from

\$12 trillion in 2018.⁴ Among U.S. asset managers, 89% say sustainable investing is here to stay, and 63% say they expect increased adoption in the next five years.⁵ In other words, ESG considerations are now part of the assessment of an investment’s fundamental strength—or weakness.

U.S. Sustainable Investing Sets New Record in 2020

FIGURE 1



Source: US SIF Foundation, data as of January 2020

ⁱⁱ Institutional investors, money managers and community investment institutions

The reach and understanding of ESG factors as drivers of both enterprise opportunity and risk has grown substantially. Investors' calls for greater corporate ESG management and disclosure on issues like climate change, labor practices and consumer product safety reflect a deeper understanding of their connection to shareholder value.⁶ The table below summarizes the main ways that strong and strategic ESG management can drive enterprise value, all of which are relevant to emerging public companies—beginning with access to capital.

Large corporations are responding to the increased scrutiny with improved ESG transparency and disclosure. For example, 90% of S&P 500 companies published a sustainability report in 2019, up from 20% in 2011.⁷

In recent months, the enormous social and economic disparities exposed by both the global COVID-19 pandemic and the heightened movement for racial equity have brought additional public and investor scrutiny to how companies respond to societal challenges. For example, 71% of U.S. adults now say corporate brands have a role to play in responding to issues of racial injustice, according to a survey by research firm Opinium.⁸ In response, many leading U.S. companies are taking actions, such as donating to organizations that promote racial equity, and pledging to include more underrepresented groups in their senior ranks.⁹

While it is early days to determine whether or how companies will meet these growing challenges, their emergence drives home the risks that can face companies that do not manage ESG issues well prior to going public.

HOW ESG DRIVES ENTERPRISE VALUE

1 Access to Capital	ESG management helps attract ESG-aligned capital from private and public investors focused on sustainability. ^{10,11} Strong ESG credentials can also bolster access and valuation in debt capital markets. ¹²
2 Business Efficiency	Companies with a sustainability focus, aligned with SASB-defined material issues, realize a 4.8% bump in annualized outperformance relative to the peer benchmark. Companies with no sustainability focus realized a 2.2% penalty. ¹³
3 Brand and Competitive Advantage	Purpose-driven brands can better compete by reaching sustainability-minded Gen Z and Millennial Customers. Sixty-three percent of customers prefer to engage with purpose-driven companies. ¹⁴
4 Risk Management	ESG-related risks are business risks: natural disasters can dislocate supply chains, ¹⁵ and disruption of existing systems can create legal risk. ^{16,17} Managing ESG-related issues can mitigate these risks.
5 Talent Attraction and Retention	Seventy percent of respondents to a Fast Company survey noted that if a company were strong on sustainability, it would affect their decision to remain at the company. In the same survey, 30% said they had left a job due to lack of sustainability programming. ¹⁸

In this paper, sustainable investing and ESG integration are defined as follows:



SUSTAINABLE INVESTING

The practice of making investments in companies or funds that aim to achieve market-rate financial returns alongside positive social and/or environmental impact.



ESG INTEGRATION

A sustainable investing approach that proactively considers ESG criteria alongside financial analysis.

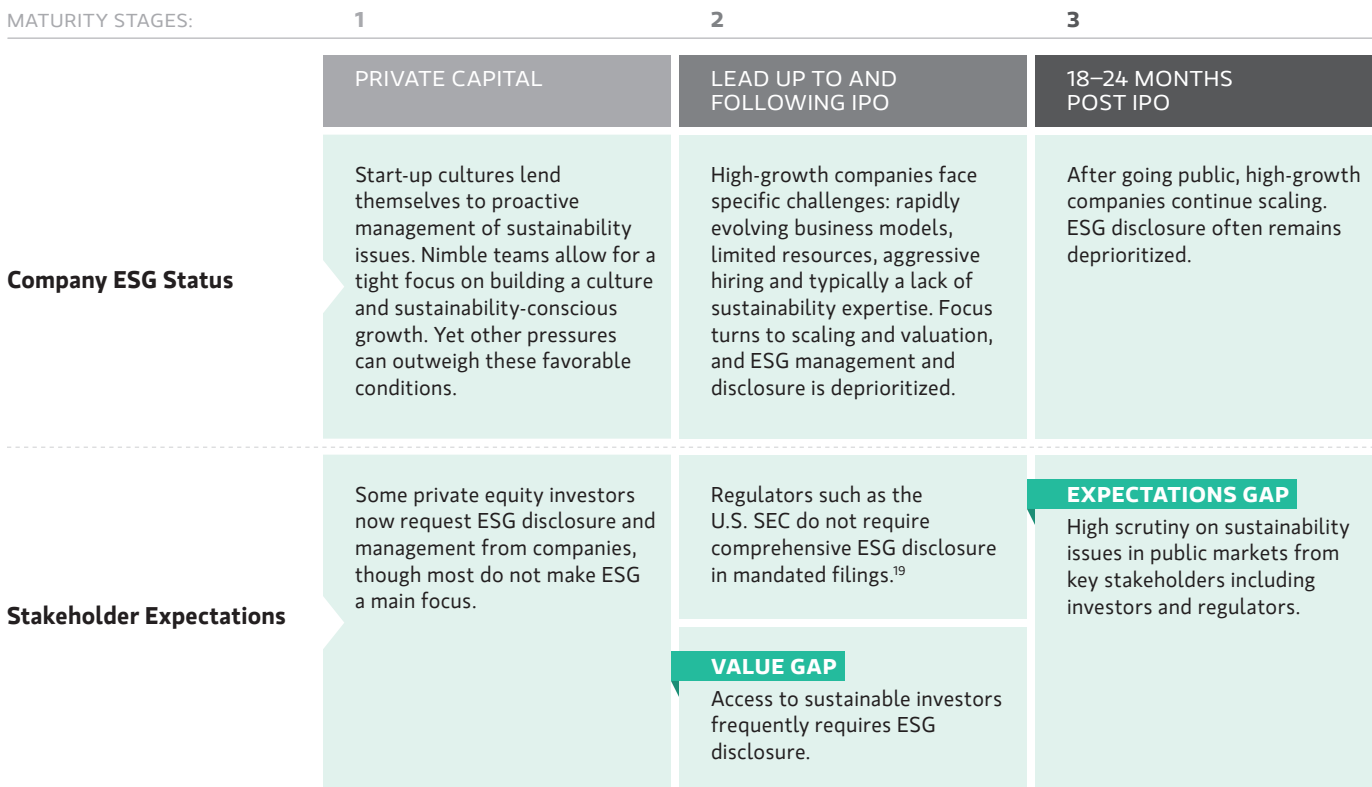
Failure to Embrace Sustainability Leaves Value on the Table

Private companies typically focus on growth, and can be shielded from broader stakeholder demands, which can result in inadequate ESG management and disclosure. This in turn creates gaps in value and expectation that can leave companies exposed to scrutiny and unable to access capital earmarked for sustainable investing.

Consider the path of a high-growth private company as an illustrative example to highlight the key gaps that may arise when transitioning to public markets. Below, we analyze how this dynamic can play out over three stages:

ESG Management and the Transition to Public Markets

FIGURE 2



Private Capital

Prior to an initial public offering (IPO), startups often focus almost exclusively on business growth. Typically, lean teams work with a narrow set of investors, owners and customers. With the exception of mission-oriented startups, these

conditions can insulate private companies from broader sustainability expectations, leading to a lack of attention to material ESG risks, and laying the groundwork for value and expectations gaps to form.

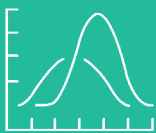
IPO Lead-Up and Early Access to Public Markets

At this stage, companies will encounter new ESG-related expectations in the public markets. Nevertheless, the allure of securing a high valuation can lead to deprioritizing efforts to build a sustainability strategy and disclose ESG-related information despite the growing body of research that suggests a link between strong ESG management and long term economic performance. Ninety percent of the sources reviewed in an Oxford University meta-study on businesses' sustainability and economic performance found that sound sustainability management lowers companies' cost of capital.²⁰ Increasingly, private equity investors are even targeting companies with explicit sustainable products and corporate practices to potentially take public and capture growing appetite for ESG-focused IPO deals.²¹ Ahead of sound sustainability planning or ESG risk management, however, a private company may be required to meet specific growth and hiring targets that put pressure on operational systems and employees.

As companies look to raise capital in the public markets, lack of a strong sustainability strategy and ESG disclosure can backfire. Specifically, it deters investors with explicit sustainability considerations in their strategies whose funds may rely on the availability of robust and timely ESG-related data. In 2018, the Global Sustainable Investment Alliance (GSIA) reported that over \$30 trillion of global assets under management were managed with a focus on sustainability and rely on ESG information about issuers.²² Yet, research conducted for this brief points to a clear lag in ESG disclosures among companies that recently went through an IPO compared to more established peers, leaving them potentially unprepared to provide robust evidence of sustainability practices. Based on overall ESG transparency,ⁱⁱⁱ newly public companies in the Russell 1000^{iv} index lag their more mature peers^v by 10 points on average.²³

This is the Value Gap. Due to the lack of a clear sustainability strategy and ESG disclosure at the time of accessing public capital, a private company risks limiting its value potential as it may be inappropriate for sustainability-focused investors.

Lessons for Companies in Transition



VALUE GAP: If a company aspires to access the growing pool of capital dedicated to sustainability, it should consider improving management and disclosure of material sustainability issues.

EXPECTATIONS GAP: To meet stakeholder demands in public markets and preserve its reputation, a company in transition should consider prioritizing sustainability management.

Post-IPO or Public Capital Investment

In public markets, companies face a new set of investors and additional scrutiny from regulators. These stakeholders each have a growing interest in sustainability issues that can affect the success of newly public companies.

Investor interest in sustainability is surging, with 33% of total U.S. assets under professional management employing a sustainable investing strategy.²⁴ Some investors have an even more granular, topic-specific focus, for example, diversity and inclusion, with 83% of venture capital investors recognizing the value proposition associated with investing in minority founders.²⁵ Moreover, adoption of sustainable investing practices is expected to grow as Millennials accumulate more wealth. According to a 2019 survey by the Morgan Stanley Institute for Sustainable Investing, 95% of Millennials are interested in sustainable investing, and 41% already invest in companies that target positive environmental and social outcomes, compared to 28% of individual investors in general. In addition, 28% of Millennials have exited an investment based on objectionable corporate social, environmental or political activity compared to 17% of investors in general.²⁶

After going public, high-growth companies also face scrutiny from third-party ratings and rankings agencies that inform many ESG-focused investors. Firms such as Sustainalytics (owned by Morningstar), ISS-ESG and MSCI scrutinize disclosure of ESG information available in the public domain to assess performance.²⁷ These third party data providers use a company's environmental and social policies, including environmental health and safety policies, as well as violation track records, as proxies for sound sustainability management. Credit rating agencies, including Moody's, S&P Global and Fitch Ratings, are also increasingly including ESG information in their credit assessment methodologies, making it imperative for companies across the maturity spectrum to proactively communicate material sustainability information.²⁸

Regulators now increasingly consider non-financial issue management and disclosure by corporations a 'must have' not a 'nice to have'.²⁹ While jurisdictions have taken different approaches to regulating disclosure, 24 stock exchanges require ESG reporting as a listing rule, including the Hong Kong Exchange, Euronext London and the Johannesburg Stock Exchange.³⁰

This is the Expectations Gap. Companies entering public markets may be unprepared to meet increasing stakeholder demands on material ESG-related issues, raising potential business and reputational risks.

ⁱⁱⁱ Bloomberg Disclosure Score is a 0–100 measure of overall transparency of ESG information.

^{iv} Companies that have IPO'd since 2013.

^v Companies that IPO'd prior to 2013.

Closing the Gaps: Three Building Blocks for Realizing the Value of Sustainability

Companies in transition have much to gain from making the changes required to close the sustainability value and expectations gaps. According to a 2020 McKinsey survey, 83% of C-suite leaders and investment professionals expect ESG considerations to contribute greater shareholder value over the next five years than today.³¹ To help companies lay the groundwork for strong ESG performance and disclosure, we provide three building blocks for realizing the value of sustainability. These fundamental pillars reflect opportunities along a company's sustainability journey to help enhance its value proposition for internal and external stakeholders.

BUILDING BLOCK 1: **Articulate corporate purpose to help drive valuation, sustain capital and attract and retain talent**



ARTICULATE CORPORATE PURPOSE

Companies that succeed in entering public markets typically have a strong business model, strategic purpose and vision. To close potential sustainability value and expectations gaps, company leaders should also take steps to integrate sustainability into their purpose and strategic plan. By laying this foundation early in the company's history, or even committing to a new corporate purpose later in a company's journey, executives can establish a clear business agenda on which to build an authentic sustainability strategy. Companies will take different approaches to sustainability based on, for example, a focus on product design or job creation, or a family-owned history that values the company's role in its community. For many companies, this approach points to a sense of purpose and a broader role in the world that can help attract investors and stakeholders and bridge any value and expectations gaps.

FOCUS ON PEOPLE

In addition to corporate purpose, human capital management and workplace culture are essential to a company's ability to attract and retain talented employees that are key to a successful transition. Factors that influence the perception of strong ESG management with respect to people include the impact of a company's products and services, executive behavior and accountability, safe working environments, employee well-being, diversity and inclusion, and employee benefits and compensation. Employees and other key stakeholders are increasingly calling on boards and executives to take action on topics ranging from pay disparity to climate change and systemic social challenges that have been brought to the fore by movements such as #MeToo and Black Lives Matter.

In Fast Company's 2019 survey of 1,000 U.S. employees, nearly 70% of respondents said that if a company had a strong sustainability plan, it would affect their decision to stay with the company long term. Four in ten survey participants said they had chosen a job in the past because the company had a stronger sustainability profile than an alternative employer.³² Employee professional groups, and CEO-led town halls are among the increasingly common activities that demonstrate the growing power of employee values and interests.

Companies can also establish sound human capital management and workplace culture by investing in the well-being of their people. Research suggests that this not only leads to increased employee engagement and productivity, but can also improve brand reputation.³³ In addition to standard healthcare benefits, many employers have begun addressing employees' financial health to support retention. Nearly 75% of employees said it was important for an employer to offer financial wellness benefits, and 60% said they would be more likely to stay at a job that provided such programs, in a 2017 survey by the Financial Health Network.³⁴ The financial insecurity stemming from the COVID-19 pandemic has provided added impetus to improving wellness benefits of all kinds.

The Evolution of Corporate Purpose

While individual companies serve unique functions, there is increasing consensus that companies share a universal set of fundamental commitments to all stakeholders.³⁵ Defining corporate purpose is an emerging best practice in governance accountability and should help define and drive a company's business strategy, outline its positive contributions to society, including how the company compensates employees, values customers, protects and respects communities and the environment in which it works, as well as how it generates long-term value for shareholders. Corporate purpose can also establish a clear articulation of progress towards these universal commitments.

BUILDING BLOCK 2:
Identify potential ESG-related risks and build a strategy to manage them



ASSESS MATERIALITY

Assessing material issues—those likely to impact a company’s financial condition or operating performance³⁶—is helpful for companies and investors alike. Given the plethora of sustainability standards and frameworks established in recent years, the range of such issues is wide and generally bucketed into environmental, social and governance categories (see Figure 3). Conducting a business-specific materiality assessment can help companies in the early stages of managing their social and environmental impacts, and with limited dedicated resources identify the top issues they need to manage as

a priority. For example, the widely-adopted Sustainability Accounting Standards Board (SASB) framework provides industry-specific guidance and disclosure standards on fundamental ESG-related material issues for companies, such as climate risk management and human rights. Companies that adopt an ESG focus aligned with SASB-defined material issues realized a 4.8% bump in annual outperformance, while firms without an ESG focus realized a 2.2% penalty.³⁷

SASB disclosure of material sustainability information can offer a useful starting point for companies in transition. Companies with greater exposure to climate-related risks can also explore reporting in accordance with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD). Companies can also consider using the Global Reporting Initiative (GRI) standards, which brings broader stakeholder expectations to defining materiality.

Sustainability Issues for High-growth Companies (as an Example) Overlaid on SASB’s Material Issues

FIGURE 3

	ENVIRONMENTAL	SOCIAL	GOVERNANCE
SASB Material Issues	<ul style="list-style-type: none"> • GHG Emissions • Climate Change • Business Resilience • Air Quality • Energy Management • Water & Wastewater Management • Waste & Hazardous Material Management • Ecological Impacts • Product Design & Lifecycle Management • Supply Chain Management • Materials Sourcing & Efficiency 	<ul style="list-style-type: none"> • Human Rights & Community Relations • Customer Privacy • Data Security • Access & Affordability • Product Quality & Safety • Customer Welfare • Selling Practices & Product Labelling • Labor Practices • Employee Health & Safety • Employee Engagement, Diversity & Inclusion 	<ul style="list-style-type: none"> • Business Ethics • Competitive Behavior • Management of Legal & Regulatory Environment • Critical Incident Risk Management • Systemic Risk Management
Additional Issues Specific to High-Growth Companies	<ul style="list-style-type: none"> • Packaging • Product Impacts on Environment • Scope 3 Emissions 	<ul style="list-style-type: none"> • Contractor Benefits & Wellbeing • AI Product Use Phase Due Diligence • Pay Equity & Equality in Promotion for Women and other minorities 	<ul style="list-style-type: none"> • Board Diversity

Source: SASB Material Issues

ENGAGE WITH KEY STAKEHOLDERS

External and internal stakeholder engagement can help companies build relationships with key constituents as well as identify material risks and opportunities.

External: Gaining the trust and support of key stakeholders including customers, investors and regulators, is critical to business success. A recent survey from Weber Shandwick and KRC Research revealed that, on average, global executives attribute 63% of their company's market value to their company's overall reputation.³⁸

When they set out to define material issues, companies in transition should take into account all external stakeholders that their operations impact—directly or indirectly. Where companies neglect to build relationships with these stakeholders or fail to take their views into account, they risk facing future regulatory action or customer pushback. Engagement with these stakeholders can also help companies monitor and rectify any unintended consequences of their products or services. For instance, in recent years, companies in the sharing economy—such as ride-hailing and car-sharing services—have faced regulatory actions across different local and national jurisdictions on issues including unfair competition, contractor benefits and lack of diversity and inclusion. Early engagement with external stakeholders, including joining industry networks and coalitions, may help a company identify and address such issues before they become damaging regulatory or reputational challenges.

Internal: Employees are also vital stakeholders, tasked with delivering on the company's value proposition. Hence, the ability to attract and retain talented and committed people is often key to a transitioning company's financial success. Employees both shape and are shaped by workplace culture and, as described above, feel increasingly empowered to speak out on sustainability-related topics. Recent surveys found that 82% of Millennials believe they have the right to challenge their employer, while 48% of Millennials have taken action against their employer on a social or workplace issue.³⁹ Employee activism can cause reputational challenges for companies transitioning to public markets, underlining the importance of ongoing, transparent and collaborative workforce engagement. In practice, companies can facilitate opportunities for employees to share their perspectives on key sustainability issues, hear from management on key corporate developments and contribute to long-term success.

DEVELOP AND IMPLEMENT A SUSTAINABILITY STRATEGY

As companies better understand material issues and stakeholder views, they can continue developing a sustainability strategy to drive performance and positive impact in these priority areas. These sustainability priorities and strategies will be fundamental to resilient business models and must be integrated into core business operations and enterprise risk management.⁴⁰ For example, a car company that does not include electric vehicles in its business and sustainability strategies is unlikely to be sustainable in the long run, or to bridge the value and expectations gaps. All multinational companies should also design sustainability programs to manage global priorities while taking into account local operating contexts. For example, a technology company consulted for this report established a global focus on issues including cyberbullying, violent extremism, child safety on content channels and climate change, but opted for regional ownership and implementation of these programs to ensure a locally relevant approach.

Many private companies, especially startups, may lack the resources and expertise to develop and implement a strategy to manage ESG-related risks and opportunities effectively. In this context, leadership should consider hiring employees with expertise in the company's high-priority sustainability issues or goals and/or shifting existing staff into ESG-focused roles to develop internal expertise. Companies may also consider working with external consultants to jumpstart a sustainability strategy.

As an extension of the first building block, companies should establish sustainability leadership at the top of their organizations, with clearly defined governance, roles and responsibilities. Input from the Board of Directors and C-Suite is important for establishing a sustainability strategy—and potential related targets—that link to the company's purpose, vision and business strategy, as well as for ongoing oversight. Depending on a firm's size, a senior-level ESG working group can be useful to coordinate enterprise-wide efforts while limiting the need for extensive dedicated resources.

MEASURE AND MANAGE

After identifying material issues and building them into a sustainability strategy, the next component is to establish quantitative and qualitative key performance indicators (KPIs) to measure and track progress. KPIs can vary, with some intended for internal monitoring to inform improvements, while others serve as metrics for external reporting. While many public companies ultimately set goals or targets for their sustainability programs, this is not always necessary for those in the initial stages of ESG management and integration. Instead, companies can integrate clear and comprehensive KPIs as their ESG management and disclosure strategies evolve. For example, a company focused on deploying artificial intelligence in facial recognition can establish metrics to show how it integrates anti-bias and anti-discrimination throughout the product design, sales and customer use phases.

BUILDING BLOCK 3: Communicate authentic approaches to ESG-related risks and business opportunities



COMMUNICATE, DISCLOSE AND DEMONSTRATE

Companies accessing public capital markets should aim to provide ESG data that is robust and decision-useful to investors. Wherever possible, they should include information on relevant past performance as a private company to provide context for external stakeholders.

However, in the early stages of implementing a sustainable strategy and disclosing progress on targets or KPIs, sustainability reporting will likely be limited. Companies in transition can address this by setting a baseline to disclose data that is consistent and comparable with peers, and by sharing their strategy and progress on all material issues. A useful way to start this process is to launch sustainability communication programs internally via newsletters, bulletins or town hall meetings. Once company leaders are comfortable with internal communication, they can authorize a public 'soft launch' via a landing page on the corporate website. Private companies have also successfully used the B Corp Certification process to create internal focus and activate the resources and systems to track KPIs relating to the company's workforce, governance structure, environmental impact, suppliers and customers. Laying this foundation as a private company and eventually transitioning to a Public Benefit Corporation (PBC) before going public can also assist in preparing a business and leadership to engage with sustainability-focused investors active in the public markets.

The next stage is to issue a sustainability report, with the format depending on the company's key audiences and availability of resources. As noted earlier, 90% of S&P 500 companies publish sustainability reports, making such disclosure an important milestone for public companies looking to access sustainability-focused investors and meet stakeholder expectations.⁴¹ At a minimum, companies preparing for financial transition should consider issuing a streamlined sustainability report tailored for an investor audience. This would ideally disclose information on all material issues and the process for identifying these issues as material, as well as the firm's governance structure, sustainability strategy, targets, goals and KPIs. It may also be beneficial to incorporate a narrative that explains current performance and planned areas for improvement. **This disclosure can bridge the Value Gap, helping companies transitioning to the public markets track performance on material issues and engage investors with ESG mandates.**

For U.S.-based companies, detailed disclosures on financially material risks are mandatory in various annual public filings, including the S1, 10-K, 10-G and Proxy Statements. ESG disclosures are voluntary within these documents. However, integrating ESG disclosures into financial reports is considered a leading practice that companies in financial transition might consider, especially if their product or service creates revenue by addressing sustainability challenges directly and ESG-focused investors are their top funders. A third reporting approach for companies to consider is publishing a robust standalone sustainability report targeted at a broader stakeholder audience. These reports can be more resource-intensive and typically include detailed coverage of programs and case studies. Public companies that choose this form of reporting tend to follow guidance from framework providers such as GRI or SASB, and include a comprehensive index for the framework(s) they use at the back of their reports. **While there is a range of approaches, successful reporting should be transparent, authentic and demonstrate effective management of ESG-related issues. Ultimately, such an approach can help transitioning companies bridge the Expectations Gap and meet the demands of stakeholders in public markets.**

Looking Ahead

As emerging public companies seek to address investor needs and stakeholder expectations, sustainability must be at the heart of their strategy. Pressure from across the investment value chain has reached a point where companies that fail to embrace and disclose effective ESG management risk limiting their value potential. At the same time, the first half of 2020 has driven home the importance and urgency of addressing the systemic social and environmental challenges afflicting society.

Over the course of this paper's development, both the COVID-19 pandemic and the expansion of the Black Lives Matter movement have laid bare some of the structural challenges of the current U.S. economic and social systems.

These include vast socioeconomic health disparities, the vulnerability of workers to sudden business downturns, the lack of severance pay and paid sick leave, inadequate childcare and insufficient unemployment insurance. These crises have also provided new perspective on environmental concerns, as lockdowns have resulted in reductions in air pollution and greenhouse gas emissions. Moreover, as the economy and society recover, investors, regulators and consumers will look to companies to show leadership in minimizing negative impacts and creating long-term, sustainable and inclusive value. By using the building blocks detailed in this brief as a guide, emerging public companies can lay the groundwork for demonstrating that they are part of the solution.

Notes

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