TREXIN
TRUST • EXPERIENCE • INNOVATION

WHY COMPANIES CONTINUE INVESTING INTO ESG

Many believed that corporate ESG efforts would be short lived, however going into 2023 companies have continued to invest in ESG efforts due to ESG's strong value proposition.

This article is the first of a multi-part series where Trexin will be diving into Environmental Social Governance (ESG), as we seek to explain the trend, how it benefits businesses, and how Trexin can help your business succeed with it.

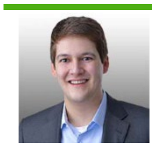
Seemingly regardless of the predictions that it was a fad, ESG has continued to gain in popularity with companies and investors in recent years; an especially impressive feat considering the headlines of war, plague, famine, and semiconductor shortages dominating the globe. In fact, more than 5,000 companies have made a net zero commitment as part of the United Nations' campaign "Race to Zero"[i]. There are innumerable theories out there as to why the ESG trend continues, but ultimately the simplest is the most likely, ESG is good for business. A recent meta-analysis by NYU Stern found that 58% of studies on the topic of ESG confirmed there was positive business financial performance tied to ESG efforts and that only 8% showed a negative impact[ii]! Not only were the studies overwhelmingly positive towards ESG efforts but they also became more positive the longer the time period they looked over, thus indicating that ESG efforts aren't just a flash in the pan but a genuine long-term benefit to adopters. This leaves perhaps the most important question unanswered though… why, why do ESG efforts lead to increased business performance? Ultimately the impact of ESG can be categorized into three categories: top line growth, bottom line performance, and x-factors.

Top line growth, or revenue in simpler terms is one of the most discussed topics in the corporate world especially from in the viewpoint of market share; companies are almost always looking at ways to expand the top line: expand into new markets, increase market penetration, launch new products, increase prices, etcetera. Research suggests that many of these growth methods can be enhanced or built around ESG efforts, for instance a recent study of consumers showed that 70% of customers would be willing to pay a 5% or greater premium for "green" products[iii]. Not only do customers show a preference towards buying ESG positive products in the lab but they have demonstrated it in the real world too; a study of over 1200 companies by Moore Global over the past three years found that companies focusing on ESG had their sales increase at twice the rate of firms which did not focus on ESG. Further evidence of consumer preferences for companies with strong ESG can be found in retention as well. Eighty-three percent of the surveyed companies who were focused on strong ESG reported improved customer retention[iv]. Sadly, the world is not all carrots though, sometimes it is sticks as well, just as 70% of customers indicated they were willing to spend more for "green" products, 43% of customers indicated they are willing to walk away from companies that do not meet their ESG expectations. Ultimately, this means that, all told, ESG efforts promote both growth for the top line and serve to protect revenue as well, because there is genuine revenue and market share risk to not investing in ESG too.

Bottom line growth can best be thought of as increasing profits, and in many cases, it is the end goal of a business. ESG efforts often find the most success in the bottom line, finding opportunities to drive efficiencies and reduce overall costs. Another interesting, and sometimes unexpected way in which having strong ESG performance can boost profits is by lowering the cost of capital. There are numerous studies on this effect, and it is estimated that companies with strong ESG scores have a 10% lower cost of capital than those without them[v]. When examined further this makes sense both from a risk management perspective and when looking at the amount of capital available; ESG – specific investment funds grew from $4 trillion to $12 trillion between 2012 and 2018, and about 1 in 4 new investment dollars now go into ESG funds[vi]. These dollars are only accessible to companies with strong ESG efforts. All told between increased efficiencies and a lower cost of capital companies with high ESG scores have 3.9 times the operating margin of companies with poor ESG performance[vii].

The final category of reasons ESG boosts financial performance are what are best referred to as x-factors; these factors don't cleanly fit into either top or bottom-line growth because they either affect both, or are sufficiently nebulous as to be too hard to directly study. The most talked about of these x-factors is greater talent attraction. Workers are increasingly looking to their employers to match their values and invest in the causes they care about. And, given the growing popularity of climate groups it is no surprise that ESG efforts are one of the top social causes workers look for these days. In fact, Moore Global found that during their study of over 1200 companies, companies with strong ESG efforts grew headcounts by 11% versus the 6.5% headcount growth experienced by other businesses[viii]. With how tight the labor market remains, and the premiums and difficulties companies are experiencing in attracting top talent, ESG can represent a surprisingly cost-effective way to get the best of the best employees, allowing firms to out-compete their peers. The second important x-factor to go over is also one of the most difficult to calculate, and that is the affect that strong ESG efforts can have on reducing regulatory and legal interventions. Regulatory and legal interventions are actually one of the greatest risks that many businesses face, and frequently one of the least talked about due to how nebulous they are. One recent study estimated that in the typical company 25-30% of corporate profits are at risk of state intervention, with that percentage rising to 60% for industries such as financial services and defense[ix]. In addition, it is increasingly clear that ESG causes are increasingly important to governments across the globe as a raft of potential new regulations have been proposed in recent years, such as Biden's proposed Federal Supplier Climate Risks and Resilience Rule. These proposed rules, along with general posturing from watch dogs and regulators plus the high amount of monetary risk involved for companies, suggest that any ESG move that would give a business the "benefit of the doubt" or directly appease concerns may well be worth the effort.

Between the top line growth, bottom line growth, and x-factors ESG can enable, it is no surprise that companies are increasingly choosing to invest in it. And that investment appears to be paying off, companies with high ESG scores have 2.7 times the total return than those with poor performance[x]. If your company is looking to expand, redevelop, or otherwise adjust their ESG efforts please feel free to visit Trexin's ESG Practice Area page and learn more about how we can help you with your journey. We will be back with part two of this TIP series which will be focused on ESG operating models and organizational ESG maturity.



This TIP was written by Duncan Goeden. Duncan welcomes comments and discussion on this topic and can be reached at duncan.goeden@trexin.com.

---

[i] Pérez, Lucy, et al. "Does ESG Really Matter--and Why?" *McKinsey & Company*, McKinsey & Company, 24 Oct. 2022, https://www.mckinsey.com/capabilities/sustainability/our-insights/does-esg-really-matter-and-why.

[ii] Whelan, Tensie, et al. "ESG AND FINANCIAL PERFORMANCE: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published between 2015 – 2020." Center For Sustainable Business, https://www.stern.nyu.edu/sites/default/files/assets/documents/NYU-RAM_ESG-Paper_2021%20Rev_0.pdf. Accessed 16 Jan. 2023.

[iii] Henisz, Witold, et al. “Five Ways That ESG Creates Value - Mckinsey & Company.” McKinsey Quarterly, McKinsey & Company, Nov. 2019, https://www.mckinsey.com/~/media/McKinsey/Business%20Functions/Strategy%20and%20Corporate%20Finance/Our%20Insights/Five%20ways%20that%20ESG%20creates%20value/Five-ways-that-ESG-creates-value.ashx.

[iv] Malik, Zoya. “$4 Trillion Increase in Revenue for Businesses Placing Greater Importance on ESG.” International Accounting Bulletin, 26 Sept. 2022, https://www.internationalaccountingbulletin.com/analysis/4-trillion-increase-in-revenue-for-businesses-placing-greater-importance-on-esg/.

[v] Rapier, Robert. “The Cost of Ignoring ESG.” Forbes, Forbes Magazine, 10 Dec. 2021, https://www.forbes.com/sites/rrapier/2021/08/25/the-cost-of-ignoring-esg/?sh=4a9baa353d28.

[vi] Lacy, Peter. “UN Global Compact Study: Corporate Sustainability.”, Accenture, 20 Oct. 2022, https://www.accenture.com/us-en/insights/strategy/ungcceostudy.

[vii] Gross, Pierre. “Opportunities and Challenges for Integrating ESG Risk into Existing Frameworks.” Financial Services Blog, Accenture, 11 May 2021, https://financialservicesblog.accenture.com/opportunities-and-challenges-for-integrating-esg-risk-into-existing-frameworks.

[viii] Malik, Zoya. “$4 Trillion Increase in Revenue for Businesses Placing Greater Importance on ESG.” International Accounting Bulletin, 26 Sept. 2022, https://www.internationalaccountingbulletin.com/analysis/4-trillion-increase-in-revenue-for-businesses-placing-greater-importance-on-esg/.

[ix] Henisz, Witold, et al. “Five Ways That ESG Creates Value - Mckinsey & Company.” McKinsey Quarterly, McKinsey & Company , Nov. 2019, https://www.mckinsey.com/~/media/McKinsey/Business%20Functions/Strategy%20and%20Corporate%20Finance/Our%20Insights/Five%20ways%20that%20ESG%20creates%20value/Five-ways-that-ESG-creates-value.ashx.

[x] Gross, Pierre. “Opportunities and Challenges for Integrating ESG Risk into Existing Frameworks.” Financial Services Blog, Accenture, 11 May 2021, https://financialservicesblog.accenture.com/opportunities-and-challenges-for-integrating-esg-risk-into-existing-frameworks.