The ESG bar has just been raised… Who will get over it?

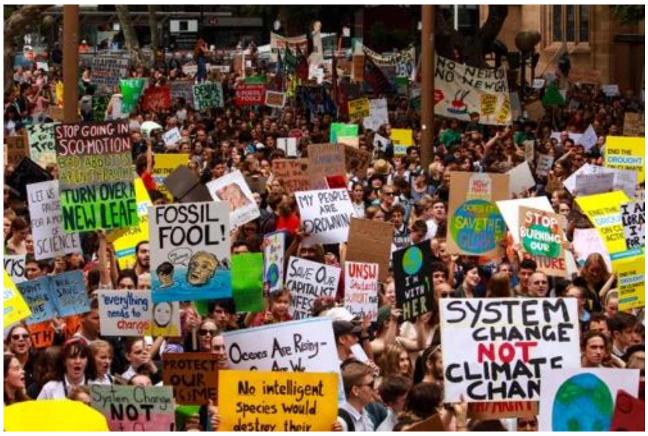
By Aldo Pennini, Associate Director, Strategia Worldwide

‘ESG’ has firmly established itself in the investor lexicon to describe the performance of investment portfolios against Environmental, Social and Governance (ESG) criteria and, importantly, the quality of their performance against measures that are reported to shareholders. This is a good thing because it is only in recent years that the investor community started to move beyond regarding ESG or sustainability in the extractives sector in particular as a ‘nice to have’, to a ‘must have’ in de-risking their investment decisions. However, the absence of standardised reporting guidelines, let alone a single universally accepted definition of ESG, make it difficult for investors and companies to identify what is important to report and how to measure positive impact.

The Financial Times’s Lexicon defines ESG as a generic term used in capital markets, and by investors, to evaluate corporate behaviour and to determine the future financial performance of companies. Company-specific ESG metrics offer a benchmark for investors to judge the overall quality of the board’s governance and risk management processes and their positioning within an industry sector. The growing interest in ESG from institutional investors, in particular, reflects growing pressure from shareholders, consumers, employees and wider society to show they are investing in solutions not problems. CEOs also realise that good ESG performance can safeguard their company’s long-term success by exposing them to a larger pool of capital and diversified investor base. In 2019, global sustainable investment topped $30 trillion - up 68 percent since 2014 and tenfold since 2004.[1]

Societal concern

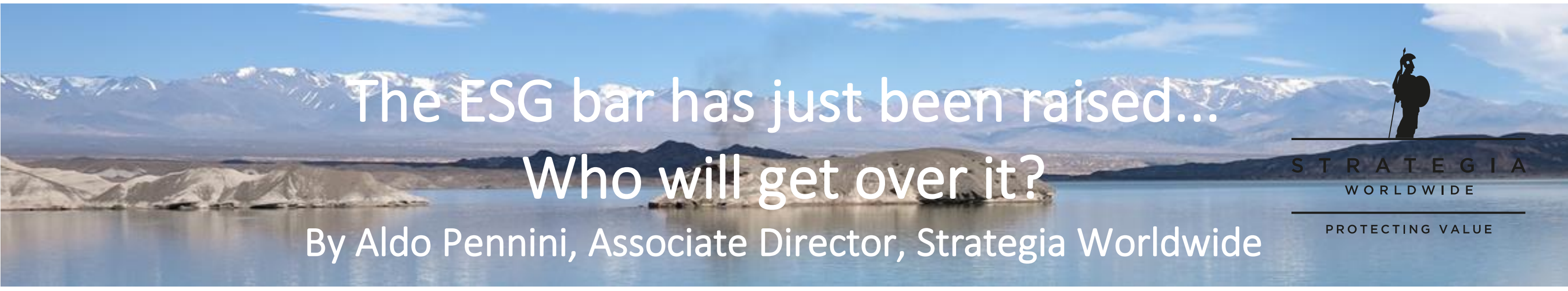
The backdrop to this shift in investor behaviour is growing societal concern over the negative impacts human activity is having on the planet and people. Climate change is at the forefront of these concerns. Social activism like the student protests led by Greta Thunberg; images of unprecedented global heating and weather events across the planet being seen on billions of television sets and hand-held devices; and the warnings of scientists and respected naturalists such as David Attenborough, are influencing public opinion. In turn, this is driving higher expectations for the corporate sector to address these challenges and to be held to account. The World Economic Forum’s Global Risk Report 2020 states that:



“For the first time in the history of the survey, climate-related issues dominated all of the top-five long- term risks by likelihood among members of the Forum’s multi-stakeholder … and members of the Global Shapers Community— the Forum’s younger constituents—show even more concern, ranking environmental issues as the top risks in both the short and long terms.”

[Source: http://www3.weforum.org/docs/WEF_Global_Risk_Report_2020.pdf]

1 Article – *Five ways that ESG creates value*, McKinsey & Co (Nov 2019)



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In the mining industry recent catastrophes, such as the devastating collapse of a tailings dam near the town of Brumadinho, Brazil, in January 2019, served to highlight the critical importance of getting ESG right if companies are to attract investment and retain their social Licence to Operate (LTO).

"Fatal environmental disasters, corruption and bribery allegations, polluting fossil fuel production. The global miners' roll call of shame is increasingly making the industry uninvestable at a time when demand for socially-responsible investments is booming."

Henry Sanderson and Neil Hume – 'Global miners count the cost of their failings'
[Source: https://www.ft.com/content/66965d68-2bc2-11e9-88a4-c32129756dd8]

Protecting value

Mining companies, to varying degree, are incorporating ESG as a priority at board and executive leadership level, but the industry as a whole still has some way to go to. Whether you are a 'junior' miner seeking investment or a 'major' listed company looking to protect value and reputation, ESG awareness and compliance is now an imperative at the highest level of the organisation. Poor external engagement can normally destroy 30% of value.[2]

"Over time, companies and countries that do not respond to stakeholders and address sustainability risks will encounter growing scepticism from the markets, and in turn, a higher cost of capital. Companies and countries that champion transparency and demonstrate their responsiveness to stakeholders, by contrast, will attract investment more effectively, including higher-quality, more patient capital."

Larry Fink letter to CEO
[Source - https://www.blackrock.com/uk/individual/larry-fink-ceo-letter]

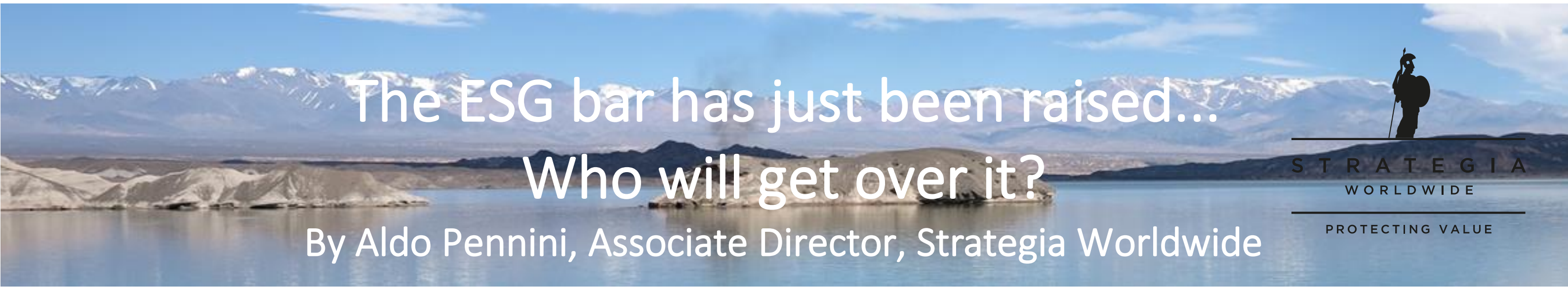
"How companies react this year will determine our actions in 2021: while our approach has always been driven by engagement over divestment, we will consider shifting capital away from non-responsive companies.

David Cumming, Chief Investment Officer for Equities, Aviva Investors
[Source - https://www.ft.com/content/ac9c2345-ed98-4f03-a537-b9926819b675]

Raising the bar

As access to capital becomes harder for the extractives sectors, competition for investment will require companies to move **beyond compliance** and to **demonstrate** to investors they are adopting 'good practice' that extends far beyond 'box-ticking'. The recent announcement by the International Council of Mining and Metals' (ICMM) of **'at mine site validation requirements'** is testament to this shift. The ICMM represents 28 of the world's leading mining companies and with this move they are sending a signal for the rest of the industry to follow. Its requirements seek to maximise the benefits of mining and metal production to host communities and minimise negative impacts to effectively manage issues of concern to society.

2 Article – *Five ways that ESG creates value*, McKinsey & Co (Nov 2019)



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ICMM's ten mining principles define good ESG practice through a set of Performance Expectations (PE) or standards, last updated and made public at the end of 2018. Validation of implementation of these expectations will, for the first time, take place at the site-level for all members' assets, involving a mix of self-assessments and independent, third-party assessments, coupled with transparent disclosure of the outcomes.

Although billed as an enhancement to existing PEs, it is a **significant 'raising of the bar'** with the ultimate aim of improving the sustainability performance of the mining industry. These new validation requirements will apply to all ICMM's 27 company members which manage almost 650 assets in over 50 countries, covering nearly half of the world's iron ore and copper production, and a quarter of all mined commodities. [Source: http://www.icmm.com/en-gb/news/2018/environment-and-human-rights]

"ICMM's Mining Principles will support our members to supply the increasing demand for metals and minerals, while giving confidence to customers and other stakeholders that they have been produced responsibly. We encourage all mining companies to embrace good practice environmental, social and governance requirements. Societal expectations of the mining industry encompass a broad range of environmental, social and governance challenges. Our aim has been to develop a holistic set of requirements that establish a benchmark for responsible mining practices."

Aidan Day, Chief Operating Officer, ICMM

[Source – ICMM media statement: https://www.icmm.com/en-gb/news/2020/icmm-enhances-memebership-requirements

In order to meet these new requirements mining companies will need to **establish expert at-mine-site assurance**, with a move away from annual 'spot-checks' towards continuous engagement that incorporates third-party stakeholders including non-governmental organisations (NGOs), local or indigenous communities, community and political leaders and other opinion formers. By making this information public, mining companies are taking a calculated risk that by exposing themselves to public scrutiny they will engender trust and enhance reputation, improve ESG outcomes and - by extension - business performance; and differentiate themselves as an attractive investment proposition.

Risk and opportunity

Investors tend to see ESG as a risk when they assess target companies, and these can be significant. Between 2008 and 2012 just 30% of precious metals projects were delivered on time, the main cause being social opposition, which accounted for 42% of project delays.[3] On the other hand, there is growing recognition that good ESG presents opportunities. Companies that perform well on ESG are more likely to generate long-term value. S&P 500 companies that ranked in the top quintile for ESG factors outperformed those in the bottom quintile by more that 25 percentage points between 2014 and 2018 with their stock prices being less volatile.[4]

[3] Article – *Precious Metals: Sustainability in a Rocky Environment*, Sustainalytics (1/5/2015)
[4] Article – *Does ESG Investing Produce Better Stock Returns?*, The Motley Fool (26/07/2019) [Source: Arabesque Asset Management]

Despite the cost implications of implementing at-mine-site assurance, there is a growing body of research that clearly demonstrates the value of good practice. Firms in the top quartile of ESG performance delivered growth approximately 40% faster than the averages of their industries.[5]

"What we've seen from our studies, is that not only does sustainable investing not require a discount, but it can actually help reduce risks"

Audrey Choi, CMO and Chief Sustainability Officer, Morgan Stanley

Conclusion

The mining industry has been grappling with the challenge of making the production of metals more sustainable for some time. Mining companies have, to varying degrees of success, made ESG part of their core business. Just as safety in the mining industry has over the past 20 or so years come to be equated with good business practice, so too is ESG today. The difference now is higher societal expectations on ESG performance and increasing pressure on companies from investors to improve performance through their investment ratings. Investors are on a path towards attributing a price to the industry's environmental impacts with the cost gradually shifting from society to the corporate bottom line. There is, however, a way to go, in trying to figure out how to set a price, particularly when it comes to measuring and putting a value on social impacts.

The shift in investor behaviour on ESG could signal the start of a virtuous cycle of responsible investing generating competition for capital based on good ESG performance. In the meantime, the raising of performance standards by the mining industry and requirement for independent and transparent validation at site-level are steps in the right direction. They provide the basis for driving improvements in performance across the sector, while helping investors differentiate between good and poor performers in determining where to place their capital.

[5] Article – *Does ESG Investing Produce Better Stock Returns?*, The Motley Fool (26/07/2019) [Source: RBC Global Asset Management]