ESG – An emerging important variable in investing and business

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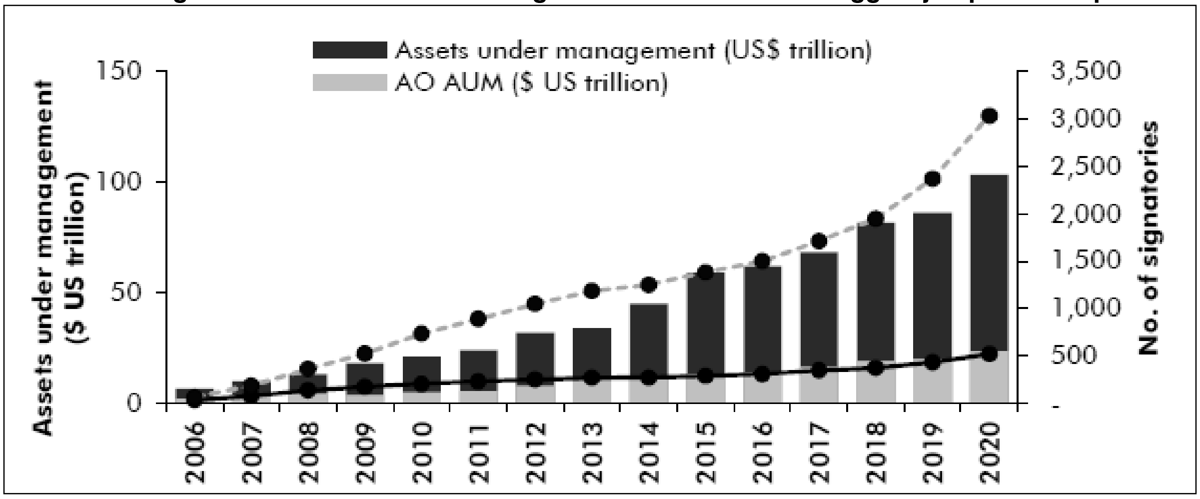
Rise in the number of PRI signatories

The Principles for Responsible Investing (PRI) is the world's leading proponent of responsible investing. PRI were developed in 2006, but from Mar 2020 to June 2021 the number of signatories increased from 2,766 to 4,113 - a 48% jump! While developed countries like USA and UK have been interested in ESG for a long time, responsible investing is gaining momentum in India post-Covid. In India, the number of signatories increased from 5 in March 2020 to 11 in June 2021. Overall, Covid-19 has fuelled the discussion around sustainable investing. Like global peers, India Inc. too has witnessed increase in management commentary around sustainability.

It is difficult to comment in the context of Indian companies that better ESG performance leads to better company performance and hence better shareholder returns. Whilst ESG funds have witnessed increasing flows in recent years, sharp spike in incoming funds or rising PRI signatories was seen post the Covid-19 pandemic struck the world. This probably explains why there is increasing attention to much softer aspects like E and S. This increased attention was possibly largely the reason that led ESG funds to perform better versus the broader markets in the last 1-2 years.

Exhibit 1: PRI signatories have been increasing since 2016 but saw the biggest jump after the pandemic

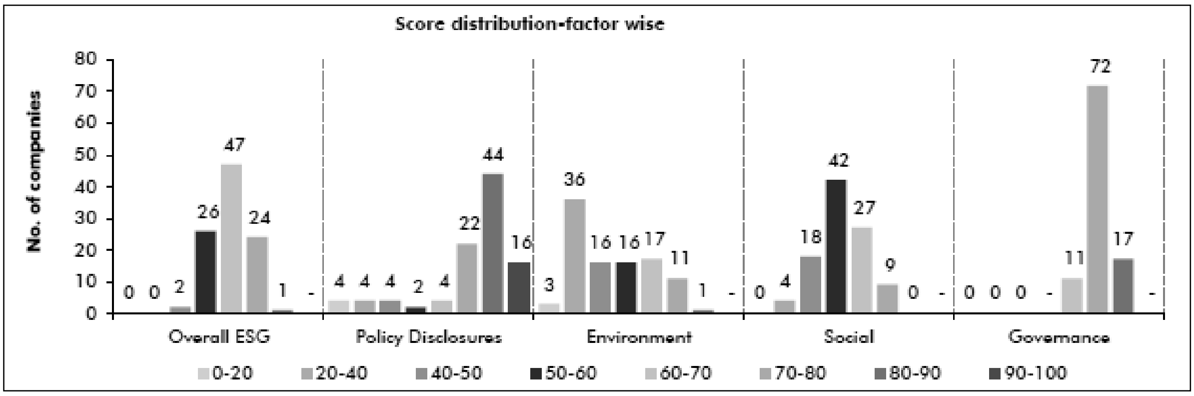


Source: PRI, Ambit Capital research, Company. AO= Asset owners; Total Assets under management (AUM) include reported AUM and AUM of new signatories provided in sign-up sheet that signed up by end of March of that year. Total AUM since 2015 excludes double counting resulting from subsidiaries of PRI signatories also reporting, and external assets managed by PRI signatories. AUM for previous years include some element of double counting. Asset Owners' (AO) AUM for 2014-2020 are based on reported information (and include double counting). AO AUM for 2007-2013 are estimates calculated using 2014 AO AUM data, growth rates for 2007-2013 from the OECD pension market focus report from 2015, and signing dates of signatories to the PRI.

Very early to do a meaningful ESG analysis of India Inc.

Whilst ESG investing has gained momentum, it seems very early to do a meaningful ESG analysis for India Inc. The disclosures are weak! Possibly regulatory push is essential and hence company scores are better on governance and policy disclosures where regulatory intervention is higher. Business Responsibility Report (BRR) does not provide mandatory regulatory push to provide disclosures on E & S. Lack of scrutiny from regulators, no standard formats, low historical data and lack of uniformity of data even by the same company YoY make assessment under E and S difficult. IT, cement and metal companies do well on ESG parameters.

Exhibit 2: A higher number of companies perform poorly (i.e. score below 60) on environment and social aspects; 90 out of 100 companies do well on governance parameters



Source: SES, Ambit Capital research, Company. Universe is top 100 companies (ex of PSUs) basis mcap at 31 Mar 20

Currently, out of top 100 companies (basis their mcap as at 31 Mar 20) in India, ~50 companies make voluntary sustainability disclosures. These voluntary disclosures take guidance from some global sustainability frameworks like Global Reporting Initiatives (GRI), International Integrated Reporting Council (IIRC), Sustainable Development Goals (SDGs) etc. Global standards essentially provide for more effective and meaningful insights into a company's sustainability initiatives. Current Business Responsibility Report (BRR) framework which the top Indian companies are mandatorily required to report in annual reports works more like a self-compliance checklist. Standardisation, comparability and transparency are the key challenges one faces while making ESG analysis for most companies.

Most companies seem to have not fully appreciated environmental risks and hence these don't reflected in the disclosures made for different environmental parameters. However, there is a broad understanding on respecting environmental concerns. There is lack of evidence of concrete steps taken to prevent environmental damage. Probably too much focus on companies which actually cause greater harm to the environment have led these companies to adopt better and more efficient practices. Surprisingly, cement companies, metal companies and IT companies are at the top because they adopted global reporting standards and better ESG initiatives. Pharma, banks and financials (excluding banks) score low largely due to lack of disclosures.

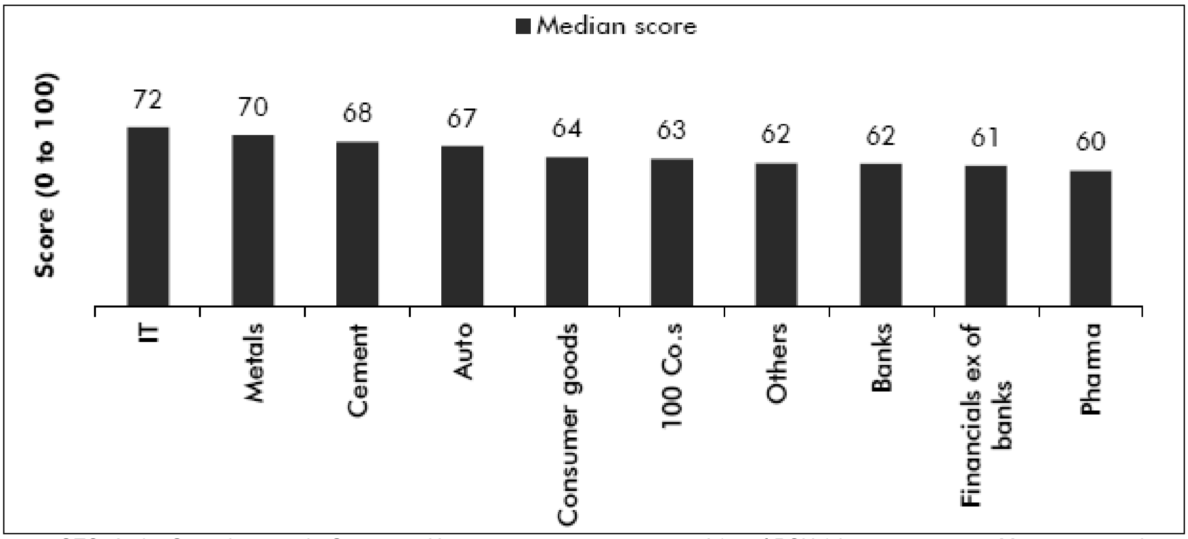
CSR is not necessarily the S in the ESG

CSR was probably largely understood only as a social parameter until now. Even the regulators have fixed CSR norms and made it mandatory for companies to do CSR spends. Naturally, scores of companies look better on parameters related to CSR. Nevertheless, there is a lot of scope for improvement on other social parameters related to workforce composition, employee health/safety measures and data security/privacy. For instance, on median basis, the proportion of women employees in the workforce is only 10%. IT companies and banks have higher strength of women employees, but also have higher instances of sexual harassment complaints. Most companies do not disclose details around third-party certifications on quality management systems or data security/privacy practices. Despite being mandatory, several companies do not disclose data on customer complaints. It is interesting to note financials ex of banks do very well on CSR activities over other sectors. Also, on social aspects cement, metals and IT companies are the top three performing sectors. Better workforce composition, community initiatives and product/ service quality aspects or customer orientation lead to higher scores for these sectors.

Good governance scores are an outcome of the last decade's multi-stakeholder initiatives

A string of regulatory measures and actions over the last decade have significantly brought some positive changes in governance practices; hence this is reflected in the governance scores of the companies. Auto, consumer goods and IT companies perform well on governance parameters. Out of all parameters related to governance, companies can make some improvement related to board composition. For instance, 20% of independent director (IDs) positions are held by individuals who are associated with the company for a period of more than 10 years. In a few cases the ID does not fit into the definition of ID in its true spirit. These exceptions get effectively captured in the framework which also recognizes true intent of law and hence have some scope for improvement. Governance analysis can be subjective and hence it is critical to know whether a particular practice by the company just ticks the box or actually holds the intent of law. In such cases, accounting quality checks can act as a first-level filter to gauge governance culture within a firm and hence should be coupled with regular governance parameters.

Exhibit 3: Companies from sectors like consumer goods, pharma, financials (ex of banks) have lower scores; IT, cement and metal companies do well



Source: SES, Ambit Capital research, Company. Universe is top 100 companies' (ex of PSUs) basis mcap at 31 Mar 2020. 0 is the worse score versus 100 is the best score. Consumer goods include FMCG, paints, consumer durables and consumer non-durables. Others include industrial manufacturing, services, oil & gas, construction, telecom, fertilizers & pesticides, power, textiles and chemicals

Surprisingly, cement and metals perform well

Overall, cement and metal companies perform well on the ESG framework despite being generally construed as having operations which are anti-environment. More regulatory push or attention has possibly forced these companies to adopt better ESG practices and disclosures. Most companies from other sectors have either still not fully appreciated the ESG initiatives or simply lack disclosures. Hence, ESG ranking will only evolve over time. A few laws have possibly shaped ESG disclosures in India. Until now the term ESG was interchangeably used with CSR; however as we witness ESG gaining momentum, Indian companies will have to take serious steps to improve disclosures typically on environment and social. Interestingly, SEBI came out with a detailed format (based on global standards) for sustainability reporting and made it mandatory for top 1000 companies starting FY23. Such disclosures are extremely critical for meaningful ESG analysis.

Exhibit 4: BRSR will significantly improve the quality of ESG reporting standards

Criteria	BRR	BRSR
Standardisation	High degree of subjectivity	Detailed guidelines and formalisation of reporting
Comparability	Inconsistency in qualitative and quantitative info	Standardisation facilitates time series analysis; lacks sectoral composition
Transparency	No checks on execution	Explicit responsibility to disclose certain aspects
Sustainability goals	No accountability or back tracing	Setting goals/ targets and measuring actual performance

Global standards	Lack comprehension and depth compared with global standards	Benchmarked against internationally accepted disclosure frameworks
ESG opportunities and risks	No view	Overview of material ESG risks and opportunities and their financial implications
Environment disclosures	Subjective disclosures/ No back testing/ Lack of quantitative data	Extensive, including – resource usage, emissions, waste management practises
Social disclosures	Few quantitative data points – lack comprehension	Extensive, including- social impact assessment (SIA), CSR, consumer complaints regarding data privacy, employee diversity

Source: Ambit Capital research, SES, Company

India Inc.'s slow pace on adoption of disclosures related to sustainable practices probably stems from its narrow understanding of issues around environment protection, employee welfare or stakeholder protection etc. Till very recently, the Business Responsibility Report (BRR) published by listed companies clearly lacked on several counts in terms of providing meaningful insights into the company's sustainability initiatives. Adopting global practices is not a new thing for India. India Inc. even lagged at the time of adoption of accounting standards. Currently, the Indian accounting standards (Ind-AS) are nothing but globally adopted International Financial Reporting Standards (IFRS). Similar to lagged IFRS adoption, SEBI very recently came out with a much detailed ESG reporting format (Business Responsibility and Sustainability Reporting - BRSR) for Indian listed companies. This format is essentially developed using different global standards already in practice.

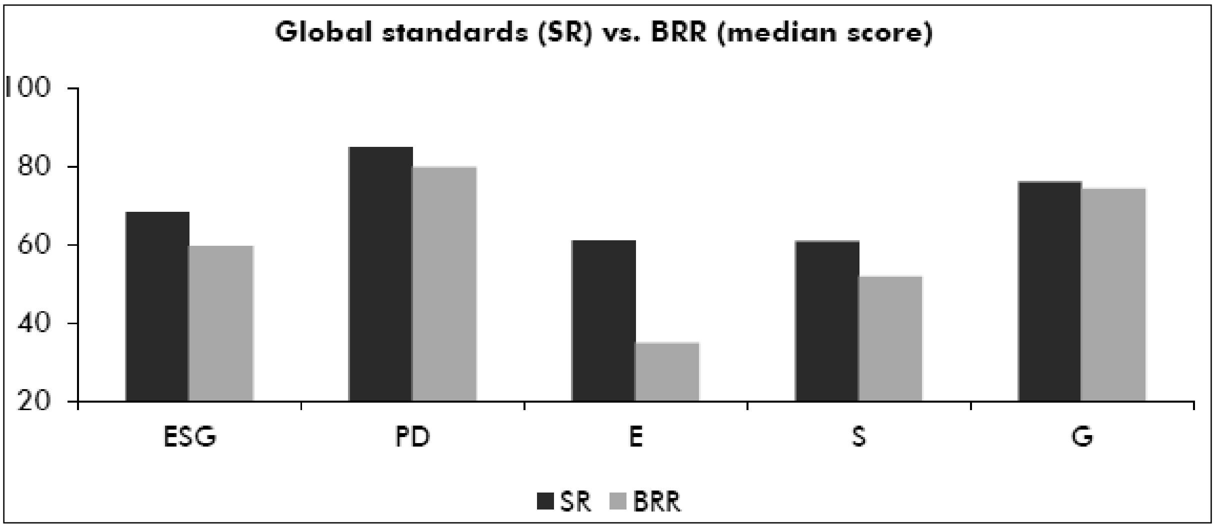
BRSR will improve disclosures and make analysis better

Business Responsibility and Sustainability Reporting (BRSR) will be applicable to the top 1,000 companies (basis market-cap). It will be voluntary for FY22 but mandatory from FY23. This is a substantial shift from erstwhile reporting norms for ESG. Erstwhile disclosures provided no meaningful insights into a company's ESG activities. Peer or time series analysis around ESG parameters was almost impossible. Moreover, it was very difficult to validate a company's sustainability goals and performance against the same. Also, it lacked a comprehensive and explicit consideration of all ESG parameters. Addressing these challenges, BRSR explicitly requires disclosures on a wide range of parameters on E/S/G. Onus is on the company to identify ESG risks/opportunities and disclose plans to mitigate or adapt these risks along with financial implications of the same. On most paramaters, details are required for the current year and the previous year. Simply putting it, companies will have to gear up as SEBI mandates the detailed disclosure format BRSR (Business Responsibility and Sustainability Reporting) for ESG reporting from FY23 for top 1000 companies. The new standard takes inspiration from global standards and puts onus on companies to make more meaningful ESG disclosures

A few are taking the lead in adopting global standards

There are ~50 companies out of the top 100 companies (basis mcap as at 31 Mar 20) which are making voluntary disclosures basis the global standards. If one plots the scores of companies which make such disclosures versus companies which make disclosures only under the old BRR format, one can observe that companies making voluntary disclosures perform very well typically on environment parameters in a comprehensive framework versus companies which make no disclosures. Companies voluntarily making global-level disclosures strongly convey their intent and underlying efforts on environment-related initiatives and hence come out better. Since BRSR is based on global standards, companies will have to make necessary shifts in practices and processes that have a negative impact on environment.

Exhibit 5: Companies that used international standards to report on ESG will obviously perform better



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