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ESG AS A BUSINESS PARAMETER

ESG is changing from a purely reputational factor to a complex business parameter. My colleagues and I at Grant Thornton estimate that ESG may become a significant business moment affecting every company within five years. That means ESG is an opportunity for "early adopters" to get ahead of the competition.

Terms such as sustainability, renewables, diversity, and equal treatment of employees, have recently become more prominent in the corporate lexicon. Companies are increasingly concerned with their reputation and are trying to present themselves in a 'green' and 'community' way. All this is ESG (environmental, social, and corporate governance), but it is becoming much more.

FROM REPUTATION TO BUSINESS SUSTAINABILITY

The current focus of companies on ESG is primarily on sustainability reporting. It responds to pressure from customers who expect companies to behave responsibly towards their surroundings. Many companies do some environmental activities, but these have not gone in depth. In principle, companies try to "look nice" in their activities.

But this situation is beginning to change. ESG will soon become a matter of survival for every company. Business partners and banks are starting to evaluate business sustainability. Those who begin changing their 'ESG performance' will get a head start on the competition. And those who neglect sustainability may have problems. The time is not far off when banks consider ESG as a parameter for financing. Many projects will not be profitable due to higher interest rates, and some will not get funding at all. Therefore, companies must start managing ESG risks today and work on sustainability as a new business model.

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ALONGSIDE CREDIT RATING COMES ESG RATING

A new step is the introduction of ESG rating of companies and financing in the context of sustainability. There is not yet a universal framework for ESG rating. Ratings are provided by independent agencies (Moody's, Bloomberg, Robecco-Sam), each with its non-public methodology. In any case, there is a general consensus that the ESG criteria (ecology and sustainability, people and relationships, leadership, and management) will become the key monitored parameters for ESG rating.

Carbon footprint is the most well-known indicator in measuring the environmental burden. However, firms should not only fixate on direct emissions. Indirect and supply chain emissions also calculate a firm's carbon footprint in an ESG rating. In addition, metrics such as Consumer Perception Index CPI, Pay Gap, Fair Trade, GDPR, and cyber-security audits will help assess a company's social policy. Also, systems for reporting corruption and encouraging civic activism for corporate governance will be part of ESG indicators.

THE IMPACT OF ESG ON ACCESS TO FINANCE WILL GROW

Banks today, by default, assess the credit quality of companies and the level of business risk through indicators from financial statements when considering operating or development financing. However, in the medium and long term, ESG will enter their risk models as one of the risk indicators. If a firm has a lower ESG rating, it will be a riskier client in the eyes of the bank, which will affect its capital adequacy requirement. It will have to reckon with a higher cost of credit to compensate for the higher risk. And it might result in a refusal to finance a firm.

This change will not come suddenly. Instead, banks and other capital providers will gradually start to analyze the ESG reporting of companies. As a result, high-quality ESG reporting and adjusting the company's activities with sustainability in mind will become necessary for companies.

Like any change, ESG reporting also brings opportunities, as it serves a dual function. Firstly, it shows stakeholders that the company cares about its activities' sustainability and environmental impacts. At the same time, it sets a mirror for management to see their sustainability margins and helps to identify and address risks or adapt to new conditions early enough. Even though today there is no established structure and content for ESG reporting, companies cannot be mistaken if they describe their activities done in this matter.

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THE FIRST STEP IS TO IDENTIFY RISKS AND MEASURE PROGRESS ON ESG

An essential first step for companies is to have a sustainability analysis prepared. Such an analysis identifies ESG risks, considers the likelihood of their occurrence and potential impacts, and sets performance indicators for the firm to measure progress in ESG categories. ESG analysis is part of the services portfolio at every top consultancy.

Some companies are already putting ESG at the forefront and aligning their business to these criteria. For example, the ZSE Group has set ambitious internal targets for the electrification of company vehicles, energy efficiency in buildings, and customer solutions, including offering green electricity and supporting the installation of photovoltaics and heat pumps. In the building sector, ESG is already in demand for energy efficiency in buildings. In the future, companies will likely favor new, sustainable buildings over old ones when it comes to financing.

In retail, ESG criteria will increasingly favor online sales. However, this can potentially leave a much smaller carbon footprint if companies can sustainably build the entire supply chain. The result could be a shift to a more sustainable business. An example is the Velits brothers' Slovak brand Isadore Apparel, which focuses on producing quality sportswear from ethically sourced, locally farmed merino wool. Biodegradable material combined with online sales results in a sustainable business with a minimal carbon footprint.