ESG, moving beyond the box tick

A discussion paper

August 2022

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1: Executive summary

Environmental, social and governance (ESG) factors have evolved rapidly over a relatively short time frame. Global ESG assets, now calculated at approximately $35tn, will likely surpass $41tn by the end of 2022 and $50tn by 2025.[1] These assets now comprise one-third of the projected total assets under management (AUM) globally. ESG has become of such importance to capital markets that by 2020, 88% of publicly listed companies, 79% of venture and private equity-backed companies and 67% of privately-owned companies[2] had already put initiatives in place.

This discussion paper sets out in general terms what ESG is and how the theme is developing from the perspective of corporate and financial market engagement. The paper outlines the current model of engagement and how the regulatory landscape is developing, detailing the challenges companies face in assessing and disclosing ESG risks. Additionally, the paper explains the role of ESG ratings and assesses what the future of ESG may look like, while considering relevant purpose, strategic focus and capacity constraints.

This discussion paper is not a comprehensive summary of the current ESG landscape. Instead, it introduces the key topics of note, within the context of the fast-changing environment, and will outline core touchpoints designed to spark further discussion.

2: Introduction

Sustainability is a choice, a conscious decision to look beyond near-term profit and consider our future impact on the planet and on society. The concept of ESG is not new. It is a further development of sustainable finance. A rebirth of socially responsible investing (SRI) 30 years ago in the early to mid-1990s saw a move away from investment in industries perceived to have negative social effects, like alcohol, tobacco, fast food, gambling, pornography, weapons, fossil fuel production and the military.[3] This followed on from the 'green' movement of the 1960s and 1970s, which was fundamental in establishing the US Environmental Protection Agency (EPA) and the Clean Air Act. In the mid-1800s, the conservation movement developed the US National Parks and laid the groundwork for future environmental legislation. The genus of ESG though, can be found as far back as the 1700s, in the work of clerical environmentalists like John Wesley, who believed that 'we ought not to gain money at the expense of life, nor at the expense of our health.'

The term ESG was first proposed over 15 years ago (although initially the acronym was GES). This version was rejected, as 'environmental' needed to be prioritised and there were concerns 'social' considerations would become marginalised after 'governance'. The acronym's main purpose was to promote consideration of environmental, social and governance factors in capital market thinking, on the premise that doing so made good business sense. The objective was to create more sustainable markets and, ultimately, better outcomes for societies. These efforts were followed up by the 2005 publication of the 'Who Cares Wins' report,[4] which became the springboard for the creation of the UN supported Principles for Responsible Investment (PRI). Despite these initiatives, for years financial institutions were slow to embrace ESG, arguing that their fiduciary duty was limited to the maximisation of shareholder value. Milton Friedman argued that because a CEO is an 'employee' of a company's shareholders, he or she must act in their interest and focus on giving them the highest return possible.

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1 Bloomberg

2 https://www.perillon.com/blog/esg-statistics

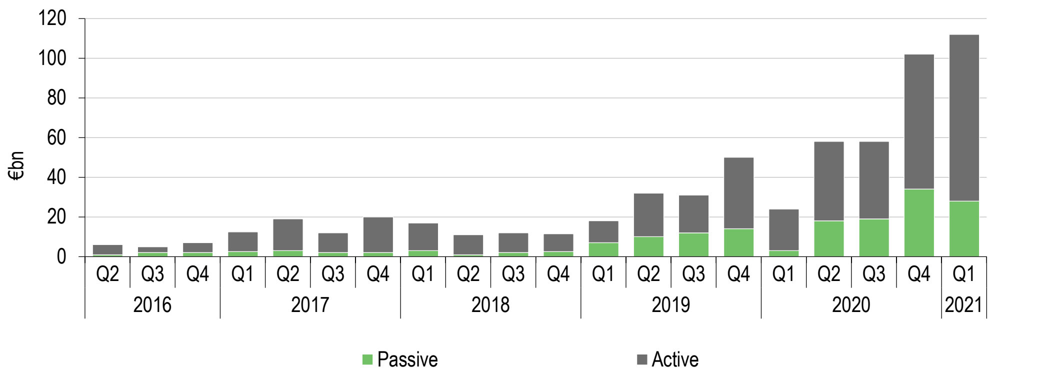
3 https://en.wikipedia.org/wiki/Socially_responsible_investing#cite_note-2

4 https://www.ifc.org/wps/wcm/connect/de954acc-504f-4140-91dc-d46cf063b1ec/WhoCaresWins_2004.pdf?MOD=AJPERES&CVID=jqeE.mD

Fast forward to 2019 and The Business Roundtable, representing 200 large American companies including Apple, Pepsi and Walmart, issued a statement[5] saying the purpose of a corporation should no longer advance only the interests of shareholders. Instead, companies must also invest in their employees, protect the environment and deal fairly and ethically with their suppliers, considerations very much at the heart of ESG.

In 2022, ESG is now one of the top considerations for corporate and investment strategies. This stratospheric rise has been fuelled by client and consumer demand alongside a genuine desire to make a positive impact. It has also become self-evident that effective ESG engagement can help better inform the strategic development and business models for many large organisations. As engagement momentum continues to gather pace, investors are evolving ESG strategies, moving away from rudimentary screening towards more targeted, sophisticated approaches, which includes more focused thematic and impact investing.

Exhibit 1: Quarterly European sustainable fund flows 2016–2021



Source: Morningstar

Global ESG assets, currently calculated at around $35tn, will likely surpass $41tn by the end of 2022 and $50tn by 2025[6] – one-third of all projected total AUM globally. By 2020, 88% of publicly listed companies, 79% of venture and private equity-backed companies and 67% of privately-owned companies[7] had already put ESG initiatives in place. Breaking this growth down geographically, there is a significant split between ESG engagement at the company level in developed markets versus developing markets. Using MSCI's ratings of a company's exposures to ESG risks and the ability to manage risks relative to peers, companies receiving a AAA rating in developed markets numbered 130 versus only seven in developing markets. Within this, Europe has a higher concentration of stocks with a high ESG score than other developed markets like North America. This is not surprising given Europe leads the rest of the world in ESG frameworks, standards and regulation.

While ESG engagement has been led by large companies, an increasing number of small to medium companies are beginning to engage with ESG issues, or, perhaps more accurately, are looking at ways to understand and integrate the key tenets. Research from a recent survey[8] of UK based small and mid-sized listed companies shows that more than three out of four (77%) now have a formal purpose statement related to ESG. Almost one in five (18.5%) are already referencing ESG standards or frameworks, like the UN Sustainable Development Goals (UN SDGs), Global Reporting Initiative (GRI), or the Value Reporting Foundation (a merger between

[5] https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans

[6] Bloomberg

[7] https://www.perillon.com/blog/esg-statistics

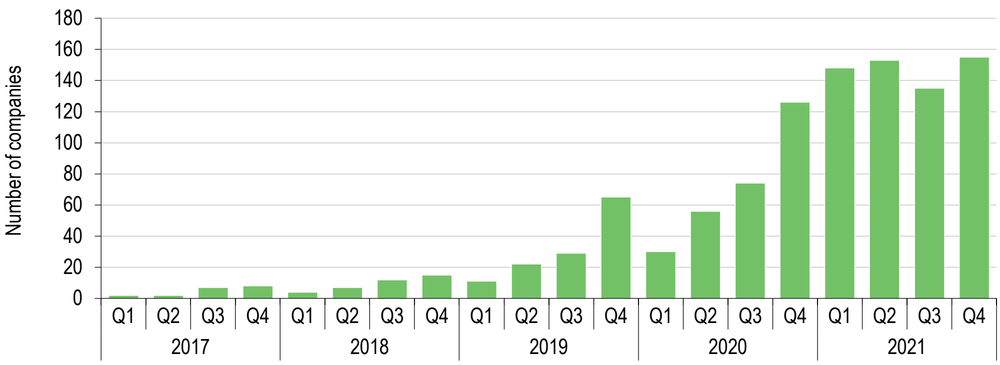
[8] https://centaur.reading.ac.uk/94646/1/QCA_Research_Report_ESG_in_Small_and_Mid-Sized_Quoted_Companies.pdf

Sustainability Accounting Standards Board (SASB) and International Integrated Reporting Council (IIRC)).

These findings are significant because smaller companies are typically 'late market adopters' of new business trends and unlike their bigger contemporaries, they do not face the same early phase regulatory imperative. When it comes to reputation, smaller companies garner less attention and have smaller footprints, so consequently face less pressure to effect change than their larger peers. Typically, smaller companies usually only adopt trends when it becomes a financial imperative, balancing the need to manage less in-house resource and capacity. These developments illustrate the growing importance of ESG. Considering its effective integration is an integral part of the business ecosystem, in the same way as safety or compliance, and the case for adoption is to be commended and further facilitated, no matter how small the company.

In Q421, nearly one in three S&P 500 companies, 156 or 31%, conducting earnings calls cited the term ESG during their discussions on financial results.[9] This was the highest overall number of S&P 500 companies citing ESG on earnings calls over the last 10 years. The previous record was 153, which occurred in Q221, which doubled the Q320 record of 74 companies.

Exhibit 2: Number of S&P500 companies citing ESG on earnings calls (5 years)



Source: Factset

Despite this laudable mainstreaming of ESG, there is some way to go if we are to collectively achieve the original goals of fully integrating ESG into capital markets. On the plus side, there is now little doubt that companies understand the concept and the need to prioritise engagement. A UK based study[10] found that 73% of companies understand the positive impact that ESG integration can have on their long-term financial performance, while 85% of asset managers say ESG engagement now is a high priority for their respective companies.[11] Much has been written on the value that focusing on ESG can deliver to a company; the concept is important to investors and customers, who are closely intertwined.

Companies that demonstrate strong ESG engagement through targeted programmes, policies and risk management perform better, both operationally and strategically. As a result, they will be looked upon more favourably by capital markets, receiving more competitive lending terms and reducing their weighted average cost of capital (WACC), and ultimately they will see an increase in enterprise vale. From a consumer and business customer perspective, having a progressive ESG narrative is important; there are now high expectations regarding transparency, accountability and ethical products and services. Focusing on a wider set of stakeholders is good not only for people and the planet, but also for long-term profitably with the help of more sympathetic capital markets.

9 Factset

10 www.theqca.com/article_assets/articledir_442/221356/QCA_Research_Report_ESG_in_Small_and_Mid-Sized_Quoted_Companies.pdf

11 www.indexindustry.org/esg-survey/

This is the virtuous cycle former UN secretary general Kofi Annan and the creation of the term ESG was looking to unlock in 2006, although as mentioned earlier, there is much work to do.

3: ESG value drivers

As the concept matures and enters the mainstream, ESG should now be considered an important part of business strategy and, by extension, investment analysis. The individual tenets – environmental, social and governance – are inextricably linked, so it can be misleading to isolate specific underlying metrics like remuneration, employee safety, waste management or energy efficiency and assess each as an isolated consideration. A company may have a phenomenal record on employee safety, but be completely ineffectual on waste management. Good governance sits at the heart of an effective ESG corporate strategy. This means boards being able to demonstrate a deep understanding of the key ESG drivers specific to their business and being progressive in identifying and addressing potential issues. For example, ensuring openness and transparency with regulators, or getting in front of violations before they occur, must be company-wide practices. To be a good company, an organisation will need both solid governance and strong ESG engagement. It is incumbent on boards to understand the key metrics relevant to their business.

Since the mid-1970s, over 2,000 studies have analysed the relationship between ESG and corporate performance. One study[12] published in 2015 found that the business case for ESG investing was empirically well founded, while approximately 90% of the 2,200 studies found a non-negative ESG to corporate performance correlation. More significantly, a majority of the studies reported positive findings, also discovering that a positive ESG impact on corporate performance remains stable over time. This research is supported by significant work done more recently by George Serafeim at Harvard Business School, which strongly links purposeful activity with improvements in productivity and performance, driven by employee engagement. Purpose does not have to come at the expense of profitability; in many cases, it can be a driver of outperformance.

Author John Elkington reached similar conclusions in 1994 when he published his triple bottom line theory,[13] stating that companies could do well by doing good and equally prioritising their impact on people, planet and profit. The evidence is clear, both theoretically and empirically, that effective ESG engagement has a direct, verifiable impact on enterprise value, from facilitating top-line growth, reducing costs and minimising regulatory interventions, to increasing employee productivity and optimising investment and capital expenditures.

In EY's 2022 CEO survey, 82% of respondents viewed ESG as a value driver to their business. Furthermore, 73% of respondents stated that their company engaged with ESG for strategic purposes, such as to lower the cost of capital, a figure up from 43% in 2020.

The impetus behind this greater engagement comes largely from three main drivers: rapid development in regulatory frameworks; consumer sentiment and employee preferences; and greater shareholder and lender ESG focus. Financial institutions themselves are also responding to increasing regulatory and client pressure. In response to this shifting landscape, understanding where an effective ESG strategy can drive value enhancement is hugely important.

[12] Gunnar Friede, Timo Busch & Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies, *Journal of Sustainable Finance & Investment*, 5:4, 210-233, DOI: 10.1080/20430795.2015.1118917

[13] https://www.johnelkington.com/

Exhibit 3: Value enhancement through ESG engagement

	Strong ESG engagement (illustrative)	Weak ESG engagement (illustrative)
Top-line growth	■ Attract customers with more sustainable products ■ Achieve better access to resources through stronger community and government relations	■ Lose customers through poor sustainability practices ■ Lose access to resources (including from operational shutdowns) as a result of poor community and labour relations
Cost reductions	■ Lower energy consumption ■ Reduce water intake and waste	■ Generate excessive waste and pay higher waste-disposal costs ■ Expend more in packaging costs
Regulatory and/or legal interventions	■ Achieve greater strategic freedom through deregulation ■ Earn subsidies and government support	■ Suffer restrictions on advertising and point of sale ■ Incur fines, penalties, and enforcement actions
Productivity uplift	■ Boost employee motivation ■ Attract talent through greater reputational credibility	■ Deal with reputational risk, which restricts talent pool ■ Lose talent as a result of weak purpose
Investment and asset optimisation	■ Enhance investment returns by better allocating capital for the long term ■ Avoid investments exposed to longer-term environmental issues	■ Suffer stranded assets as a result of premature write-downs ■ Fall behind competitors that have invested to be more energy efficient

Source: McKinsey, 2019, Net Positive (Paul Polman, Andrew Winston)

Top-line growth opportunities

Customer expectations have shifted. Recent research[14] by Cone Communications found that 88% of consumers will be more loyal to a company that supports social or environmental issues, while a PWC[15] study found that 76% of consumers will stop buying from companies that treat the environment, employees or the community they operate in poorly. Both studies illustrate the importance to customers of positive ESG engagement and demonstrate the negative impact of not prioritising sustainability considerations.

Cost reductions

Implementing effective ESG policies can significantly reduce capital expenditure and operating expenses, particularly in areas involving raw material or resource use. Adopting ESG principles leads to better management and the minimisation of increasingly expensive, depleting resources, like water and energy. Effective waste management is now an important consideration, with ever tighter regulatory constraints and increasing demand for efficient and sustainable disposal and control.

Businesses that fail to adequately consider metrics like resource and waste management can expect to pay more in securing funds for capital expenditure. In a four-year study conducted on this issue, MSCI found that companies with stronger ESG engagement were more likely to experience lower costs of capital, lower equity costs and lower debt costs, compared to companies with poorer engagement.

Regulatory and legal interventions

Comply or die may be a bit of an exaggeration, but the sentiment is not far from the truth. It will become increasingly essential for companies to get ahead of ESG regulatory requirements and communicate their progress; boards and senior management teams need to understand the ESG themes and be the change makers that investors, consumers, activists and regulators expect. Companies also need to understand how the various disclosure mandates are shaping up so they can address stakeholder concerns and respond to new disclosure guidelines and requirements. Those who take the lead on addressing regulatory issues can expect greater strategic freedom and potentially government support (which in some cases could be in the form of subsidies or favourable tax regimes).

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14 https://www.cbd.int/doc/case-studies/inc/cs-inc-cone-communications-en.pdf

15 https://www.pwc.com/us/en/services/consulting/library/consumer-intelligence-series/consumer-and-employee-esg-expectations.html

80% of the world's largest companies are reporting exposure to physical or market transition risks associated with climate change.[16] Many of these disclosures were not originally mandatory, but it made business sense for companies to start reporting risks on a voluntary basis. Businesses that wait to be pushed will risk jeopardising strategic control and could suffer reputational risk as a result. Mandatory ESG disclosures are still outnumbered by voluntary disclosures, but this will undoubtedly change. Climate disclosures, which are at the forefront of environmental disclosures and rapidly solidifying into mandatory releases, illustrate that organisations must ensure they are in a position to comply with the necessary requirements. As of July 2021, the London School of Economics reported 73 examples of climate change litigation in the UK. This figure was before many mandatory disclosure requirements were put in place. The number of ESG reporting provisions issued by governmental bodies has grown 74% over the last four years; there are now nearly 400 reporting provisions across 80 different countries included in the study.[17] Ignoring these developments would be foolhardy; ensuring compliance with ESG goals will become an even bigger priority.

Productivity uplift

A Marsh McLennan study found that companies with the highest employee satisfaction had ESG scores 14% higher than the global average, likely due to their strong environmental performance.[18] Moreover, satisfied employees work harder, remain loyal and are more willing to go the extra mile to produce better results for the company. The same study found that the companies most attractive to young professionals possessed ESG scores that were 25% higher than the global average. This creates a virtuous circle, as prospective employees strengthen a company's talent pipeline and ensure the availability of desirable, qualified and motivated human capital. Companies are struggling to navigate the global talent shortage and effective ESG engagement would provide a competitive advantage and serve to engage today's employees and attract future talent.

Investment and asset optimisation

Businesses must understand the relevance of the ESG landscape to ensure their strategic direction enhances investment returns via better allocation of long-term capital. To do this, boards and senior management must make investment decisions that take ESG issues into full consideration. Environmental change is particularly consequential and companies with assets vulnerable to major climate events like earthquakes, typhoons and other extreme weather phenomena are increasingly more exposed to damage and increased costs. Climate-related weather events are expected to cost businesses $1.3tn by 2026.[19]

Fixed assets like buildings are more exposed to potential damage, but building materials are advancing, as are smart modelling tools that can highlight an asset's strengths and vulnerabilities, and technology that can gather data about specific resource uses. Cutting-edge materials can future-proof new builds and projects, but data and detailed analysis will be the key to attaining more resilience when it comes to protecting existing stock. Becoming more data-driven could therefore help to drive value and prevent the accumulation of stranded assets.

The impacts of climate change are a growing threat to life on earth as well as company assets. Boards and senior management must address these threats by prioritising climate resiliency, reducing exposure to potential risks and playing a proactive role in investment and asset optimisation. With 80% of the world's largest companies reporting exposure to physical or market

16 S&P Global

17 https://www.carrotsandsticks.net/reporting-instruments/?status=Forthcoming&status=Current

18 https://www.marshmclennan.com/esg-interactive.html

19 https://www.cdp.net/en/research/global-reports/transparency-to-transformation

transition risks related to climate change[20] it is imperative for businesses to make appropriate investment and asset optimisation plans to mitigate the effects.

DISCUSSION: Companies require a better understanding of material issues and need accurate advice on the ways ESG can impact their businesses, so they can put a strategic roadmap in place.

Bearing in mind the main value drivers behind the ESG push, what areas of the business are most likely to be affected if more action is not taken to integrate ESG goals into strategy? Which of these areas is it important to prioritise first when it comes to adjusting the approach to ESG, and what strategies best fit the business when it comes to the bottom line and future vision?

4: Regulatory landscape

ESG frameworks, standards and regulation have come a long way over the last five years, but there is still a pressing need for greater uniformity and standardisation. Government policy and regulation act as the preeminent drivers of ESG developments. In 2021, there were at least 34 regulatory bodies and standard setters undertaking official consultations across 12 different markets. This has created significant demand for a global convergence of standards; the IFRS Foundation announced the formation of the International Sustainability Standards Board (ISSB), at COP26 in Glasgow. The initiative is a consolidation of the Climate Disclosure Standards Board and the Value Reporting Foundation and will include the Integrated Reporting Framework and SASB standards, by June 2022.

Global ISSB standards will elevate sustainability standard setting to match the level of financial reporting, promoting transparency and consistency in sustainability disclosures to better inform decision making. The pressure on companies to comply is increasing dramatically and repercussions for non-compliance are significant, including large fines, poor publicity leading to loss of public trust and a detrimental impact on revenue. Most companies recognise the importance of this and many now see the need to understand regulatory developments as a core part of successful ESG engagement.

It is crucial that ESG efforts reach beyond tokenism; while many large companies set sustainability goals and published ESG-related data in 2021, investors, regulators and the public are exercising greater scrutiny of corporate sustainability efforts, calling out what they perceive as superficial engagement, commonly termed ‘greenwashing’. Much of this stakeholder scepticism is based on concerns that companies are using disclosures and sustainability-related labels on products and services as a marketing tool, to appear more proactive than they actually are. Shareholder activism has increased significantly recently, combating token ESG engagement. The most notable example of significant shareholder activism is Engine No. 1’s campaign[21] to gain four board seats (ultimately it won three) at ExxonMobil, to pressure the company to minimise its environmental impact, impose greater long-term capital allocation discipline and implement a strategic plan for sustainable value creation.

Regulatory developments have both accelerated the focus on ESG and formalised the way company management and investors have assessed and disclosed against their company ESG credentials. As regulatory developments continue, understanding areas of priority and risk

20 S&P Global Market Intelligence

21 https://reenergizexom.com/who-is-engine-no-1/

exposures will become a much more important consideration for companies; new regulations and reporting standards will demand more credible corporate disclosures.

The European Union has been at the forefront of global ESG regulation. New global ESG-related standards will continue to evolve throughout 2022 and, hopefully, standard-setting bodies like the newly formed ISSB will address what is arguably the largest obstacle to accountability: the lack of a baseline for disclosure standards across jurisdictions and industries. This will be challenging, as illustrated by the current regulatory workstreams in process listed in Appendix 1, but as ESG becomes an increasing priority, it is a goal that is worth striving towards.

DISCUSSION: There is a need for greater clarity and standardisation when it comes to regulatory requirements, along with better organisation. Data needs to be simplified and readily accessible and easily updatable.

Where is the organisation at in terms of compliance and how can it improve performance so it stays ahead of regulatory requirements? What tools and frameworks entering the picture can help the business flexibly respond to fast-changing regulatory requirements and what is most urgent to consider when it comes to current shifts? Is there a danger that standardised ESG disclosure becomes solely a box-ticking exercise?

5: Disclosure challenges

ESG integration and engagement is challenging as there is no 'one-size fits all' approach and significant inconsistency continues to exist in the way different companies report their ESG data. This is an issue commonly cited by financial institutions trying to analyse ESG integration and performance. From a company perspective, historically ESG assessments were time-consuming and costly, leading to uncertainty and subjectivity in how companies prioritised and reported certain metrics. Understanding the 'what, why and how' to disclose is not straightforward and there can be sectorial differences in terms of ESG maturity, knowledge and drivers, as well as the degree of integration and disclosure.

Ask 100 companies to define ESG and there may be a high correlation of answers, but ask those same companies what ESG metric they prioritise and the responses may differ drastically. This variance will depend on size, sector, regulation and the competitive landscape, as well as reference frameworks and existing levels of engagement. A Harvard Business School study of 50 randomly selected Fortune 500 companies identified over 20 different ways the studied companies reported employee health and safety data. As the metrics were not necessarily measuring the same thing, it was difficult to assess which company was the top performer in relation to health and safety.

To date, agreement on key metrics and reporting frameworks for environmental factors has crystallised more rapidly than for social factors. By the end of 2022, we could see an increasing convergence on the data, metrics and reporting requirements most relevant to social issues, alongside a rising pressure to ensure these metrics measure impact, not just inputs.

There is typically a disparity between the size or sector specificity of companies and the quality of disclosure they make. By way of illustration, the top 100 UK companies are significantly more likely to disclose climate change-related information and provide greater detail than companies in the top 250.[22] Some of this discrepancy is due to a variance in data collection and reporting. A pertinent example of this relates to climate commitments and emission disclosures. At the most

22 https://www.clientearth.org/media/wbglw3r3/clientearth-accountability-emergency.pdf

basic level for example, it is imperative to understand and differentiate between scope 1, scope 2 and scope 3 emissions when assessing carbon accounting.

Scope 1 measures ‘direct emissions’ from resources owned and controlled by the company, including emissions from the company’s own facilities and vehicle fleet. Scope 2 refers to ‘indirect emissions’ generated from purchased energy, or utilities, encompassing all greenhouse gas (GHG) emissions from the consumption of purchased electricity, gas, heat and industrial refrigeration. Scope 3 emissions cover all emissions generated throughout the entire corporate value chain, including all aspects of the business beyond physical assets and people operations, which are defined as scope 1 and 2 risks. All ESG risks, including climate-related, social capital, human rights and governance risks, apply to third parties as scope 3 risks.

Having this knowledge is essential to making more accurate disclosures and this is a fact borne out by reliable, consistent and transparent data. ClientEarth,[23] an environmental law non-profit, found that while 31% of 250 companies assessed clearly disclosed a target to reduce their GHG emissions in alignment with the goals of the Paris Agreement, ‘net-zero’ objectives or ‘science-based targets’, 15% of companies surveyed failed to disclose information about their scope 1 and scope 2 GHG emissions. Though 40% of companies clearly referred to climate change in their discussion of principal risks and uncertainties, just 4% of the 250 companies reviewed made a clear reference to climate change-related factors in their financial accounts.

Many companies appear to lack confidence in the quality of the ESG information they and their peers disclose. The Quoted Companies Alliance 2020 survey found that small to mid-sized UK companies rated themselves lower than their investors across five disclosure categories: environmental; social capital; human capital; business model and innovation; and leadership and governance. Environmental data was perceived as the worst measurable and corporate governance and leadership the best.

While voluntary self-disclosure is understandable from the perspective of proactive regulatory intervention, it has not helped build confidence in ESG data. In some ways, the heterogeneous, dynamic nature of ESG has advantaged larger companies, which have been able to more readily simultaneously engage across different facets of sustainability. This outcome can be attributed to a number of reasons.

By virtue of their greater economic impact, there has been a greater onus on larger companies to effect positive change by taking action such as signing up to sustainability-linked pledges and commitments. Larger companies also have greater resources and the capacity to engage more readily, whereas small and mid-sized companies struggle to engage at anywhere near the same extent. Even without the same regulatory obligation or competitive thrust, the majority of small to mid-sized companies just have not been in a position to engage to a similar degree.

The impetus for firms to improve how they report their ESG data is likely to ramp up, especially as mandatory disclosures are now partially in place. Climate-related disclosures are leading the charge, as noted in the ‘Regulatory landscape’ section above. From 6 April 2022, over 1,300 of the largest UK-registered companies and financial institutions will be required to disclose climate-related financial information, using guidelines from the Task Force on Climate-Related Financial Disclosures.

By taking this step, the UK has become the first G20 country to make it mandatory for its largest companies and financial institutions to report on climate-related risks and opportunities. The UK government’s intention is to assist businesses, investors and directors to ‘better understand the financial impacts of their exposure to climate change, and price climate-related risks more

[23] https://www.clientearth.org/media/wbglw3r3/clientearth-accountability-emergency.pdf

accurately, while supporting the greening of the UK economy'.[24] The creation of more uniform standards and regulations should streamline ESG reporting, consigning the 'kitchen sink lob everything in' style reports to the recycling bin of history.

There is a further development in environmental disclosures looming on the horizon, in the form of the Taskforce on Nature-Related Financial Disclosures (TNFD). Continuing the work of the Taskforce on Climate-Related Financial Disclosures (TCFD), the TNFD's goal is to provide a framework for organisations to assess and report on risks and opportunities from biodiversity loss and ecosystem degradation; improving the availability of data and information will enable organisations to integrate nature-related risks more accurately into their decision making. Like its forerunner, the TNFD is an international cross-sector, market-led initiative, funded by government and philanthropic partners, and backed by G7 and G20 political leaders. It has 34 members drawn from the private sector along with a secretariat of industry experts. This latest development has yet to reach the inbox of many companies, but there is strong appetite from governments and regulators to accelerate the adoption of nature-related mandatory disclosures, using TNFD guidelines, as soon as practicably possible.

It is clear we are now at a point where box-ticking disclosures will no longer suffice. The future focus will be on crafting strategies to embed relevant ESG factors into business strategy, while embracing shareholder capitalism. Doing so will require bold leadership and decisions, as well as a willingness to increase resources and capacity. Companies will need to make greater investment in ESG intelligence organisation-wide, and will have to have the foresight to strategically plan, so they can proactively address future ESG shifts that could affect the business.

Discussion: ESG needs to become more than an ad-hoc or once a year manual reporting exercise, it must morph into an ongoing program that is integrated into company strategy, continuously tracked and improved upon. Where will the capital for this increased investment in ESG engagement come from? Will investors tolerate potentially higher near-term operating costs (and therefore lower returns) from an ever-increasing ESG burden on companies?

What is the current standard of disclosure reporting that has been consistently reached by the organisation, and what are the strengths and weaknesses that can be built on or improved? How can the organisation more accurately identify relevant future ESG trends, so it can pivot and plan accordingly, and how much more investment in ESG expertise should it make?

6: ESG ratings

As ESG has gone mainstream, ratings have played an unjustifiably significant and often arguably detrimental role. As demand for greater ESG engagement has grown, so has the need for the relevant metrics and data needed to populate ratings. Voluntary self-disclosure has been a driver of this; ratings methodologies have been developed to provide comparison and context to financial institutions. Yet the ESG data disclosed by companies is largely unstandardized. Often it is also unstructured, difficult to compare and in need of more interpretation.

Some metrics are used universally, like energy productivity, GHG emissions, water usage, waste management, pension fund status, supply-chain transparency, employee turnover and diversity. But

[24] https://www.bankofengland.co.uk/prudential-regulation/publication/2022/june/the-bank-of-englands-climate-related-financial-disclosure-2022

as there is still no unified approach across all metrics, the average ESG audit can take months to complete and prepare, while the end result remains uncertain in terms of accuracy.

Search for the five largest companies in the world by revenue and every list is the same, yet look up the most responsible and there is typically no agreement. In 2018, only one company made it into the top five of both Barron's 100 Most Sustainable Companies and Newsweek's Top 10 Green Companies. When looking at a company's credit rating, there is an almost perfect correlation between how different ratings agencies evaluate them, but between a company's various ESG ratings, the correlation is approximately halfway between perfect and zero. This is no surprise, given that ESG factors are typically assessed using nonfinancial, voluntary data. As the large ratings companies stressed recently, in response to a recent academic paper,[25] ESG ratings are currently considered no more than opinions and so should not be treated as settled facts.

ESG engagement requires additional technical capacity, and companies and financial institutions must navigate this fragmented, still evolving landscape. Corporates must understand the 'why, what, how' of ESG risk assessment and disclosures specific to their business. Gathering, analysing and reporting on relevant ESG data is incredibly challenging and requires significant resources, investment and expertise. Though many smaller companies recognise the importance of ESG and have a genuine appetite to engage, they are mostly still at the start of their journey. Committing to initiatives and using frameworks like the GRI or standards like the Value Reporting Foundation (a merger between SASB and IIRC) are encouraging steps, but this still requires management, which is difficult for smaller companies to allocate.

Due to the vast breadth of ESG metrics, combined with individual companies' often ambitious goals for improvement, progress must be made incrementally. Every organisation will be at a different point on the journey; prioritising the most important goals first is essential. Though companies have to be ready to adapt, they must define short-term (one to two years) and long-term (three to five to 10 years) goals for ESG aspects of the business.

Accountability and progress will be critical to success and transparency; organisations must disclose their baseline and goals, then regularly disclose their progress. There are various options for choosing where and how to disclose, but as ESG programmes mature, annual ESG reports for consumers and investors will become the norm.

Due to the over-reliance on ESG ratings by companies and financial institutions, an inverted relationship with the proverbial tail (ESG ratings companies) wagging the dog (corporates and investors) has been created. There is an insatiable demand for ESG engagement, coupled with a serious lack of standardisation, and ratings have played an integral, albeit possibly deleterious, role in the mainstreaming of ESG engagement.

Businesses and investors craving clarity and uniformity have been drawn to ESG ratings. ESG adoption has grown rapidly, but this has seen an increasing number of companies and investors over relying on ratings to obtain a 'uniform' third-party assessment of ESG performance. 3,038 investors representing over $100tn in combined assets have signed a commitment to integrate ESG information into their investment decisions. Asset managers using ESG strategies are seeing significant fund inflows, while companies are under greater pressure than ever to benchmark themselves against their peers.

ESG ratings have been used as a shortcut to demonstrate and measure ESG performance, shaping the market. This market disfiguration has been further compounded by the increasing reliance of academic studies on ESG ratings for empirical analysis (eg Servaes and Tamayo, 2013; Flammer, 2015; Liang and Renneboog, 2017; Lins et al., 2017; Albuquerque et al., 2018).

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[25] Florian Berg, Julian F Kölbel, Roberto Rigobon, Aggregate Confusion: The Divergence of ESG Rating, *Review of Finance*, 2022; rfac033, https://doi.org/10.1093/rof/rfac033

ESG ratings agencies appear to dictate which metrics are referenced, with an avalanche of competing questionnaires being sent out to companies for completion. S&P, for example, send out a questionnaire that takes approximately 200 hours to complete.[26] Companies must ensure that the metrics they are using to measure their ESG performance are most relevant to their businesses and support their underlying goals of reaching predetermined sustainability targets. This requires a detailed knowledge of the 'whats, whys, and hows', but it is an effort worth undertaking; significant value can be created by taking a proactive stance to ESG engagement.

DISCUSSION: Due to the vast array of ESG measurements, a set of specific, relevant reporting metrics and guidelines need to be agreed upon and established within the organisation, with senior executive buy-in.

What ratings are being used to currently measure ESG performance and what metrics are most relevant to the business? Are there ways to sharpen up evaluation so it more precisely reflects the company's performance and how could the way ESG is audited by the company be improved, so that it is more accurate? Historically asset managers outsourced their ESG research and analysis of portfolio companies to a third party, thereby placing the costs of compliance and disclosure on the underlying companies. Should the investors bear more of the costs of this compliance as seems to be happening post the release of the *Sustainable Finance Disclosure Regulation (SFDR)?*

7: ESG 2.0

Companies need to understand that ESG and the ecosystem that feeds it are changing, so they can prepare to adjust accordingly. As businesses become more engaged and allocate greater resources and capacity to ESG, there will be more clarity over which metrics are relevant to specific businesses, sectors and geographic locales. This will enable greater transparency and better quality of both input assessment data and output reporting data. Greater uniformity in frameworks and standards, coupled with the move towards compulsory reporting, will address many shortcomings of the current ESG ecosystem.

There is no doubt ESG ratings will undergo significant shifts over the coming years, whether due to regulatory overhaul, a data revolution or even user revolt. As ESG engagement becomes more bespoke and considered, generic ratings will become less prominent and tick boxes will no longer be the norm. The companies that will be rewarded by investors tomorrow will be the ones who approach ESG holistically and plan out long-term strategies aligned to the business's purpose and goals.

If integrated properly, ESG will have implications for almost every aspect of the organisation, from human resources, risk management and compliance, through to public relations and the management of the supply chain. Ultimately, proactive ESG engagement will be key to the success of a company overall and, looking ahead, it will be a major differentiator. Pressure from governments, regulators, investors and employees will only intensify in the coming years, until the destructive effects of our continued economic activity – fossil fuel burning, unsustainable land use, overfishing and deforestation – show signs of slowing down or reversing.

Data will also play a big role as ESG continues to evolve. Without improving the quality and frequency of ESG data, investors will struggle to discern between assets that genuinely contribute or at a minimum do no harm, versus assets that appear to contribute but actually do not. Being able

26 S&P employee

to accurately collect, collate and disseminate data will be essential, and as technology advances, machine learning and AI will enable smarter data analysis that provides much deeper insight.

Certain segments of ESG are already seeing these developments and there will undoubtedly be more down the line. The potential live reporting of environmental outputs and social standards will be a game changer, letting investors and other stakeholders work from a new risk framework that takes real market drivers of time into consideration. Having the ability to draw direct comparisons between a company's ESG performance and its profitability or cost of capital objectively will usher in a sea change when it comes to the way ESG is integrated into business.

DISCUSSION: ESG is inevitably evolving and companies will have to adapt accordingly, if they are to be compliant, meet customer, client and stakeholder expectations, and become more ethical. Suppliers and customers will also be evolving, so companies will have to engage in ways that go beyond 'what do we have to do because we are told to?' to 'what do we want to do because it is the right thing to do?'

As ESG evolves, how can the business adjust its approach, so social, environmental and governance goals become drivers of value? How much does the organisation need to develop its ESG approach, to get from where it is now to where it wants to be? Who should ultimately take responsibility for the ESG policy? Is it a newly created executive role (the chief sustainability officer (CSO)), or is it the CEO, Chairman, Senior Independent Director (SID) or other? How does this play out for smaller resource-constrained companies?

Conclusion

ESG is now a top priority for businesses, driven by a combination of consumer and stakeholder pressure to address social, ethical and environmental concerns. It is no longer believed that purpose has to come at the expense of profit; now it is well-established that strong ESG engagement correlates positively with performance.

Drivers of ESG engagement

Research has shown that companies that have a high ESG engagement outperform their peers in a number of areas: from boosted top-line growth and productivity; better compliance with regulatory requirements; improved asset optimisation; to more effective cost reduction.

ESG is now viewed as a value driver for the business, with small to mid-sized companies looking to engage. This enthusiasm is driven by regulatory framework developments and greater stakeholder prioritisation, as well as consumer and employee sentiment.

If companies focus on improving their ESG engagement, they will find they will be able to meet consumer expectations and alleviate stakeholder pressure, as well as navigate issues like asset protection in the built environment and the global talent shortage.

Regulatory landscape

Inconsistency of ESG metrics and reporting has been one of the biggest hurdles to greater accountability so far, and there are now moves to create a common baseline for disclosure standards across industries and locales.

The formation of boards, such as the ISSB, will raise sustainability standard setting to the level of financial reporting, ensuring more consistency within disclosures.

ESG efforts must go beyond greenwashing and reports must accurately reflect a company's ESG engagement and impact. New regulations and standards will force corporate disclosures to become more credible; companies will have to ensure they can meet this bar to avoid the impact of non-compliance, including a loss of public trust.

Disclosure and reporting

To date, ESG assessments have been laborious and expensive, with huge variance between how different businesses prioritise and report certain metrics. The metrics used by each company vary depending on their engagement, as well as business size, sector, regulation and reference standards.

There is still a lack of knowledge when it comes to particular areas; if ESG reporting is to become more accurate, terms such as scope 1, 2 and 3 have to be better understood.

Though they are now interested in the concept of ESG, small to mid-sized companies struggle to access the resources and capacity needed for effective ESG engagement and disclosure. Despite this, the pressure on all firms to become more accountable and improve their ESG reporting will only increase, particularly as mandatory disclosures become the standard.

ESG disclosures are becoming compulsory, starting with climate disclosures, with the UK becoming the first of the G20 countries to mandate reporting for its largest companies and financial institutions. Organisations must prepare to ensure they are in a position to enable compliance, as climate, then other disclosures, become mandatory.

Ratings

As ESG engagement has increased and businesses and investors have craved consistency, an over-dependence on the data and metrics used to populate ratings has developed. Yet because the ESG data disclosed by many firms is often unstandardised and the metrics used vary from company to company, these ratings are often inaccurate and remain little more than opinions.

Ratings have been used as a shortcut to demonstrate engagement and this has distorted the market. Investors and consumers are now sceptical of companies' engagement with sustainability; to make more accurate disclosures, firms must ensure the metrics they are using are relevant to the business.

Where are we headed?

Businesses are becoming more engaged with the concept of ESG, and as they do are coming up against a need to allocate greater resources and capacity to the underlying considerations. This increased engagement means that there will be more clarity as to which ESG metrics are relevant to specific markets, sectors and geographic areas. Along with advances in analytics, AI and machine learning, and the development of regulatory frameworks, this will cause transparency levels to improve and will boost the quality of both input assessment and output reporting data.

Many of the current issues plaguing the ESG ecosystem will be refined by the establishment of new global standards for ESG metrics, set by newly formed bodies such as the ISSB, as well as by the push towards mandatory disclosures. As companies become more data-led, this will further boost the process, allowing businesses to gain greater visibility over their raw and unstructured ESG data.

The ESG ratings system will morph significantly over the next few years, due to regulatory shifts, technological developments and user pressures. ESG engagement will become more customised, as companies and financial institutions move beyond tick boxes and ratings. But also there will be growing calls to include greater impact measurement. Current ESG engagement primarily focuses on reducing harm, but there will be a need to go beyond this lense to begin creating solutions.

Being able to accurately demonstrate strong ESG engagement will give companies a huge competitive advantage in the future marketplace; if they invest in ESG now, they will be able to use it as a major value driver for the business.

Appendix: Regulatory summary

European Union

The European Securities Market Authority (ESMA) published its Sustainable Finance Roadmap to ensure the coordinated implementation of the ESG mandate for 2022–24, identifying three key priorities:

1. tackling greenwashing and promoting transparency,
2. building national competent authorities' and ESMA's capacities in the sustainable finance field, and
3. monitoring, assessing and analysing markets and risks.

ESMA also published a timeline[27] on the steps in the implementation of the Sustainable Finance Disclosures Regulation (SFDR) and related affected regulations SFDR, Taxonomy Regulation, Corporate Sustainability Reporting Directive (CSRD), Markets in Financial Instruments Directive (MiFID), Insurance Distribution Directive (IDD), Undertakings for the Collective Investment in Transferable Securities (UCITS) and Alternative Investment Fund Managers Directive (AIFMD).

The Project Task Force on European Sustainability Reporting Standards (PTF-ESRS) of the European Financial Reporting Advisory Group (EFRAG) has released three additional working papers[28] on the first draft standards on sustainability reporting.

The European Commission (EC) published a draft proposal[29] of a new Corporate Sustainable Governance Directive, aiming to foster sustainable and responsible corporate behaviour and to anchor human rights and environmental considerations in companies' operations and corporate governance.

The European Banking Authority (EBA) published a report[30] analysing the recent developments and challenges of introducing sustainability in the EU securitisation market. The report examines how sustainability could be introduced in the specific context of securitisation to foster transparency and credibility in the EU sustainable securitisation market and the EBA recommends adjustments to the proposed EU Green Bond Standard.

The Platform on Sustainable Finance (PSF) has submitted a final report[31] to the EC setting out proposals for the structure of a social taxonomy. The PSF proposes a structure for a social taxonomy within the present EU ESG legislative.

FinDatEx (Financial Data Exchange Templates) has officially published two final templates: the first version of the European ESG template (EET V1[32]) and the related update to the European MiFID

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27 https://www.esma.europa.eu/system/files_force/library/sustainable_finance_-_implementation_timeline.pdf?download=1

28 https://www.efrag.org/News/Project-572/EFRAG-publishes-today-the-next-set-of-PTF-ESRS-Cluster-Working-Papers

29 https://ec.europa.eu/info/business-economy-euro/doing-business-eu/corporate-sustainability-due-diligence_en

30 www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2022/1027593/EBA%20report%20on%20sustainable%20securitisation.pdf

31 https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/280222-sustainable-finance-platform-finance-report-social-taxonomy.pdf

32 https://findatex.eu/mediaitem/db1f6f28-927e-4b84-bab1-1a2741a89431/20220314%20-%20EET%20V1.0%20-%20final.xlsx

Template (EMT V4[33]). FinDatEx recommends the delivery by product manufacturers as of 1 June 2022.

The three European Supervisory Authorities (ESAs), which include EBA, ESMA and the European Insurance and Occupational Pensions Authority (EIOPA), published a joint report recommending actions to ensure the EU's regulatory and supervisory framework remains fit-for-purpose in the digital age.

ESMA launched its Simple, Transparent and Standardised (STS) Register for the notification of securitisation under the Securitization Regulation, which entered into force on 1 January 2019. This register will allow originators and sponsors to benefit from an enhanced notification system.

FinDatEx published the European PRIIPs (packaged retail and insurance-based investment products) Template (EPT) v2.0 to incorporate the necessary changes based on the revised PRIIPs regulatory technical standards (RTS). The products sold from January 2023 onwards will use this new version of the EPT.

FinDatEx published an updated version of the Solvency II Tripartite Template (TPT v6) incorporating minor error corrections. V6 can be used concurrently with v5 starting 31 March 2022; full cutover to v6 is recommended starting 30 June 2022.

ESMA is launching a common supervisory action (CSA) with national competent authorities (NCAs) on the application of costs and charges disclosure rules under MiFID II across the EU. This CSA will be conducted during 2022 and will focus on the information provided to retail clients.

ESMA published an opinion to proposed reforms to the EU money market funds (MMFs) regulatory framework. The proposal aims to improve the resilience of MMFs by addressing liquidity issues and the threshold effects for constant net asset value MMFs.

The EC published a targeted consultation on options to enhance the Suitability/Appropriateness Framework (as part of MiFID II review).

United States

The US Securities and Exchange Commission (SEC) has unveiled Proposed Climate Disclosure Rules[34] with the release of its long-awaited proposals for climate disclosures for US public companies. This proposal aims to require that for the first time, US public companies provide certain climate-related information in their registration statements and periodic reports. This would include Form 10-K disclosures on climate risks facing their businesses and plans to address those risks, along with various metrics detailing the companies' climate footprint including scope 1, 2,[35] and in some cases scope 3[36] GHG emissions. The SEC proposes that these first disclosures would be made by larger companies in 2024, based on fiscal year 2023.The SEC has also released a fact sheet[37] on the Enhancement and Standardisation of Climate-Related Disclosures.

[33] https://findatex.eu/mediaitem/09373df3-12cf-4a4a-ae29-eea6f8567965/20220314%20-%20FinDatEx%20-%20EMT%20V4%20-%20final.xlsx

[34] https://www.sec.gov/rules/proposed/2022/33-11042.pdf

[35] https://www.epa.gov/climateleadership/scope-1-and-scope-2-inventory-guidance

[36] https://ghgprotocol.org/sites/default/files/standards_supporting/FAQ.pdf

[37] https://www.sec.gov/files/33-11042-fact-sheet.pdf

World

The Taskforce for Nature-Related Financial Disclosures (TNFD) published the first beta release[38] its Nature-Related Risk Management Framework for market consultation. This includes:

1. foundational guidance, including key science-based concepts and definitions,
2. disclosure recommendations aligned with the approach and language of the climate-related guidance developed by the TCFD, and
3. practical guidance on nature-related risk and opportunity analysis for companies and financial institutions to consider incorporating into their enterprise risk and portfolio management processes.

This launches the beginning of an 18-month process of consultation and development. The release of the final version v1.0 of the framework is expected in the third quarter of 2023.

The Global Legal Entity Identifier Foundation (GLEIF) published its verifiable LEI (vLEI) Ecosystem Governance Framework,[39] which defines the vLEI operational model and describes how the new ecosystem's range of vLEI issuing stakeholders will qualify for and perform their roles in the Global LEI System.

[38] https://framework.tnfd.global/

[39] https://www.gleif.org/en/vlei/introducing-the-vlei-ecosystem-governance-framework

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