ESG: AT A CROSSROADS

SIFA STRATEGY

With thanks to

PEEL HUNT

ESG Review 2023/24 Edition

The link between ESG and value creation is at risk of being lost.

"I think ESG is a very unhelpful phrase. It is too nebulous. It needs to be put in context of business, business priorities, and the sector it operates in. When it is specific you can drive accountabilities rather than a generic conversation on ESG."

"I don't like that all the language is driven by and is geared by large enterprise. There is very little thought as to what it means for small and medium enterprise even though they are the backbone of the economy. Someone needs to think about them when things like the ESRS are put in place."

"More companies should be brave. Some companies are scared to not answer the 999 questions even though they should only be answering the 9 that are important to them. It is about materiality and doing it properly."

"This is how we discuss it with our shareholders: 'we don't do anything on ESG that we only do because we need to tick a box because we're a listed company; we do it because it's good for the business'. We would be doing the same things if we were privately owned. What we try and do is what's right for the business and then try to explain to shareholder how that ticks their boxes. Whether that is in driving carbon, looking at biodiversity, social impact, or driving more community engagement."

"Shareholders don't really engage. It was a big topic about three years ago, but now we have ticked the box saying we have an ESG policy. The actual fund managers themselves are not particularly interested. I get the impression that it is someone in the back office just reviewing our accounts to see if it complies with whatever internal standards that they feel it has to comply with. They should be having a wider sustainable discussion and asking a 'how sustainable is your business model' question rather than asking us to answer very specific environmental questions."

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FOREWORD

This year we have looked at ESG as a business practice from the Boardroom perspective of small- and mid-cap companies. Our findings show that driving and implementing ESG initiatives remains a core part of Board and corporate activity. However, the approach to valuing ESG by corporates and the capital markets needs to evolve if the opportunity for positive impact and value creation is not to be lost.

Our third research report into ESG tracks the continuing shift in how ESG is being perceived. According to our findings, many Boards believe that the capital markets are failing to link corporate ESG efforts to performance and value, created by a sense that there is an overreliance on "tick-box" data. Too often there is demand for ESG data for data's sake, rather than for relevant data; or that questions are being raised on ESG purely to satisfy regulatory demands. Few Boards feel that there is any proactive analysis to identify or differentiate how successfully ESG is being embedded as a value driver within corporate strategy and operations.

There is no doubt that the cynicism from Board members towards ESG is in part linked to the current macroeconomic environment creating a more short-term approach for corporates and investors alike. Boards recognise that the long-term influence of ESG will return more strongly with a bull-market. This does not, however, detract from the immediate challenges being posed by ever greater demands for more disclosure and reporting, balanced against the resulting resource constraints that many companies face. This concern increases with impending regulations and guidelines such as CSRD, ISSB, and TPT, with many Board members having the sense that they have been created for the benefit of large companies with little consideration for the impact on the small- and mid-cap market.

Despite this frustration, this year's research shows that Boards and the executive management are 'getting on with it'. ESG is firmly on the Board agenda and companies are continuing to embed ESG within their businesses, with the understanding that it does and will have an impact on business performance, resilience, and valuation over the long-term. This is in part because Boards are looking to do what is right for the business, but also because stakeholder influence is changing. When we published our first research report in early 2021, the capital markets were the dominant stakeholder group driving the implementation of ESG programmes within organisations. Today, it is customers and employees, as companies strive to remain competitive in terms of their commercial decision-making and in attracting and retaining talent. As a result, while many companies may have initially delved into the world of ESG as an extension to their corporate responsibility or public relations, they are now continuing their efforts in recognition that it is right for their business, commercial performance, wider stakeholders, and the planet.

So, what does this all mean? It is clear that ESG and how it is approached needs to evolve. We have set out our general advice, on page 6, on how we think the small- and mid-cap market needs to respond to the findings of our research.

Overall, there is a need for corporates, as well as regulators, the capital markets and other industry practitioners, to enact change. We believe the small- and mid-cap companies have the opportunity to lead on this and to demonstrate what sustainable business truly is. As one of our interviewees noted:

> “We had an 'ah-ha moment' where the business said, 'we are not implementing a sustainability strategy, we are implementing a sustainable business strategy'; it's a small change in emphasis but meaningful nonetheless.”

We couldn't agree more. This approach will be critical for companies going forward. Too often, ESG is seen as a factor of cost and resource, when it can be implemented and measured as a return on investment.

Last but not least, we would like to thank all the Board members who participated in this research project for their invaluable time and input. With ESG as a concept being at a crossroads, it is vital that we share resources and ideas for the way forward. We hope that this report will provide a useful insight into the Boardrooms of the small- and mid-cap market. Please do not hesitate to be in touch to discuss the findings, implications, and potential solutions.

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KEY FINDINGS

43% of Boards view ESG as positively aligned with shareholder returns, a decrease from previous years, reflecting frustration with the capital markets' lack of meaningful engagement with corporates on ESG. The view from the Boardroom is that the capital markets are treating it as a tick-box, despite its importance, with short-termism potentially governing this approach. Proactive engagement will be welcomed with the focus being to find the balance between corporate responsibility and corporate profitability.

43%

Regulation is seen as having bypassed reality for the small- and mid-cap market, putting an undue cost and compliance burden on smaller corporates to keep up. While supportive of the intent, compliance pressures are distracting smaller companies from being able to actually do the work and enact change, with the end result instead being constraints to human and financial resources.

71% agree that the Board's role is to oversee, not to drive ESG. With this comes a challenge for the Board to understand its significant impacts, to trust and empower management to focus and deliver on the right areas, and to dare to step away from the box-ticking culture of yesteryear.

71%

The term 'ESG' needs to evolve. It needs to be better defined and set within the specific context of individual business' corporate strategy and purpose in order to drive value. It is seen by too many companies as a factor of cost and obligation and buckets too many vital aspects into one three-letter acronym. If you break out the material aspects of ESG to your business, and focus investment, time, and transparency in these areas, it can protect and drive value.

Materiality, while potentially onerous, is an opportunity to direct strategy and investment to more impactful issues. Beyond meeting impending regulatory requirements, if done right, it can enable management to identify and harness the specific elements of ESG which pose the greatest risk and opportunity and set these within the context of commercial viability. It is the antidote to over-reporting and death-by-data.

88% note that ESG should be a collective responsibility, in particular given how far-reaching the impacts are, how many aspects of a business it touches (if embedded properly), and the increasing regulatory burden. Boards are stepping up to the plate and are actively educating themselves and keeping up to date on developments. It is clear, however, that Boards value an understanding of business and how it might be impacted by ESG, over technical expertise in ESG itself, which can be brought in when needed.

88%

OTHER FINDINGS

Challenges to achieve data quality, traceability, and auditability, coupled with a lack of standardisation across international frameworks and guidelines, is making demands for ESG data and information hard to meet. While small- and mid-cap companies are taking a cautious approach to making external disclosures, regulation may force many into publishing data they are not fully confident in.

52% of Board members consider ESG as being 'very' or 'significantly' embedded within strategy, with no one scoring it as 'fully embedded'. While still a positive indication, it speaks to the challenge of operationalising and integrating ESG considerations into day-to-day operations and decision-making. For it to be effective, Boards argue that ESG should not be a separate practice, strategy, or reporting requirement.

Climate change and natural capital are rightly high on the agenda of newspapers, regulators, and investors. Greenhouse gas emissions and reducing environmental impact has become a particular area of focus, with companies being challenged, technically and strategically, to meet the Scope 3 challenge. It is important however, not to let the E crowd out the S and G.

Customers and employees continue to act as the driving force behind corporates implementing ESG, demonstrating ESG's significant role in a company's licence to operate and reputational value. Regulation has been successful in pushing responsibility for the planet further across the value chain, incorporating more corporates and stakeholders.

The role of Governments has added to the Board's frustration. Many Directors perceive that Governments are failing to be consistent and to take responsibility to drive meaningful change for climate and social challenges. The responsibility is passed to corporates to enact change seemingly without support or understanding for what this means for them or how short-term policy changes can impact capital allocation.

WHAT DOES THIS ALL MEAN FOR COMPANIES?

Clearly, every company's approach to ESG should be tailored to the Board and senior management's strategy and ambitions. Taking a general view, we have outlined our recommendations for how we believe small- and mid-cap companies need to respond to the challenges and dynamics that we have set out in our research report. Any approach also needs to take into consideration the raft of impending regulations, and the increasing role that data and AI will play in the future.

In summary, the responsibility lies across multiple stakeholders to ensure that ESG as a business practice can have the impact for which it was created. We need better clarity from companies on the identified areas for value creation, something we are seeing many small- and mid-cap companies make great headway with. What we also need is more understanding, flexibility, and engagement from regulators and capital providers.

This all sounds easy, but as one of our interviewees stated:

> “In the history of regulation and governance, tick-box has always won.”

Let's see.

OUR RECOMMENDATIONS

01

Materiality testing and improved disclosures will support value generation.

Without being over simplistic, we believe the answer lies firstly in clear and robust materiality testing. This will require a detailed and verifiable analysis exercise, but the output will enable management teams to better understand, implement, and communicate to all stakeholders where their core efforts in ESG are being made and where value creation opportunities exist. The results will need to be combined with the provision of transparent data that has been identified as relevant and material to each individual business, taking account of regulatory frameworks, and made accessible in a way which can be tracked by rating agencies and AI tools. We also believe that proper materiality testing will be a key step in evolving the mindset of management teams away from seeing the E and S as a cost to becoming a measurable return on their time and investment.

02

Separate and embed the important elements of the E, the S, and the G within strategy, operations, remuneration, reporting and engagement.

Materiality, if done right, will enable companies to move away from the singular term of ESG that implies simplicity and a siloed approach. The E, the S, and the G need to be broken down and better reflected into business strategy, operational performance, and financial reporting with clear identification of potential value creation. This will also support a stronger correlation between various elements of ESG and remuneration, which our research shows remains a challenge for many companies but is a key quality test for the financial community. There are a number of companies who have started to provide good analysis on materiality. The identified drivers of the E, the S, and the G are reported as part of ongoing operations as they become embedded into the business with targets that the management are being held to account on. These companies have a clear narrative and are gaining a better level of engagement with their stakeholders, especially the capital markets.

03

There needs to be more recognition and engagement from regulators and the capital markets.

Last but not least, the regulators, rating agencies and in turn, the capital markets must make more effort to consider the constraints on small- and mid-cap companies and enable them to differentiate themselves within ESG, rather than force them down a route of data uniformity. The efforts that small- and mid-cap companies are making in ESG need more recognition and feedback. At the moment, it seems as if the industry is being hamstrung by well-intended but overly onerous regulation and a sense that the capital markets, and many others, are simply box-ticking. As a result, it is easy to understand the frustration from the Board, if management time and financial resource are being put behind ESG, as demanded by the capital markets three or four years ago, when today there is little engagement or value attached to these efforts. If corporates do not experience more proactive engagement, there is a risk that some will back away from their E and S initiatives which will be detrimental to their long-term value, and responsibility to the planet and society.

THE TERM ‘ESG’ NEEDS TO BE BETTER DEFINED TO HAVE IMPACT

The term ESG was first coined by the United Nations Environment Programme Initiative in 2005, though its roots date back much further. Despite over 19 years of more formal existence, it is still finding its feet with many arguing over its application and definition. What is clear, however, is that it is a dynamic and constantly evolving discipline, which as the planet continues to get hotter and as social issues magnify, is being challenged to become more impactful, more defined, more understood, and more widely applicable.

The term has gained particular prominence in recent years, as investors and other stakeholders increasingly recognised the need to consider factors beyond financial performance in their investments and decision-making. It has evolved into a system which helps to assess and understand a company’s risks and opportunities and ethical performance and aligning that (if you’re doing it right) to long-term value creation and preservation.

According to our interviewees, to group all of these, often vital, non-financial factors into one headline of “ESG” is no longer fit for purpose. Some argue that it has been oversimplified in order to enable the bucketing of issues into one of the three camps and is, as a result, missing the point for which it was designed.

“I think ESG is a very unhelpful phrase. It is too nebulous. It needs to be put in context of business, business priorities, and the sector it operates in. When it is specific you can drive accountabilities rather than a generic conversation on ESG.”

“It is something every Board needs to be aware of. Is it a priority? No, ESG as three letters is not. The issue with ESG is that it means different things to different people. So, you need to be very clear on what ESG means for your business.”

“I don’t think of it as ESG. I think of it as three components. The G is taken care of already as companies have to do that. S has been on the agenda for a long time and companies are doing quite well in this area. It is the environment part that is a new thing. ESG as a three-letter thing is not a helpful context at all because it makes companies struggle with what to do.”

“The only observation I would make with ESG is that it is very difficult to deal with at a general level. You need to look at it in the context of the three words and the context of the business.”

“To look at it all together is quite hard. We are in different places with the strands of ESG. We’re much further ahead in other aspects of sustainability, and early on the journey in others so grouping it together complicates things.”

The argument is that if companies can be specific, and fully define and understand what ESG means to them and how it relates to their corporate strategy and market dynamics, then there is opportunity to drive value. This in part relies on internal efforts to define the aspects of ESG which are most material, and also to ensure these are more widely understood by, and communicated to, relevant stakeholders.

“Define ESG. That is a problem. Many people don’t know how to define it. What should they be focused on within that whole framework? What will really make a difference? Do you want to tick all the boxes in order to get BCorp certification or do you want to do the stuff that is really relevant to your organisation? It’s challenging for people to know where to start and how to do it.”

“There is a tiredness around ESG because the phrase has been bouncing around for so long. It comes down to that point on definition and prioritisation. The best way to refresh and reinvigorate is to make it specific to particular companies otherwise you have ESG fatigue setting in unless you bring it to light in a specific way.”

One particular area of challenge relates to governance and its inclusion in the ESG framework, and how it is understood, measured, and communicated. The line between ethical behaviour, business integrity and compliance versus the structures and processes related to governing a company and its ESG ambitions, is difficult to set and difficult to measure.

“We don’t talk enough about Governance. It is not very effective. I don’t see many companies doing it right or well and we see lots of companies fail despite the governance they have in place. I don’t think G belongs with E and S. It is its own entity that has its own skillset and people and everything.”

“I have an issue with Governance. There are two different kinds. There is one that is business integrity, and the other is the processes and structures about governing oneself and this area of ESG. It is confusing and can make it difficult for small and medium companies.”

Overall, there is a concern that companies engage in aspects of ESG simply because it is required by the frameworks and structures, which regulators, investors, and other stakeholders are imposing. Where this becomes particularly challenging is when you then look to put in place metrics and targets to evaluate performance over time. While there is agreement that many of the aspects being included and measured within ESG are critical and have the ability to protect or generate value, there is concern over how this is accomplished.

“The concern I have is that some people are doing it because they think they should, rather than because they must. Call it greenwashing or whatever you want, but they’re doing certain actions to show that they are following ESG principles to give an aura that they’re responsible, but in actual fact they are not doing anything. Once measurement comes in, people will then be able to peel the layers of the onion to see whether they are adhering to ESG principles or not. I think people who are giving lip service to it, but don’t actually care. Too many companies see it as just not relevant. But let’s be clear, it is absolutely crucial but we’re only just starting this journey.”

“It’s a cost and an obligation at the moment. It is not seen by enough people as a factor of business strategy. For the better businesses, it is at the core of business strategy, and that has to be what happens. But for most people it is a tick box.”

“These factors are real and important, but they have been trivialised to a certain extent. They are hard to measure, apart from the environment, and they require more experienced, informed, and long-term viewpoints from investors than what we’re getting. ”

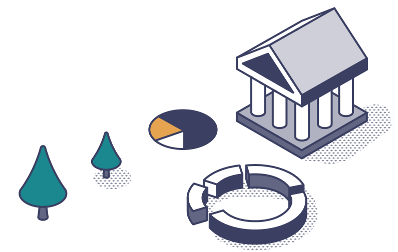
“The E, S, and G are critical for business, but the labelling of it and treating it as a discrete silo is wrong. And the misleading performance measures are dangerous and value destroying.”

There is a sense that ESG as a concept, industry and reporting practice is in flux and has evolved too quickly in the past few years. This is in part fuelled by increasing regulation and the efforts of the capital markets to categorise and analyse companies on their sustainability efforts, whether they be E, S, or G.

“If you are going to call ESG an industry it is one that is trying to grow up very quickly and going through a lot of pain at the moment.”

“Even now, we are still at the beginnings of the growth phase with sustainability disclosure regs. I wonder if one of the things we’re struggling with is that with all of these rules, TCFD and accounting standards and everything else, it makes it sound like it’s a mature market but it’s really not. You have regulators turn up and saying, “we are going to hit you on green washing” and maybe that is right to encourage the right behaviours but, really, I think everyone is trying to make it look shiny and well thought out but it’s actually just the Wild West at the moment.”

“It is very relevant, and it is not going away. Similar to the conversations in the early 2000s when everyone was going digital, digital, digital, ESG has entered this phase. We will see it grow and become more embedded but there will be some pain getting there. ESG is in its infancy.”



YOU CAN'T PAY LIP SERVICE TO ESG; IT NEEDS TO BE FULLY EMBEDDED

Looking back to our research in 2022, 80% of the executive management of 72 companies surveyed considered ESG to be either 'very', 'significantly', or 'fully embedded' within the business and strategy. This year, Boards took a more sceptical view with only 52% of those we surveyed considering ESG as being embedded to these levels, with no one viewing ESG as being 'fully embedded' in any of the companies represented. This speaks to a wider theme of acknowledging the importance of ESG, but a general lack of understanding as to how it can and should be effectively embedded to drive value.

Overall, management teams and Boards agree that it needs to be fully operationalised and integrated into the day-to-day operations and decision-making, as well as reflected in and supportive of corporate strategy and purpose. How this is done and resourced is much more challenging to agree and make progress on.

“We see people talk about the results of the business alongside the key strategic areas, whereas ESG feels new and is presented differently and sits separately. But this doesn't feel right and doesn't work long term.”

“ESG shouldn't be treated separately. This is what surprises me with ESG being treated as something special. It is part and parcel of doing business. We all have to have an understanding of all of these issues.”

“People need to grasp it as an opportunity and engage and explain why they're doing what they are doing. If you don't engage, people will explain it for you, and you will likely end up in a place where you don't want to be. It needs to be part of business-as-usual activity and be integrated into the business.”

“In some respects, it's like technology. Businesses now are technology-enabled because they have to be in order to remain relevant or they will be considered dinosaurs and die out. ESG is the same. Once ESG is embedded it will become the only way to do business. Once it is embedded, people will be remunerated against it, and it will become a core part of business practice, but it just isn't there at the moment.”

“It would be great to start to see expectations and reporting requirements starting to coalesce. You have to try to stick to your guns to a certain extent and just say what is important to you. There is so many things you could do in ESG that might be of no value at all really.”

“I see it as integral. It can be made a distraction if a particular company's ESG strategy or management plan is not fit for purpose and is trying to do too much and listening to all the sounds from everywhere. For me it is part of how a Board does business and it is about saying "I am going to carry about my business without causing harm to business or people, and I'm doing it with integrity and transparency". Unfortunately, it has been made into a side issue and has become a business in and of itself, rather than as part of the business. If you see it as part of the business, then it becomes integral.”

Given the inextricable link to so many parts of a business and strategy, Boards are arguing that ESG should not be considered as a separate practice, strategy, or reporting requirement. It needs to be fully embedded across all aspects of a business in order to achieve real impact, with many companies making progress with this work.

“We had an 'ah ha' moment where the business said, 'we are not implementing a sustainability strategy, we are implementing a sustainable business strategy'. It's a small change in emphasis, but meaningful nonetheless.”

“In my view, the relationship to ESG shouldn't be any different than the relation to financial strategy, people strategy and other elements.”

“In terms of how to align it with business strategy, we're clear that we don't want a different sustainability strategy from corporate strategy. It has to be completely intertwined.”

“It is your duty to ensure it is strategic priority. It is not something sitting to the side where you tick a box. I see that approach a lot. I can see a cottage industry growing where they just hand over to consultants who do it all, but don't take it into the company properly. It needs to be operationalised.”

“It is your bread and butter. There is no way you can distinguish it as a separate practice. It goes beyond compliance and goes into all other elements of your business.”

Looking ahead and aligned with the belief that ESG needs to be treated holistically alongside other aspects of a corporate strategy, is the expectation that ESG will become sufficiently embedded that it ceases to exist as a separate practice.

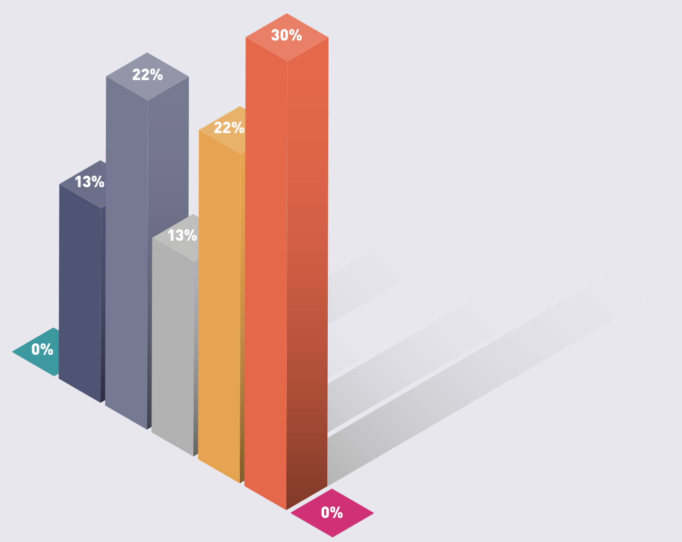
“It will be a hygiene factor over the next 5-6 years. You just need a certain level of quality and sophistication in place in these areas.”

“I think ESG will be gone in 3-5 years and the three facets will just become embedded.”

“ESG almost becomes a hygiene factor rather than it in and of itself driving valuation.”

TO WHAT EXTENT DOES YOUR BOARD BELIEVE ESG IS EMBEDDED WITHIN YOUR BUSINESS AND STRATEGY?

Not at all 1 2 3 4 5 6 7 **Fully aligned**



DECLINING ENGAGEMENT FROM CAPITAL MARKETS RAISING QUESTIONS ON LINK BETWEEN ESG AND SHAREHOLDER RETURNS

One of the main themes to come out of the interviews this year was a sense of decline in investor engagement, particularly in the most recent years. Despite a regulatory environment which pushes the elements of ESG further and further up the corporate agenda, this is not being reflected in how the capital markets are engaging with companies.

Looking back to the report we published at the end of 2022, 80% of the executive management we surveyed viewed ESG as positively aligned with shareholder returns, with almost 20% viewing ESG as fully aligned. This year, the Board perspective differed with 43% noting a positive alignment, and only 13% viewing it as fully aligned. While there is still clearly an acknowledgement of the link between ESG and shareholder returns, there is little doubt the scores reflect a level of scepticism as to how the capital markets are treating this important area. It has therefore also raised a question on the link to shareholder returns.

“There is very limited engagement from our shareholders on ESG.”

“The capital market are not the drivers. The only time they tend to be drivers is if you have something in the box ticking area which typically tends to be in the S-box like diversity or in governance where the Board will act because it's easier than not doing it.”

“You would think there would be more pressure from shareholders, but the reality is our governance outreach is very extensive and the main focus from investors is Board diversity and Remuneration. It is not ESG. If we're talking to our biggest shareholders, they are not putting any pressure on us. It feels very siloed.”

“As of right now we are not yet getting questions from investors.”

While ESG is still acknowledged as important to investors, it appears to have shifted in priority and the current approach adopted by investors is viewed by corporates as being more of a “tick-box” item. The challenge corporates are facing is in translating their ESG strategies and efforts into the models and processes which investors have designed to analyse ESG progress. Too often these do not account for individual company dynamics or progress and appear more focused on simply having certain policies or procedures in place.

“I don't detect that there is any downplaying on the ESG agenda but other things will be at the forefront of investors' minds. That is more about other things coming up the agenda rather than ESG coming down. There is no change to their commitment. That stable door has been gently closed and it is part and parcel of our business going forward.”

“Shareholders don't really engage. It was a big topic about three years ago, but now we have ticked the box saying we have an ESG policy. The actual fund managers themselves are not particularly interested. I get the impression that it is someone in the back office just reviewing our accounts to see if it complies with whatever internal standards that they feel it has to comply with. They should be having a wider sustainable discussion and asking a 'how sustainable is your business model' question rather than asking us to answer very specific environmental questions.”

“It feels a little like they have stopped listening as soon as they have asked the question because they just needed to tick the box that they had asked the question.”

“The majority of our conversations with investors include ESG in some way, but it does feel quite tick-boxy still.”

“You have to talk about ESG, but other things are much more important to them. They want to see it in objectives for management, but they are not driving it anymore. They are more in the 'keep them happy' focus. It is still on their forms – they use it, no question – but they ask it and then they move on to the next thing. ”

One potential reason for this perceived lack of engagement is the short-termism with which investors appear to approach their investments. Consideration of ESG factors requires a long-term perspective, irrespective of investment timeframes, in particular

HOW WELL ALIGNED IS ESG TO MAXIMISING SHAREHOLDER RETURNS?

Not at all 1 2 3 4 5 6 7 **Fully aligned**

given that the global challenges being addressed are long term in nature.

“We need to get away from this short-term business. My long term starts at 10 years. That's where we need to start with ESG, but that is not the term that others look at.”

“It is not there at all yet. Unilever is a good example. There needs to be an understanding that you can create long-term value with ESG. It is the biggest financial opportunity of our lifetime, but it is not understood yet. Work needs to be done across industry. Shareholders are still focused on next quarter, and next HY results, instead of what will the business look like in next 5-10 years. There is a big disconnect. CEO tenures is also an issue.”

“There is a metaphorical rolling of eyes for companies making commitments to 2030 as the executive team making the commitments won't be around then, so investors are sceptical, perhaps even cynical, about promises made by these CEOs in the interim.”

“Their interest is really in whether there is a market for whatever you are doing over the next five years. So, as long as you give them comfort then they don't care about the rest. Anything beyond five years is beyond their time frames.”

“I am very sceptical as to their ability to value a business in the long term and to have the patience to see it through. The ability to value ESG properly is not recognised in the investment community.”

“You can separate out the reporting aspects of ESG which may sit alongside non-financial and financial reporting commitments, but that is only a small part of ESG. The rest is how we address ESG as a benefit to the long-term success of a business.”

There is a desire to see investors take a more proactive and clear approach to engaging companies to ESG issues and to ascertain company direction and future value creation opportunities. For too many, the experience of the capital markets is that ESG is viewed predominately from a risk mitigation lens, and not enough time is spent understanding the commercial opportunities entailed.

“I think there needs to be more on materiality and more understanding from corporates about what investors want to get out of their own metrics. Whilst there has been more interest, ESG is only 5-10% of the conversation, so it needs to get more space in the conversation.”

“If the capital markets, did it right, they could really drive ESG, but they don't.”

“For the capital markets ESG is just a risk mitigation approach. You have all these impact funds, supposedly to encourage growth in a particular area but it has just been made too complex. Anyone who is investing should be looking at all sorts of risks related to ESG but should also be looking at what growth and value opportunities there are.”

“These tick box exercises don't really take into consideration what is right for the business. Far too many of them are analysing the business in too many different ways, and you're supposed to engage with all of them on a proactive basis and it is just impossible to dedicate the manpower to this kind of thing, especially given the materiality of it.”

“Investors ask questions, and we don't quite know what they're asking or expecting the answer to be. The issue is that everyone is on a learning curve and we're all learning in real time. There are then multiple frameworks and multiple badges that people sell. Add to that the constant change in compliance requirements where some are quite esoteric and not that relevant. All that risks you spending a lot of time on disclosures which feel disconnected from the journey we're trying to be on.”

Interestingly, the consideration of ESG issues and wider stakeholders in decision-making, is not considered to be affected by more short-term economic cycles. While the order in which it appears on the corporate agenda may change, the capital markets still place emphasis on ESG issues. When more confidence in the macroeconomic environment returns, so will the focus

DECLINING ENGAGEMENT FROM CAPITAL MARKETS RAISING QUESTIONS ON LINK BETWEEN ESG AND SHAREHOLDER RETURNS

on ESG, and the expectation that companies have continued to make progress.

“The world has moved on from yesteryear when the view was 'if you get the financial performance right everything else looks after itself and the only thing the board can control is that financial performance'. I think for all the reasons we know that focus has changed. Boards are, in some cases, slow to embrace it, but no one argues against that direction of travel.”

“Eventually, when it is taken as read that it needs to be in strategy, it can have a huge uplift in valuation, but the market is what it is at the moment.”

“I think it has gone quiet since the invasion of Ukraine. I do think we're in a transition. I wouldn't mind betting that it will come back again. ESG doesn't go away in companies that really get it and who really understand that decarbonising their operations is a good thing to do.”

Our belief is that investors will continue to look for the balance between corporate responsibility and corporate profitability. There is much more understanding, particularly in this market, that any ESG initiative, in order to be successful, has to make commercial sense and has to consider the particular dynamics and resources of the specific company. Listed companies, regardless of size, will all be challenged to demonstrate how their ESG initiatives link into corporate strategy as well as to shareholder returns, in whatever timeframe. The responsibility also lies in the hands of the investors to change their outlook, and to refocus attention to a company's long-term potential, considering both emerging ESG risks as well as capturing the many opportunities.

“Fundamentally it is about delivering returns and whether sustainability efforts deliver returns. That is the focus.”

“Investors are interested in everything but ultimately, they want you to make money and ideally without hurting anyone or endangering anything. Unilever went out and pushed the sustainability agenda heavily and people pushed back questioning the focus on financial performance, and now their new CEO has gone out to row that all back.”

“These tick box exercises don't really take into consideration what is right for the business. Far too many of them are analysing the business in too many different ways, and you're supposed to engage with all of them on a proactive basis and it is just impossible to dedicate the manpower to this kind of thing, especially given the materiality of it.”

REGULATION IS BYPASSING REALITY FOR THE SMALL- AND MID-CAP MARKET

Small- and mid-cap companies are experiencing a very different life and engagement than their larger counterparts from both a capital markets and regulatory perspective. Often, regulatory intervention is driven by government efforts to protect multiple stakeholders from the risks of, in particular, large corporate failures. Cases like Carillion have made headlines globally, shaping sentiment and engagement with corporates across the value chain.

Coupled with this, the small- and mid-cap have been largely absent from the development of ESG rating systems which primarily targeted large caps as these featured more heavily in the portfolios of institutional investors. ESG legislation evolved with the large caps as a main focus and target, under the guise of guarding against greenwashing, ensuring quality of disclosures and encouraging sustainable behaviour. Inadvertently the small- and mid-cap have been swept up in these safeguarding measures and have had to adapt to a system which appears to disregard their needs.

“The regulatory reporting burden is horrendous for a small-cap group. If we get asked about the "what if" scenarios, there isn't a team doing it. It is the CEO and CFO figuring out how to do it. I feel quite strongly that the regulatory environment is too far ahead of reality. When I do ESG I want to do the things that make a strategic difference, but instead I am being dragged into the regulatory piece.”

“We pay attention to all the guidance on ESG matters and produce a copious report on all things ESG which is just getting longer and longer. From an environmental perspective, the amount of paper produced by ESG matters is getting frankly ridiculous.”

“There needs to be some recognition that the ESG regulatory burden for small caps is too big.”

“I don't like that all the language is driven by and is geared by large enterprise. There is very little thought as to what it means for small and medium enterprise even though they are the backbone of the economy. Someone needs to think about them when things like the ESRS are put in place.”

“ESG has become a shorthand for something that, especially medium to small sized companies find really hard to deal with. These companies don't have big teams of people attending industry gatherings and don't get as much chance to talk about it amongst their peers.”

Regulatory pressures for business to prioritise ESG has increased dramatically in recent years. While the large caps often have the resources to keep pace with expectations from compliance, whether regulated or voluntary, this isn't the case for many smaller corporations. Often, the burden of compliance means there isn't time to actually do the work and enact initiatives, not to mention the cost of compliance affecting profitability. While smaller companies may agree with the purpose of it all, the burden is leading to questions and cynicism.

“The plethora and burden of requirements sits in contrast to just getting on with business. It is getting that balance right.”

“The desire to have comparability which is admirable ends up with us making disclosures which are not important to our business or industry.”

“It has to be managed so the ESG agenda doesn't take over and be balanced with maintaining profitability and shareholder returns. It can be done side by side and alongside the risks that a Board should be looking at anyway. But not in its current form.”

“It is just another factor of cost. You are getting more rules and reporting, none of which are joined up and all with different emphases. There is a plethora of things that you have to try to weave into a sensible narrative in an annual report. But it is really just a bag of spanners that you have to try to turn into something else.”

“There is a theme from events I have been to that regulation is taking up too much time from companies so they can't do initiatives and actually decarbonise. I feel that pressure. It's just me working on this stuff and it's a lot to stay on top of. ”

“I think that the regulatory piece has gone a little far and is being heard over and above the really critical piece which is activity and action. Too many are dragging their feet to reporting requirements of TCFD and CSRD with a big yawn. That is probably the biggest burden to ESG. We're not hearing enough of the opportunity piece. It will take some time before the pendulum swings to the middle, and to see evidence of actions leading to benefits. That in itself will carry ESG to a more positive territory. Right now, the regulatory piece is holding everyone back.”

“Regulation makes people think about metrics and KPIs that we didn't think we needed to bother with before. Improving the transparency will enable investors to make more informed decisions but it will be a big ask of companies in terms of what they need to do. And the big thing will be resourcing that.”

“The challenge we have is this has become an industry where the interest is to raise the bar and make reporting difficult to some extent. There is no doubt that where Boards start to lose the plot is where they feel they are just on a reporting treadmill that has begun to lose sight of the real purpose. To paraphrase Larry Fink very broadly - these things have got out of control.”

Overall, there is a sense that there is a lack of understanding of the impact that ESG regulation has on business, in particular on the small- and mid-cap. Governments are progressing with potentially noble intent but are not appropriately considering the burden it creates for companies to align with the vast array of rules and guidelines it produces, and to contend with the many different approaches adopted across geographies.

“The main challenges are interference from governance and overregulation and inexperience in the asset management area (and I mean in how a PLC should be run). I also Chair a pension fund and it's so frustrating to be forced down an investment route which I think is value destroying because the fund is having its homework set by the Government. Reactions to corporate failures like Carillion has also been ridiculous and promoted by people who don't understand how to run a business. Businesses fail, but politicians and civil servants don't have enough experience of that.”

“Regulation without buy-in is not effective. I don't think businesses understand what is required. Regulation needs to proceed in parallel with education, buy-in, and collaboration.”

“Regulators are moving ahead of business. You have to set the standard, but you have to make a judgement on how far ahead are you? PLC boards tend to have a greater focus on regulation than private companies, but my cynical side says that's more box ticking because it is moving too quickly to keep up with it.”

“My concern is twofold – one is compliance becomes disconnected from reality and delivery, and the other side is it seems to become people's raison d'être to try to conjure up new disclosure standards and rules. It seems very few will sit down and suggest trying it for 3-4 years and then reviewing it to see where we're at. They just enforce it.”

As a result of these concerns, and as we have seen in previous years of conducting our research, corporates are still loudly calling for a simplification of regulation and requirements. Clarity on how to interpret and respond to the various rules and regulations remains a key issue.

“It's easy to say that all advice and guidance is good, but you do get lost in the overlap, duplication, and lack of clarity. My hope would be that out of all of this, there will be sane minds that say, 'let's now clarify and simplify what we expect business to be doing'. It is very easy for regulators to just add more regulation. Even if that is worthy, it all takes time and there is cost attached to it. Staying on top of the current complexity is more than most can handle.”

“I would like to see a simplification of the regulatory environment. Rating agencies have become less influential which is good, but it would be good to see more homogenisation of the regulation piece.”

“It doesn't help that there isn't one global approach. It risks becoming a spaghetti of requirements, some of which might not talk to each other and so you're adding more complexity and more pages to an annual or sustainability report. The more simplification in this area the better.”

FOCUS ON MATERIALITY, NOT JUST COMPLIANCE

One of the key features of the aforementioned reporting regulations in both the UK and Europe is the demand for materiality to be clearly measured and reported on, taking into account both impact and financial considerations. In the UK, ISSB takes the IFRS definition of materiality and prioritises material issues as those which investors will be most concerned with. In Europe, and for the many UK companies who fall within its remit, the CSRD requires double materiality, which entails looking at both the outside-in (financial materiality) and inside-out perspectives (impact materiality). While some may consider these requirements overly onerous, and there is undoubtedly a lot of detail and process to navigate, they are also an opportunity to focus strategy and investment in a more impactful way, with clear acknowledgement of the link between ESG to performance and value.

"I do think ESRS is overly complex because of the double materiality element but also because I favour a single materiality approach. I believe if you do your single and financial materiality really well then, the rest will follow. While it overlaps a lot, there will be too much time spent chasing fringe bits to keep things consolidated and concise and people will get lost in detail that isn't important. It is hard to cut through it all. It is very different for those who are practitioners versus those who are recommending."

"These frameworks should help support our strategy in focusing our mind on what matters, and I think as long as the concept stays on what is material to the business and proportionate, then that is fine. For TCFD you had to explain why it wasn't material and that can sometimes take more effort. You don't need to explain the things that aren't material for other parts of the business, or for other non-ESG regulations. It just applies to ESG and can be quite onerous and challenging."

"The challenge that all those frameworks and regulatory bodies have is to remember the importance of the substance and ensure they are focused on what's relevant, as opposed to them becoming the end in themselves. ESG is important for clients, people, and just morally and ethically and the rest of it. So, let's not lose sight of that."

Understanding materiality, for the braver management teams and Boards, could be the antidote to reams of potentially irrelevant data being generated and published. Instead, there is opportunity for companies to identify and understand the specific elements of ESG which pose the greatest risk and opportunity, and which have the potential to drive real value.

"We shouldn't be doing this because we are being made to do it. We should be doing it because it is about finding what it is that we think can truly help the business that drives the E the S or the G."

"The pendulum will swing. It has to come back to the middle point where it is fit for purpose. I use the story of David and Goliath a lot to explain ESG. Instead of using all the weapons, he used what he was used to and killed the lion, because he did what was fit for purpose and right for him, not what everyone else demanded."

"The principle of picking things we believe in, that aren't tick box, and that you really believe can impact your business. That is where you have to get to."

"There are companies who are doing it as a compliance issue because investors are asking questions or regulations are requiring it, but it shouldn't be if it is properly explained and properly understood."

"More companies should be brave. Some companies are scared to not answer the 999 questions even though they should only be answering the 9 that are important to them. It is about materiality and doing it properly."

Even though the regulations are clear in that this has to be done, materiality has to be led by senior management for strategic purposes, not just in pursuit of box ticking. With further understanding of material ESG issues, decision-making can then better consider

the commercial viability of how these issues should be prioritised and invested in.

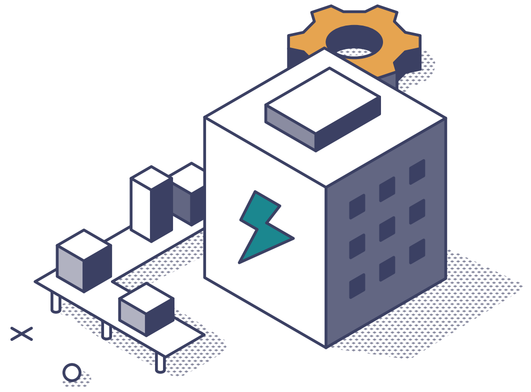
"You can't do away with your profits to be good to the earth because you won't survive. You have to survive as a profitable entity. If you survive you can be charitable and say not everything will be profitable and not everything will be a quid pro quo. So, quantifying what won't give a return but is the right thing to do, and quantifying what might give a financial return and quantifying what will definitely give a yield – you need those three bands."

"The first thing you have to do is understand you are talking to businesses. You have to come down a couple levels and build numerical cases that really make sense. Otherwise, all these ESG initiatives won't work and won't make sense."

"This is how we discuss it with our shareholders: 'we don't do anything on ESG that we only do because we need to tick a box because we're a listed company; we do it because it's good for the business'. We would be doing the same things if we were privately owned. What we try and do is what's right for the business and then try to explain to shareholder how that ticks their boxes. Whether that is in driving carbon, looking at biodiversity, social impact, or driving more community engagement."

"Why would a business that is set up for profit, do anything that does not add to the value? "

"ESG initiatives are frankly the same as business initiatives. Reducing our emissions is actually also operating more efficiently which is also bottom-line benefit. If we are lax on Health and Safety, we will be cut out of business. If we don't look after our people, people will just go down the road and work somewhere else. It is about all the other things we can do. The ESG lens helps me to focus on those areas where we perhaps haven't spent so much time before."



> "We shouldn't be doing this because we are being made to do it. We should be doing it because it is about finding what it is that we think can truly help the business that drives the E the S or the G."

CHALLENGE REMAINS TO REMUNERATE AGAINST ESG AMBITIONS

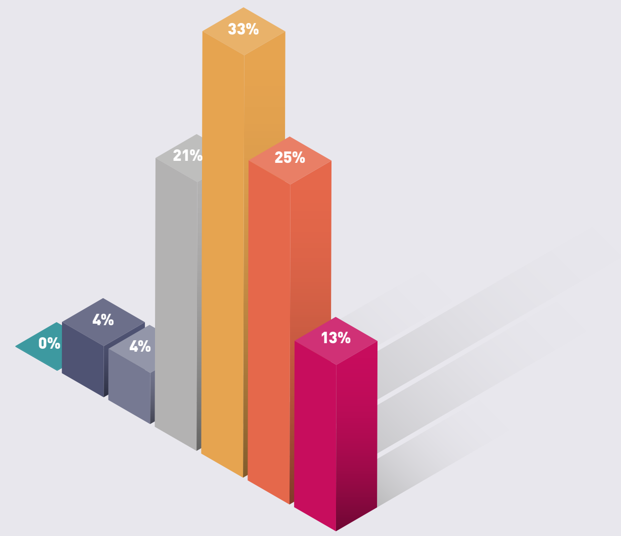
As our research identified last year, and despite general frustration expressed around ESG, it is still clearly seen to have a direct impact on valuation and performance over the long-term. Boards fully recognise the opportunity in getting the approach to ESG right. 71% of respondents this year view ESG as having a 'somewhat significant', 'significant', or 'very significant' impact on performance and valuation over the next decade. While this is being in part driven by regulatory requirements such as the Taskforce for Climate-related Financial Disclosures (TCFD) and the push for Net Zero, this view is also reflective of the inherent positive impact that ESG can have if properly embedded within business.

This link to valuation is, however, not reflected in how ESG is being linked to remuneration and there has been slow progress in this area, with only 4% of companies noting that the leadership team's remuneration is 'fully linked' to ESG performance. This reflects the challenge entailed in properly embedding and measuring ESG, and in turn to linking ambitions to viable targets that can be remunerated against. While many companies include elements of ESG in annual bonuses or LTIPs, going forward there will be pressure to ensure the metrics are linked to material issues and drivers, and not arbitrarily set targets. We expect this area to become more defined as companies become better at judging materiality and knowing which are the most important levers on which to benchmark leadership, and the wider organisation.

We believe that materiality testing can play an important role in linking ESG ambitions and targets to remuneration. How companies approach this area will come under increasing scrutiny in the future driven by both investor interest and regulation requiring ESG to be more closely aligned to financial materiality.

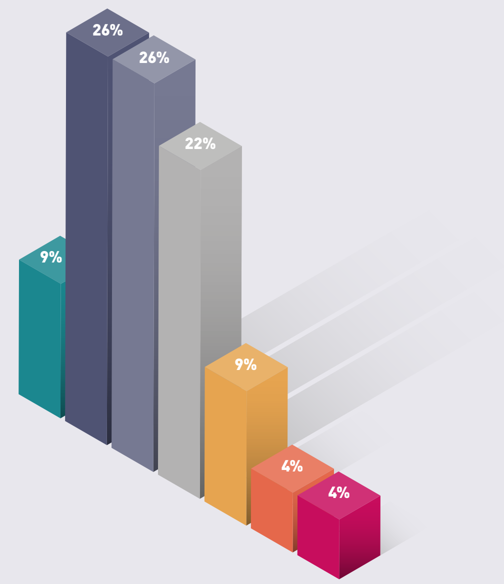
WHAT LEVEL OF IMPACT DO YOU BELIEVE ESG COULD HAVE ON THE VALUATION AND PERFORMANCE OF YOUR COMPANY OVER THE NEXT DECADE?

Not at all 1 2 3 4 5 6 7 **Very significant**



TO WHAT EXTENT IS THE LEADERSHIP TEAM'S REMUNERATION DIRECTLY LINKED TO THE COMPANY'S ESG PERFORMANCE?

Not at all 1 2 3 4 5 6 7 **Fully aligned**



CUSTOMERS AND EMPLOYEES DRIVING ESG STRATEGY

Aligned with the perceived shift away from capital markets driving ESG strategy, we have seen a continued trend towards customers/consumers and employees driving ESG within the small- and mid-cap sector. We believe this has in part derived from regulation pushing responsibility for ESG further across the whole value chain, encompassing many more corporates and stakeholders.

" I don't think people are trying to maximise shareholder returns any more. People are trying to maximise stakeholder returns."

" All stakeholders have influence, to a greater or lesser extent. The biggest driver is employees as ESG is a key aspect of recruiting people. I also know where shareholders put pressure on and ask questions is causing people to change. Customers look for suppliers that match their ESG principles. It goes through the whole value chain."

Similar to previous years, employees featured heavily in conversations about which stakeholders were most important in encouraging companies to implement ESG within their businesses. Once again, almost two thirds of respondents (64%; 2022: 65%) referenced employees. Social and environmental aspects were particularly mentioned as being important to this stakeholder group, with examples including net zero and diversity, equity, inclusion (DEI) initiatives.

" Our values increasingly recognise that if we are to attract talent into the business and retain talent that we need to embrace change and diversity and net zero and ESG and all those good things in the balance of what they do."

" Our biggest critics and most engaged people, around sustainability and diversity, are our staff. It may not always feel particularly relevant to us as a listed entity but under the bonnet, we do need to have a purpose, or our staff will vote with their feet or give executive management a hard time."

" I think particularly at the moment, with the labour market as it is, ESG is seen as something which can attract and retain employees. The S bit of ESG is especially important and is a very important part of our strategy and our focus on being a great place to work."

" People want to work with companies that do the right things in this area."

" The opportunity is that it is relevant for many employees in many organisations. Employees want to see that the companies they work for follow ESG principles."

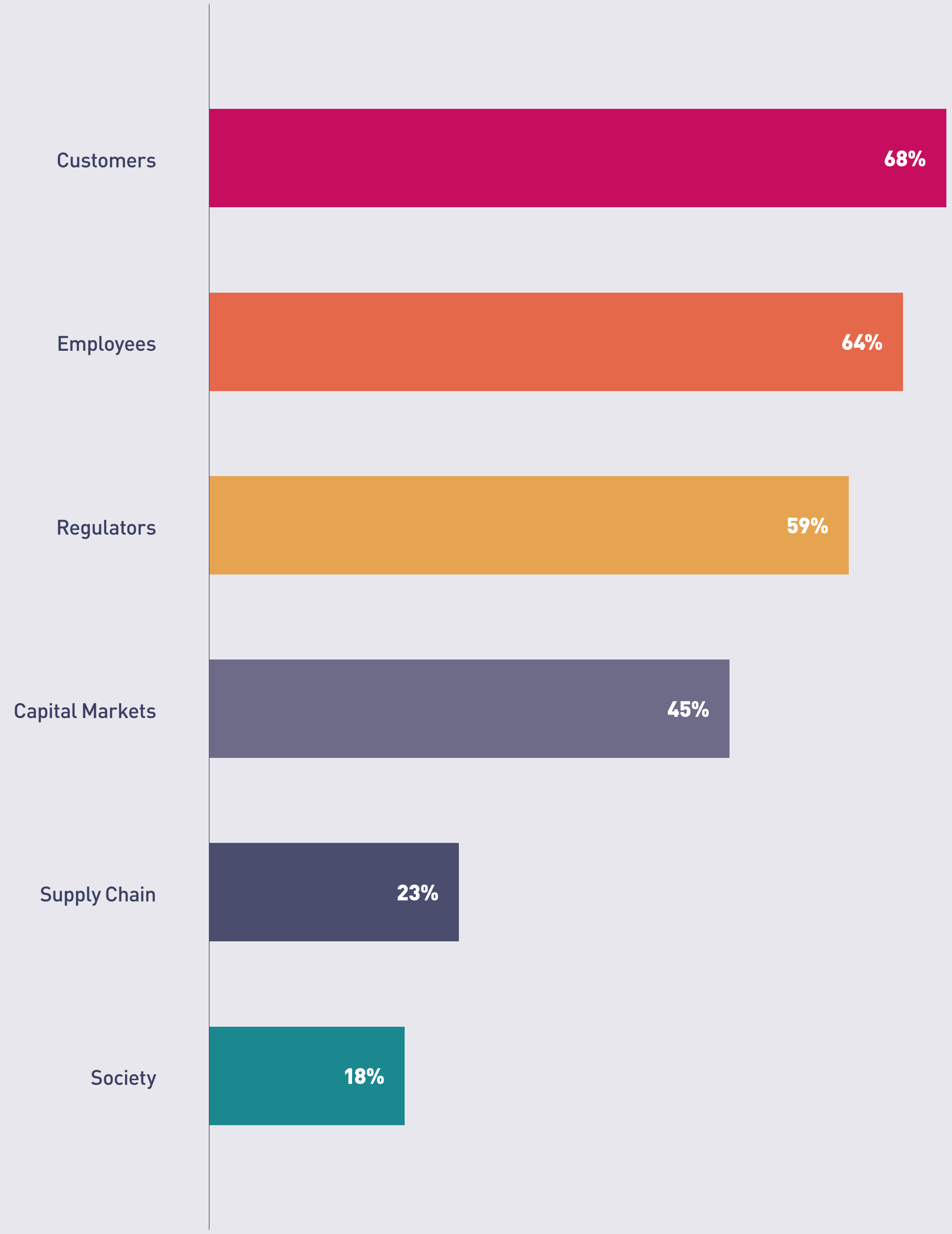
" The ones that don't treat their people correctly will battle. The world has moved on and the companies that don't take these factors into consideration will not get the best people. It is about how they work with their communities and how they look after their people."

This becomes particularly relevant in capturing talent from younger generations, whose career decisions are much more motivated by an employer's commitment to ESG. Younger generations expect companies to actively promote and behave in accordance with their ESG commitments and to back them with targets and transparency.

" I do think pressure will increase. To this point around younger people and how important these things are. The old cynics at the top of the organisation will be pushed out."

" It is more a perception thing in that they want to feel like the business cares. Management is key to this. A lot of the work is driven by the management and our Board members ensuring we keep it as a priority. In my perspective, the staff is young, and it is key to that generation and so it is important to us to match their expectations."

WHICH STAKEHOLDERS ARE MOST INFLUENCING YOUR BUSINESS TO IMPLEMENT ESG?



The most frequently mentioned stakeholder group as drivers of ESG were customers, referenced by 68% of respondents. Overall, ESG was recognised as a competitive differentiator and value generator for many of the companies represented.

“There is big commercial and business opportunity to work with our clients in this space, in particular our corporate clients. The opportunity lies in working with our customers and helping them as they go on their journey with their own ESG commitments and strategy.”

“Our customers are really leaning on us. We are much further ahead in ESG because of that and in the part of our business where our customers are putting more pressure on, we are in the process of trying to get B Corp certification because there is a genuine commercial benefit in that.”

“You can't ignore the role of ESG in winning customers.”

This becomes more evident depending on where in the value chain the company sits. Exposure to the larger cap corporates appeared to put a higher pressure on companies to deliver more detailed and wide-ranging ESG performance and transparency.

“The clients are driving it. To get a big client like a Microsoft you need to be able to show how you score on ESG. It's an important driver so, you are almost forced to have it at the top of the mind.”

“Competitors and customers drive the agenda to a certain extent. We have to ensure we stay up where the competitive tension is.”

“Our clients are driving this and so we're going to respond to that. To a certain extent we work hand-in-glove. There is also a sense of chicken and egg. We need to be very much intertwined. Clients can ask for what they want. We can describe what's the art of the possible.”

Linked to a company's position in the value chain, 23% of the interviewees referenced the supply chain as an important influencer in implementing ESG within a company, in particular related to decarbonisation efforts, with companies facing challenges to understand the implications of Scope 3 emissions, which we will discuss in more detail later in this report.

“Suppliers to some extent but we're asking them more than they are asking us and trying to understand what they're doing on ESG matters.”

“Subcontractors and supply chain is where a lot of the Scope 3 emissions sit so, they have undue influence.”

Outside of specific stakeholder groups, regulatory pressures are well understood and discussed, with demands for increased levels of disclosures and transparency driving ESG strategies in many cases. This is a theme that is discussed across this report.

“Public interest is key. Regulators are very concerned about this area and it's growing. And it's growing as I think regulators, whether its FRC or ICAEW, know they have to do it, engage with companies on it, and want it to be properly reviewed and audited.”

“Of course, over the last 15 months, our ESG efforts have also been driven by regulatory changes.”

These findings are further evidence of the evolution of ESG as a driver of social, enterprise and reputational value. Boards and management will continue to be challenged to ensure wider stakeholders are considered in their strategy development, including all aspects of ESG. Regulatory requirements and investor demands will need to be considered alongside engagement with all stakeholders, including employees, customers, communities, and the supply chain. This is a lot of work, and puts the onus on management teams and their Boards to get it right.

> “I don't think people are trying to maximise shareholder returns any more. People are trying to maximise stakeholder returns.”

ESG DATA DEMAND IS CONSTRAINING RESOURCES AND DECISION-MAKING

As the pressure grows for companies to show that they meet increasingly rigorous ESG criteria, so does the pressure on Boards and management teams to generate, understand, and communicate the data that proves this. Even if a company has successfully undertaken an ESG materiality assessment, then generating the right supportive data is a challenge. Reporting to regulators on ESG can mean collating and analysing non-financial data across a wide spectrum of issues ranging from greenhouse gas emissions and diversity statistics to water usage and human rights data. This challenge is only expected to grow as there is increasing pressure to ensure the traceability and auditability of data used. While this pressure will first impact larger cap companies as a result of being caught in regulatory requirements, it won't take long until this pressure reaches the small- and mid-cap.

Data quality is one of the main challenges companies are being faced with. Obtaining accurate and reliable data to use for both ESG reporting, as well as internal decision-making can be challenging. ESG data can often be considered inconsistent or unreliable, putting the onus on management to put in place effective tools and frameworks to facilitate the data gathering and analysis. All of this is to be managed on top of already constrained internal resources, both financial and human.

“ I think the way we feel about this is that it is less resentment at cost and complexity and it's more a challenge to get our heads around the data that allows us to report and tell a story of progress. You are talking about very complicated analysis which we do, but the issue is the quality of data and how we embed that.”

“ The biggest thing I would say is what data? How do I measure things? How reliable is that? How do we get hold of it in normal course of business rather than set up some huge process? Measuring how we're doing will be hard. People don't know how to get that right. It's both human and budget constraints. It needs investment in systematic ways to collect the data. I think senior management can say we need to measure X, Y, Z but actually how that works is another question.”

“ It is getting the quality of data improved and pinning some of this stuff down and that is where we want to make most progress.”

“ Boards are only just getting to grips with how to organise themselves and hiring people within the firm and pinpointing people responsible for collecting data and thinking about this.”

“ In practical terms the risk is the increased demand for data and not having appropriate systems in place which is pretty challenging I have to say.”

The lack of current standardisation across different regulatory frameworks and other ESG guidelines, means that data demands become incredibly onerous for many companies. Instead of focusing on data linked to a company's own value drivers, companies are being forced to generate data on a wide range of issues to satisfy external demands. The lack of standardisation, and the aforementioned quality issues, means that it becomes difficult to compare and analyse data accurately, meaning there is reduced chance of deriving strategic value from data presented.

“ Energies put into gathering data to answer questions related to a particular framework or rating agency means they then don't have the bandwidth to be innovative and take advantage of opportunities. Instead companies are constantly on the backfoot.”

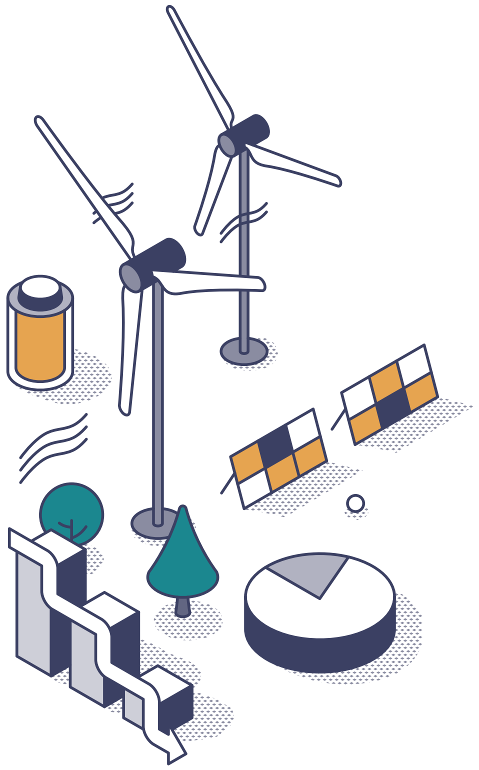
“ There are 1178 data points required for ESRS. What am I supposed to do with that? It is madness! I understand why it is done and the purpose of it and I know that the EU is a kingdom unto itself, but I don't understand how this is all playing out. If you translate that to small and medium sized companies, it can be quite problematic.”

“ One of the issues we have on the reporting is the level of detail we have to provide, particularly on environment, which is a second order thing for us.

Pages and pages of stuff at a very detailed level and you'd have to be a geek to make sense of it all. It would be better if we could summarise what we're trying to achieve rather than deal with all these detailed questions. If the regulations were geared towards that, which I don't think they are, that could be useful. ”

Beyond the difficulty in analysing data is then the challenge of how it is communicated externally and positioned to stakeholders such as investors. Many companies are taking a cautious approach to external disclosure and are, rightly, trying to ensure and assure the quality of disclosures before making them public. Unfortunately, regulatory pressures may push many companies into making disclosures they are not ready or confident to make.

“ There is a balance on how far you go. How much do you need to communicate if the data underlying it is based on assumptions and estimates? There needs to be a path of improving the underlying inputs before we start communicating that outward.”



“ Energies put into gathering data to answer questions related to a particular framework or rating agency means they then don't have the bandwidth to be innovative and take advantage of opportunities. Instead, companies are constantly on the backfoot.”

CLIMATE AND NET ZERO IS CROWDING OUT THE S AND G

Understanding the environmental portion of ESG has become a particular challenge for the small- and mid-cap. It covers a wide remit of subjects including the utilisation of natural resources; energy consumption and greenhouse gas emissions; the impact of a business on the wider environment (across the whole value chain); policies and practices; as well as understanding and adapting to how climate change can impact your business. Increasingly, a broader set of stakeholders are demanding that companies actively work to mitigate and manage these complex environmental factors, with regulators also taking a clear stand.

Greenhouse gas emissions has become a particular area of focus, with companies being required to disclose both the direct and indirect emissions emitted as a consequence of business activities. This includes the more challenging Scope 3 emission which result from activities that a company does not own or control, but still sits within a company's value chain. A key theme of this year's interviews was the real and expressed concern of the ability for companies to measure and deliver on reducing Scope 3 emissions.

"If we used environmental as a base: my Scope 3 is horrendous but I can do something about my Scope 1 and Scope 2 so that is what I want to talk about. We want to be more efficient in what we're doing and make our business more efficient and there is real action we can take to achieve that. But if we have to talk about Scope 3, it dwarfs our efforts on Scope 1 and 2, even if we can't control the Scope 3."

"Calculating our Scope 3 data and understanding the levers we can pull and how to engage the players in minimising our emissions, collecting data, and embedding operational carbon is a huge challenge."

"Nobody is suggesting that we shouldn't have this net zero nirvana by 2050 but I do think we need to get there in a sensible fashion. I am not sure what's worse - setting an overambitious target or just an arbitrary date."

There was also a sense of frustration of having to make business decisions and disclosures based on hypothetical scenarios which management often have doubts on, or of which they have little to no control over. There appears to be understanding in the wider market that this is a work in progress and a learning curve for everyone, however this also means that many public targets for net zero are met with some scepticism.

"You could do a huge amount of work, built on a very flaky premise of scenarios which may never happen. That is why I get frustrated. It is very hard for us to do it."

"What we are being asked to do from a reporting perspective is so difficult. For us to get to net zero, we are wholly reliant on other people doing technology things. My path to net zero relies on what something someone else builds will look like in 15 years, and everyone has a different response for what route they are taking. It then becomes all about 'are we just going to report a lot of hypothetical scenarios?'. What we should be focusing on is 'what have we done this year to reduce emissions by operating more efficiently' because that is the bit we can control."

"Part of the challenge is that the decisions we're taking and things we're doing to reduce carbon emissions are not really good business decisions. We want people in the office and face-to-face and we're an innovative business, but then we're saying, 'don't commute' to meet some environmental challenge."

"People expect you to be able to talk more credibly to join the two points of here we are and the end point of net zero is 2050. And so many people have just set a target without doing the work. That is where you lose the credibility in the whole sector if you're not careful."

"We have targets in place for our CEO that are science-based, based on Scope 3 emissions, and we have been given a lot of credit for doing that. But we have had to be clear with our investors that it's a bit of an experiment, so we're not hooking a lot on to it and targets aren't wildly ambitious as we're still working through it. We do get a lot of understanding on that approach."

"The key problem for us is the data from customers and we just can't get it. We do various high level stress tests which include some climate implications but that is just a general Bank of England type stress test. If you can't get hold of realistic data, then how can you decide one way or another?"

Some companies note that there is opportunity in Scope 3 to engage with the value chain in a more meaningful way to achieve change.

"There is a mindset shift. Is this just a compliance issue and we're just ticking boxes? I think we've got past that and stopped changing light bulbs to LEDs and thinking that is a big deal. When you look at Scope 3 it gets interesting as it forces you into a partnership with your customers. The biggest impact we can have is to address how do we work with them, how do we help them, how do they help us to drive down emissions. The really interesting bit is in that mutual interest in driving down carbon footprint."

There is also a call for standardisation and more guidance from regulators and investors on how this should be achieved and what is expected.

"There is no standard methodology. Even with our peers we haven't seen what good looks like. There just seems to be a laundry list of caveats and uncertainties. We are doing what we can – things like CDP, benchmarking our peers. I think simple is the way and simple means transparent."

"I am desperate for some sort of standardisation for how you achieve a dollar figure for these impacts and climate-related risks. We have had internal conversations for what a number looks like for 4 or 5 key issues like fuel tax, carbon tax, regulations."

While much management and regulatory time is being spent on trying to manage environmental risks and opportunities, there is a sense that the other elements of ESG are being disproportionately deprioritised. With the challenge and technical skill entailed in understanding climate impacts and measuring emissions, there is a risk that social and governance efforts appear neglected. More time is spent questioning GHG emissions, than social impact.

"There is a risk that the E bit becomes so crowded and big that it crowds out the other areas. It's actually the C (carbon) in the E that can crowd out everything else. And the E crowds out the S and the G."

"The E bit of ESG can overwhelm sometimes and there needs to be a lot of work and clarity in that area. S and G are always trying to catch up. There used to be a lot more structure around S and more community awards which seems to have fallen by the wayside and E has taken over to an extent."

"Long term the biggest risk and opportunity has to be environmental given the impact of climate change. But short-term, social has the biggest impact. High attrition rates and people leaving you get into a spiral where moral gets impacted. So, both E and S are essential but from different perspectives but S risks getting lost."

One reason for this is potentially that companies have had longer to develop effective strategies in this space and have a clearer understanding of the ambitions and targets they have in this area.

"The social piece is very embedded. Our USP is all about our people so looking after people is key and it's a core part of the strategy. It's much more mature and sophisticated on the people side than the carbon side."

"The social side I feel we're really on top of and supporting people at the lower end of wage scales. Is the opportunity there? No, because, we have already captured it and we're all over it so it's much more about protecting it and making sure we're strong."

BOARD MEMBERS MUST LET THE EXECUTIVE LEAD

The key to successfully embedded and impactful ESG strategies is a well-balanced Board and executive team who are able to work together to set and achieve realistic ESG ambitions and targets. This year's interviewees were clear in their view that the executive team, led by the CEO, has to lead the ESG strategy, with 71% noting that the Board's role is oversight not leadership. There was a call for executive leadership and for the management team to take ownership of the ESG space and ensure it is structured in a way which is fit for purpose for the business. The role of the executive is to design the strategy and then go to the Board to validate the decisions being made. It is not for the Board to drive the ESG strategy.

“5 years ago, I would say it was the Board asking questions because you could sense the direction of travel. As management, when you're in the day-to-day business it can be hard to get perspective on what's happening around. So, whether it was Larry Fink messages or Mark Carney on TCFD, Board Members were influencing and starting the conversation. Today, I would say the competence within management has grown. There has definitely been a build of sustainability competence within the organisation, in particular within the E and S. They're living and breathing it day to day and therefore coming to the Board more to say, "this is what we're doing."

“Obviously as legislation has been changing so rapidly people can get in a muddle, but once we as the Board have agreed an approach, then the management will be responsible, and the Board should make sure it is going in the right direction."

“My view is ESG is really important, but it is important in the same way other things are. It's about having a balanced board with the right expertise to drive all relevant agendas, not just ESG."

“If executives who should know better could just get off their arses and go to the ground floor and understand what is really happening in a business and not what is on Sky News, then that would really help. I am disappointed that businesses aren't waking up and looking for other opportunities."

“If you get a generation of executives whose feet are held to the fire on this, you are breeding another generation of non-executives who have grown up in that environment and will make great non-executives in a few years."

“It is important, but it is not universally felt. There are still some real doubters. The Board has a disproportionate number of executives on it, and the scepticism tends to be on the executive side, not the NEDs. There are enough NEDs that see this as critical importance."

“ESG is a distraction because most Boards don't understand it. I am talking in the context of highly operationalised companies. The concept of having a NED who is an impassioned environmentalist is akin to having people turn up to talk to generals in an army about how to run a war – it is not going to work. What I think is missing is the executives who will take responsibility, within the context of a public Board. I have been surprised at how unusual that is and how few executives have put a light on and thought 'do I want to listen to a non-exec on ethics and sustainability or do I actually want to lead this'. That is what is lacking. You have too many 'peace time protagonists' trying to preside over a war time and not enough leaders stepping up to lead."

“What everyone has missed is how do you bring the executives to the table but instead you just have the NEDs crusading over it. Then you have proxy boards just existing, NEDs being clueless, and so many executives just get away with it."

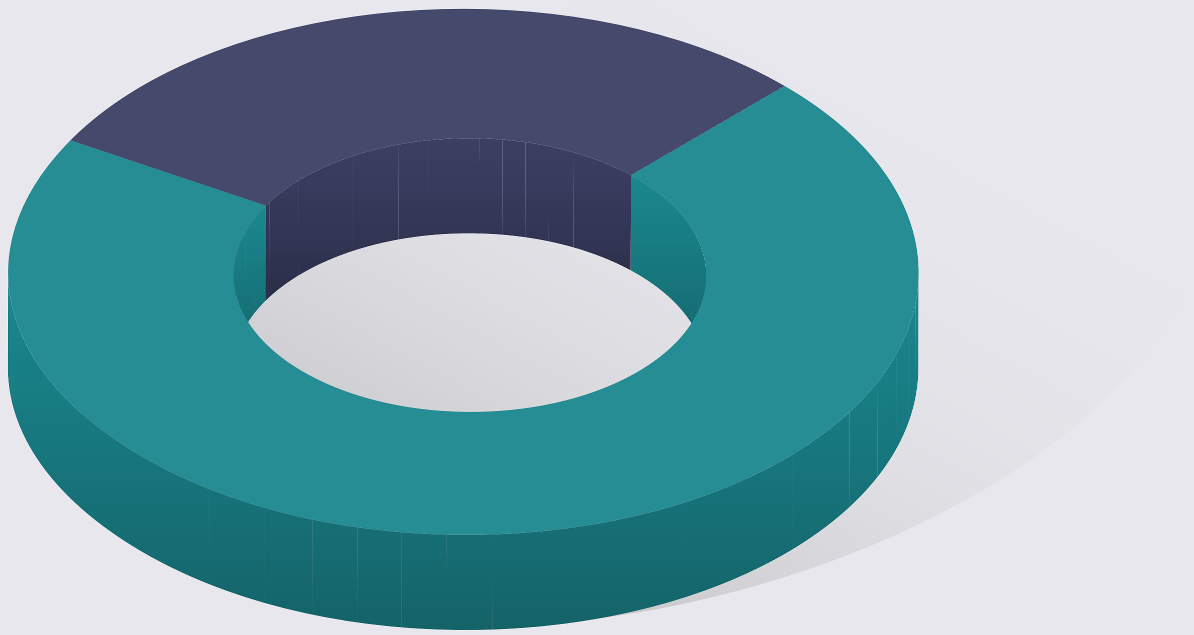
The challenge for Boards today is to gain enough understanding of ESG in order to enable them to identify the many areas in which it can have impact and then to trust management to focus on the top issues.

“They have to work the executive harder. Not by saying 'we're the experts and this is what you should do' but by saying 'here are your 100 things, which hills do you want to die on?"

“Astrologists look at the stars while astronauts figure out how to get there. On a Board you have a bunch of astrologists. What I say to them is they need to

WHAT DO YOU BELIEVE THE BOARD'S ROLE SHOULD BE RELATED TO ESG? IS IT TO DRIVE OR OVERSEE THE IMPLEMENTATION OF ESG?

71%	Oversight
0%	Drive
29%	Both



BOARD MEMBERS MUST LET THE EXECUTIVE LEAD

understand where being an astrologist ends, and where being an astronaut begins. Your job as a Board is not to be an expert in E and the S. Your job as a Board is to encourage the exec team to embrace it. It doesn't mean bribe them with pay or tell them they have to. It means engaging with them to help point out where the benefits are and see out of the menu which are the most appropriate solutions or actions. A NED should roll out a menu of 100 things and then pick the 2 or 3 which make most sense for the business and "where is your strategy around this."

With management being asked to take a bigger leadership role to own the ESG agenda, Boards are also being challenged to be braver in supporting the management in their decision-making. Too often the Board is viewed as simply following regulation over being led by strategic benefits.

“ A sensible Board should be saying 'I know nothing about this, but it isn't my job'. The CEO should go away and come up with the strategy and why it's right and why people should believe in it. The CEO should work with key senior exec leaders and decide 'what do we stand for as a business' and 'how do we break that down to our middle managers and employees'. Instead, you have a bunch of NEDs who try to be squeaky clean and tick boxes and self-preserve."

“ To do it properly you need a much deeper understanding of the business. That is why it should be an executive job. It is time for executives to take more influence and for Boards to admit what they don't know instead of professing to be masters of all knowledge. It is for executives to take a leading roll and NEDs to support and fall in line or deciding that they don't want to support. But really, I think they will sit around the table and hide and just do what regulations require them to do."

“ Have Boards got the balls to explain rather than comply? No, they haven't. I don't think you will get many NEDs who will stick their necks on the line and say I will explain something. What you might get is executives who find a compelling enough story to tell shareholders about it, but then the question is whether the Board backs them. It is another argument for executives to chair ESG committees and then have you got a Board strong enough to stand behind an executive and say we support their explanation."

BOARD MEMBERS MUST LET THE EXECUTIVE LEAD

> “ They have to work the executive harder. Not by saying 'we're the experts and this is what you should do' but instead by saying 'here are your 100 things, which hills do you want to die on?'. "

BOARD MEMBERS ARE COLLECTIVELY STEPPING UP TO THE ESG KNOWLEDGE CHALLENGE

As ESG has continued to gain prominence on the Board agenda and as the regulatory landscape has become increasing complex, there was acknowledgment that Boards may not be properly equipped and informed to stay up to date with the evolution of ESG. With the impacts of ESG becoming ever more wide-ranging and touching every aspect of a business, 88% of respondents made it clear that ESG was better as a collective responsibility. It is simply too far-reaching and complex to be the responsibility of one individual.

"It is definitely something Boards are challenged by. It is a very broad subject and is relatively new. You are at best gifted amateurs. We rely on consultants who can help us with various things, but you learn best by asking questions."

"I would say that the skills and knowledge are quite low if I am honest. I recognise that it is a complex topic, and I am all over it every day, so I know it's impossible for everyone to keep on top of it. It is a necessary part of your job to understand the key things. You don't have to know the detail, but you need to know the big things, the regulations, what the company needs to do to comply and to understand if you embed ESG it can drive value and future proof you in terms of risks. If the Board is not aware of key components of ESG and the risks and opportunities, then they definitely need to be upskilled."

"There is a lot of engagement and interest and the ESG Committee is treated like every over committee. Because we have agreed the strategy and setting targets, all Board members are interested to attend and follow and everyone has attended the meetings, not just those who are on the committee more formally."

"The danger of having too many functional experts around the board table is you can get sidelined, but everyone needs to understand the fundamental issues and see to them."

Boards have recognised this challenge and have worked to ensure that their knowledge stays up to date. This is taking place through individual and Board training, as well as through the support of external consultants and auditors.

"We have the right expertise because we have endeavoured to help the Board to understand what the issues are."

"The legal responsibility around this area will be important. Increasingly Board members will need to ensure they have adequate training to keep up."

"It has been a fast-moving topic across all those business items, so we do have to bring in, and want to bring in, experts from time to time. We are quite good at knowing what we don't know."

Understanding environmental issues including decarbonisation, net zero and climate change, has also put requirements on Boards to understand more technical elements. Industry groups like Chapter Zero were frequently mentioned as being instrumental in supporting Board Member understanding of these complex issues.

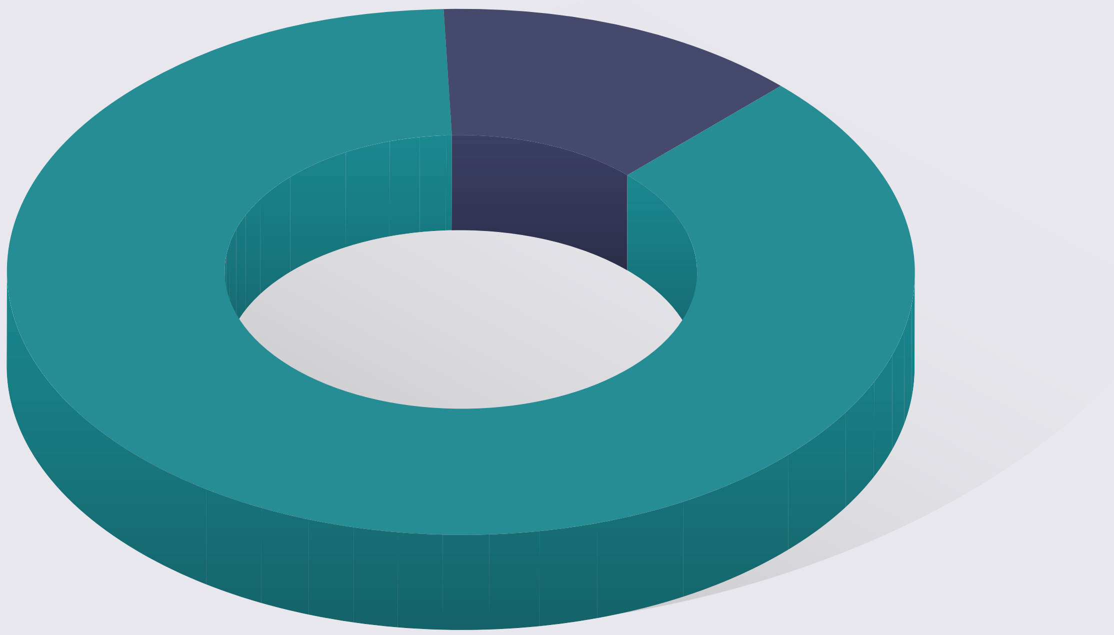
"It is a constantly evolving space, so people need to keep up to speed and learning as things evolve. We have provided training specific on TCFD and climate change risk and areas that are more technical and where we feel the Board needs a quick overview on external guidance on how to prepare things a bit better and will continue to do that as required."

"I think with ESG we absolutely must have relevant experience on the Board. It is something of concern to shareholders and stakeholders which means we need people on the Board who have relevant experience on these issues. Obviously, there is quite a lot of detail when you get into what all the requirements are, in particular related to the environment. Some of those technical requirements require some research and learning. Overall, the Board is there to provide common sense and their own experience."

While there is clear recognition that the ESG space will continue to challenge the knowledge base of Boards,

SHOULD ESG BE AN INDIVIDUAL OR COLLECTIVE RESPONSIBILITY FOR THE BOARD?

88%	Collective
13%	Individual



there is also understanding that there are many other responsibilities for a Board, and they cannot be expected to become subject experts. A broader understanding and experience of how ESG impacts a business and strategy is preferred over technical skills.

“Our Board has the foresight to see demands and issues before they perhaps materialise, and they can definitely identify the ceilings but there is no doubt that the Board recognises client demands and what that means for our projects and growth. It is so core to the business. Regardless of if it’s mandatory, it is still good business, and we hear that a lot from the Board and our C-Suite.”

“In terms of expertise, we have all done training as a Board and we upgrade our own skills at a Board level. You don’t get ESG experts as you will then get scientists who don’t get business. So, there is a lot of individual responsibility to stay educated. It’s never ending. I am not a scientist, but I would say our skills are particularly good for a Board in comparison to other Boards. ”

“You can’t chock the Board full of specialists and experts as our responsibilities are broader than that. You think back to the digital push when in time you realised that getting external consulting input is better at holding you to account and their knowledge is more contemporary. Or perhaps external verification that we’re heading in the right direction and focusing on the right issues.”

This shift in what is expected from the Board is also reflected in how often ESG is being included on the Board agenda. ESG is now firmly established, with 88% of companies discussing it at least quarterly and 46% of companies discussing it at every Board meeting (ranging from 7-12 times per year). While not always discussed under the headline of “ESG”, there is recognition of how far-reaching and impactful the elements of ESG are. While there is criticism of how ESG is positioned and measured, it is clear that Boards are just getting on with it and recognise its long-term importance and influence.

HOW OFTEN DOES ESG FEATURE ON THE BOARD AGENDA?

46%	Every board meeting
21%	More frequently than quarterly
21%	Quarterly
13%	Three times per year
0%	Half yearly or less

GOVERNMENTS ARE FAILING BUSINESS AND THE PLANET

Governments, in the UK and internationally, are vital players in ensuring that ESG issues are taken seriously and have attempted in recent years to accelerate the sense of urgency on climate action. Net zero targets have been put front and centre with the UK Government pledging to be net zero by 2050, and the EU aiming to be climate-neutral by 2050. In both these cases, the targets are legally binding. With commitments like these, all levels of government will need to focus on ESG, and they will need to rally all constituents and society in general to drive positive change. The challenge however, beyond a decline in public and corporate trust in government as an institution, is how to drive this change.

A key theme of the interviews this year was a great sense of frustration that Government is failing at achieving or driving meaningful change. The impetus is put on corporates to enact change and deliver government targets, seemingly without support or understanding for what this means for them.

“The other frustration is that the UK Government is doing this to actually avoid doing something real. They go on about how “we are at the forefront and doing something” but all they are doing is shifting the pressure onto corporates without doing anything real themselves.”

“You need to have a level playing field as a business in order to get on. Only the government can set the level playing field. In this particular day and age, name me a government that can be moved by a love for its people rather than a love for votes. If we have a government who loved its people, it would be easy to set targets and ambitions for net zero and plans for making the world better. But if a government is scared of its own shadow, then what hope do we have?”

“We need greater leadership and support from government. Business is stepping up to the plate as a result of regulations but actually the Government needs to step up and give clear leadership. Not just in the UK but governments around the world.”

“For businesses in areas where there is significant pollution its credible to have ambitious long term aims and credible plan and capex to achieve that plan, but it’s not for government to tell business how to create their strategy.”

“All of this gets lost in translation. What the Government has announced about net zero and its commitments has been more about its own priorities than what is good for important industries. In some ways the Government could never have come out of it looking good because you can’t please everybody.”

“Governments are slow. This is the first time in my life where the corporates and the investing world have moved ahead of regulation. It is really important for governments to catch up. And they are in catch up mode. All of this needs to be integrated and brought together.”

“It is important to engage with current and future administrations on this, but a number of ESG pillars, and we have five of them, are reliant on some kind of engagement with the government and supportive government policy. You need government to understand that and create a public policy framework that allows us to translate our policies to something achievable. We need a public policy framework which understands what us and others are trying to do. That isn’t happening.”

Despite this sense, corporates appear to be ignoring the political football, and are getting on with their own initiatives. Not because they think Government will make them do it regardless of who is in charge, but because they recognise it is the right thing to do, for both profit and planet.

“It is critical to have government support to implement sustainability initiatives and set an achievable strategy. But really, when it comes down to it, we are agnostic to what they talk about. We just have to get on with it.”

“Governments are always going to be political and will always do what the political agenda dictates, and you have to accept that. Of course, it would be helpful if they were clearer. It would be wonderful if we could wave a magic wand and get governments to be more

responsible. You have to navigate yourself around this in spite of governments, not because of them.”

“Where you get the hindrance piece is the uncertainty, and the chopping and changing. Business is very good at moaning about change but then very good at dealing with it. The government changing their thoughts on it won’t make us undo our strategy because it’s the right thing. Business with consistency can make the right investments. When things constantly chop and change it undermines the agenda.”

“The change in Ministers and leadership is not helpful. It is realistic that the targets will change but we just plough on regardless and do the day job.”

“I am just going to carry on. I won’t slow down. If it’s not the UK, then the EU will carry on and that will still apply to us. The right thing to do is to carry on as quickly as possible.”

Overall, corporates are calling for more educated and constructive debate on the implications of policy on business, as well as an increased recognition that the elements of ESG should not be politicised.

“It is a shame that ESG can’t be discussed in a more mature way. It is always Daily-Mail-ised by the time it hits everyone and it’s always something dramatized like a U-turn on a policy or a goal. The lack of a constructive debate is what is probably missing. I suspect most people find it very hard to know what is going on at all really.”

“I would like to see governments rise above the politics and realise the environmental significance.”

“It shouldn’t be politicised. Regardless of who is in power it is something that should just be taken forward and not be changed. It’s the one thing that needs to stay the same. It is a massive topic that will affect all of us and we need to collectively take action. It shouldn’t be dialled back depending on who is in power.”

In September 2023, the UK Government delayed certain net zero-related targets including moving the ban on sale of new diesel and petrol cars back by five years to 2035 and other notable policies. Many have expressed frustration and disappointment at the announcement; however, it should not be interpreted as a policy reversal on climate change, but instead a recognition that some of the targets set were potentially unrealistic. Flip-flopping on the environment and other commitments is however not helpful to business who need certainty in order to allocate investment to support government targets being reached.

“There is a broader issue of engagement with government, and I think most issuers will say the same thing and would express some degree of frustration and that the current administration seems to have given up on putting any plausible scenario out there that is helpful to business. There is no point pretending there will be any policy framework which will support ESG or business after May/ June this year.”

“People need clarity and certainty to make capex decisions so when a government flip flops it doesn’t help. It is not helpful. The capital you’ve already decided to invest is broadly sunk, and it adds uncertainty and doubt for future capital. The best thing government can do is set a direction and let the industry get on with it and not meddle too much. A better way of asking would be what would you be doing with more certainty? Would you be spending your money differently?”

“It weakens government commitment to ESG and makes it look like a farce. To the average Joe it sounds like “we’re not really committed”. It would have been better to explain that the industry said “we can’t make the dates, and these are the reasons and that these are temporary measures, but we have the same goals”. Instead, it came across as a weakening of resolve. The US has also gone backwards. You have companies who were never really committed already saying it’ll be ‘one of those things that goes away’.”

“Business needs certainty and flip flopping is very unhelpful. The country is broken so flip flopping adds to uncertainty. Sadly, it’s a result of poor preparation and analysis before indicating a direction of travel in my opinion.”

THE RESEARCH SCOPE

SIFA Strategy conducted in-depth interviews with 31 senior Board Members, who through their Board responsibilities have insight and oversight for over 70 companies or institutions across the UK and Ireland. These companies cover 16 sectors and in the public and private markets, span a broad range of market capitalisations ranging from £49m to over £5bn. The interview questions covered themes related to the current status of ESG as a focus, practice, and industry. The main intention was to understand the Boardroom perspective on ESG in the small- and mid-cap, as companies face a fast-changing regulatory and capital markets landscape which is shaping the approach and oversight of ESG.

The interviews and analysis of findings were conducted from late October 2023 to January 2024.

Throughout the review, where relevant and appropriate, we have drawn comparisons to some of last year's findings in order to provide a sense of trends and changes. As in previous years, we have not highlighted specific sectors in the analysis as it would not be statistically appropriate to do so. We are, however, happy to discuss sector insights we have gained from this research and our work. Please contact us if this would be of interest.

We facilitate the understanding, implementation, and embedding of ESG within a business. Our team of consultants work at Board, committee, and management levels, supporting and challenging our clients to approach the material elements of ESG as part of their operational and financial decision-making, not just as a factor of compliance and reporting.

As a specialist ESG consultancy, we deliver a range of services as integral parts of wider ESG programmes or as standalone projects. We have developed a detailed approach to materiality in line with regulatory demands and have created a Senior Advisor Panel of experts who are available to Boards and senior management teams for workshops and specific operational change programmes.

Our purpose is to support our clients to be sustainable and successful by linking ESG actions to commercial performance and value creation.

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Peel Hunt is a leading UK investment bank that specialises in supporting mid-cap and growth companies. We put long-term success above short-term gain, helping good companies succeed and delivering outstanding results. We have three business areas, but we act as one Peel Hunt.

Our integrated approach combines expert research and distribution, a range of investment banking services, and an execution services hub that provides liquidity to the UK capital markets.

ESG sits at the core of our strategy and is rooted in the values and behaviours which have informed our culture for more than a decade. We not only look at our responsibilities as the direct impact of our operations but we also focus on the wider influence and impact we can have through our work with our corporate and institutional clients, including supporting our corporate clients to develop and manage their own approach to sustainability.

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