Gartner Research

Harness ESG Exuberance

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Sudden overprioritization of environmental, social and governance factors can trigger an expensive reputational crisis. But underplaying them increases risks. Here's what executive leaders should do to leverage ESG to gain access to new, less expensive capital.

Overview

Key Findings

- ESG and sustainability are often used interchangeably but are not the same thing.
- CEO and stakeholder interest in ESG factors is rising rapidly, signaling zeal in the market.
- ESG practices done wrong can create an authenticity crisis that takes years to overcome and calls wider business ethics into question.

Recommendations

Executives should help CEOs and boards harness ESG exuberance:

- Distinguish ESG from sustainability. Define and communicate the difference between them.
- Set the strategic ambition for ESG practices. React to stakeholder pressure or get a head start on change.
- Don't ignore the "G" (governance). Distinguish between ESG credentialing and tangible steps the enterprise is taking versus risky ESG washing that overstates actions or is illegal.

Introduction

Attention on ESG is on the rise with investment in funds more than doubling in 2020. **Executives should moderate ESG exuberance to avoid an authenticity crisis and improve access to capital, stock performance and customer loyalty.**

What ESG Is

ESG is a measure of performance. It's a collection of corporate performance evaluation criteria that assess the robustness of a company's governance mechanisms and its ability to effectively manage its environmental and social impacts.

Why ESG Performance Is an Opportunity

Well-managed ESG performance can improve financial benefits, for example:

- Access to capital — $20 trillion in AUM sits in ESG-aligned funds globally (see ESG Assets May Hit $53 Trillion by 2025, a Third of Global AUM).
- Cost of capital — Higher ESG scores correlate to lower costs of capital — 6.16% compared to 6.55% for lowest ESG scores (see ESG and the Cost of Capital).
- Stock performance — In 2020, 75% of ESG funds outperformed their benchmarks (see ESG Index Funds Are Outperforming (Mostly)).
- Cost savings — ESG execution can reduce operating costs by up to 60% (see Five Ways That ESG Creates Value).

Why ESG Focus Is on the Rise

Stakeholder pressure is driving the growth in attention on ESG issues. Our annual Gartner CEO and Senior Business Executive Survey showed that, within the corporate category of top business priorities, social responsibility and ESG mentions almost doubled year over year from 5% to 9%. A recent Gartner survey showed that stakeholder pressure from customers, investors, regulators and employees is driving an increased focus on environmental and social issues. According to the CFA Institute, the top two motivations to consider ESG factors include managing investment risks at 64% and customers/ investors demand it at 59%.

What Could Go Wrong

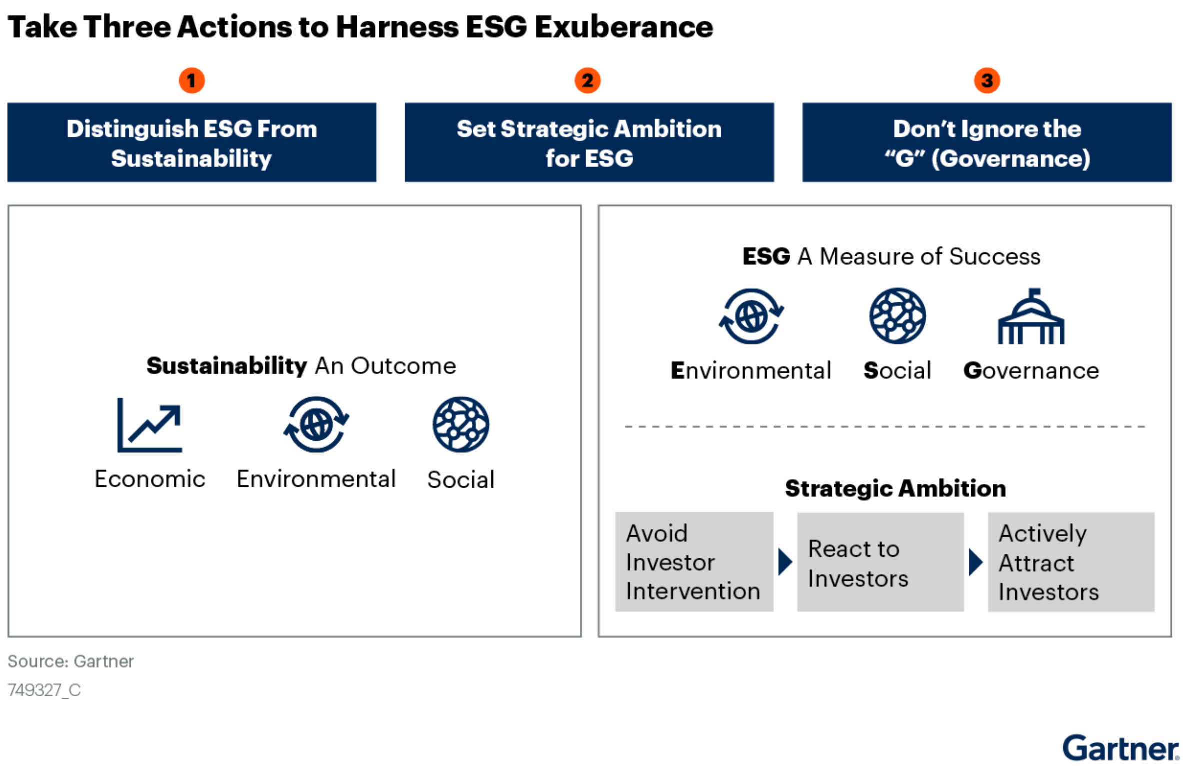
ESG practices done wrong can trigger a reputational or even a legal crisis. Executives should monitor two practices that create especially high risk:

- **ESG washing.** This promotes a false impression or provides misleading information about the environmental, social and governance strengths of an enterprise. ESG washing is often misleading (like creating a video of a hydrogen-fueled vehicle rolling downhill rather than on its own power). But it can be illegal (like installing defeat software to improve emissions performance).
- **Insufficient focus on governance.** "E" (environmental) and "S" (social) are getting the bulk of investor ESG focus. **Governance accounts for just 8% of total ESG metrics.** The relative lack of focus on "G" sows the seeds for ESG practices hitting a Trough of Disillusionment as investor priorities become increasingly narrow. And insufficient governance increases the odds of illegal ESG washing.

How Executives Should Moderate ESG Exuberance

Executives should take three actions to benefit from ESG practices (see Figure 1).

Figure 1: Take Three Actions to Moderate ESG Exuberance

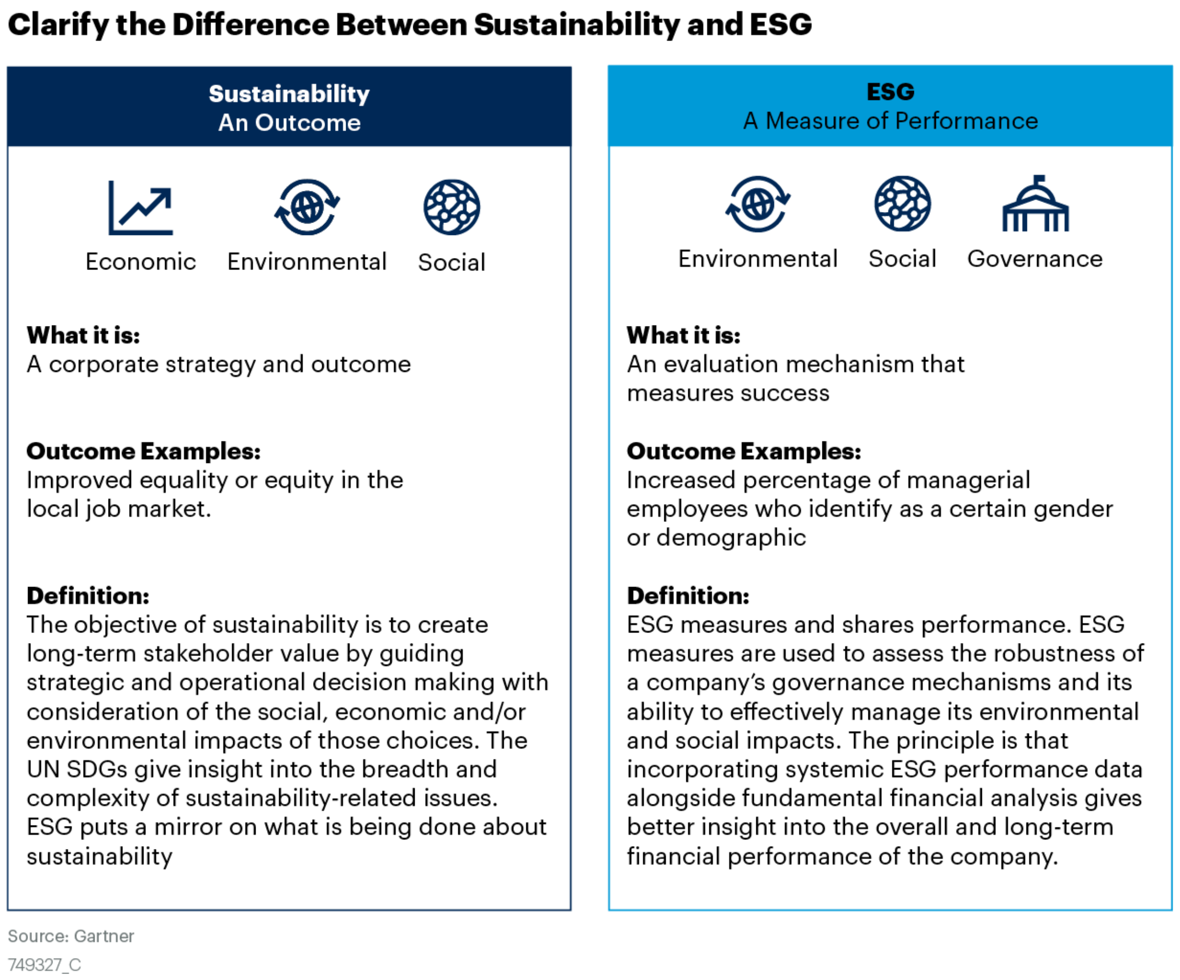


Analysis

Distinguish ESG From Sustainability

ESG and sustainability are not the same thing. We often hear ESG factors being conflated with sustainability, or the terms being used interchangeably. We also hear ESG practices referred to as simply external reporting and investor relations, or in other words keeping the investor and regulator community happy. Distinguishing the difference between sustainability and ESG is essential to a coherent and effective strategy (see Figure 2).

Figure 2: Clarify the Difference Between Sustainability and ESG



Executives should:

- Create common definitions for sustainability and ESG (see Figure 2 above). Make clear distinctions between the two terms.
- Design ESG as a governance mechanism that measures success.
- List issues that could materially impact the enterprise or be of interest to its stakeholders. These will ultimately be the metrics to measure and report as part of an ESG function. Examples could include workplace safety, land use, climate change, fair pay and share-class structure. The United Nations Environment Programme (UNEP) recently started urging others to think beyond just materiality. Consider the sustainability crisis as climate change, pollution and loss of biodiversity.
- Use peer company and/or aspirational company ESG reports, proxy advisory firms and activist investor reports to create the list of potential material issues.
- Apply the relevant frameworks (such as SASB, GRI and TCFD) consistently and methodically, and develop an ESG data strategy to support their use.

Set Strategic Ambition for ESG

Ambition is the aspirational plan and direction to achieve business outcomes. A business outcome is an observable change in business performance. **ESG measures have three levels of strategic ambition that support sustainability outcomes** (see Figure 3).

Figure 3: Align ESG Ambition With the Desired Sustainability Outcomes

Align the Strategic Ambition for ESG with Sustainability Outcomes

Sustainability Outcomes	Strategic Ambition for ESG	Use When	Benefits	Drawbacks
Drive New Business Models and Revenue	**Actively Attract Investors**	• Investor pressure is high. • Other stakeholder pressure is high. • Executives want to differentiate and act on values.	• Sustainability creates white space, new growth opportunities in many industries	• Requires deep business model change. No profit, no purpose.
Improve Stakeholder Engagement and Efficiency	**Avoid Investor Intervention**	• Investor pressure is moderate. • Other stakeholder pressure is low to moderate. • Executives want to get a head start on big change.	• Low to moderate costs to improve brand	• Stakeholders can be quick to discern greenwashing and DEI washing. • Stagnation can attract activist investors.
Meet Regulatory Compliance Requirements	**React to Investors**	• Investor pressure is low. • Other stakeholder pressure (customers, employees) is low. • M&A is consuming energy and attention.	• Cost avoidance	• Stakeholder pressure can arrive abruptly (example: plastic straws).

Source: Gartner
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Executives may choose to do the bare minimum with ESG practices by complying with reporting regulations to avoid investor intervention. They can react to investor pressure for ESG principles by choosing to make changes to products and/or a more diverse, equitable and inclusive work environment. The most aggressive ESG approach is to actively attract investors by differentiating through sustainability-driven business models and operating models.

Executives should:

- Identify and prioritize key stakeholders based on their importance to the enterprise and intensity of interest. Of those who have long-term economic relationships with the company, whose interests/opinions can have the greatest impact on company success? And which groups or organizations are most impacted by the organization's activities (regardless of economic relationships)?

- Solicit input from key stakeholders to rank the material issues identified above by their impact on the enterprise and by their importance. This is called a materiality assessment.
- Choose the ESG ambition that best addresses the material issues identified by key stakeholders, while balancing risk and reward for the enterprise. For example, annual shareholder meetings have been stalled because investors (one type of stakeholder) did not sign off, based on missing or incomplete ESG reports.
- Avoid investor intervention by doing the bare minimum with ESG measures if investor pressure is low, customer and employee pressure is low, or M&A is consuming considerable resources.
- React to investor pressure if investor pressure is moderate or executives want to preempt change.
- Actively attract investors if investor pressure is high or executives want to act on values and differentiate as a sustainability-focused business.
- Move between levels of ambition, in most cases by increasing from one level to the next due to stakeholder pressure or a shift in personal priorities.

Don’t Ignore the “G”

We are concerned about the current lack of sufficient focus on the “G” (governance) in ESG metrics. Governance examples include decision transparency; separation of powers; share-class structure; shareholder relations; business ethics; and integrity, government relations, board leadership and executive compensation.

Gartner research of S&P 500 companies in 2020 showed that 94% issued a comprehensive ESG report and 89% issued an environmental impact report. **But only 47% issued a report that addresses organizational governance.** And as we mentioned above, governance metrics are also referenced less frequently than environmental and social metrics are.

The G in ESG underpins the E and S elements. Governance fosters trust, transparency and longevity around the required environmental and social initiatives. If an organization suffers from poor governance, its chances that it will make a lasting and meaningful impact on its performance are far from optimal.

Executives should:

- Analyze the percentage of governance metrics relative to social and environmental metrics used in ESG reporting.
- Create an ESG task force to identify and implement governance issues that would have the greatest impact on cost and growth. This task force should also focus on ESG efficiency and help embed risk considerations into ESG planning and strategy. A good ESG task force focused on governance should pull individuals from legal and compliance/corporate secretary, risk, investor relations, HR, audit and internal controls.
- Design or reinforce internal controls to detect and safely report illegal ESG washing. The hype around ESG will create pressure for results, and this can and does go wrong.
- Walk a fine line between ESG credentialing and risky ESG washing. ESG credentialing is communicating tangible, meaningful steps the company is taking to improve sustainability. Risky ESG washing is overmarketing menial actions.

Evidence

Gartner conducted this research from July 2020 through December 2020, with questions about the period 2020 to 2023. One-quarter of the sample was collected in July and August, and three-quarters from October through December.

In total, 465 actively employed CEOs and other senior executive business leaders qualified and participated. The research was collected via 390 online surveys and 75 telephone interviews.

By job role, the sample mix was:

- 287 CEOs
- 115 CFOs
- 29 COOs or other C-level
- 34 chairpersons, presidents and board directors

By geographic region, the sample mix was:

- 183 North America

- 109 Europe
- 97 China, Japan, Australia and other APAC
- 56 Brazil, Mexico and other Latin America
- 13 Middle East
- 7 South Africa

By enterprise revenue, the sample mix was:

- 46 $50M to <$250M
- 122 $250M to <$1B
- 226 $1B to <$10B
- 71 $10B or more

The survey was developed collaboratively by a team of Gartner analysts that examines technology-related strategic business change, and was reviewed, tested and administered by Gartner's Research Data and Analytics (RDA) team. The results of this study are representative of the respondent base and not necessarily business as a whole.

Recommended by the Authors

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