Investment funds that target companies with environmental, social, and governance (ESG) policies have experienced record growth. Yet it’s difficult for companies to know which ESG actions will affect the value of their stock. Although ESG rating providers focus on different ESG elements and market pricing of corporate ESG actions has been uneven, companies can take steps to influence how their ESG activity is valued.
ESG investing initially focused on excluding the stocks of certain companies or industries from investment portfolios, and as the definition shifted to focus on including securities of companies with socially beneficial practices, the stock market has also evolved. Intangible assets like intellectual property rights, customer data, and software now account for 90 percent of the value of S&P 500 companies, up from 17 percent in 1975, according to companies that track this data. In the disconnect between market value and traditional valuation models for companies — which favor tangible assets such as buildings, equipment, and real estate — asset managers and rating agencies are seeking new ways to value companies. As practices evolve, companies can take action that gives them “credit” for their ESG actions.

Before adopting any ESG policy, companies should ensure they are making a genuine commitment, as retail investors and intermediaries to pension plans and investors are increasingly scrutinizing corporate actions. Many asset owners and investment managers are signatories to the United Nations’ Principles for Investment Management (UN PRI) and therefore required to report on how ESG is incorporated into their processes.

In the governance arena, incorporating recognized best practices, including in relation to board composition and executive compensation policies, and expanding shareholder voting rights, can help companies elevate their ESG rankings. Asset managers often look to the major proxy advisory and governance services organizations, Institutional Shareholder Services and Glass Lewis, for guidance on evaluating these issues. Companies can also use the shareholder voting mechanism to get feedback on whether and when to adopt ESG-driven policies.

Creating a separate report about the company’s commitment to ESG, instead of or in addition to adding ESG information to the 10-K, is another way to showcase corporate commitment to ESG goals to the investment community. Although not all analysts currently review such reports, due to resource limitations and because they use the same data as other analysts, that practice is ripe for change. The widespread adoption of machine learning and artificial intelligence tools enables analysts to scrape the internet and gather more data easily.

Aside from making policy changes, taking care to enhance and protect a company’s reputation can also boost the organization’s ESG score. Although social media activity, sanctions, and executive service on boards of organizations that support ESG goals, for example, are not assessed when analysts run a valuation, they can be incorporated into an overall ESG score. ESG data science companies aggregate information from public sources and stakeholders around the globe in determining ESG risks.

The lack of standardization of ESG ratings makes it difficult to make direct links from corporate actions to ESG ratings to shareholder value, yet the growing focus on ESG in the asset management and investor communities is likely to increase the value of ESG activity. Creating an ESG infrastructure will help companies capture value as the investment community and market “catch up” with the corporate world’s widespread embrace of ESG.

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