Follow the Money:
The ESG Revolution in Finance

EXECUTIVE ACADEMY

"Following the money, maximizing financial returns for your shareholders has been a strong tenant of traditional financial management. In post-pandemic business reality, following the money will leave many traditionalists irritated by the observation that a lot of capital appears not to chase solely financial returns but a cryptic acronym called ESG. What are the implications of the phenomenon, that will play an even greater role in the global financial markets in the future, for companies, leaders and decision makers?"

Prof. Jakob Müllner

INTRODUCTION

Environmental, Social & Governance – short ESG – denotes a loose set of standards for responsible and sustainable investment that are applied to investment valuation and reported to external stakeholders. While the COVID pandemic has turned many long-lasting trends upside down, the ESG train has not only withered the storm of the pandemic, in fact, it is coming out of the pandemic in a force and variety previously unseen.

In the fourth quarter prior to the pandemic, issues of green bonds totalled 78,394 million USD. 12 months later and in the middle of the first major lock-downs quarterly issues topped 210,371 million USD (+ 268 %) (Q2 2020). Similar growth trends of ESG-linked financial products were observed in corporate lending, project finance, M&A and even SPAC transactions.

Today, a total of $30.7 Trillion or 39% of total AUM (assets under management) actively weight Environmental, Social and Governance (ESG) factors in their investment strategy.

TO BE OR NOT TO BE WITH ESG

The takeaway from these figures is clear: There is a flood of earmarked green money chasing sustainable investments. In fact, the number of qualified uses for the funds

is much lower than the abundant supply and practitioners reportedly hit breaks on new issues because of fear of not being able to spend raised money. Recently, banks and exchanges have even started offering specialized ESG linked derivatives.

From the onset, the trend might appear like a fad in the finance industry but its implications are much more fundamental. Companies gaining access to abundant ESG capital can develop a financial competitive advantage. Companies that miss the ESG train may ultimately struggle to keep up with increasing ESG requirements from creditors, investors, suppliers, policymakers and customers.

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ESG and CSR – Crucial Topics for Large Companies Only?
Rating agencies, for example, have included specialized metrics in their rating methodologies. Of the nearly 8,000 private-sector rating actions (downgrades or upgrades) announced by Moody's in 2019, 33% contained references to ESG reasons (Moody's ESG Focus, 2022). Such ratings can directly affect corporate borrowing, cost of capital and growth opportunities. Academic research by leading universities like Columbia or Wharton Business School, shows that ESG and Corporate Social Responsibility is acknowledged by both shareholders and consumers and potentially has financial benefits for companies. But are increasing ESG requirements limited to large, credit-rated companies? The answer is: certainly not.

On 6 July 2021, the European Commission unveiled its "Strategy for Financing the Transition to a Sustainable Economy" that will support the EU Green Deal. A central tenant of the strategy is to give individuals and SMEs greater access to sustainable finance.

In October 2022, the first set of standards of the Corporate Sustainability Reporting Directive (CSRD) became effective. These improve the flow of money from large companies, banks and insurers towards sustainable activities across the European Union. This opening of the gates has a trickle-down effect on companies previously unaffected by the ESG train. At present, many SMEs lack organizational capacity and knowledge to comply with sustainability reporting requirements. This restricts SMEs' ability to demonstrate robust ESG credentials and access the money that is chasing the deals. Jointly excess ESG capital and regulatory policy will create a situation in which ESG strategy and literacy are sources of firms' competitive advantages. But is ESG here to stay? The answer is yes. In fact, industry experts such as Moody's expect COVID and the societal changes that it has created to increase the relevance of ESG, and of the social part in particular, in the long run.

ESG LITERACY AS A KEY COMPETENCIES FOR FUTURE LEADERS

Whether it is corporate CEOs pursuing competitive advantage or policy makers trying to (hopefully) maximize public wealth, the diagnosis from following the money is clear: Sustainable finance is the most promising source of economic recovery from the COVID pandemic and the energy crisis, and ESG literacy is the way to tap into this source.

ACCEPTING THE ESG CHALLENGE: HOW TO GET STARTED

ESG is here to stay and it is a double-edged sword. Ignoring it might result in an increase in firm risks. Similarly, addressing ESG factors improperly/or misleadingly can result in a damaged reputation. Therefore, in order to gain a competitive advantage from the ESG trend, firms must understand their own situation. Firms can start by looking broadly at the ESG issues that are most likely to affect their industry (Material ESG Issues). For example, the ESG Ratings provider, MSCI, has an online ESG Industry Materiality Map that can serve as a useful reference to get started. How can companies gain competitive advantage from the ESG trend? While some companies that are ill-equipped for ESG realities (e.g., Exxon was caught off guard by activist investors Engine No.1) others can leverage their ESG competencies and track-record to open up new sources of finance, new customers and, in some industries, innovation.

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Once there is a general understanding of the most important issues likely to affect companies in the industry, companies can begin the process of assessment and benchmarking. In financial markets, most actors rely on ESG ratings (e.g., Sustainalytics, MSCI, etc …) to assess a firm's ESG. Thus, it is crucial to understand how these ratings work and where the firm scores vis-à-vis its competitors.

THE MOST IMPORTANT ESG INSIGHTS FOR COMPANY LEADERS

What Should Managers Do?

Developing ESG competencies and recognition requires companies to build relationships with all stakeholders, report triple-bottom line results and actively promote their ESG values within and beyond their organizational structure. Key to credible stakeholder relationship management is honest, open and fact-based communication. Superficial or even misleading information can result in costly accusations of greenwashing and damage corporate reputation. To achieve this, managers require ESG literacy.

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Content: Applied Corporate Finance, Financial Risk Management & Corporate Hedging, Behavioral Finance, Portfolio Investment & Management, Valuation & Topics in Investment Banking
Duration: 18 months, part-time
Language: English
Academic Qualification: Executive Master of Business Administration (EMBA)

What Does ESG Literacy Mean?

ESG reporting is still in its infancy and there are no clear, universal reporting standards (yet). Nevertheless, it is important for managers to get acquainted with established frameworks for ESG reporting. Investors might be familiar with the Sustainability Accounting Standards Board (SASB), the Global Reporting Initiative (GRI), or the Carbon Disclosure Project (CDP) among to others. Additionally, communicating ESG progress by referring the UN's sustainable development goals (SDGs) also provides an opportunity to relate to multiple stakeholders. There are several promising private and multinational attempts to establish unified concepts such as the Natural Capital Protocol and The Equator Principles in banking. Once managers are ESG literate and competent, it is time to convert these competencies into competitive advantage.

How Do You Create Competitive Advantage From ESG?

In order to not only anticipate necessary change in business practices from these initiatives, but actively create business opportunities from them, requires companies to develop knowledge about and strategic capabilities within these ESG frameworks. If a company leader has no experience with the topic, it might be a good idea to get external assistance. Many firms offer specialized ESG assessments. In addition to specialist knowledge, these assessments can also lend third-party legitimacy to further reports or communications, similar to the role of a financial auditor. However, in order to create business opportunities from the information obtained from an ESG assessment, companies will need to develop knowledge about and strategic capabilities within these ESG frameworks.

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