ESG Viewpoint

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ESG disclosure at mid-cap companies

Summary

- The importance of ESG disclosure has grown as a result of regulatory changes, the development of internationally recognised disclosure frameworks, and rising demand from investors, who are increasingly incorporating ESG factors into investment decision-making.
- We contacted 43 companies – each with a market cap of less than US$10 billion – to highlight the most material environmental and social issues for their respective industries which we think should underpin their ESG reporting frameworks.
- Of these 43 companies, 20 were willing to engage in dialogue. With few other investors engaging them on ESG disclosure, we found that they were receptive to our advice.

Background

In recent years, disclosure frameworks established by governments, international listing agencies and non-profit organisations have paved the way towards reporting on ESG issues being the norm rather than the exception.

Of all the frameworks developed, the most widely used is the Global Reporting Initiative's (GRI) framework. The GRI's Standards, the first global standards for sustainability, are currently used by 82% of the world's largest 250 corporations[1]. The Carbon Disclosure Project (CDP) has also achieved global recognition for its standards on environmental disclosure, and reporting companies now represent approximately 56% of global market capitalisation[2].

Government-led disclosure guidelines have developed alongside those of non-profit organisations, and analysis conducted by the Principles for Responsible Investment (PRI) revealed that 38 of the 50 largest economies in the world had, or were developing, disclosure requirements for corporations covering ESG issues[3].

[1] https://www.globalreporting.org/information/news-and-press-center/press-resources/Pages/default.aspx
[2] https://www.cdp.net/en/scores-2017
[3] https://www.unpri.org/how-effective-are-corporate-disclosure-regulations/211.article

Finally, ESG data providers – widely used by institutional investors and asset managers – are drawing on publicly available information to evaluate and score company ESG performance over time and relative to peers.

Against this backdrop, those companies which are laggards from a reporting perspective are arguably at a competitive disadvantage, and we are keenly aware that mid-cap companies may lack the necessary resources to deliver the quality of reporting that stakeholders have come to expect.

BMO Engagement

As an investor, we see ourselves able to play a role in assisting these companies to improve the quality of their reporting by flagging critical gaps and helping them to close them, based on our experience of engaging their larger peers.

In order to identify target companies, we began by combining BMO's proprietary industry ESG materiality assessments with quantitative data provided by our third-party ESG research provider, enabling us to pinpoint mid-cap companies with low ESG scores on the issues flagged by our analysis as the most material for these companies' respective industries. We used the results of this process to shortlist 43 companies with disclosure gaps belonging to three comparatively high-risk sectors: consumer staples, industrials, and materials. We then evaluated the reporting of these companies, and found that 65% align their reporting with the GRI's Standards to varying degrees and 77% are receptive to CDP.

Given the gulf in the quality of reporting between the leaders and laggards, we were not surprised to find that – at the laggard end of the spectrum – 8 of the 10 mid-cap companies included in this project that do not submit to the CDP also do not use the GRI's Standards to report on their sustainability performance. Moreover, 5 of these 8 companies disclose very limited non-financial information.

All companies with a market cap of US$10 billion or more would ideally report in accordance with the GRI's Standards and participate in CDP. However, we recognise that they are facing an array of obligatory and voluntary reporting requirements, not to mention time-intensive questionnaires, which is why we think disclosure should focus on the most material issues to internal and external stakeholders. One commonly used approach to identify these issues is the construction of a materiality matrix, exemplified by the one shown overleaf, which is taken from Marine Harvest's Integrated Annual Report 2017[4]. In the case of **Marine Harvest**, a mid-cap Norwegian seafood company, we would expect to see more detailed disclosure on the issues in the top right quadrant.

[4] Marine Harvest, Integrated Annual Report 2017 – http://hugin.info/209/R/2177429/840178.pdf

Marine Harvest most material value drivers

Source: Marine Harvest, Integrated Annual Report 2017

With this approach in mind, we determined which issues are material for each sector, and then considered which points our target companies should disclose to stakeholders, factoring in the key risks associated with their respective industries.

The table below summarises where we focused our engagement on an issue-by-issue basis, and the number of companies engaged on each issue:

	Consumer Staples	Industrials	Materials	No. of companies engaged
Biodiversity & Land Use	✗	✓	✓	3
Carbon emissions	✗	✓	✗	1
Chemical Safety	✗	✗	✓	6
Corruption	✗	✓	✓	8
Health & Safety	✗	✓	✗	4
Labour Management	✓	✓	✓	20
Packaging Materials & Waste	✗	✗	✓	6
Product Carbon Footprint	✓	✗	✗	6
Product Safety & Quality	✓	✓	✗	13
Raw Material Sourcing	✓	✓	✓	11
Toxic Emissions & Waste	✗	✗	✓	6
Water Stress	✓	✗	✓	10

In our dialogue with companies, we were encouraged that many were willing to take our suggestions on board, particularly those which told us that they are striving to improve their ESG disclosure year on year, such as Royal Mail. However, it became apparent that there are two factors which can lead to shortcomings in how well company reporting reflects sustainability performance:

1. Companies operating in countries where market disclosure standards are low may appear to be managing ESG risks less adequately than is actually the case.

This point can be illustrated by the Sustainability Reports published by **Sealed Air**, a packaging company headquartered in the US, where the level of disclosure varies significantly. Sealed Air's reporting compares favourably in a US context, and in a call with the company we were positively impressed with their sustainability commitments. However, its reporting is less thorough than that of **DS Smith** and **Mondi**, packaging companies headquartered in Europe which, unlike Sealed Air, prepare their reports in accordance with the GRI's Standards. We are pleased to say that Sealed Air is on a positive trajectory: subsequent to engaging the company we were informed that the 2018 Sustainability Report will include a materiality matrix, and that the company's new set of goals will be linked to the UN Sustainable Development Goals.

2. Companies using the GRI Standards can opt to tailor their reporting to reflect the regulatory reporting requirements they are subject to.

This can, however, lead to the omission of useful information. For example, two Japanese construction and engineering companies, **Obayashi Corporation** and **Shimizu Corporation**, do not disclose. "near-miss" events – defined by the UK Health and Safety Executive as events "not causing harm, but [have] the potential to cause injury or ill health"[5] and referred to in GRI Standard 403 as "close calls"[6] – even though the quality of both companies' reporting is very good overall. We were informed by an investor relations representative at Obayashi Corporation that the company follows the Japanese Industrial Safety and Health Act and other relevant Japanese laws, which do not require "near-miss" events to be recorded.

As a general rule, we encourage companies to benchmark their reporting against that of leading peers in their respective industries, regardless of geographic location, and to go beyond mandatory reporting requirements, particularly on topics which are directly relevant to their core operations. Furthermore, we believe that companies should provide information about the oversight of key environmental and social issues – an indication, in our opinion, of effective governance. The mid-cap companies shown in the table below are to be commended for not only meeting and exceeding our expectations on disclosing information about material issues, but also for communicating a credible sustainability narrative:

Material issues	Leading companies
Biodiversity & Land use	Agnico Eagle Mines
Carbon emissions	Royal Mail
Chemical safety	Arkema; Mitsui Chemicals
Corruption	Agnico Eagle Mines
Labour management	Agnico Eagle Mines; MTU Aero Engines; Royal Mail; Trelleborg
Packaging materials & waste	DS Smith; Mondi
Product carbon footprint	DS Smith; Mondi
Product safety & quality	Marine Harvest
Raw material sourcing	DS Smith; Mondi; Smurfit Kappa
Toxic emissions & waste	Mitsui Chemicals
Water stress	No leading companies identified

[5] http://www.hse.gov.uk/toolbox/managing/accidents.htm
[6] https://www.globalreporting.org/standards/media/1910/gri-403-occupational-health-and-safety-2018.pdf

Benefits of ESG disclosure

Besides the intrinsic value of ESG disclosure, in our experience high-quality disclosure is a powerful tool for revealing:

1) Companies' ability to achieve targets

We encourage companies to clearly state their targets, explain what action is being taken to achieve these, and what their current status is. This transparent approach, exemplified by GEA Group, an industrial machinery company, and MTU Aero Engines, an aerospace and defence company, holds companies accountable and enables stakeholders to gauge a company's ability to implement appropriate measures to achieve targets.

2) Progress over time

Stakeholders can evaluate companies' progress over time by examining ESG data, which should ideally be presented over a five-year period. In our dialogue with President Chain Store Corporation, for example, we asked whether the company would consider disclosing the "disabling injury data" for the year in question alongside the equivalent data for previous years, explaining that this would facilitate the identification of trends.

3) Organisational integration

We like to see company-wide trends, in addition to figures for different regions and divisions, because this suggests that a company has effective channels of communication. We were concerned, for instance, when a representative from Spirax-Sarco Engineering, a rapidly growing company with 114 operating units in 47 countries[7], informed us that employee turnover data is collected on a local level rather than on a group-wide level, one reason why the information is not disclosed. Given that financial and reputational damage frequently arises as a result of a company acquiring another with weaker risk management systems, we welcome evidence that all business divisions report to the same standard, thereby enabling data aggregation, and, by extension, effective oversight.

Key takeaways

Mid-cap companies are having to navigate a complex and rapidly evolving reporting landscape, and it is hardly surprising that company representatives are feeling increasingly pressured. The rationalisation and harmonisation of disclosure frameworks would help, and although steps have already been taken in this direction, achieving greater global homogeneity will be a complex and lengthy process.

In the current environment, we think that companies should focus on using a combination of qualitative and quantitative information to cover material ESG issues comprehensively in their reporting, thereby giving investors an insight into how key risks are being managed. This process should be a fundamental element of corporate strategy, and we would recommend board oversight of disclosure transparency to enhance the development of high-quality reporting, and, most importantly, the underlying policies and procedures.

Finally, we would like to make it clear that, as investors, we do not expect perfection; indeed, it raises alarm bells if a company's reporting does not flag any obstacles and challenges. We want to hear about what steps companies have taken to solve problems and reduce the likelihood of similar problems occurring in the future, alongside information about achievements and accomplishments. By providing us with a complete picture, we and other stakeholders can feel more confident about our investment decisions.

In terms of next steps, we will review the future reports of the companies we engaged in dialogue with to determine which of our recommendations have been adopted, and we are expanding the scope of this project to focus on companies in the following sectors: consumer discretionary, energy, health care, information technology, telecommunication services, and utilities. We expect that, over time, we will see the quality of companies' reporting improve further still in response to continued pressure from regulators and stakeholders.

[7] As at 31 December 2018

Continued

Key risks

The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

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