Incorporating Sustainability Into Long-Term Strategy

February 2019

Summary
• State Street Global Advisors’ (SSGA) asset stewardship program is aimed at engaging with our portfolio companies on issues that impact long-term value creation across environmental, social and governance (ESG) considerations
• In the recent past, SSGA has issued extensive guidance on key governance matters such as effective, independent board leadership. SSGA’s current focus is on helping boards think about the possible impacts of environmental and social issues and incorporating a sustainability lens into boards’ oversight of long-term strategy as a sound business practice
• Our framework for evaluating companies is based on each company’s approach to sustainability, drawing upon our past engagements with many companies on these issues
• This framework reviews and categorizes a company’s approach to sustainability according to three criteria:
  – Has the company identified material environmental and social sustainability issues relevant to its business?
  – Has the company assessed and, where necessary, incorporated the implications of relevant environmental and social sustainability issues into the company’s long-term strategy?
  – Has the company adequately communicated its approach to sustainability issues and its influence on strategy?
• We then classify companies according to which criteria they have met:
  – Tier One companies have satisfied all three
  – Tier Two companies typically have satisfied one or two
  – Tier Three companies have not considered sustainability issues at all
• We believe boards can play an important role in strengthening a company’s approach to sustainability. Thus, we have provided a framework that is intended to help boards consider and communicate how these risks and opportunities affect long-term strategy

Overview
Sustainability encompasses a broad range of environmental, social and governance (ESG) factors that include topics such as effective, independent board leadership and board composition, workplace diversity, safety and management of environmental impacts. Sustainability has been at the center of SSGA’s asset stewardship program for a number of years. SSGA has had approximately 2,200 engagements on ESG issues with over 1,200 companies in our global portfolio since 2013. While board governance has been a significant focus of our thought leadership efforts in the past, we have also been engaging with companies and developing our views on environmental and social considerations and their effect on our stewardship obligations. We acknowledge that sustainability issues differ by industry and do not impact all companies equally. However, we are certain that over time these issues pose both risks to and opportunities for long-term returns. Therefore, as stewards we are convinced that, as part of good business practice, ESG issues must be part of effective board leadership and board oversight of long-term company strategy.

Since we have made our position on governance matters clear in the past, this paper focuses more specifically on board approaches to environmental and social sustainability issues.

SSGA’s Framework for Evaluating Sustainability Approaches
Engagements with portfolio companies are typically conducted on a multi-year basis. Initial engagements on sustainability focus on company processes, practices and reporting/disclosure. Ultimately these engagements evolve into an assessment of whether the board has considered the impact of sustainability issues and how, if appropriate, these sustainability factors are linked to the company’s long-term business strategy. We evaluate companies according to a framework (see Figure 1) that we have developed based on numerous engagements with portfolio companies on their sustainability approaches.

Figure 1: SSGA’s Framework for Evaluating a Company’s Approach to Sustainability

<table>
<thead>
<tr>
<th>Step 1</th>
<th>Step 2</th>
<th>Step 3</th>
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<tbody>
<tr>
<td>Has the company identified material</td>
<td>Has the company assessed and, where</td>
<td>Has the company communicated its</td>
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<td>environmental and social sustainability</td>
<td>necessary, incorporated those issues</td>
<td>approach to sustainability issues and the</td>
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<td>issues relevant to the business?</td>
<td>into their long-term strategy?</td>
<td>influence of these factors on strategy?</td>
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Figure 1: SSGA’s Framework for Evaluating a Company’s Approach to Sustainability
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We use this framework to categorize companies according to how comprehensively a company has considered sustainability risks and opportunities. Tier One companies have undertaken all three steps, while Tier Two companies have undertaken only one or two of these steps. Companies that have not undertaken any of these steps are categorized as Tier Three.

We believe that Tier One companies are positioning themselves for the long-term, as these companies have successfully incorporated a sustainability lens into their strategic planning process around innovation, product development and capital allocation. These companies have developed a strategic perspective on sustainability that clearly supports the company’s business objectives, and the impact of sustainability considerations on long-term business decisions is clearly articulated.

In contrast, we have found that Tier Two companies may have well-developed, standalone sustainability programs, but these programs are often not integrated into their overarching business strategy. For example, while these companies may have identified material ESG factors, they may not have expressly incorporated them into the company’s strategy. Or a company may not clearly articulate for investors how these factors influence long-term strategic choices, or not provide relevant data on key performance indicators (KPIs) or not establish long-term goals that align with the strategy.

We believe returns at Tier Three companies are at the greatest risk in the long-term, as management and boards fail to acknowledge and plan for business disruptions or opportunities related to sustainability issues.

Of the 177 companies in our global portfolio that we deeply evaluated in 2016 according to their approach to sustainability, we found that only 7% of companies qualified as Tier One; 72% of companies were classified as Tier Two; and 21% were in the Tier Three category.

Active Stewardship of Portfolio Companies

As an index investment provider, SSGA invests in Tier One, Tier Two and Tier Three companies. However, because we take a risk-based approach with our active stewardship program, we focus efforts on Tier Three companies that have disregarded sustainability issues or have failed to communicate their position on such issues to shareholders. When we believe that engagement alone is not effective, we will incorporate our assessment of a company’s approach to sustainability into our proxy voting decisions. As a result of these efforts, we have had a growing number of inquiries from our portfolio companies on how to improve their approach to sustainability issues.

Guidance for Directors on Incorporating Sustainability into Strategy

As long-horizon investors, we believe it is important for companies to assess the possible impacts of sustainability issues on strategy as a good business practice. We also believe that boards can play an important role in strengthening a company’s approach to sustainability and that it is for the board, as part of its oversight of strategy, to ensure that management consider, and communicate, how these issues affect long-term strategy, if at all.

We have developed a series of questions (see Figure 2) to help guide boards in undertaking this process.

In addition, we have also provided examples in Figure 3 of how some companies have addressed each one of these issues. These examples are not prescriptive; rather they are illustrations to help companies and boards develop their own approach to sustainability.

Figure 2: Addressing Sustainability Issues: Questions for Boards

1. Has the company identified the sustainability issues material to the business?
2. Has the company analyzed and incorporated sustainability issues, where relevant, into its long-term strategy?
3. Does the company consider long-term sustainability trends in capital allocation decisions?
4. Is the board equipped to adequately evaluate and oversee the sustainability aspects of the company’s long-term strategy?
5. Does the company’s reporting clearly articulate the influence of sustainability issues on strategy?
6. Is the board incorporating key sustainability drivers into performance evaluation and compensation programs?
Identifying sustainability issues material to the business

- Many companies conduct peer reviews to identify sustainability-related Key Performance Indicators (KPIs)
- Some companies are adopting a more scientific approach to identifying materiality and prioritizing KPIs by using analytic tools to quantify environmental and social impacts
- KPIs are further managed using management information systems (MIS) or dedicated environmental management systems (EMS) which facilitate internal and public reporting
- Life-cycle assessments (LCAs) are an example of how companies can identify the environmental and social areas that are most impacted throughout a product’s life-cycle, from raw material extraction through end-of-life management. The information collected from LCAs can be supplemented with a company’s internal and external stakeholder engagements to prioritize impact areas by materiality

Analyzing and incorporating sustainability issues, where relevant, into long-term strategy

- At some companies, boards get regular updates on material sustainability matters or boards have dedicated sessions to discuss sustainability trends relevant to the industry and company
- Some companies have appointed a Chief Sustainability Officer to reflect the importance of sustainability issues to the company’s strategy

Including long-term sustainability trends into capital allocation decisions

- Some companies that have incorporated environmental and social factors into strategic planning and capital allocation decision-making processes have made early investments that have helped the company realize benefits through brand differentiation, introducing new lines of businesses, lowering the risk profile of the company, and improving access to capital
- For example, some companies have invested in clean-tech research that has led to the development and marketing of products that are eco-friendly and have a lower environmental impact than traditional products

Strengthening board oversight of sustainability practices

- To ensure that the board is actively engaged on emerging risks and opportunities as they relate to sustainability, some companies give their directors explicit oversight responsibility of sustainability practices by incorporating it into committee charters or governance guidelines or through a dedicated Corporate Responsibility Committee

Incorporating key sustainability drivers into performance evaluation and compensation programs

- While several companies include sustainability drivers in executive compensation programs, very few companies meaningfully communicate to investors the efficacy of achievements that justify compensation payouts
- Companies that effectively incorporate sustainability drivers into performance evaluation and compensation programs are good at:
  - Identifying sustainability matters that are material to the business
  - Have systems in place to quantify or measure performance related to material sustainability issues
  - Establish performance goals against which they measure achievement
  - Disclose to shareholders the material sustainability issues that drive compensation, the specific goals or performance targets that management has to achieve and report on the actual performance against established goals to justify compensation payouts

Communicating the influence of sustainability factors on strategy

- In their strategic narrative to investors and other stakeholders, Tier One companies communicate their approach to sustainability and the extent to which sustainability factors are integrated into or impact strategy. These companies include relevant information such as ESG KPIs in investor presentations
- Examples of Tier One companies that demonstrated the impact of sustainability issues on long-term strategy:
  - In response to obesity and public health concerns, a food and beverage company developed product lines that reduced fat and sodium content, giving customers healthier product options
  - An energy company invested in low-emission technologies and decommissioned aging carbon-intensive operations to create a more diversified energy portfolio in response to the board’s assessment of regulatory and investment/consumer trends pertaining to climate change
  - An international coffee company changed its sourcing guidelines to incentivize and reward farmers who use sustainable practices to make its supply chains more resilient, while ensuring consistency in the quality of its agricultural products
- Examples of Tier Two companies that did not fully communicate their sustainability narrative:
  - A services company that identified talent recruitment and employee retention as a material social issue, communicated the programs implemented to address the issue but did not disclose the material KPIs (such as employee turnover) that allow investors to measure progress against goals and the effectiveness of the current program
  - An energy company that identified climate risk as a concern in its financial reports but only provided emission data against annual goals. Therefore, it failed to demonstrate to investors how the company is managing the potential impacts of climate change on the company’s long-term strategy
  - A grocery chain that has positioned itself as a leader in organic and healthy product offerings that are sustainably farmed failed to provide meaningful data on ESG KPIs such as supply chain and waste management
This guidance was initially published in 2017.

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Contact Us

We hope board members of our portfolio companies find this guidance useful. Any questions or comments may be directed to:

Rakhi Kumar
Senior Managing Director & Head of ESG Investments and Asset Stewardship
Rakhi_Kumar@ssga.com

Michael Younis
ESG Analyst, Asset Stewardship
Michael_Younis@ssga.com

Caitlin McSherry
ESG Analyst, Asset Stewardship
Caitlin_McSherry@ssga.com

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ID15587-1997714.2.1.GBL.0119 Exp. Date: 01/31/2020