S-RM

2024

ESG Report

The rise of social sustainability

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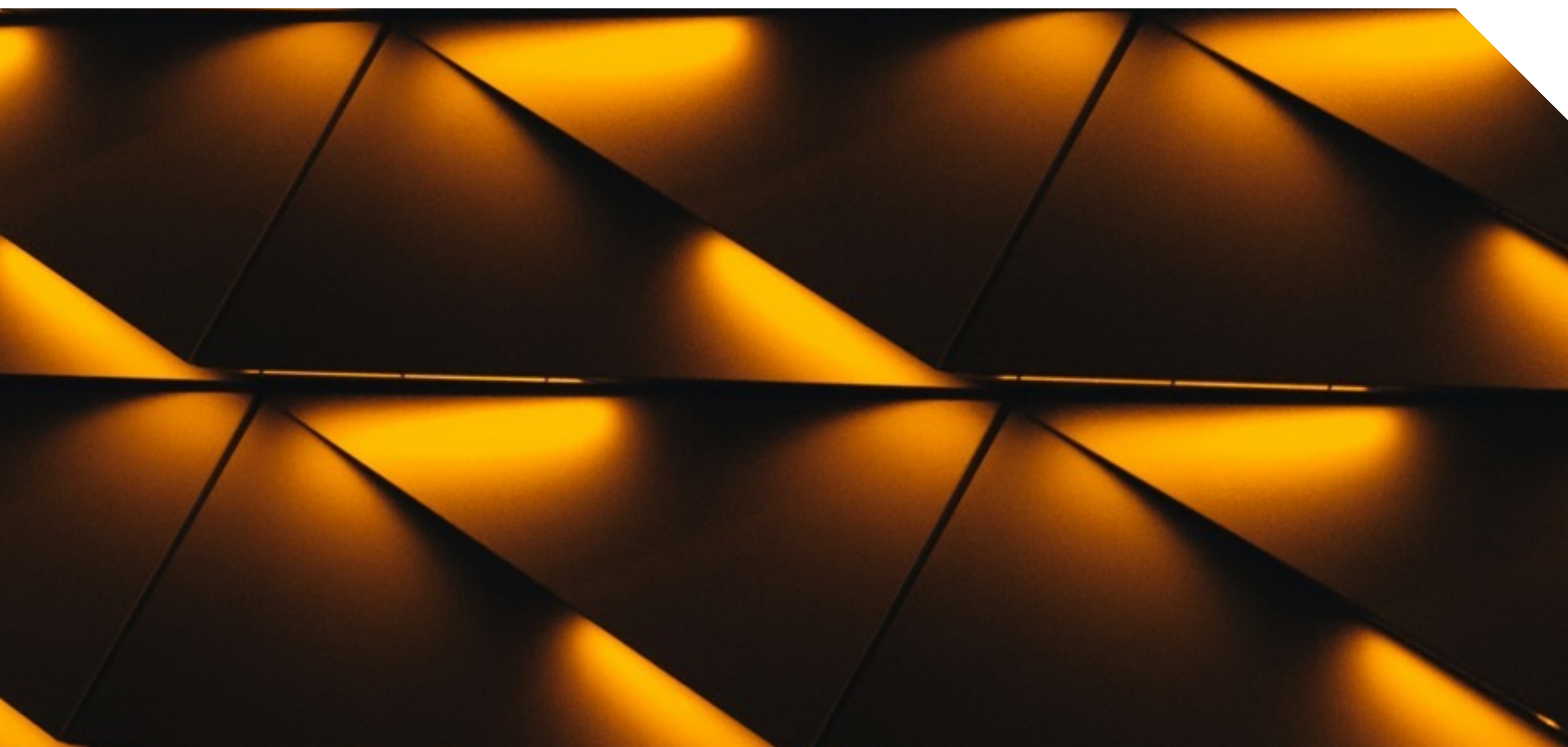

Introduction

It seems like the world can't get enough of 'ESG' and Sustainability these days. Everywhere we turn, we are hearing about how 'ESG needs to be at the core of the business strategy' or 'Sustainability is central to value creation'. But what do people mean when we talk about ESG? And are we all thinking the same thing? If we don't know exactly what Sustainability means for us, how do we succeed in ensuring we are maximising our outcomes and impacts? How are we adequately addressing our risks?

What we can all for the most part agree on, is that ESG, or Sustainability, is here to stay. It is not a fad or a trend, as evidenced by budget allocation, regulation and legislation. But it is often still a messy concept applied very differently across different companies. For some it's a tool of risk management, others value creation and people retention. It can be a real force for good, not just in an altruistic sense, but also for bottom lines, if it is properly understood, measured, and harnessed in a way that is fit-for-purpose and results-oriented. If it is not, it can pose risks to revenue, operations, and reputation.

At S-RM, in our conversations with clients about these very such questions we have always found ESG and Sustainability to have more of an environmental focus. But, recently, we have been detecting a steady shift in these questions to capturing more of the Social issues that have hitherto been further down the corporate agenda. So, we commissioned a survey with 550 corporates and 200 investors across the UK, France, Germany, the Netherlands and the US, across a range of sectors, to understand the extent to which, if at all, the Social issues within ESG are considered to be a growing risk and/or value creation opportunity. [1]

Our findings revealed a corporate world still unprepared for the regulation and legislation that is coming down the line on Social issues in particular, but also one with a worrying lack of maturity when it comes to their ESG programmes more generally. 74 percent of companies we surveyed do not believe they have a very mature ESG programme or policies. This may help to explain why much of the ESG focus to date has been on the more visible environmental aspect of ESG rather than grappling with the disparate and complex Social issues. Nevertheless, our survey showed that there is a growing consensus on the importance of the Social pillar of ESG – historically neglected, but now steadily rising up the corporate agenda, partially driven by legislation, and partially by specific stakeholder pressure, as well as the increasing public prominence of Social Issues such as Human Rights and Responsible Supply Chains.

[1] Survey conducted by Coleman Parkes between 4 December 2023 and 9 January 2024. Respondents comprised: 550 senior ESG decision makers with corporate organisations plus 200 senior ESG decision makers within investment firms. Investors were asked to comment on the businesses within their portfolios, rather than their own organisations.

The ESG agenda will follow the money. The companies we surveyed spend an average of 4.2 percent of their annual revenue on ESG factors. Two-thirds of corporates and 58 percent of investors expect these budgets to rise over the next five years, with money invested in the Social pillar expected to rise across the board, while the Environment takes a small dip. There are some clear priorities within the Social pillar – Human Rights, Labour and Equality, Diversity and Inclusion (EDI), but also some curious omissions. Responsible Supply Chains and integrating Geopolitical Risk into your sustainability agenda, for example, fall surprisingly low on our respondents' priority lists. In this article we will examine why and explain how this may be a false economy.

A major factor is the push from the leaders and board on the 'Governance' to empower the energy transition"

Director of Corporate Responsibility,
Oil and Gas company, UK

Those companies we spoke with who have a high to medium ESG maturity were clear as to why this is the case. One British company expressed it simply as a "push from the leaders and board on governance". For any and all aspects of ESG to work, good governance is absolutely critical. Some of this relates to how ESG is managed within a business. Of the companies we spoke with, it was almost evenly split among those who hold a holistic approach to ESG i.e. looking at Environment, Social and Governance together (56 percent) and those who place greater emphasis on individual elements of ESG (44 percent). This lack of consistency in how to approach ESG shows just how important good governance is now, but also to ensure that the larger budgets coming ESG's way are allocated effectively and managed by people with appropriate skills and knowledge.

Unsurprisingly, views on how to handle ESG pressures, and particularly the growing focus on Social issues, are determined to a large extent by the industry and sector. People-focused technology businesses are more fixated on aligning organisational culture with ESG, whilst mining, resources and energy are dominated by the drive for greater transparency for demonstrable proof of ESG impact, conscious of the public scrutiny, and often criticism, that their ESG posture needs to withstand.

Key findings

66%

of companies and

58%

of investors

expect their ESG budgets to rise in the next five years, with 'Social' receiving a greater allocation.

74%

of companies feel they lack full ESG maturity.

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over

80%

of European investors and corporates do not feel fully prepared for forthcoming ESG regulations.

77%

of companies do not include 'responsible supply chains' within their ESG programmes.

01

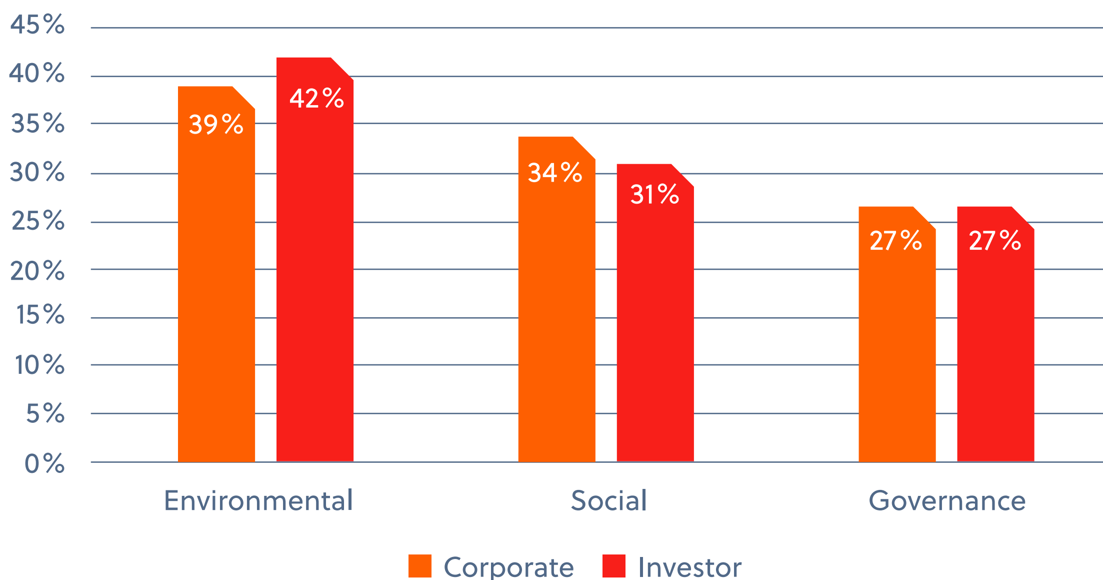
The Environment still dominates. But Social is on the rise

ESG, often interchangeably described as Sustainability, is dominated by the Environment. This is evident in discourse around the issue and on average the vast majority of our survey respondents put the greater effort into this pillar. Assessed by any metric, whether effort and resources, KPIs or budget, Environment is dominant across all sectors and investors. 39 percent of effort and resources of corporates is dedicated to the Environment, as well as 42 percent by investors (figure 1). Right across the board, Social comes next, followed by Governance. Similarly, Environment currently consumes 42 percent of corporate ESG budgets and 41 percent of investor ESG budgets, followed, again, by Social and Governance, in that order (see figures 2 and 3). The fact that Governance consistently ranks at the bottom is not necessarily reflective of prioritisation, but, as a German logistics firm we spoke to explained, "the importance of the Social element of ESG has risen versus Governance, which has always been there because everybody is always required to operate legally".

> The importance of the Social element of ESG has risen versus Governance, which has always been there because everybody's always required to operate legally."
>
> **VP Social Sustainability,**
> Logistics company, Germany

FIGURE 1

Distribution of efforts and resources across the pillars of ESG



It is not surprising that Environment has started off so prominently. This is the area which has the most developed policy asks by governments, presents the most tangible single issue to address, and where the public consciousness has most recently been focused. Reducing greenhouse gas emissions is a unifying objective across all businesses. As one extractive company we spoke with said, when it comes to the Environment "we have fewer key areas to focus on". Virtually any listed company will now have a net zero strategy and plans to reduce greenhouse gas emissions are expected, and measured, by just about every investor. However, there is a risk that too many ESG programmes are being too narrowly focused on the Environmental pillar. One company we spoke to, for example, spends around 50 percent of its whole ESG budget on the Environment. Yes, there may be the need for capital investment in new technologies, but there is a question as to what extent this crowds out budget spend on other aspects of ESG.

What issues fall within ESG's Social pillar?

HUMAN RIGHTS

MODERN SLAVERY

COMMUNITY PROGRAMMES

EQUALITY, DIVERSITY AND INCLUSION (EDI)

HEALTH AND SAFETY

LABOUR LAWS

DATA PROTECTION AND PRIVACY

GEOPOLITICAL RISK

RESPONSIBLE SUPPLY CHAINS

As a result, companies face the risk of being dangerously exposed on Social issues. It is here where much of the new regulation is principally focused. In addition, the drive for transparency, increased public scrutiny and the ability of social media to dig into hitherto opaque supply chains and project the results quickly into news reports and board room meetings, show why Social risks are starting to creep up the risk register. Similarly, from a value creation perspective, getting these Social issues right will attract talent, improve retention and ultimately bolster human capital.

Certainly from our survey of 550 corporates and 200 investors, for decision makers at the board and C-suite level, it is Social issues which are expected to receive growing traction over the next five years (figures 2 and 3). There is an urgent need for action on Social issues, but, overall, businesses are still starting from a low base. They have usually not had the cash injection or board focus of the Environment, nor have they enjoyed an institutional history of being part of a firm's legal, risk and compliance apparatus, like Governance. Instead, Social issues are disparate, often handled by different functions within a company, and can require complex human engagement. Around one quarter of both investors and corporates assessed there to be little or no awareness of Social issues or challenges in their industry. This in itself presents a concern. As with compliance, with Social issues there needs to be some onus of responsibility of each employee to take ownership and be vigilant. This is how a collective culture of responsibility will emerge.

But, the drivers are now all there. Executive decision-making is combining with projected budget increases to tackle Social issues over the next five years at least, and the growth of regulation is a key motivation for undertaking meaningful Social programmes.

FIGURE 2

% budget split across ESG pillars currently vs in next 5 years - corporates

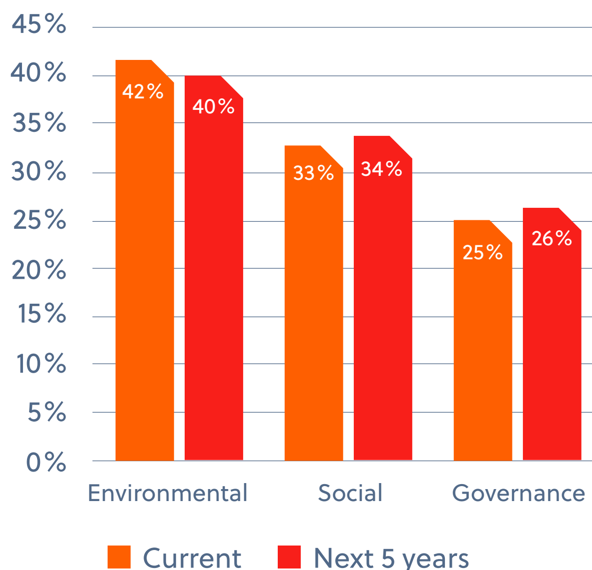
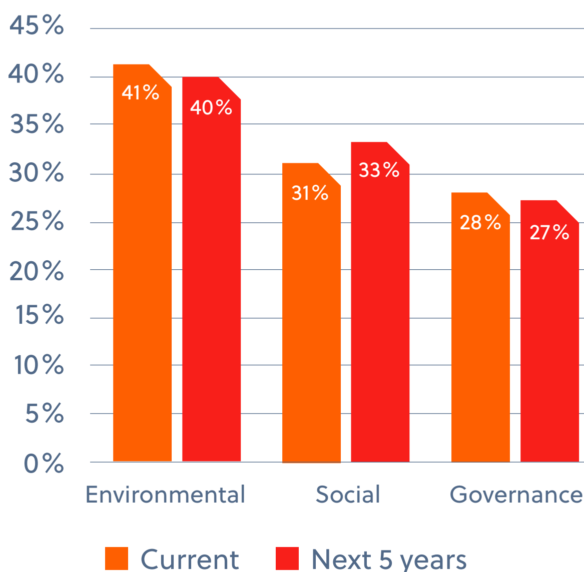


FIGURE 3

% budget split across ESG pillars currently vs in next 5 years - investors



Pharmaceuticals: falling behind the pack?

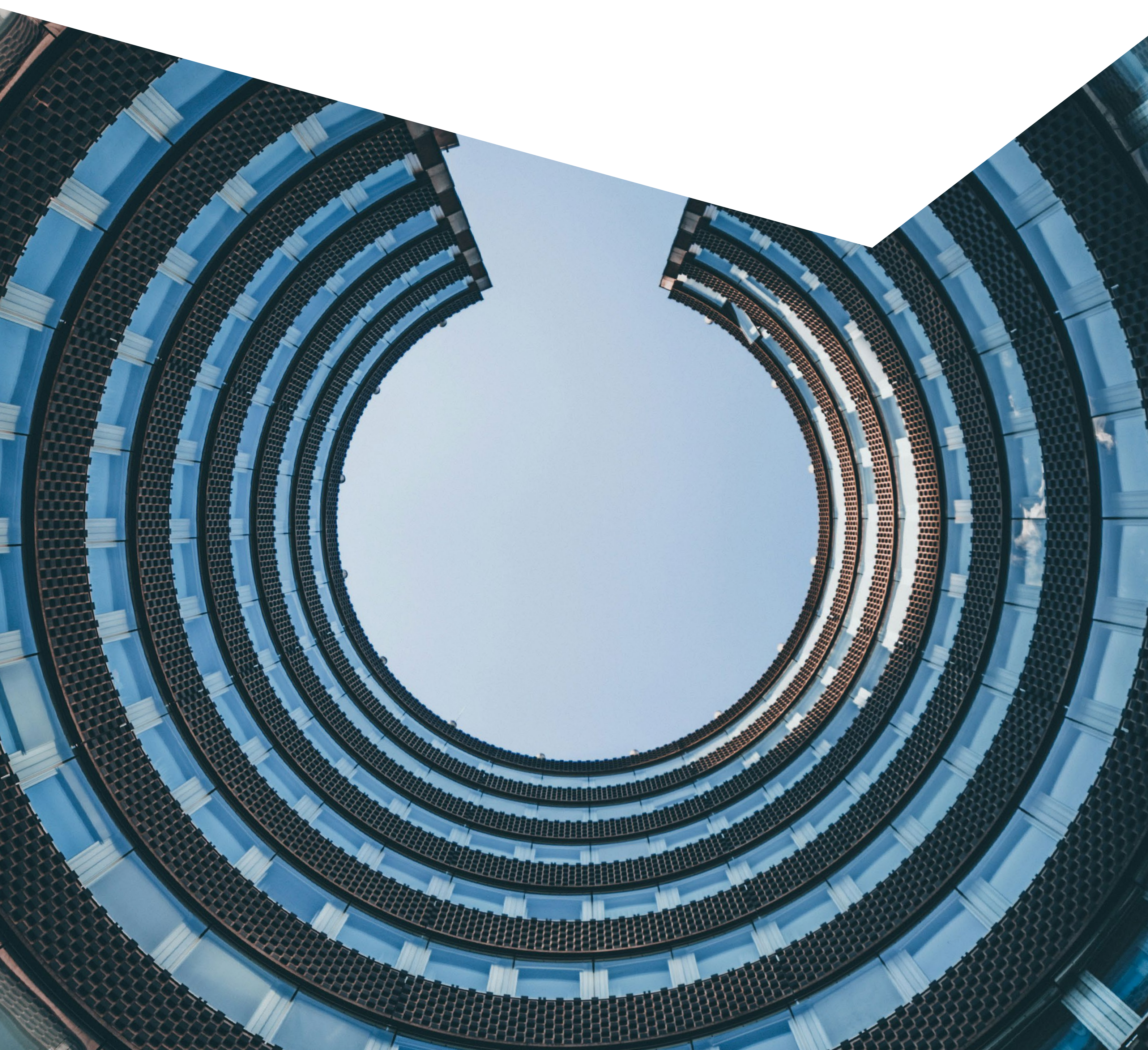
S-RM analysed in detail eight sectors as part of our survey. It was the pharmaceutical sector for which the results were consistently falling below the average overall corporate response. One quarter of pharmaceutical respondents said they considered their business to have a low awareness of ESG, alongside no formal structure and no formal process of integration across the business. Perhaps unsurprisingly, this meant that less than half of them believed their company to be currently aligning organisational culture with ESG and only 9 percent of respondents felt themselves to be very prepared for upcoming ESG legislation.

Pharmaceutical companies hold a unique role among the sectors we surveyed in that there is an inherent social good attached to their business – improving health outcomes. There is a risk that this can be conflated with the need to have a comprehensive ESG strategy, programmes and policies i.e. that the latter does not need to be a priority if the business can point to its social good providing it with a licence to operate. This may explain why the pharmaceutical sector invested the lowest proportions of its annual revenue – 3.8 percent – in ESG, compared to an average across all sectors of 4.2 percent.

Pharmaceuticals seem to be falling behind the pack not just in terms of their overall approach to ESG and Sustainability, but particularly on Social issues. Only 15 percent of respondents felt that Social issues would pose a bigger risk to their organisation over the next five years, again significantly lagging behind other sectors. Yet, it is on Social, and Governance, issues that pharmaceutical businesses are most exposed, including operational risks in their long and complex supply chains and distribution networks, as well as litigation risks around problems like price-fixing of generics, off-label marketing, kickbacks, failing to grip the challenge of counterfeits and the promotion of opioids, all with significant implications for their reputation and the bottom-line. Regular double materiality assessments would help to reinforce the relevance of these issues to pharmaceutical ESG teams, and hopefully push the issue back up their corporate agendas before it is forced to by shareholders, consumers or litigation.

02

Regulation. Regulation. Regulation



Few conversations regarding ESG or sustainability happen these days without some reference to the alphabet soup of regulations and legislation that is coming out of the EU, in particular. Whether the CSRD, the CSDDD or beyond, there is no hiding from the upcoming regulatory burden.

ESG has traditionally been an underregulated area, partially a function of the disparate issues that fall within the wider term, and also because, historically, many of these issues have been considered 'nice to have' rather than a corporate requirement. However, the last five years has seen a growing patchwork of regulations and legislation, predominantly at the domestic level, which are starting to build a more consistent regulatory picture, at least for European businesses.

When surveyed, 84 percent of European corporates said they do not feel fully prepared for these regulations, along with 81 percent of investors. These are quite staggering numbers. Many of the regulations emerge from European directives that have been in the works and consulted on for years. In some instances the urgency to prepare has been lost and there is certainly a sense that in these early days of more sweeping ESG regulatory change, any directives or laws will be considered as works in progress for some time, to be refined and further modified as more companies fall into scope and their costs, benefits and challenges become clearer. So, as long as a company can illustrate their broad intent at compliance, this may be enough to see them through initially. Similarly, the extent of reporting requirements now required, particularly for investors to report upwards to their institutional investors, means the demands of today are taking precedence over the worries of tomorrow. With ESG teams still often small, or responsibility falling across different business functions, priority will necessarily be placed on dealing with reporting to all current stakeholders, or for financial services firms dealing with existing regulation like the SFDR. But in the long term that is a false economy. The CSRD, and particularly the CSDDD, will require new data to be collected. Prior to this happening, businesses may need to conduct a double materiality assessment, agree or review their ESG strategy, make sufficient changes to the programme and cascade this appropriately. Particularly for the CSDDD where the focus is the supply and value chain, it can really take time to even agree what the required processes are, let alone get them in place across your supply or value chain. And this is before even thinking about data collection. This is not a short exercise. If a company isn't feeling prepared for regulation and it does not currently have a plan in place, then it needs to move quickly.

> There are many regulations about which businesses must be concerned, such as Sustainability Disclosure Requirements (SDR), Corporate Sustainability Due Diligence Directive (CSDDD), Corporate Sustainability Reporting Directive (CSRD), and more... if they fail [to comply], this may impact their business."

Director of Sustainability,
Manufacturing company, Netherlands

Digging into those regulations causing companies the greatest concern, it is not surprising that these have a large Social component, given this is hitherto the least regulated aspect of ESG. Both domestic modern slavery laws and the CSDDD are causing the most sleepless nights overall. 23 percent of all corporates (figure 4)

we spoke with named domestic modern slavery laws as their biggest regulatory concern, and 25 percent of investors ranked the CSDDD as their most significant issue (figure 5). There also some clear differences of opinion by sector (figure 6).

It is perhaps unsurprising that the CSDDD posed the biggest worry for investors and the financial services industry (figure 6) given the protracted debate over whether they should even be included in scope of the regulation at all. Late last year it was agreed that the due diligence obligations within the CSDDD would only apply to the financial services sector in respect of their own upstream operations. At this stage, there is no requirement for the financial services sector to consider due diligence through any of its lending, insuring or investing activities. But, many lobby groups are calling for the sector to be fully included in scope and it is only a matter of time before their responsibilities are further increased. Such a move to really mainstream sustainability risk mitigation would have a transformative impact on the sustainability agenda given the reach of this due diligence. Requiring the financial services sector to better understand and monitor the development of human rights and environmental issues of any entity it engages with, including its own supply chains, would have some serious financial costs attached.

The CSDDD was watered down in the political horse trading that followed Germany and Italy's announcement in February that they would abstain on a vote to progress the regulation. The CSDDD negotiations also reduced the number of companies that will fall in its scope, by raising the amount of annual revenue to be generated before the rule is applied. Nevertheless, the CSDDD remains a seismic piece of regulation. It clearly sets the direction of travel for environmental and human rights due diligence and its ripple effect will ultimately pull many smaller businesses into alignment by virtue of their presence in the supply or value chains of larger European companies.

US respondents to our survey had a similar view to their European counterparts (figure 7). Given the paucity of US ESG regulation, the majority of both

FIGURE 4

ESG legislation or regulation most concerning corporates (UK and Europe)

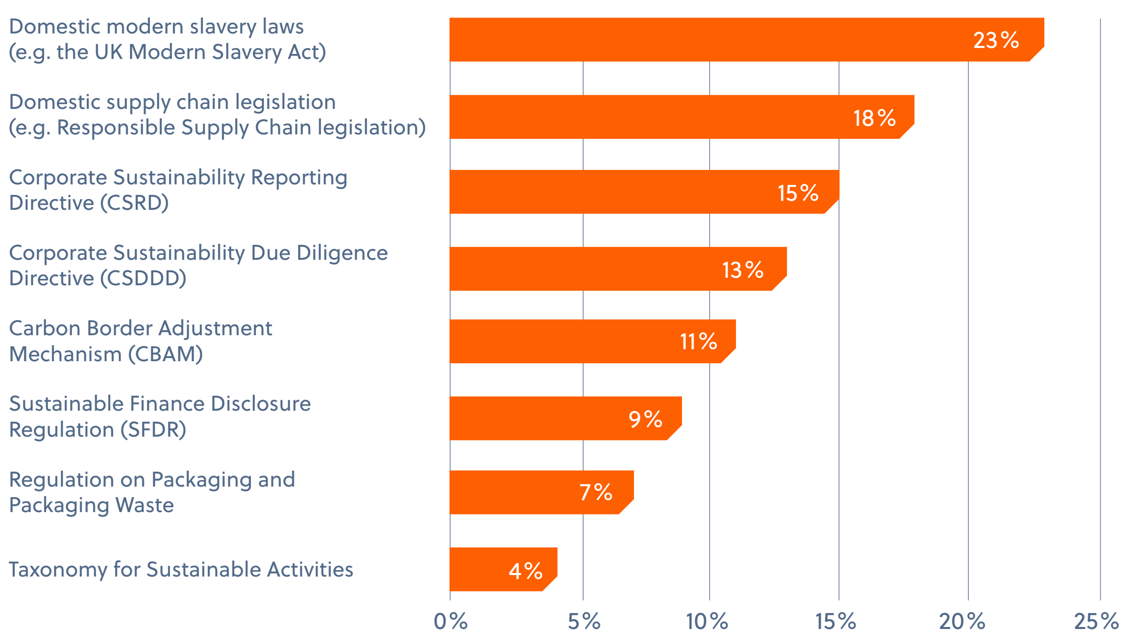
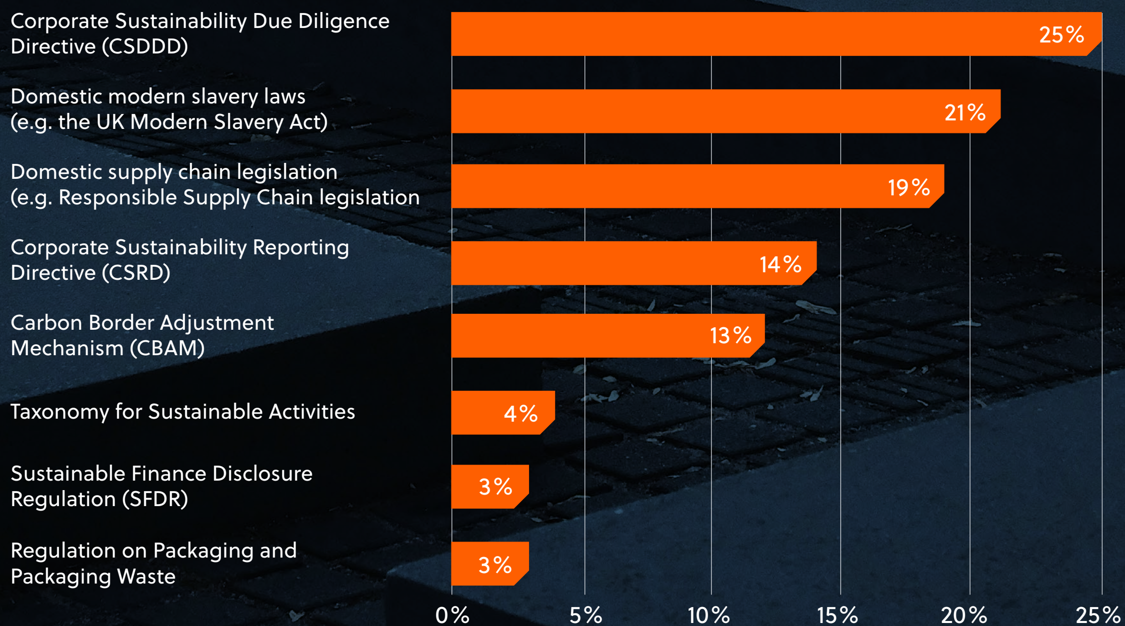


FIGURE 5

ESG legislation or regulation most concerning investors (UK and Europe)



corporates and investors say that European legislation remains their biggest worry. Nearly one quarter of US businesses we surveyed highlighted the CSRD as their biggest concern, compared with 30 percent of US investors stating their primary concern was over the CSDDD, just like European investors. The presence of the CSRD high on the worry list results from the fact that ultimately non-European firms will fall in scope of the regulation. Estimates suggest that more than 3,000 US firms, alongside the nearly 50,000 European firms, are expected to fall in scope of the CSRD. Listed subsidiaries of non-EU companies will need to start making CSRD disclosures from 2025, first focused on the largest companies, but with the rules progressively applying to other companies until the regulation reaches its fullest form in 2029. Many of these US firms have medium market capitalisation and simply don't have the data collection and reporting tools needed. Others will not be accustomed to the double materiality assessments required under the CSRD, which have the capability to quite radically change a company's ESG programme.

The growing shift to focus on non-environmental ESG issues is evidenced in the US market's concerns over SEC disclosures. For both investors and corporates, it is the SEC's requirements over cyber security that are the biggest concern for 10 percent of respondents, compared with regulatory concerns over SEC climate disclosure being the primary concern for just 6 percent of US corporates and 4 percent of US investors.

FIGURE 6

ESG legislation/regulation causing most concern - UK and Europe corporates

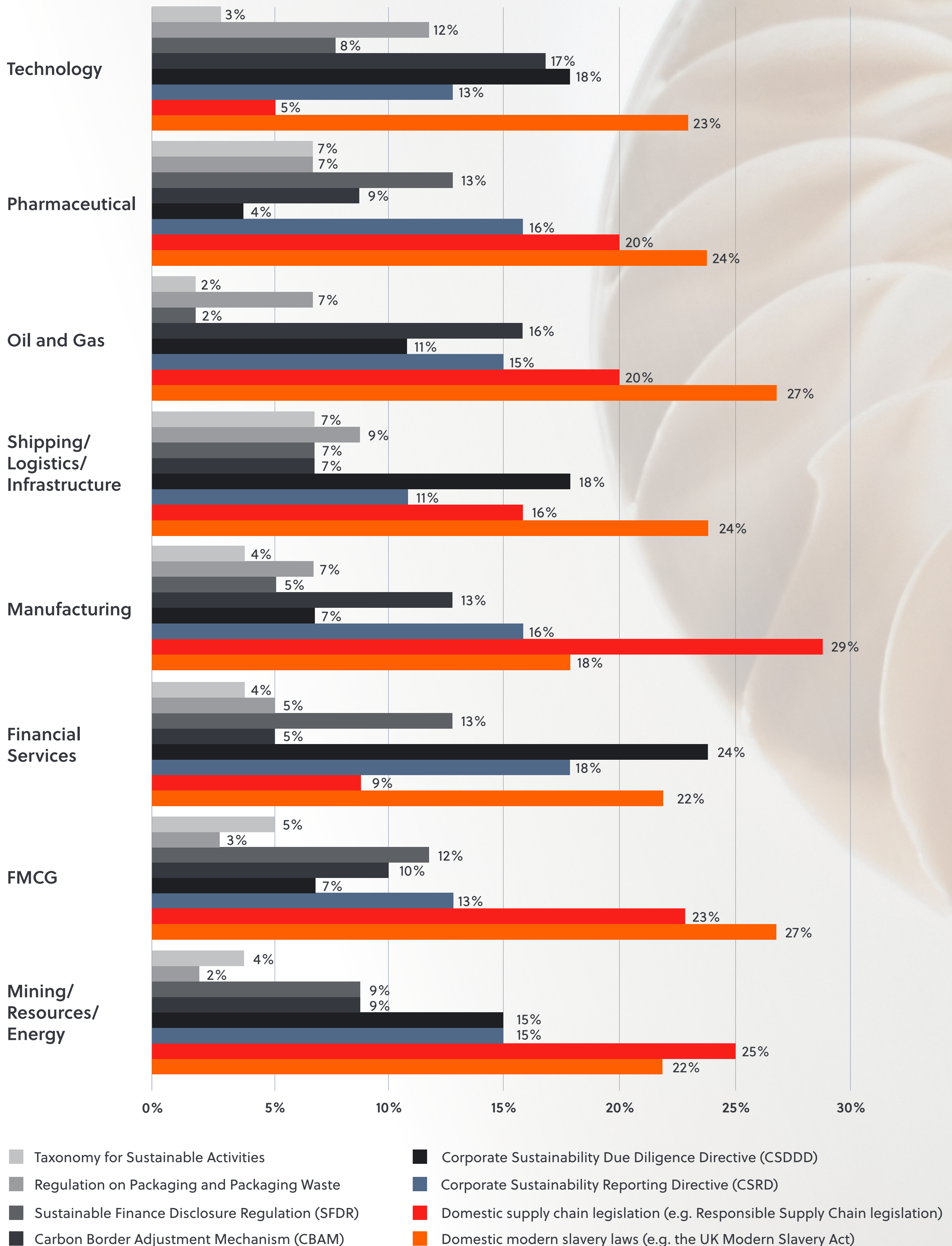
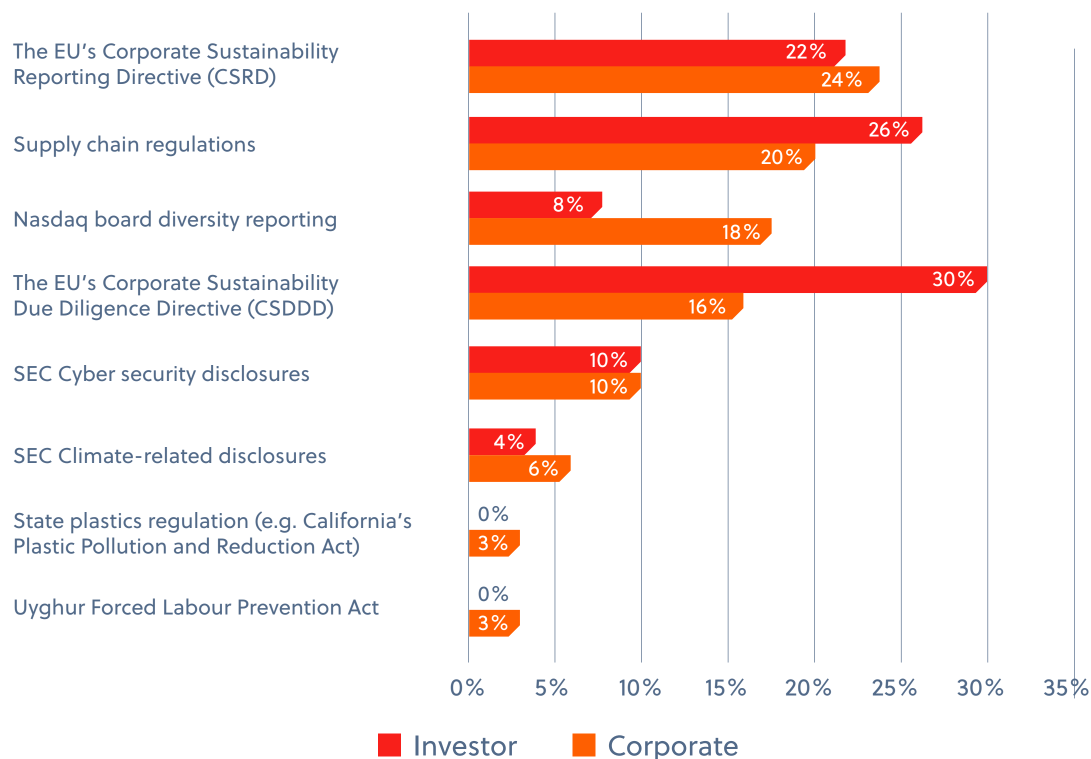


FIGURE 7

ESG legislation or regulation most concerning US corporates and investors



Cyber security is ESG

Cyber security is increasingly being seen as one of the biggest ESG risks, particularly to investors. No longer a relatively isolated technology issue, for private equity clients in particular we are seeing cyber security now sitting cross-functionally between a CISO and an ESG team. This gives the chance to build a more integrated ESG programme of business risks and to approach cyber security through a governance rather than compliance lens. Even at specific points of the deal cycle, there are some clear efficiencies to be had by approaching ESG and cyber pre-deal due diligence together if cyber security is flagged as a material ESG risk. Although forming part of the Governance pillar of ESG and therefore not an issue we directly asked the companies in our survey about, it was still a frequently occurring theme. One German logistics firm we spoke with described cyber security as their single biggest ESG worry, even above Environmental issues.

On its own, a strong cyber security posture protects data, operations and reputation, but when considered as part of the ESG agenda it has an important role in shaping corporate governance and helping to fulfil wider Social and Environmental obligations. Cyber security reinforces at least two of the UN Sustainable Development Goals (SDGs) – supporting a resilient infrastructure (SDG 9) and supporting effective, accountable and transparent institutions, and public access to information (SDG 16). It is also absolutely vital in ensuring that hackers cannot, for example, take control of industrial systems and cause water or soil contamination, or ensuring employee data is protected and not sold on the Dark Web for malicious purposes. Cyber security needs to sit cross-functionally within businesses if it is to be deployed effectively.

But, the abundance of regulation does pose a real challenge to impactful ESG and Sustainability programmes. A UK oil and gas firm we spoke with, for example, highlighted that they are purely focused on "meeting legal requirements without necessarily going beyond them", simply because this is already onerous enough. As our survey identified, ESG, and particularly its Social component, is generally not approached in a unified way. There is therefore a real risk that with everyone's eyes focused on what can be an overwhelming regulatory burden, companies fail to step back and look at what really matters – creating an impactful and coherent ESG programme.

And of course there will be plenty more regulation and legislation to come. An international FMCG business we spoke to, which already has a well-developed Social programme, said that they needed to "establish a resource to observe and do the horizon scanning piece of upcoming legislation and regulations". This is the only way for a company with a complex supply chain and operations in multiple geographies to ensure it stays on top of its regulatory requirements.

> Meeting legal requirements without necessarily going beyond them"

03

Materiality matters, but all eyes are on human rights, EDI and community programmes

Companies, and to a lesser extent investors, are increasingly thinking about materiality, focusing on their most material ESG issues, largely driven by GRI and the arrival of double materiality in the CSRD. But, we are seeing an emerging consensus around those Social issues that companies and investors are choosing to prioritise effort, resources and budget on, and on which they gather metrics and report for.

In our survey, human rights, EDI and community programmes are favoured by virtually all sectors in terms of Social issues which are measured, reported on and which have KPIs and targets set against them. Certainly for human rights, this is to be expected with the raft of European legislation outlined previously, including the CSDDD. Similarly, government and listing requirements regarding reporting on EDI are also forcing this topic up the corporate agenda. For both human rights, which includes modern slavery, and EDI, the risk of not doing anything, and the value in doing something, compels decision makers to prioritise these areas. But still some of the mandatory requirements are treated as a box-ticking exercise. A French firm that we interviewed already felt quite comfortable with human rights legislation given they were an early adopter due to the French Modern Slavery Act of 2015 and the Duty of Vigilence law of 2017. However, they recognised that "more effort is required to substantiate our impact. (We) must be able to demonstrate tangible progress within the next five years". For modern slavery, in particular, again, this firm felt itself to be advanced compared to its peer group, but still recognised it to be "easy to produce a bland statement. We use that (statement) as a real opportunity to enhance our position and demonstrate where we have issues, risks and opportunities."

We continually evolve and improve around mandatory ESG reporting, transparency, and audit legislation [but] more effort is necessary to substantiate our impact. We know what needs to take place, and we've started to develop those draft reports ready for publication."

Chief Sustainability Officer,
FMCG company, France

Europe and UK-headquartered companies have generally produced their modern slavery statements at a similar time, as a result of national legislation, so they can all claim a focus on this. However, given few of the modern slavery acts have any enforcement mechanism, the extent to which a reported commitment to modern slavery matches with actual action beyond this basic statement varies enormously.

Community programmes are a more straightforward Social 'win', and we have seen a steady upward trend in organisations deploying this voluntarily, often as a means to benchmark against their peers, or because these programmes can exist as discrete projects with measurable outcomes which

are promoted to increase brand awareness and reputation. For example, in the mining sector, we have seen a distinct uptick in the number of companies looking to undertake meaningful and hyper-local community programmes in the areas local to their mine sites. While this used to be a nice-to-have, maximising positive outcomes for the communities in which an organisation has a presence is becoming a necessary factor to ensure a social licence to operate. The mining sector is relatively early to the party on this, but it does compare very favourably across all of the sectors we interviewed on most metrics relating to its understanding, engagement and progress on Social issues. But, whether for mining or other sectors, the key focus of these programmes now needs to be clear and measurable impact – this is not the CSR programmes of days gone by.

A greater focus on the importance of materiality, often supported by the double materiality assessment required as part of the CSRD, is helping to push Social issues up the agenda. For some sectors, like technology and financial services, issues like data protection and privacy were always on the radar. But, a logistics company we interviewed specifically credited its new annual materiality assessment with pushing Social elements up the agenda. This resulted in cyber security and data protection being added to their ESG board's remit only last year.

04

Don’t forget about your supply chain

How and where to integrate ESG into your supply chain is one of the trickiest areas for companies and investors to deal with. The challenge of deciding which tier to go to, the exposure supply chains give you to unfamiliar and often risky geographies and governments, and the difficulty of working out where your biggest exposure is in a supply chain you may not have full visibility on are proving headaches for ESG and sustainability professionals worldwide. Yet the time when a company can claim it does not know of a serious issue within its supply chain is fading. Regulation has caught up.

It is telling that the supply chain registers very high as a regulatory concern, ranked second among corporates we surveyed and third among investors, yet this does not seem to be borne out in terms of the programmes and policies they have in place, or the issues for which they measure and report on. Only 23 percent of corporates include a responsible supply chain within their ESG programme or policies, and 28 percent of investors. The statistics for some sectors in terms of gathering metrics, i.e. hard data to be used to track progress, is even lower – just 18 percent of FMCG businesses we surveyed gather measurements on a responsible supply chain within their ESG programme. The oil and gas sector was best in class, albeit still low, at 30 percent.

The most onerous supply chain regulation, the CSDDD, is not yet in force, but it can’t be argued that there is no immediate regulatory imperative to focus on a responsible supply chain. A mix of domestic legislation ranges from the German Supply Chain Act (Lieferkettensorgfaltspflichtengesetz or LkSG) that requires companies to identify and address risks of human rights violations within their supply chain, to the UK or Australian Modern Slavery Acts which require companies to ensure there is no slavery or human trafficking in their supply chains. Even in the US there is the California Transparency in Supply Chains Act (2010) which has broad similarities to these modern slavery

acts and the Uyghur Forced Labour Prevention Act (2021) which encourages a close review of supply chains, as well as the French Duty of Care Law (2017) which mandates due diligence on human rights abuses and environmental risks throughout their entire supply chain.

So why does supply chain seem to sit so low in the pecking order for companies and investors when it comes to their ESG programmes? Sometimes this is a result of supply chain management sitting as a separate function. It is being tackled, but by a stand-alone team. This approach fails to recognise that for ESG programmes to really work, they need to sit cross-functionally and be embedded across the firm. One of the trickiest issues highlighted by a French FMCG company we interviewed was around market competitiveness. Some suppliers say they just can’t work with them if they attempt to enforce certain standards through the supply chain, particularly regarding the living wage or working conditions. “Unless we have a collective approach, it becomes very commercially tricky for one organisation to lead the way”, they explained. Some companies are attempting to mitigate this through switching to longer-term contracts, but this still doesn’t address the core challenge.

But, still, the responses to our survey suggest there are some heads stuck in the supply chain sand. This aligns particularly when talking to our private equity clients, outside of the parameters of this particular piece of survey-based research, when we regularly hear comprehensive explanations of their ESG strategies and programmes, with clear processes and reporting cycles. But, when probed on the supply chains within their portfolios they almost unanimously respond that they just don't have good enough sight or understanding to really know what is going on, or to comment on where the highest levels of risk are, and how to respond to that. This is particularly the case when an investment strategy focuses on a region or sector perceived to be less 'risky', but yet the supply chain of the portfolio companies extends into some challenging areas. For example, less than 10 percent of the corporate respondents we spoke with in the technology and financial services sectors said they had policies on a responsible supply chain. Yet the 'invisible' supply chains in these very sectors include critical minerals which are well known to face challenges of human rights abuses, labour exploitation, corruption and environmental damage in their extraction. If the companies using them do not have responsible supply chain policies then these practices are simply not being scrutinised adequately.

Sooner rather than later a mixture of regulation and the fear of reputational damage and potential litigation will force those companies to lift their heads from the supply chain sand. One of the best first ports of call here is technology. Using technology to conduct almost instantaneous desktop reviews across your supply chain, potentially numbering tens of thousands of companies, can give you some peace of mind. By highlighting those companies where the risk is greatest, it means you can focus on these hotspots and conduct a much deeper dive on these specific high-risk companies or operations, including the use of questionnaires and gap analysis in order to truly understand exposure and to remedy issues.

There will be a need for thorough due diligence in supply chain management, identifying and mitigating risks, especially in regions where these issues are prevalent."

Director of Corporate Responsibility,
Oil and Gas company, UK

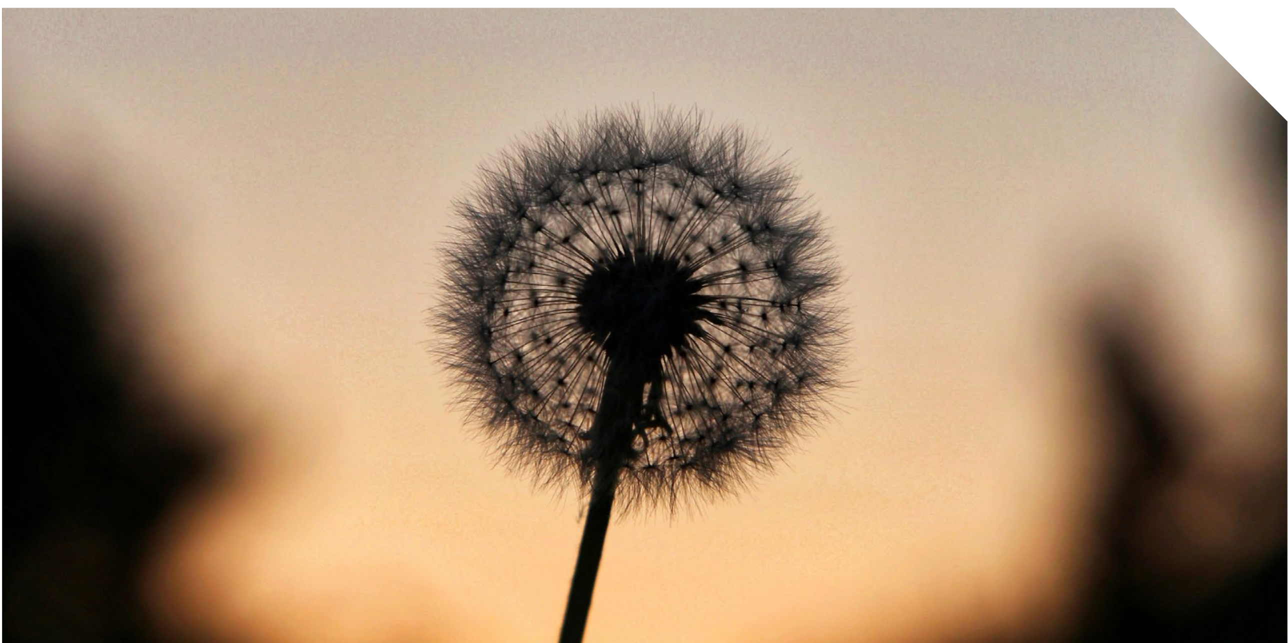
05

What about geopolitics?

Just as human rights, EDI and community programmes consistently rank as the Social issues both companies and investors consistently prioritise, there are also Social issues that consistently rank towards the bottom of the agenda. Geopolitical risk is a surprise entrant here. Only 19 percent of companies we surveyed factor geopolitical risk into their sustainability programmes. This may be partially borne out of the absence of obvious metrics to track and measure. Geopolitical risk is inherently qualitative and is a complex matter that can be interwoven into so many other issues. There are also no regulatory or mandatory requirements upon which to hang a geopolitical hat – no external party is forcing a business to consider its geopolitical exposure and how to manage it.

Failing to consider geopolitical risk, both in terms of managing business risk and thinking about how to progress the corporate sustainability agenda, can have potentially costly consequences. The very nature of the interdependence of global economies, and companies' extended exposure that results, means that one has to take a geopolitical view. Major shifts in geopolitical alliances, trade disputes, and regional conflicts contribute to changes in trade relationships and supply chains, create uncertainties in the market, impact commodity prices and fundamentally affect the bottom line. And, in the extreme, geopolitical risk can pose security and safety threats to your people, assets, operations and the surrounding environment, or have long term consequences for business continuity.

Turning to the Israel / Hamas war, for example, the conflict presents a range of direct considerations and potential shifts that corporates and investors need to be aware of. In the short term, there is the threat to the safety of personnel in conflict areas; asset destruction risks in conflict areas and as a result of vandalism and targeted attacks in countries facing rising tensions; reputational risks stemming from a misalignment in corporate messaging regarding the conflict or boycotts driven by perceptions of an organisation's position on the war as well as compliance and risk management considerations linked to disclosure obligations. Yet, as the conflict continues, we have seen the longer term and more widespread consequences. This is nowhere more apparent than in the Red Sea. Here, the Yemen-based Houthi attacks against vessels transiting the Bab el-Mandeb Strait as part of a claimed protest against the Israeli offensive on Gaza has resulted in a shipping crisis with consequences across the globe.



Ripple effect of conflict in the Red Sea

Just 10 percent of the shipping and logistics companies we spoke with reported to consider geopolitical risks as part of their ESG programmes. This is even lower than the corporate wide average of 19 percent among respondents. The low rates may be explained by geopolitical risk sitting within a different department, such as security or intelligence, for example. But, at best this simply suggests that geopolitical risk and the corporate sustainability agenda are being considered in isolation, with some serious and considerable costs.

For example, the ESG and sustainability consequences of the Red Sea crisis are stark. Attacks on vessels transiting the Bab el-Mandeb Strait have resulted in several global shipping companies temporarily halting Red Sea voyages or redirecting their ships around the Cape of Good Hope instead. This rerouting adds one to two weeks to voyage times, disrupting supply chains and contributing to rising freight rates. It also causes additional fuel to be consumed and greenhouse gases emitted – impacting both the industry targets to reduce emissions by at least 20 percent by 2030 and specific corporate net zero strategies.

There is also a knock-on regulatory effect, as the EU Emissions Trading System (or EU-ETS) has included maritime emissions for vessels calling at EU ports as of this year. This is a cap on emissions that will progressively drop over the coming years. Financial sanctions will be brought to bear on any company that exceeds its cap. Companies are largely unwilling to deploy usual emissions-saving tactics such as slow-steaming because the vessels are already operating with a severe delay and any further delay will impact on contracts and the commercial viability of the reroute. This means shipping and logistics firms are having to adjust, and in many cases accelerate, their decarbonisation plans, including hastening the development of alternative fuels and associated infrastructure on new routes, if they are to have any chance of meeting their own targets and regulatory requirements.

The impact is felt much wider than just the shipping and logistics sector. These vessels play an important part in many companies' Scope 3 emissions calculations, so they will soon be feeling the pressure as their carbon emissions affect the emissions reporting of companies further up the supply chain. Shipping firms therefore need to develop and communicate to all stakeholders clear plans on how they are going to bring their emissions back down in order to ensure that everyone's decarbonisation plans are not thrown off. Put simply, the earlier that geopolitics are factored into their ESG programme, the sooner these companies can make their necessary adjustments.

Clearly, geopolitical risks and the potential shock they can cause, must be factored into any corporate or industry decision-making about sustainability priorities, strategies and reporting."

The way the Houthi attacks evolve, and the extent to which this is decoupled from the Israel-Hamas war and/or Iranian influence, could, along with falling water levels in the Panama Canal and concerns of geopolitics affecting passage through the South China Sea, prove a decisive factor in a more long-term reorientation of global shipping routes. This would necessitate an overhaul of decarbonisation plans, potentially accelerating the transition to alternative fuels, and a review of human rights and labour policies to mitigate against the risk of forced contract extensions, prolonged time onboard and issues relating to supplies and refuelling. Clearly, geopolitical risks and the potential shock they can cause, must be factored into any corporate or industry decision-making about sustainability priorities, strategies and reporting.

Yet, simply being reactive to global events does not offer a strong enough foundation for risk management and business resilience, nor does it assure foolproof sustainability planning. Companies are often adept at developing a baseline understanding of the circumstances at hand and response measures for them. But unless you translate these into clear factors to monitor which help you know what to look for and where to find indicators of change, determining what could be the next geopolitical risk for your business and what the impact will be is challenging. A key consideration is whether organisations are tracking the potential shifts in countries critical to their value chain, amid a recognition that these jurisdictions may not be the same countries deemed their target markets. And of course understanding these geopolitical shifts will not just help to manage risks, but also find opportunities to add value, from shifting supply chains to take advantage of different trade tariffs, to pivoting to new markets opened by geopolitical realignments.

Businesses need to think through the varying degrees of vulnerability present in the jurisdictions they are exposed, and the interdependencies within their global footprint. Quite simply, geopolitics and ESG and sustainability programmes can and should be understood together. To not do this would be to jeopardise the whole sustainability agenda.

Conclusion

Whether it be the result of single points of failure, blindspots or a conscious decision of prioritisation, our survey has highlighted a widespread lack in confidence that the Social pillar of ESG is being sufficiently tended to, with risks mitigated and value exploited across both investor and corporate groups. There is clear consensus that Social risks are rising up the corporate and investor agendas, driven by a combination of employee retention, shareholder pressure, board instruction, regulation and legislation, and consumer and client demand.

Investors like us are increasingly considering ESG factors when making investment decisions. Companies with substantial social performance may attract a broader pool of investors, contributing to improved access to capital."

Head of Sustainability,
Private Equity firm, France

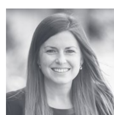
Of course, there are some clear frontrunners and laggards among the sectors we surveyed. Oil and gas is surprisingly leading the pack on most metrics, whilst pharmaceuticals have fallen behind. Overall, sector performance relates to where a company deems the greatest material risk lies – either operationally or strategically. For example, only 37 percent of oil and gas respondents felt Social issues were an 'operational risk', compared to the corporate-wide average of 57 percent. Instead, this sector placed greater emphasis on 'market risks', indicating ESG is a strategic decision for them. The tech sector has taken the policy of outsourcing a large proportion of its ESG work, whilst shipping and logistics places a remarkably low priority on geopolitical risk within their ESG programme. Clearly, materiality will play a role in determining the priorities for each sector, but there is still a sense that this is not yet as developed as it could be. With sectors performing so differently, there needs to be some urgency here. Using external specialist advice for dedicated areas like human rights, for example, is one option, or seeking technological solutions to tackle challenges of supply chain monitoring. With more than two-thirds of

the companies we spoke with using external support to meet their ESG needs regarding Social issues, they should be re-evaluating these relationships to make sure they are being properly leveraged to support materiality assessments and to identify and improve areas of weakness or where programmes are absent.
It is also clear that in terms of the question of whether ESG should be viewed as a risk management tool or a value creation opportunity, for Social issues at least, it is still viewed from a legal and regulatory perspective. More than half of the companies we surveyed said that their legal teams are monitoring Social issues, with many sectors even higher, including 70 percent of shipping and logistics firms. 43 percent of respondents said their compliance teams are monitoring Social issues, and improved handling of risk management was described as the number one positive area of impact from the Social pillar. This is not surprising given the regulatory onslaught coming for ESG has a big focus on its Social issues. If businesses have historically been putting greater resources, effort and budget into Environmental issues, then they naturally need to play catch up on the Social side. But, with two-thirds of companies expecting their overall ESG budgets to increase in the next five years, and a greater allocation virtually across the board for Social issues, a lack of budget can no longer be blamed. Companies and investors will have the resources, now they need to make sure they have the plans.

Tech sector: outsourcing ESG

Whilst most medium-sized or large businesses across our survey either had a designated ESG or sustainability lead, or the function was split across specific individuals in legal, risk, compliance and corporate affairs, the technology sector presented an anomaly in its use of external consultants. 55 percent of respondents in the sector who do use external consultants said they do so to manage their ESG programmes in their entirety. This is an unusually high number, compared to a corporate baseline of 38 percent, and may prove problematic. External support is often advisable and welcomed by businesses, particularly to provide specialist expertise. But to outsource the whole programme suggests that ESG is not embedded in the governance of the firm. As long as ESG is viewed as an 'add-on', the technology sector will continue to lag on most ESG metrics.

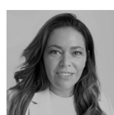
Contributors



Natalie Stafford

HEAD OF ESG & SUSTAINABILITY

Natalie works closely with corporates and private equity to build and implement ESG and sustainability programmes across their business or portfolio, with a particular focus on Social issues. Collaborating with deal and new ventures teams, investment professionals, compliance principals, and legal counsel, she advises clients including FTSE 100 and Fortune 500 companies. Natalie specialises in providing proportionate ESG and sustainability support, deploying regional expertise to support companies in the extractives, FMCG, financial and professional services sectors. Prior to her current role, Natalie ran corporate intelligence teams focused on ABC and AML risks in Africa and the Middle East, as well as holding several risk management and political risk roles.



Kendall Reid

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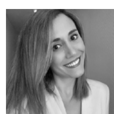
Kendall is a Director within S-RM's ESG advisory team, providing strategic advice and support to investment teams and corporates. Kendall brings with her 12 years of experience in both leadership roles in CSR and ESG markets. She has worked across a variety of geographies including the UK, Middle East and Asia Pac in financial services, tech, manufacturing, media and healthcare industries. She has a special interest in building programmes that both maximise shareholder returns and sustainability outcomes. Kendall focuses on the advisory practice at S-RM, working with corporates and investors to manage their risk and create long term value in areas such as strategy, double materiality, executive support and reporting and investor relations.



Belén Satorre

ASSOCIATE DIRECTOR, HUMAN RIGHTS

Belén runs S-RM's dedicated human rights practice, providing practical and strategic support to clients in line with international best practice. She has more than a decade of experience, including advising luxury goods clients on diverse ESG reporting frameworks and how to mitigate risks across their value chains. Her proficiency lies in the strategic management and execution of human rights and ESG strategies for both private and non-profit organisations. In addition to her private sector work, Belén has held a number of international roles with the UNHCR and UNESCO, as well as a range of think tanks and NGOs.

Gala Riani

HEAD OF STRATEGIC INTELLIGENCE

Gala started her career working for the Kurdistan Regional Government (KRG) as a political advisor to the KRG's Nordic representative in Stockholm and as an adviser to the Minister of Sports and Youth in Erbil. She later joined IHS Global Insight (now IHS Markit) as a Middle East and North Africa (MENA) analyst, before rising to manage the MENA team. Gala also spent five years wtih Control Risks, leaving as a Director in the Global Risk Analysis Department.

Contact us

To discuss how we can support any aspect of ESG in your organisation

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S-RM is a corporate intelligence and cyber security consultancy. We provide intelligence, resilience and response solutions to organisations worldwide.

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