ESG is Access to Four Capitals

senateshj

20 years senateshj

ESG IS ACCESS TO FOUR CAPITALS

ESG has its share of critics, ranging from the ideologically opposed to the open minded. It has been called everything from 'scrambled eggs' to, famously, 'the Devil Incarnate' by Elon Musk. The Economist even called for it to be abolished, in its November 2022 cover piece. Many U.S. Republican 'red' states have tried to do just that.

Fortunately, markets in Australia and its trading partners are looking past that opposition. Slowly but surely, we are embedding ESG into voluntary and mandatory disclosures, and into investment and corporate decision making. Still, there is a risk companies may see ESG as a compliance issue, at best, and miss opportunities to secure material, long-term value.

This paper puts forward a new model for thinking about ESG, one that builds on quite familiar and valuable concepts and puts them together in a new and digestible way. It helps understand what ESG is, how it is used, and who uses it.

The model we suggest is simple. You would be familiar with a financial performance-and-engagement cycle: a company that can generate financial capital will be more likely to engage with investors and get access to more.

ESG is best understood as a similar performance-and-access cycle. However, it embraces all the types of capital an organisation relies on – financial, yes, but also human, social and natural – and engages with all the stakeholders that have or control access to that human, social and natural capital.

Seen this way, ESG is at worst an innocuous representation of reality. At best it becomes a powerful, holistic way for organisations to improve their performance and get access to the capital they need.

The paper works its way through these concepts in the following sections:

- First, we present the familiar short-term financial performance-and-access cycle, and a simple diagram to represent it
- We then step back to consider all the 'non-financial' assets that an organisation relies on – the intangible assets that account for an ever-increasing share of its value
- We can then add this natural, human and social capital to the original model, turning it into a long-term ESG performance-and-engagement model
- With that model, an organisation can be much clearer on how it might nurture or diminish the natural, human and social capital it has access to, and how it might measure, disclose and engage with people on that performance.

ESG has come into the public gaze, for many seemingly out of nowhere, because it has worked for those investors and organisations who use it well. This paper both demystifies ESG for those new to it, and helps organisations gain even more value from it.

The short-term financial performance-and-access cycle

Let's start by suggesting a new model for considering the old story of how financial performance data is produced and used, shown in Figure 1.

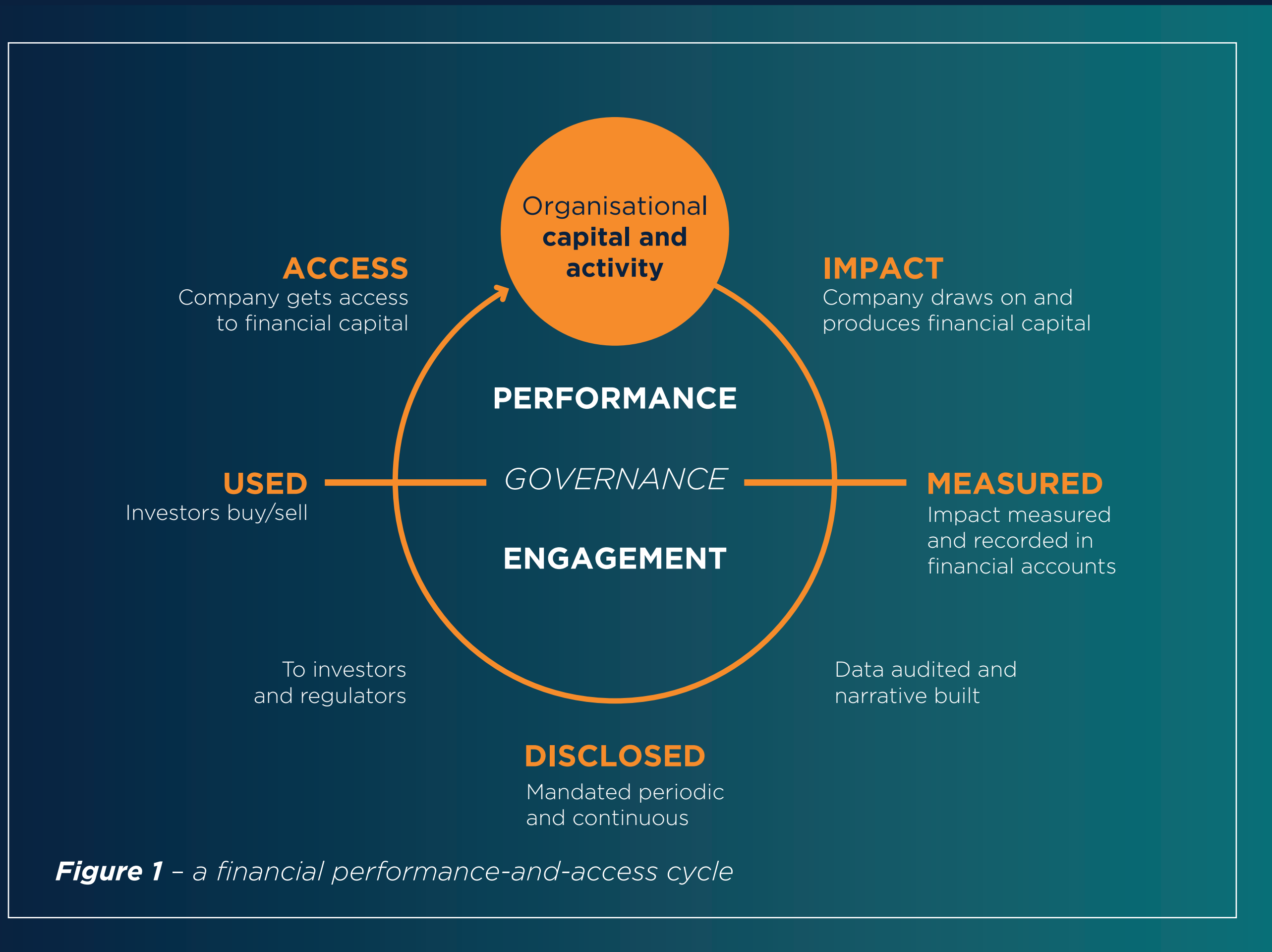

Figure 1 *– a financial performance-and-access cycle*

As soon as a company acts in any way, it affects its financial capital. A single paid person working for an hour will draw down the hour's wage from the company, immediately affecting a 'live' P&L and balance sheet. Anything the person does or any assets or materials they use will have a similar affect. With a bit of luck, that person will generate some profit, adding to the company's capital. At the end of any given period, or in real time, all those impacts are measured in dollar terms, and reported internally.

Assuming the company needs to report externally at some point, it may need to audit the numbers, and it may want to create a narrative around them. There may be regulations and standards involved to ensure those using the numbers can rely on them. All this financial data is packaged up and shared with markets and regulators, through reports, presentations and, most importantly, discussions.

The whole purpose of all this is for investors to know what's happening with their money. If they like what they see, they'll keep it there, or even chip in more. If they don't, they might sell their stake, assuming they can.

In other words, all the effort to measure, report and audit financial impacts and then engage with investors is for one sole purpose – to get access to financial capital. Without that capital, the company – or any organisation – will cease to exist.

The company is pedalling on a financial performance-and-engagement cycle that, all going well, will give it access to more capital. At the heart of that cycle is governance – everything the company does to make sure the cycle is safe, reliable and legal.

Financial capital is an outcome of other capitals

Any organisation, indeed our economy as a whole, relies not just on financial capital, but on a range of different tangible and intangible capitals. Together, those capitals tell a simple story.

Before thought, there was just the Earth's natural capital. To that we added our human capital (the whole gamut of productive imagination, labour and leadership). As individuals and organisations we then add social capital – all that it takes for others to join us in what we're doing, or just consent to it: trust, relationships, reputation, brand and social licence all rolled into one.

Natural capital

The stock of renewable and non-renewable natural resouces that combine to yield a flow of benefits to people

Social capital

The networks together with shared norms, values and understanding that facilitate cooperation within and among groups

Human capital

The knowledge, skills competencies and attributes that contribute to improved performance and wellbeing

Produced capital

The human-made goods and financial assets that are used to produce goods and services consumed by society

Figure 2 *– The Capital Coalition's four capitals with which to build a world*

With that natural, human and social capital, over millennia, we produced everything there is in the world (beyond of course the natural capital). Some of those are material, manufactured things, some of them are ideas and services (more human capital). Many of them can be sold, in turn, for money, which can be re-used to re-start the cycle.

This model of four capitals has been adopted by the Capitals Coalition, an international association of companies, organisations and advisory firms looking to make sure that each of those capitals is considered in public and private decision-making. The model is derived from an original model of six capitals, best described in Jane Gleeson-White's excellent 2015 book, *The Six Capitals: The revolution capitalism has to have*. Again there is natural capital, then social capital, then human as well as intellectual capital (or IP), then manufactured as well as financial capital.

There are real distinctions within the two sets of capital that have been merged. Human capital stays with the person, while intellectual capital can be transferred. Material capital includes physical assets, while financial capital is cash. Nonetheless the four capitals correspond to the original six quite directly and are easier to talk about. There is also a convenient correlation between human capital and an organisation's people, and social capital and its external stakeholders.

The value of intangible capital

These 'intangible' human and social capitals have become more and more significant in how investors value companies. Ocean Tomo, a firm specialising in financial valuations, has measured how much more significant over the last 50 years. It estimates that, back in 1970, about 80% of the aggregate market value of listed companies in the US represented material assets: cash or physical things that could be turned into cash. Only 20% of that value represented what investors thought of as 'intangible' capital: its people, brand, reputation, intellectual property and the like.

Over the last 50 years, Ocean Tomo suggests that the balance between the tangibles and intangibles has been turned on its head. The 20% ascribed to the intangibles has risen steadily an astonishing 90% today, with all of the balance sheet and physical stock and plant making up just 10%.[1]

Our economies are less about physical products, and more about data and services. Investors realised that the tangible capital represented past performance, but the intangible capital represented the promise of future cash flows. There is more profit in the future than the past. That's why, for instance, Tesla shares in 2021 were valued at more than all other car companies in the world, put together.

Other firms have questioned whether the value of intangibles really has risen to 90% of all market value, but all agree in the rise of that share, and that they do now account for well over half.

1. https://oceantomo.com/intangible-asset-market-value-study/

The long-term ESG performance-and-engagement cycle

The Capitals Coalition or Six Capitals models are immensely powerful constructs with which to see the world.

As Paul Druckman says,

without a focus on a range of capitals, providers of financial capital simply do not have the information needed to allocate resources most effectively.[2]

If the intangibles, in the form of human and social capital, do account for such a large proportion of an organisation's value, it makes sense that investors would want any data they could access, to understand what they're buying. Increasingly, they're asking for that information in the form of ESG data. And just because it's hard to turn that information into simple numbers, doesn't make it any less valuable.

To understand how ESG meets that need, we can go back to the simple performance-and-engagement cycle for financial capital, and expand it to take into account of all forms of capital.

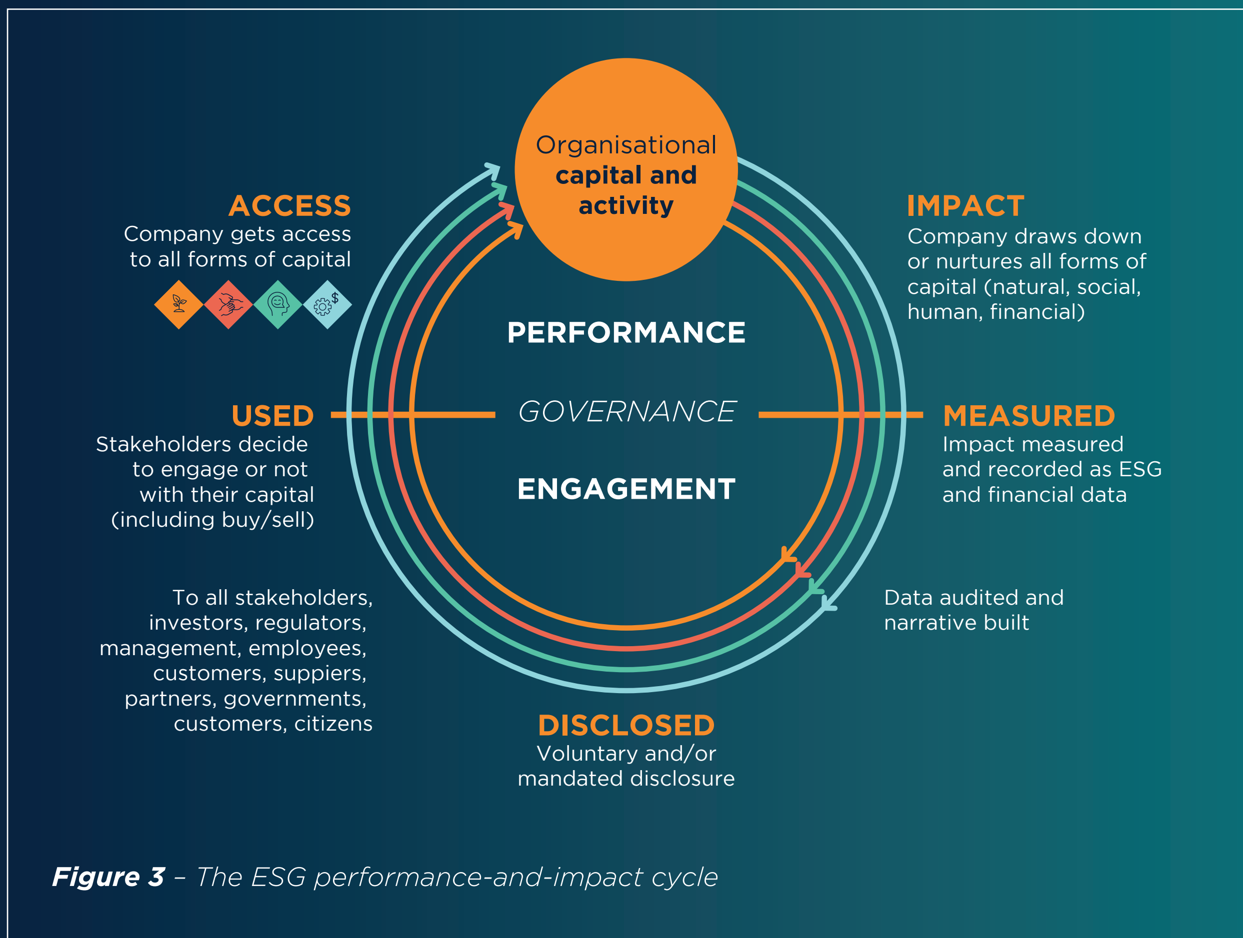

Figure 3 *– The ESG performance-and-impact cycle*

2. Quoted in Jane Gleeson-White, The Six Capitals: The revolution capitalism has to have, WW Norton 2015.

Each stage of this cycle bears a different meaning of the term "ESG". That's why the term can be so confusing, and why this model helps clear up that confusion.

At the top of the cycle is what a company[3] does, its **ESG performance.** It is the meaning of "ESG" which is displacing[4] terms like "Corporate sustainability" or "Corporate Social Responsibility" or the "the Triple Bottom Line" – i.e. how a company interacts with the environment, society and the economy, for better or for worse. Every action affects both the total capital it has, and the total capital it can access. Most importantly, each type of capital affects the others, so you only know how much capital the organisation has by considering all capitals together.

Next, **ESG measures.** Companies work out how they can measure their ESG performance, i.e. their impact on the four capitals. They can do so in many ways, from fuel efficiency or carbon emissions, to headcounts and employee engagement, to compliance, community actions and awards. Some need those measures because they need to make ESG disclosures (the next step); others want to because progress on a metric will help build the four capitals and drive business performance.

Then, **ESG disclosure.** The company decides how to report on these measures to others, whether there are any standards that apply, whether they need to meet the expectations of ESG ratings agencies or investors, and the need for any audit.

They then choose, to a greater or lesser extent, to share this information with others. Usually that's voluntarily, but there are an increasing number of regulatory obligations.

Any disclosure should be part of broader **ESG engagement.** A company uses its reports to support conversations with the stakeholders that matter. Its investors will also be engaging with companies on ESG issues, so in most cases it will be a mutually beneficial conversation. A new class of stakeholder looking to engage are the agencies that produce **ESG ratings** from disclosed measures and other sources. These ratings are used by investors who don't want to support or in place of their own engagement.

The success or otherwise of the company's ESG engagement is whether the other party offers access to their capital. A government may give a resort operator access to a national park. A farming community may give a mineral explorer access to an opportunity. A university may join a collaborative initiative, giving it access not only to its human capital, but to its reputation or social capital. An up-and-coming manager may give it their personal human capital, by joining the firm. An investor may give the company access to more, or less, financial capital. A new **ESG fund** may be created with the explicit purpose of taking all of the cycle into account in its investment decisions, i.e. the company's ESG performance, measures, disclosures, engagement and ratings.

Let's now take each of those stages and phrases in turn.

3. The model applies to any public or private organisation, for profit and non-profit, however this discussion focuses on a private or listed company, for whom action on the ESG cycle is most urgent.

4. ESG is displacing other terms for corporate sustainability mainly because it is the term that the finance sector uses, and corporates follow the money. Investors use the term because it is neutral and accurate: consideration of the non-financial factors of corporate performance. Compare that to 'responsible', 'sustainable' or 'ethical' investment – which may imply that other investment is irresponsible, unsustainable or unethical.

ESG performance and impacts on capital

When someone asks, 'What is our ESG strategy?' or says 'We've got to improve our ESG performance!', they're often referring to the story they tell about 'doing good'. Less often are they considering how overlooking human and social capital can affect their core business. Yet that is what a sound ESG approach demands.

Take an airline for example, a hugely complex operation to be sure. After years of good work, it builds up talented and engaged staff in, say, baggage handling. Their good work ensures every bag is on the carousel at journey's end. Everyone is happy, the handlers proud to be doing their bit to make the airline popular. The company is rich in this form of human capital: a number of people, with a recognisable talent, and a willingness to use that talent.

Then the company decides to replace those baggage handlers by contractors, through a hire firm, to save money. The contractors are well enough trained, but they don't yet have the skills, experience or intent of the former staff. In other words, the airline has saved some financial capital, but lost some human capital. Bags do not turn up on the carousel. They need to be found, with courier trips to passengers, eroding natural and financial capital. The airline's reputation or social capital starts to falter, and it slips from first choice to second. Revenues ease off. Tensions rise. People in other supporting functions feel nervous. Engagement falls.

This is over-simplistic, of course, but the calculus is real: every decision a company makes will impact the financial, human, social and natural capital to which it has access. And it is a representation far closer to reality than a raw financial statement.

The big downside risk of overlooking ESG factors

There is now ample research to suggest that a sound ESG approach does correlate with strong financial performance. A good example is that by Refinitiv and MSCI, who compared the ESG ratings and financial performance of the 2,933 large- and mid-cap stocks in the MSCI All Country World Index, over seven years to November 2020. The companies in the top third of ESG ratings outperformed the ACW Index by 1.31% annually, while those in the bottom third or ratings lagged their peers by 1.25% in annual returns – with earnings growth a disappointing 9.2% below their peers.[5]

Marginal outperformance over time may not, however, be reason enough to keep an eye on ESG factors in all decision-making. The aim is to sidestep the big, value-destroying crisis that a company may innocently walk into, or more likely bring upon itself. SenateSHJ researched 30 well-known corporate crises over the past 40 years to determine their immediate financial impact, and how long that impact lasted. The crises spanned the environmental (the Vale tailings dam failure), the cultural (Rio Tinto's destruction of Juukan Gorge and its 40,000-year-old artworks), the ethical (VW's emissions data) and tragic human loss (Boeing and Ardent theme park crashes).

On average, the 30 companies suffered an immediate 19% drop in share price, ranging from 2.1% for a VW advertisement, to 50.4% for BP's Deepwater Horizon explosion and oil spill. On average, it took 147 days to recover the lost ground, and some never did.[6] Some were technical failures seemingly remote from ESG considerations. Some were avoidable human failures: Deepwater Horizon was forecast by 734 notices for 'egregious breaches' from safety regulators over three years, when the other oil majors had, collectively, one such notice. Yet 22 of the 30 incidents were a failure of environmental or governance controls, or the abuse of human rights.

5. Visual Capitalist, 'The Truth Behind Five ESG Myths', 12 May 2021, using Refinitiv and MSCI data. https://www.visualcapitalist.com/fact-check-the-truth-behind-five-esg-myths/

6. SenateSHJ, Crisis Value Erosion, 2022.

Using ESG to build value

The baggage handler decision described above was a commercial decision intended to drive commercial outcomes, with much broader consequences. Such stories are everyday in the complex systems that are the modern corporation.

The same systems thinking is needed to decide what social or environmental issue a company should engage in – taking into account its impacts on all forms of capital. We have described elsewhere how these impacts can be translated into dollar terms for like-for-like comparison.[7] That's indeed a very valuable exercise, but for now let's not worry about the measurement, just the different types of impact.

Say a valued researcher at a pharmaceutical company wants to support a regional initiative to solve a public health issue. They have experience, insight and enthusiasm to offer, and want to lend a hand. They ask the company if they can access some aggregated data to help the group decide where to focus its limited resources. The company's initial reaction is one of caution – there could be legal implications, and it may set a dangerous precedent. They check, and in-house counsel gives it the 'all clear', so there are no explicit barriers to making the aggregate data available.

In making its decision, the company might consider the potential impacts on all forms of its capital. First, its human capital. The researcher likes her job, but is frustrated by the very tight rein that is kept on research, and the relatively narrow group of people involved. Sure, there is valuable IP to be protected and confidentiality to be maintained, but it wasn't the collegiate experience that drew her to science in the first place. Engaging in the public health effort would be a risk-free way of widening that collegiate scope, to be part of something bigger than her immediate work's research and so – importantly – be a reason to stay at the firm.

Needless to say, the insights that she and others in the public health effort develop would also be accessible to her company. So too would the relationships that she develops, and the appreciation in that regional community that the company is lending a hand. Alongside her in the public health effort are other people in the health ecosystem, from organisations that the company deals with commercially. Here is a chance to deepen relationships with them, outside the potentially tense negotiations on the commercial or regulatory issue. What value those relationships and presence?

Questions for companies to consider

Companies wishing to take advantage of the Capitals model might consider these questions in its ESG or sustainability strategy:

- What ESG issues are 'minimum standards' essential to access capital, of any form, in the modern economy? Are we meeting those standards?
- What social or environmental issues can we engage in to open up opportunities to build or nurture natural, human or social capital? What actions can we take to engage in those issues?
- Is any natural, human and social capital at risk from our current business activities? If so, how can we minimise or eliminate that risk?

7. J Dowse, Valuing Intangibles, *Keeping Good Companies*, Governance Institute of Australia, July 2013.

ESG measurement and disclosure

Companies have always had the option to measure the impacts of business activity and report them internally. Most have done so, ever since the first non-financial metric was conceived – perhaps how many sheafs of wheat could be harvested in an hour. Most now have some pretty complex measures for tracking and rewarding performance.

Since the 1990s, many companies have carefully shared some of these measures externally, in the form of corporate sustainability or CSR reports. It was entirely up to them what they reported. Over time, some helpful voluntary standards were developed, notably the Global Reporting Initiative or GRI, with standard metrics to enable comparison across and within industries.

Disclosure driven by the Principles of Responsible Investing

In 2006, however, things got serious. Global investors got together through the UNEP Finance Initiative, to discuss what to do about an information imbalance. They were wading waist deep in financial data, but there were only small puddles of reliable non-financial data. They declared: “As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time).”

They drew up and signed the UN Principles of Responsible Investment (the PRI) – to “seek appropriate disclosure on ESG issues by the entities in which we invest”, then to “incorporate ESG issues into investment analysis and decision making”, then “to be active owners and incorporate ESG issues into our ownership policies and practices.”

That’s powerful stuff, but not as powerful as the next three principles: “to promote acceptance and implementation of the Principles within the investment industry”, “to work together [on] implementing the Principles” and “to report on our activities and progress towards implementing the Principles”. Some of the world’s most powerful and precautionary investors had started a movement.

As a result, there are now almost 4000 signatories, who manage $130 trillion between them and who want to know more than the financial position of a company. They want to know, as much as possible, what human, social and natural capital they also have access to, and what risks to that capital there may be. There is no balance sheet to tell them that, so they need indicators. That’s what ESG data is.

Disclosure driven by ratings, standards and business judgment

ESG ratings agencies track up to 1100 different metrics for a listed company. Every last one of them is an indicator of the company's impact on and access to natural, human, social and financial capital. Some people may be interested in very few, some in a larger set. Nobody is interested in all of them, least of all the company.

The company itself has to decide which of the hundreds of measures to worry about. There's no room to go into this in detail, but they'd be looking for the ones that are both expected by stakeholders, and good for the company – i.e. they track something that would contribute to the company's business priorities and financial health.

In June 2023, the International Sustainability Standards Board issued the first ever global disclosure requirements "designed to enable companies to communicate to investors about the sustainability-related risks and opportunities they face over the short, medium and long term." Even within this standard and its attempts at objectivity, there is scope to emphasise different metrics. And that is how it should be, because the stakeholders have to make their own assessments of what is and what is not important to them. There is no numerical answer to that judgement.

Questions for companies to consider

Companies wishing to take advantage of the Capitals model might consider these questions in their ESG measurement and disclosure:

- What data on natural, human and social capital are among the 'minimum set' required for ESG reporting in the markets we operate? Can we measure that set?
- What ESG data on natural, human and social capital would correlate most with our own business priorities, i.e. which would indicate progress as a necessary or constructive input to an immediate priority or a strategic goal? What are we doing to improve that measure?
- What ESG data would indicate that we are drawing down on the capitals on which we depend in the long-term, either our own or our community's? What are we doing to limit that draw-down?

ESG engagement and access to capital

Public companies are comfortable with the idea that they should engage with investors to ensure the financial capital keeps flowing. Indeed, they have 'investor relations' teams for that very purpose. (By 'investors' I mean of course 'institutional investors' – most companies find fronting retail investors at an AGM a little less relaxing.)

As we have seen, those institutional investors increasingly want more than the company's financial story. They want to understand more about the natural, human and social capital the company has with which to generate next year's financial story, and the year after that. Hence, ESG disclosures and ESG ratings have become the norm at the institutional level.

At the same time, and independently, interest in ESG issues has developed among others who hold the capital that a company may want to access. There are multiple reasons why that interest is rising.

Take human capital first. In days past, a community may have paid to educate its young people, aware of the sweeping public benefits of education. Nowadays, families and young people are far more likely to bear that expense directly, particularly for tertiary education. Having spent well into six figures to do so, they need both to pay it back, and to do so without trampling the ethical and environmental values that those same families and schools talk so much about. They are ever less willing to work for companies that are at odds with those values. They have access to a company's performance data through the internet and, for bad company decisions, a torrent of social media.

Similarly social capital. Accessing social capital is not just about securing a 'social licence' to conduct business in a community – though it certainly includes that. It is equally about partnering with other institutions and 'brands', to access their social capital by association. A company may find it difficult to conduct research or run a pilot project in a certain area, but the local university is usually trusted to do so. If they could do it together, commercial benefits and social capital may flow. Likewise, a company may be unknown in a community. Sponsoring a local sports team gives it instant recognition, and by implication a share of that team's social capital. In fact, this is pure marketing rather than an ESG action – though it can open the door to other social investments in the area that may not have been open before.

The ever-present need for a strong narrative and old-style rigour

As we saw, the sole purpose of a company's ESG disclosure is to engage with others more deeply, so the company can access the capital it needs – whether it be natural, human, social or financial. That being the case, no company in their right mind would report raw data and leave their stakeholders to make sense of it all. They build that data into a narrative, designed to engage specific people in specific conversations. Some of those conversations are with the suddenly ubiquitous ESG ratings agencies. Although those agencies crunch all that narrative into a number, most unfairly one might argue, that number is higher than if based on data alone.

Investors find the data and narrative very helpful. Fundamental equity investors use it to understand how the company manages its valuable intangible capital. They will push and probe on the narrative to make sense of if, alongside the financial reports and the CEO's insights on them. If these stories all support each other, confidence rises, but they need the data to support the narrative. The flipside, of course, is that capital may be withdrawn if they don't like what they see.

The same applies with a company's conversations with employees, communities, sector and research partners, and regulators. Presenting the numbers is a baseline of engagement. Making consistent and credible sense of them builds understanding, trust and the willingness to work together.

Clearly, though, the story isn't everything. Attempts to tell a 'good story' without the data to back it up are doomed. It took a while for stakeholders to understand what ESG was all about, and some companies took advantage of that lag to try spin, greenwashing and anything else a marketing department might think of as business-as-usual. Now, unless a story has click-through transparency to the verified data behind it, it may be counter-productive. All that education on how to present a sound argument, with rigour, may have been a worthwhile investment after all.

Questions for companies to consider

Companies wishing to take advantage of the Capitals model might consider these questions in its stakeholder engagements:

- Can our engagement with people be more holistic, in the sense of being a conversation that includes each of the four capitals they have a stake in, rather than just the immediate cause of the conversation?
- What set of shared values on each of the four capitals is needed for a stakeholder relationship to be enduring, rather than transactional?
- How can we demonstrate, through data and events, we are seeking to protect and if possible grow the capitals a stakeholder is concerned about, rather than just drawing down on it?
- Are we making that case, or simply presenting random pictures and data?

In considering these questions, it becomes clear that a strong narrative supported by rigorous data is needed to build the enduring relationships an organisation needs.

Testing a company's ESG performance

The ESG performance-and-engagement cycle sets out a way of understanding how strong ESG performance leads to greater access to financial, human, social and natural capital.

With that understanding in mind, companies can use the cycle to test their own progress on ESG. How would they rate themselves on each of its dimensions. How would an expert rate them?

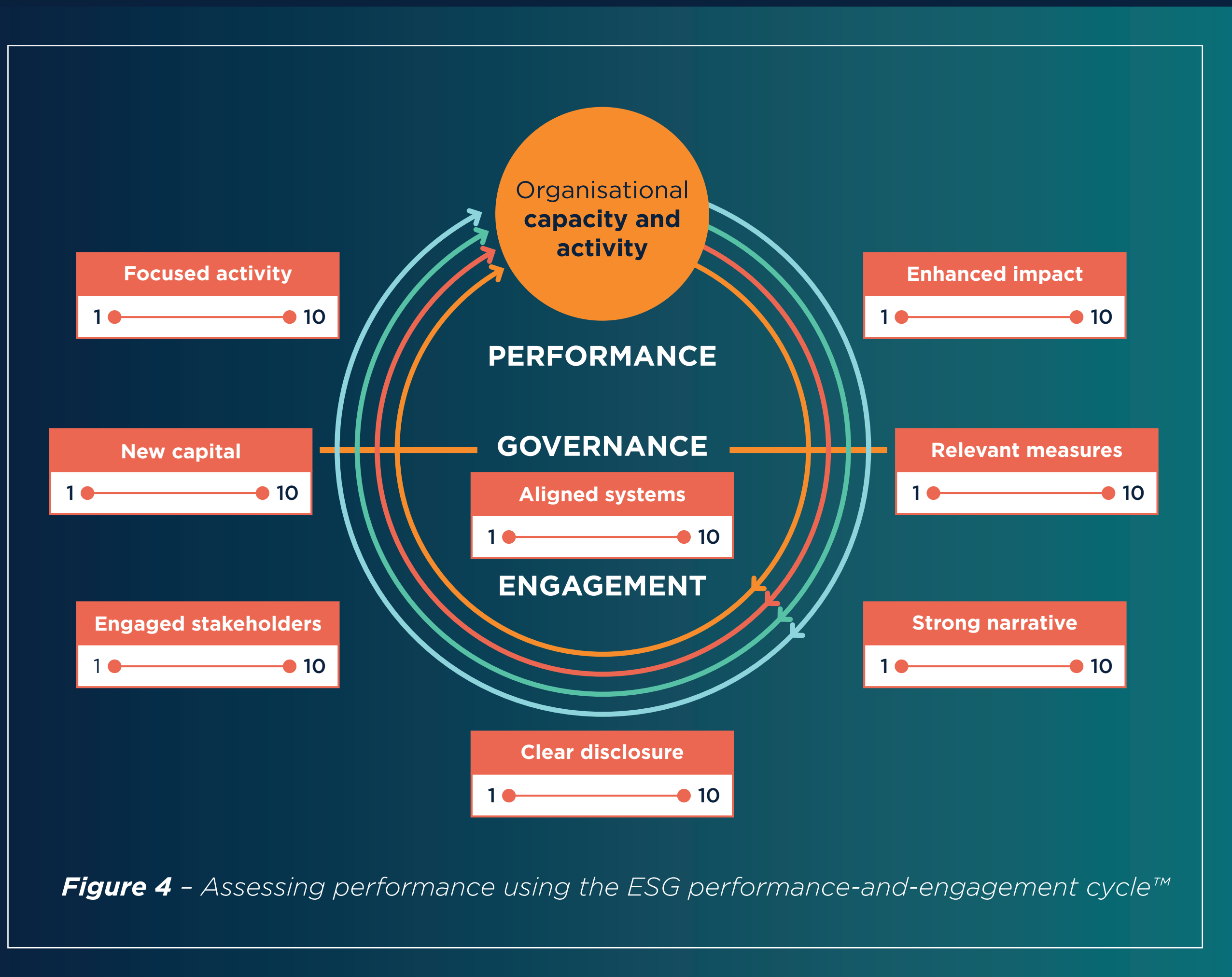

Figure 4 *– Assessing performance using the ESG performance-and-engagement cycle™*

The ESG performance-and-engagement cycle is a comprehensive model to understand the many ways in which the term "ESG" is loosely used, and why. Using it with a capitals approach can clarify the 'what, why and how' of ESG.

It can unlock the opportunities to build capital that a better understanding of ESG can offer an organisation, and better avoid the risks to that capital.

Find out more

MELBOURNE
Jill Calder
Partner and ESG Specialist
+61 419 508 597
jill@senateshj.com.au

SYDNEY
Josh Dowse
Head of ESG
+61 400 912 612
josh@senateshj.com.au

AUCKLAND
Maree Wilson
Partner and General Manager
+64 27 567 9599
maree@senateshj.co.nz

WELLINGTON
Raphael Hilbron
Managing Partner
+64 21 605 371
raphael@senateshj.co.nz

www.senateshj.com