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Roadmap to an ESG Strategy: Five Key Steps for Success in 2022

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More and more companies are committing publicly to adopt environmental, social, and governance (ESG) strategies. The equipment finance industry sees more funding sources, employees, clients, and business partners planning for an ESG future. Improved clarity in reporting and regulatory requirements can aid thoughtful ESG value creation.

Over the past several years, an increasing number of companies have made public commitments to adopt environmental, social, and governance (ESG) strategies. Although these standards have been in place for over 15 years, during the COVID-19 pandemic, a dramatic increase in interest and investments in ESG materialized. The reasons for this are numerous and include:

- Increasing public awareness of the effects of climate change and the need to take remedial action
- Heightened sensitivity to social justice concerns
- Prioritization of diversity, equity and inclusion (DEI) issues among boards, employees, potential employees, and consumers
- A desire among investors to invest in and do business with firms that share their core values
- A proliferation of public funds focused on green assets and initiatives
- Actions taken by a number of governmental and regulatory bodies mandating corporate disclosures of ESG initiatives
- Net-zero carbon commitments made by major companies, with banks looking to extend those commitments to companies for which they provide financing

Clearly the effects of a heightened ESG focus are being felt throughout the global economy. The equipment finance industry is no exception, as funding sources, employees,

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Editor's note: This article is based on a Foundation research report titled *The ESG Imperative: Understanding the Opportunities for the Equipment Leasing and Finance Industry,* published in February 2022. It is available here.

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clients and business partners are planning for an ESG future. While these trends are nascent, a number of industry participants are getting ahead of the curve in adopting strategies to reduce their carbon footprint, address DEI and social issues, position themselves in the war for talent, and finance the equipment necessary to achieve a net-zero carbon future.

Adoption of ESG strategies will require the equipment finance industry to examine both internal and external options that better align with investor requirements for increased ESG transparency and market demands. These could include enhanced availability of financing options for preferred ESG asset classes or utilization models.

Today ESG data collection, standard-setting, and disclosure represent an alphabet soup of acronyms that has fostered an environment of ambiguity, confusion, and conflict. However, as ESG reporting and regulatory requirements evolve and become more standardized, organizations will see the benefit of adapting their internal strategies and processes—both to prepare for change and to leverage ESG to create value.

Research has shown that companies that incorporate an ESG focus into their corporate priorities are more likely to:

1. increase financial performance and attract ongoing investments because they are more capable of responding to emerging market requirements,
2. attract and retain talent when employees feel an alignment of values, and
3. enhance reputational value by increasing social responsibility awareness.

Unlike financial performance—which has evolved for decades to include precise assessment metrics—the investment community is currently incorporating ESG into their investment evaluations without the benefit of tried-and-true assessment criteria. The ability to gauge ESG value will ultimately include both financial and nonfinancial implications that are measured based on the strength of a company's commitment to incorporate ESG into the core strategy of the company.

Five key steps support the successful execution of an ESG value-creation strategy. These are depicted in Figure 1 and further defined in each section following.

1. PRIORITIZE ESG STRATEGIC FACTORS

This first step is the most extensive part of the effort to identify those ESG activities that will have the greatest material impact on longer term performance. Several industry leaders who have undertaken this identification process report that ESG strategic objectives must be carefully balanced with financial objectives. Each element

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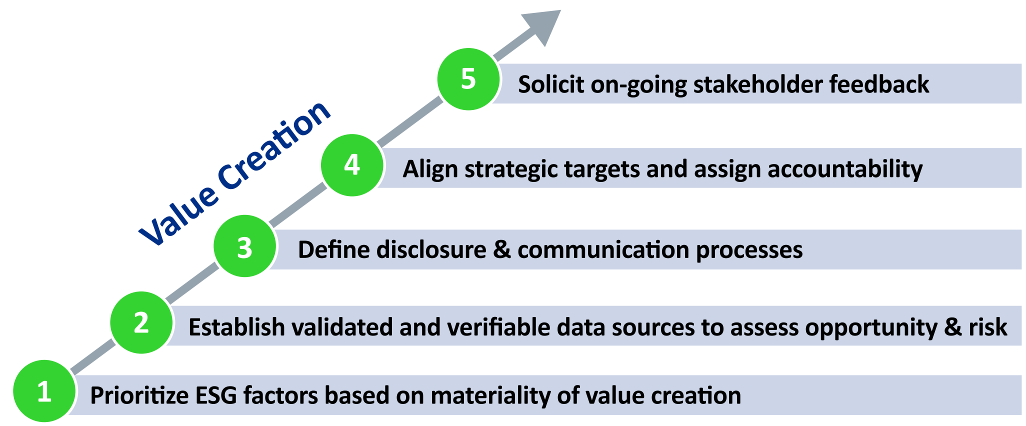
Global banks are leading the pack in declaring their goals for net-zero carbon footprints. Many of the largest bank-owned equipment finance companies are well on their way toward reducing their negative environmental impacts from operations.

Figure 1. ESG Value Creation Execution



Source: The Alta Group.

of environmental, social, and governance strategic factors should be examined for its potential value contribution to the organization.

Environmental Factors

The potential for both value creation and loss are vast within the environmental realm. Careful consideration of an organization's environmental impact through its own physical presence—as well as its relationships with suppliers, customers, and other stakeholders—is a critical starting point in developing a value-creating ESG strategy.

Organizations examining their environmental value-creation strategy need to assess three key factors: (1) their current environmental impact, (2) their market strategy, and (3) their supporting products and capabilities. Each of these environmental elements is described below.

Understand Current Environmental Impacts

Global banks are leading the pack in declaring their goals for net-zero carbon footprints. In fact, during the November 2021 Conference of the Parties 26 (COP26), the Glasgow Financial Alliance for Net Zero (GFANZ, with members controlling $130 trillion in assets), released a report on progress and plans toward a net-zero global economy.

Although its specific metrics and disclosures are still under development with guidance expected by mid-2022, GFRANZ is a stated focus on measuring the impact of investments including scope 3 emissions (Figure 2). Similarly, many of the largest bank-owned equipment finance companies are well on their way toward reducing their negative environmental impacts from operations.

Equipment finance companies should begin with a clear understanding of their existing

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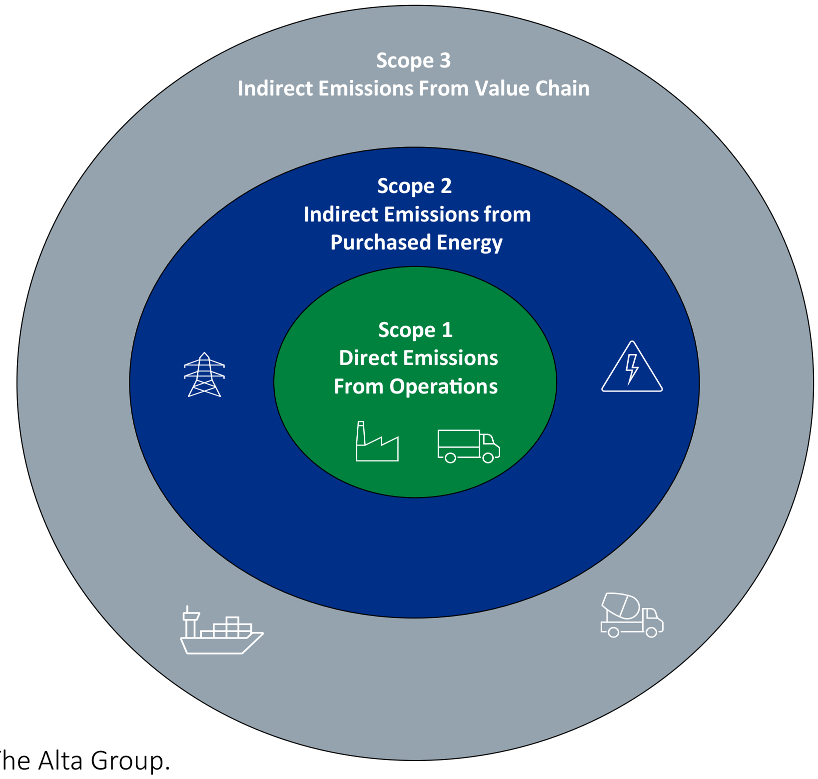
Energy usage also extends to an organization's infrastructure. Measures enhancing the energy efficiency of an organization's buildings can be key elements to an effective internal environmental strategy.

Figure 2. Scope 1, 2, and 3 Emissions



Source: The Alta Group.

carbon footprint from energy usage, transportation, and travel. Once the current impact is understood, they can develop strategies to reduce these negative impacts.

Energy usage also extends to an organization's infrastructure. Measures enhancing the energy efficiency of an organization's buildings, ranging from installation of rooftop solar panels to LED light installation, can be key elements to an effective internal environmental strategy.

An organization's staff can also contribute toward the effort to reduce the organization's energy usage. Work-from-home policies reduce the need for commuting and potentially reduce required workplace square-footage requirements. Likewise, the use of videoconferencing to reduce business travel and the purchase of carbon offsets for essential travel can be valuable contributions toward a company's net-zero commitment.

Assess and Adjust Market Strategy

The equipment finance industry is uniquely positioned to create value through the delivery of finance solutions with positive environmental impacts. For equipment finance companies, a candid assessment of their existing value proposition, industry presence, and associated evolving vendor product strategies comprise a crucial starting point.

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A finance company with a strong transportation presence may move into electric vehicle (EV) financing and perhaps from there into financing EV charging infrastructure.

A path to create value with staying power requires adopting an organic approach, evolving from the core value proposition to leverage core capabilities and market presence in a way that is both profitable and delivers positive environmental results. For example, a finance company with a strong transportation presence may move into electric vehicle (EV) financing and perhaps from there into financing EV charging infrastructure.

An important consideration for equipment finance companies entering new or adjacent markets is the risks and opportunities associated with the pace of technology evolution. Much of the technology required to address environmental challenges is in its nascency or is yet to be developed (Figure 3).

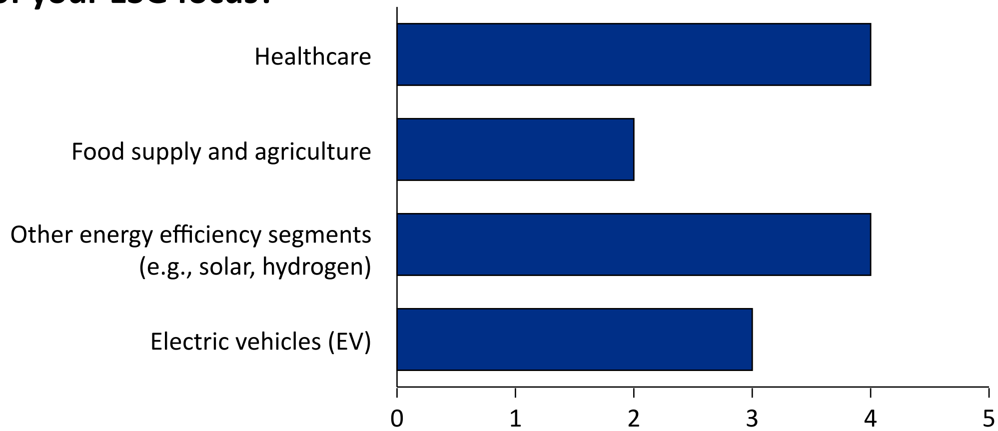
For example, the battery that powers an EV is, of course, only one component of the vehicle. Product evolution is moving at a fast pace, often with early-stage companies that may not have reached a viable commercial scale. Successful finance strategies associated with such companies must begin with a keen understanding of all the elements of a full solution and their attendant risks. This requires a hands-on, customized approach to creating vendor relationships.

In the EV scenario, battery replacement and recycling approaches can be deployed to mitigate operational and environmental risks.

One of the key opportunities for participation in the environmentally friendly finance sector relates to funding. Given banks' net-zero carbon footprint commitments alongside most of the world's largest asset managers, a tremendous amount of capital will be deployed in asset classes that can demonstrate positive ESG impacts.

Figure 3. ESG Industry Segments

Are there industries you have included in your portfolio because of your ESG focus?



Source: Results from ELFA research interviews conducted by The Alta Group.

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Portfolios or companies involved in industries perceived to have negative environmental impacts may face more challenges in securing financing or attractive purchase prices if pursuing an M&A-related activity.

This demand has the potential to drive increasingly favorable capacity, pricing, and terms for equipment-finance-enabling debt facilities. For this same reason, portfolios or companies involved in industries perceived to have negative environmental impacts may face more challenges in securing financing or attractive purchase prices if pursuing an M&A-related activity.

There are a growing number of areas for ESG investment. Some key industries and asset classes with significant investment growth expected include:

- Commercial vehicles and trucks (EVs): Vehicles and related charging infrastructure
- IT data and broadband infrastructure: Wider access to broadband for education and rural development, data proliferation from Internet of Things (IoT) artificial intelligence, and other technologies used to drive environmental efficiency
- Drones and robots: Energy-efficient means for last-mile deliveries, crop and irrigation management, delivery of transplantable organs, and numerous other industrial and agricultural applications
- Renewable energy and building retrofits: Renewable energy sources, enhanced building energy efficiency, and more efficient lighting and heating, ventilation and air conditioning (HVAC) systems

Assess Product Offerings and Asset Management Capabilities

Just as the technology in products is evolving, the way they are designed, manufactured, financed, and disposed of is becoming more "circular." Circular lifespan models are geared toward providing higher levels of utilization, potentially with multiple users, and higher levels of reliability that can prolong the life of the underlying asset. These pay-per-use or sharing models generally involve service contracts that provide comprehensive and integrated systems of hardware, software, and services for a stated contract term.

Assessing existing finance products and capabilities to support circular approaches can be a key differentiator for ESG value creation. Recent examples of enhancing current products include utilizing increases in rate factors to offer carbon offsets, via funding nonprofits that plant trees, or purchasing offsets created by farmers' carbon sequestration through the planting of cover crops.

Understanding the suitability of existing asset-management capabilities to support circular approaches, with asset remarketing and disposition executed in an environmentally friendly manner, is a critical success factor.

Social Factors

Social factors relate to how a company manages relationships with its employees, suppliers,

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The guiding principles selected by the organization must resonate with key stakeholders and be expressed clearly and in a measurable manner.

customers, and the communities in which it operates. These criteria have the potential to not just help society but also enhance brand image, employee engagement, and recruiting efforts.

Key questions that organizations should address before embarking on a social ESG strategy include these three:

- Should our company seek to do business with other firms that share our values?
- Is it important that our company's social ESG policy promotes the well-being of our employees?
- Should our company offer programs through which we can give back to the community?

Assess Programs for Organizational Fit

Once such foundational questions are answered, the focus can shift to implementing programs that are consistent with the company's mission and strategy. The guiding principles selected by the organization must resonate with key stakeholders and be expressed clearly and in a measurable manner.

Allowing employees to help select and guide specific initiatives can go a long way toward integrating ESG into the company's fiber. Just as important is creating the internal and external communication of the programs and results relative to goals. These results are increasingly important to capital markets, current and potential employees, suppliers, and clients.

Transparency in reporting progress relative to ESG goals, whether favorable or unfavorable, is critical to achieving desired results. Management and company actions must be seen as consistent with their messaging.

The types of social drivers to be implemented by companies and their employees are almost limitless but are generally very specific to each company, its community, and the issues it faces. Some examples of social ESG-related criteria implemented by public and private entities include:

- Giving employees options to choose and participate in paid periods of community service
- Establishing and empowering client-centric problem-solving teams.
- Formalizing family leave options
- Participating in school reading and STEM (science, technology, engineering, and math) programs
- Gift-matching with charities
- Addressing employee and supplier diversity
- Promoting refugee or veteran hiring programs or aid
- Addressing pay inequality
- Fostering work-life and hybrid or remote work balance

Provide Financing for Assets Compatible With Social Goals

Depending on their fit within an overall market strategy, asset classes may be financed by industry participants and be consistent with

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What a company will not finance is also part of social ESG strategy. Participants in the equipment finance industry have long maintained lists of excluded industries that can now also be expressed as part of a social platform.

a commitment to social ESG goals. Some initiatives that have been undertaken by public entities as part of their social ESG strategies include:

- Providing financing for healthcare providers in underserved markets
- Financing equipment used in the production of sustainable and humane agriculture
- Financing for retailers in urban food deserts
- Establishing or contributing to business incubators for local disadvantaged entrepreneurs

What a company will not finance is also part of social ESG strategy. Participants in the equipment finance industry have long maintained lists of excluded industries that can now also be expressed as part of a social platform. Commonly excluded industries include firearms, strip-mining and other fossil fuel extraction, gambling, pornography, and cannabis.

Governance Factors

Governance activities include those processes, controls, and procedures that an organization might use to monitor risks and opportunities. The advantage of a strong governance process is its positive impact on creating investor and key stakeholder confidence.

Activities that are critical to the demonstration of adequate governance include:

- Emphasizing activities related to employee and board diversity, equity, and inclusion
- Ensuring that the business conduct of all employees and board members meets an acceptable level with regard to moral and ethical practices
- Implementing a credible whistleblower policy
- Establishing policies, accountability, and targets for measuring performance improvement
- Aligning employee, management, and board remuneration with key targets
- Ensuring that employee skill levels are adequate to assume accountability for newly targeted elements of ESG
- Including periodic senior level and board reviews in core agenda topics
- Incorporating risks and opportunities into strategic initiatives and risk-management policies
- Maintaining adequate controls in measuring and disclosing nonfinancial ESG information
- Supporting cybersecurity and protecting all data from fraud, phishing schemes, or unauthorized access, using strong data security protocols and training

Although many of these activities have always been a focus for investors and other prominent stakeholders related to financial performance, more recent emphasis is being placed on nonfinancial disclosure, which has become

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Going forward, as part of the governance process, investors and other stakeholders may require third-party data assurance to ensure that ESG reporting is consistent with the standards they have come to expect in financial reporting.

increasingly important with the influence of ESG.

Measuring, monitoring, and disclosing nonfinancial ESG activities can be challenging because these tasks create opportunities for intentional or unintentional overstatement, or greenwashing, of performance. Inaccuracy in nonfinancial disclosure has detrimental impacts on investors and key stakeholders, both of whom rely on a level of data integrity.

When data integrity is inadequate, stakeholders can frequently make flawed decisions. Going forward, as part of the governance process, investors and other stakeholders may require third-party data assurance to ensure that ESG reporting is consistent with the standards they have come to expect in financial reporting.

2. ESTABLISH VALIDATED AND VERIFIABLE DATA SOURCES TO ASSESS OPPORTUNITY AND RISK

As priority ESG strategic objectives are identified, data quality will become increasingly important. The axiom "If you can't measure it, you can't manage it" will carry increasing weight. Developing and maintaining verifiable internal and external data sources will drive high-quality retrospective and predictive analysis.

Risks can also be mitigated by incorporating data security and infrastructure sources into traditional internal control process management. A key focus during this step is to provide stakeholders with confidence in the ESG information that is being used to make internal and external decisions.

3. DEFINE DISCLOSURE AND COMMUNICATION PROCESSES

Although some disclosure is mandated by regulatory agencies, optional or voluntary disclosures can communicate the positive impact that a company is having on the world around it. Immateriality and lack of transparency on such voluntary disclosures are common flaws and contribute to greenwashing.

In order to promote a positive image and high credibility for any ESG disclosure efforts, internal and external disclosures and communications must be well defined, with strong internal process management focused on sustaining materiality, transparency, and validation as key criteria for disclosure.

4. ALIGN STRATEGIC TARGETS AND ASSIGN ACCOUNTABILITY

As the process of successfully executing a mature ESG value-creation program continues, a key objective must be strong alignment of strategic objectives with ESG. Internal communication becomes especially critical to ensure that

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Successful execution is dependent on addressing potential changes with regard to organizational structures, processes, investment priorities, policies, and disclosure reporting.

key performance indicators are established with corresponding targets and assigned performance accountability.

Involving employees early in the process can dramatically improve their buy-in of the company's direction as well as provide them with a better understanding of their individual roles in the success of the ESG strategy.

5. SOLICIT ONGOING STAKEHOLDER FEEDBACK

Lastly, one of the challenges with nonfinancial ESG performance measurement is the fact that it is much more dynamic than its financial ESG performance counterpart. Stakeholder familiarity and reliance on key financial metrics has been time tested. In contrast, ESG priorities and the data associated with them change rapidly based on cultural, environmental, social, and other emerging material issues.

It becomes imperative to continually reassess and address values considered important to key stakeholders. This requires creating a process to solicit and prioritize stakeholder feedback on a regular basis.

New segments, asset classes, offerings, and social programs that focus on ESG requirements will undoubtedly create growth and value-creation opportunities for the equipment finance industry. However, successful execution is dependent on addressing potential changes with regard to organizational structures, processes, investment priorities, policies, and disclosure reporting.

CONCLUSION

Although there is much that can be done today, improving clarity around reporting and regulatory requirements will continue to provide even more certainty and confidence in thoughtful ESG value creation.

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