

# ESG is here to stay

Different concepts and strategies lead the debate but compliance to the methodology is fast gaining support

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WHILE the concept of ESG, which stands for environmental, social and governance, is relatively well established, its significance here came to the fore recently.

Two particular developments led to this. One was the Top Glove Corp Bhd saga. After it was revealed that the glove making giant had paltry workers' housing conditions that led to high Covid-19 infections, some analysts lowered their target prices thereby impacting the stocks' value. And then BlackRock, the world's largest asset manager that held a 1.61% equity stake in Top Glove, voted against the re-election of six independent directors at the rubber glove maker's annual general meeting. The move was ESG-driven as BlackRock held the view that the board had failed in its oversight responsibility relating to TopGlove's migrant workers' health and safety. Top Glove has since pledged to rectify those concerns.

Another more significant development is the recent declaration by the Employees Provident Fund (EPF) that it aims to make all its investments based on ESG practices by 2030.

So arguably, the EPF may no longer invest in oil and gas counters in 10 years time, because drilling for fossil fuels can be deemed a non-ESG compliant activity.

This brings the ESG discussion into two hotly debated aspects. One, what exactly is the correct interpretation or standard of ESG and secondly, what is the correlation between ESG and returns on investment.

There are other questions too. What is the state of ESG compliance of Malaysian listed companies? Are many even aware of this growing concept? And where do these companies start in attempting to get certified?

## A lack of standardisation

At this point, there is no global standard for ESG. There are multiple bodies that have come up with their own standards. This does make it difficult for investors and issuers to figure out their ESG strategies.

"Different assets managers employ very different methodologies for ESG scoring," points out Vincent Khoo the head of research at UOB Kay Hian Malaysia.

That though should not stop Malaysian companies from beginning their ESG compliance journey, says Amarjit Kaur, an experienced environmental consultant.

"The journey and thought process needs to begin with an almost existential type question. Why does the company need to exist? What contribution and impact are you having on the economy and society? If you answer these

questions honestly, you will then realise if you are doing the right or wrong things. Of course there are many standards out there that we can help companies with in their assessment but ultimately, the intention and spirit of those owning and running the companies needs to be in the right frame," she opines.

The good news though is that more companies are beginning to embark on their ESG journey. Amarjit says that her consulting firm, Shemsi Sdn Bhd, is seeing increasing client engagements.

As for concerns about the lack of global standards, Eugene Wong of Sustainable Finance Institute Asia makes an interesting point – that there is unlikely to ever be a single standard or definition of ESG.

"That's because ESG characteristics are qualitative and it's hard to translate them into a single number. If you look at ESG ratings, you'll find that the correlation of ratings on the same company by different ratings providers is less than 0.5, whereas credit ratings from different credit rating providers have correlations higher than 0.9. This is because there is a difference in what is considered as part of the ESG definition, the indicators used to evaluate those aspects and the way weightings are assigned to get to the final number."

Wong adds: "Because markets are different, the slant on ESG in each market can also vary. Take for example the Nordic countries where social responsibility and equality are built into the culture. There's a focus of the 'right' profit over profit maximisation. But in places like Asia, profit maximisation is important. So ESG products need to consider that too."

Sustainable Finance Institute Asia is a newly set up independent institute advocating sustainable finance in Asean.

For Andrew Chan, who leads PwC Malaysia's sustainability and climate consulting arm, the definition of ESG that works can be summarised as 'sustainable value creation'.

"In this context, the key paradigm shift for companies is moving from a profit maximisation lens to a value optimisation lens. And moving from a shorter term profit focus to a longer term consideration of profits as well as impact to customers, communities and the environment. Is the organisation out to maximise profit, or is it there to optimise value? Are shorter term gains more important than longer term? How are shareholder interests balanced with stakeholders?" he poses.

On the issue of the ambiguity over ESG standards, Chan says this: "Financial reporting standards have been evolving over 100 years, and they are still changing."

## Correlation between ESG and returns

For investors though, can limiting one's bets

A snapshot of FTSE Russell's ESG Ratings



TheStar graphics

on ESG compliant companies still lead to higher returns? Some think so.

Alizakri Alias, Chief EPF Officer, explains. "The market volatility during the first-half of 2020 was challenging. For the EPF, at the height of the first wave of the Covid-19 pandemic, our top 10 ESG-ranked stocks outperformed the bottom-10 in the first quarter of the year. If we were to rank the companies by their 'social' scores from our proprietary ESG rating tool, companies in the top 10 list outperformed the FBMKLCI by 6% in the first quarter of 2020."

He adds: "We view ESG to be the vaccine for any crisis. At worst, ESG-compliant assets' performance did not deteriorate as badly as other assets. This is key in delivering sustainable growth."

Funds like the EPF and The Retirement Fund Inc (KWAP) are also pushing stock brokerage firms brokerage in Malaysia to ESG considerations into their research process alongside traditional financial metrics. As far back as 2018, KWAP had begun putting some of its money into ESG-rated assets.

Affin Hwang Asset Management (Affin Hwang AM) director of equity strategies and advisory Gan Eng Peng says the anecdotal evidence is clear that the ESG theme is having a correlation to stocks' valuation.

Gan points to listed planters on Bursa Malaysia.

"Although crude palm oil (CPO) prices in US dollar terms at a nine-year high, listed palm oil company shares in Malaysia and Asia have not

moved anywhere near the CPO price movement. They have all underperformed the CPO price movement. We think there is a general avoidance of non-ESG friendly sectors and there is no differentiation consideration for those within the sectors that have better ESG practices or rating," he says.

He adds that companies linked to renewable energy and electric cars have surged to premium valuations.

## ESG drivers

Still, there is yet to be clear and definitive research showing that ESG investing leads to higher returns. And looking at returns as a driver to becoming ESG certified may be missing the point.

Rikke Netterstrom, executive director of Helikonika, a sustainability and ESG advisory in Malaysia explains: "There is very limited evidence of a direct link between share price and ESG performance. I would expect this to change over time, but this isn't the most critical driver. In discussions with CFOs in Malaysia and beyond, what appears to be more important is access to capital. Malaysian companies seeking international finance are finding that ESG performance is a critical requirement in obtaining loans, insurance and other financial products. Southeast Asian banks have yet to set up very strict requirements, but financial professionals and boards are expecting this to be a basic requirement for obtaining finance over the coming years."