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Are Hybrid Metrics the Final Frontier in ESG Disclosure?

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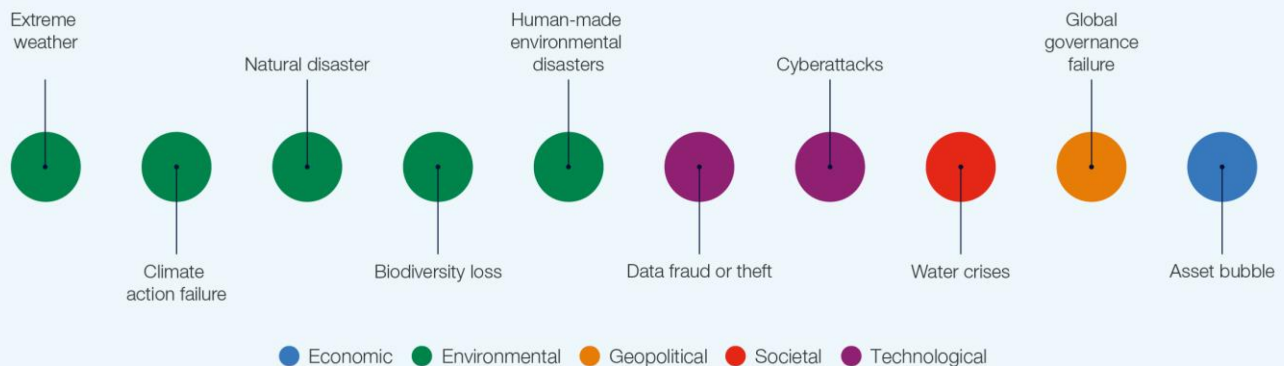
As a sustainability professional, I often heard versions of the same message: "sustainability is for rich companies that have money to spare" or "I'm just a small business trying to survive". Over the years, this outlook has changed in part due to greater exposure to climate risks. In fact, climate risks were singled out as a potential source of market instability by the Financial Stability Board prompting a study which culminated in the release of the Task Force for Climate-related Financial Disclosures (TCFD) recommendations. In January 2020, before we truly understood the magnitude of the Covid pandemic, the World Economic Forum Global Risks Report featured environmental risks as the top 5 risks in terms of likelihood and 3 of the top 5 risks in terms of impact.

> The market is acknowledging the fact that companies do not operate in a vacuum and therefore, environmental, social and governance (ESG) factors should be considered alongside financial metrics in assessing a company's performance.

TOP 10 RISKS OVER THE NEXT 10 YEARS

Long-Term Risk Outlook: Likelihood

Multistakeholders



Global Risks Report 2020

What gets measured, gets managed…but which metrics?

While this is welcome news, the challenge sustainability professionals face is quantifying material ESG factors in a way that speaks to investors, Board Directors and senior management. Although TCFD recommends adding climate-related disclosures in financial filings, aside from GHG emissions, it generally neither prescribes metrics nor suggests how to quantify them. Having identified climate risks and opportunities and the steps to greater climate resilience through a scenario analysis, this has left some of our advisory clients questioning how to take the final step to meaningful disclosure.

> *Rather than waiting for investors to become well versed in sustainability metrics and the underlying implications, is it possible for ESG factors to be presented in monetary terms?*

This is the question Mark Kramer et al. answer in their report **Hybrid Metrics: Connecting Shared Value to Shareholder Value**, which looked at potential metrics that would help investors discern which companies are "**most profitably doing the most good (p.6)**." Some metrics proposed in the report include EBITDA/CO2 Intensity for the energy sector and EBITDA/% of Workforce Above Living Wage for the services industries. To learn more about this concept and how it may impact companies and investors in the Asia Pacific region, Shared Value Project Hong Kong invited me to hold a dialogue with Mark Kramer on 22 October 2020.

Examples of Hybrid Metrics

Crop Nutrition	EBITDA/ Yield per Hectare
Retail	Cost of Goods Sold/ Value of Waste Avoided
Pulp and Paper	Revenue/ Tonnes of CO_2 Sequestered
Pharma and Medical Devices	EBITDA/ Contributions to Daily Adjusted Life Years
Chemicals and Industrial Production	Cost of Raw Materials/ Tonnes of Recycled Plastics Used
Financial Services	Revenue per Customer/ Financial Well-being

Below, I summarise some interesting points that came up during our discussion.

Key points

While ESG is often considered from the risk angle, as is common in Asia, **hybrid metrics could support the shift in mindset from ESG as risk management to sustainability as a source of opportunities and strategic growth for business** especially in our increasingly volatile, uncertain, complex and ambiguous world. Companies may want to jump straight in, however, before identifying material hybrid metrics, companies must assess ESG risks, identify opportunities, outline their strategies, and begin the process of internal change.

Hybrid metrics are the outcome of a process of reconsidering and shifting business models to be more sustainable in a profitable way. This shift depends on robust internal communications where the gap between the sustainability teams and other functions such as investor relations and operations is narrowed. Short termism, current incentive structures and unease with transparency work against this type of transition, which is why it requires the full commitment of the senior management, especially the CEO, to set the tone and initiate and drive change. In my experiences advising clients, I find that this is especially true in Asia, however, we are also seeing an increased interest in these topics as a result of investor pressure and the growing trend of active ownership and engagement.

Absent corporate action, it is incumbent on investors to begin testing, implementing and mainstreaming this concept as **it has the potential to provide clarity around the link between ESG and financial performance**. Some of the metrics, such as EBITDA/CO_2 Intensity can be calculated using publicly available information disclosed in financial filings and sustainability reports. Even if companies are not disclosing the necessary data points, we know from current experience with ESG metrics that investors calculate estimates to help fill in the gaps.

- Access the Hybrid Metrics Report
- Watch the webinar

There is still a long way to go before the concept is proven and causality is established. However, in my view, **this kernel of an idea has the potential to transform the way we translate sustainability and the value it brings to a company in the long-term**.

Dr Nadira Lamrad leads the Sustainability and ESG Advisory team at BEC. The team helps the business community connect the dots between sustainability and business objectives to manage risks, embrace opportunities, enhance growth, build trust and create value. Contact the ESG Advisory team to learn how you can convert sustainability into a strategic advantage.

For more about our services please visit https://bec.org.hk/en/esg

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About Business Environment Council Limited 商界環保協會有限公司

Business Environment Council Limited 商界環保協會有限公司 ("BEC") is an independent, charitable membership organisation, established by the business sector in Hong Kong. Since its establishment in 1992, BEC has been at the forefront of promoting environmental excellence by advocating the uptake of clean technologies and practices which reduce waste, conserve resources, prevent pollution and improve corporate environmental and social responsibility. BEC offers sustainable solutions and professional services covering advisory, research, assessment, training and award programmes for government, business and the community, thus enabling environmental protection and contributing to the transition to a low carbon economy.

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