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Seeking Growth The ESG Way

Edelweiss Securities Limited

SEEKING GROWTH

The ESG Way

- ESG reflects qualitative aspects of business – and it matters to businesses, governments and investors
- Already big in the investing world: USD 23 trillion in assets, outperforms, growing rapidly and coming to India
- India catching up on its ESG quotient and approach—in part regulatory, but also a rising belief system among businesses
- Biggest business groups leading the way – Mahindra, Reliance and Birla – and many treading their own path
- The ESG Way reflects the changing need and belief system, unique opportunities and the path ahead

INTRODUCING ESG

What is ESG?

ESG – the acronym for Environmental, Social and Governance – is a generic term for evaluating corporate behaviour and nowadays used interchangeably with sustainable, responsible, impact or ethical investment. It may be viewed as a successor to Socially Responsible Investment (SRI), which is gaining popularity worldwide. But unlike SRI, which relies on negative screening, ESG propounds an underlying philosophy of larger good without overlooking financial or economic viability. Corporate Social Responsibility (CSR) – an India economy/regulatory phenomenon that is often mistaken for ESG – is actually only a small part of ESG.

ESG – Environmental, Social and Governance

Environmental
Criteria look at how a company performs as a steward of the natural environment

Social
Criteria examine how a company manages relationship with its employees and stakeholders

Governance
Deals with a company's leadership, executive pay, audits, internal controls and shareholders rights

Source: Institutional Investor Advisory Services

What is ESG investing?

Investing based on an ESG framework is a desirable add-on that quantifies the qualitative impact of business

Traditional investment parameters talk up corporate ratios and financial returns, which are quantitative and numeric. Valuation methodologies may be fairly subjective, but they too are ultimately quantitative measures. Investing based on an ESG framework, is a desirable add-on that quantifies the qualitative impact of business, namely its Environmental, Social and Governance aspects. ESG investing is thus a comprehensive approach that integrates the Environmental, Social and Governance factors into investment analysis and decision-making.

Consequently, from investors' standpoint, ESG data are increasingly important to identify companies that do business the right way and are well positioned to exploit the opportunities thereof. And for policymakers too, it should be a welcome market-led development that ascribes a high weighting to common good (or avoiding common bad), which is typically sacrificed at the altar of short-term profit making.

Why is ESG investing important?

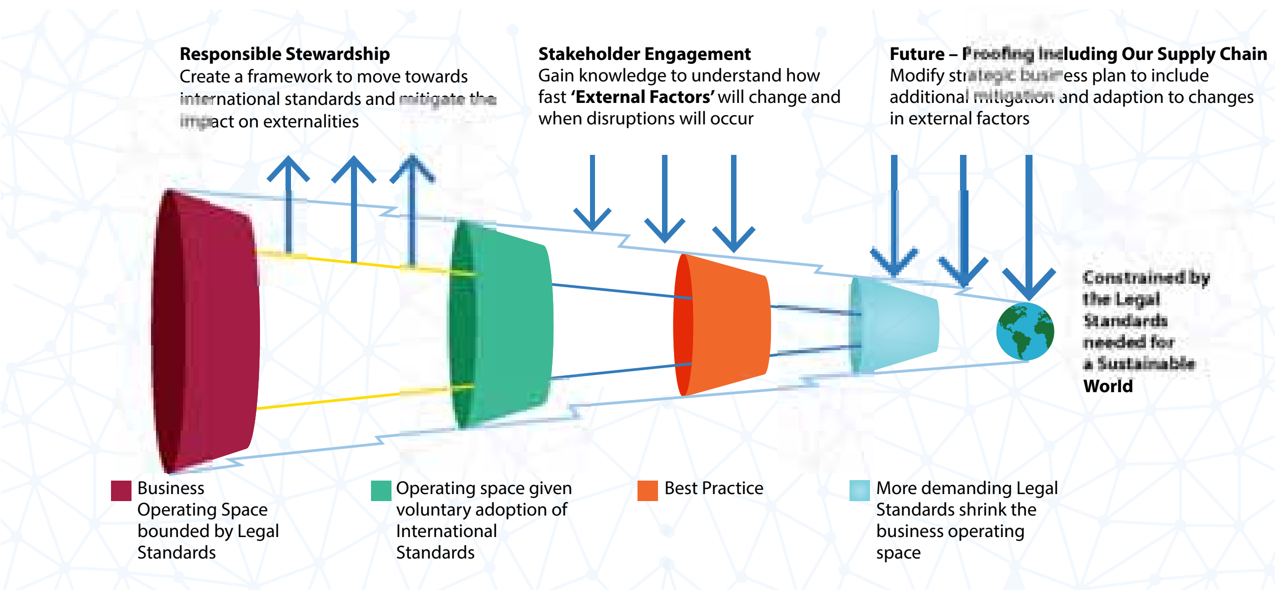
ESG norms are progressively defining the way businesses should operate, particularly in developed markets. **E**nvironmental sensitivity continues to rise as health, lifestyle and economic risks are increasingly quantified. **S**ocial imbalances are becoming political hot potatoes: whether it's rising economic disparities and opportunities, gender biases or social class systems. And **G**overnance makes headlines – until recently more often the lack of it – with progressively lower odds of sparing those that let down or get caught.

Over time, ESG has risen from being a fuzzy concept to a business, investing and political priority – whether global or Indian

Over time, ESG has risen from being a fuzzy concept to a business, investing and political priority – whether global or Indian – and it shall, eventually, command overriding importance in the world of business as well as investments. We see ESG increasingly driving: a) the quality of companies and the way they conduct business; b) higher economic returns that such businesses generate over the long term – in spite of short-term or upfront financial costs or trade-offs; c) investor orientation and investment mandates, and the flow of capital; d) higher financial returns – for businesses and investors; e) regulatory tightening or operating risks for businesses, particularly that are not compliant; and f) goodwill for businesses within the sociopolitical space they operate in. It's a wide ambit.

In general, ESG norms are tightening and, therefore, profit preservation would nudge companies to meet the statutory ESG requirements. In this constantly evolving operating landscape, only companies that have built businesses on ESG foundations shall eventually thrive.

ESG narrows operating framework: Future-proofing businesses



Source: Aditya Birla Group Sustainability Model

INVESTING IN ESG

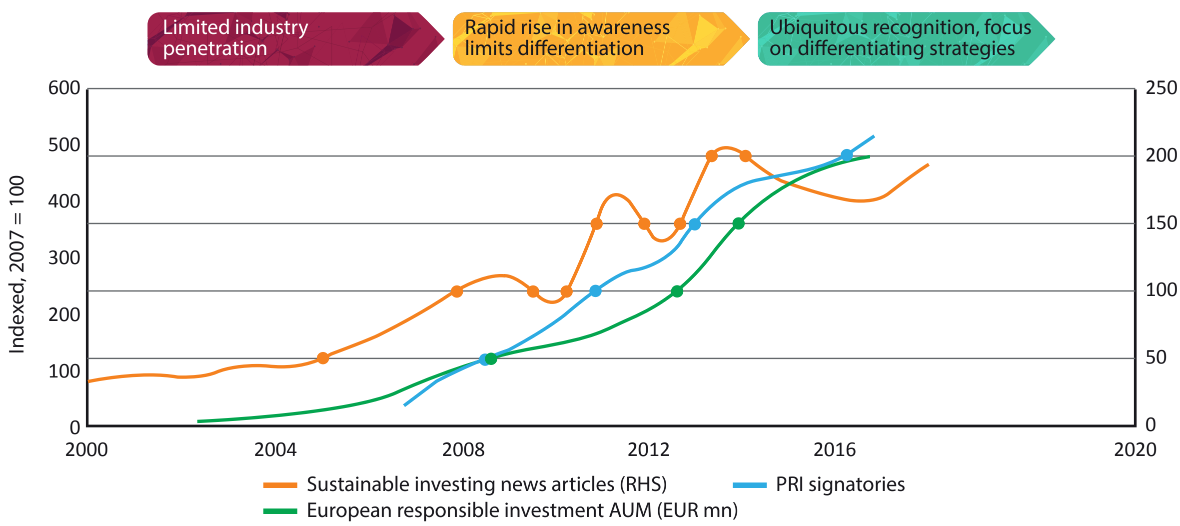
ESG investing is big. Assets mandated globally under SRI strategies jumped from USD 11 trillion in 2012 to USD 23 trillion in 2016. Tracking the trend, SRI assets in India more than doubled to about USD 30 billion from USD 13 billion over the period. Globally, SRI accounts for about one-fifth of capital under management*. While there could be definitional variances (ESG, SRI, Sustainable Investing among others), broadly defined ESG investing is already very large and among the fastest-growing investment segments globally.

a. ESG investments in spotlight

It is now standard for institutional asset owners to ask about asset managers' credentials in integrating ESG considerations in the investment process

Over the past decade, sustainability has emerged as a crucial aspect of investing. This is evident from the exponential rise in publicly available information as well as signatories to the United Nations' Principles of Responsible Investing (PRI). The rising number of ESG equity indices across major stock exchanges is only reflective of this expansion. In fact, leading European investment firm Schroders states that it is now standard for institutional asset owners to ask about asset managers' credentials in integrating ESG considerations in the investment process. The firm further states that retail investors have also shown appetite for products that recognise and reflect the relationship between their investments and an increasingly challenging social and environmental backdrop.

ESG emerges as pivotal theme in investment discussions



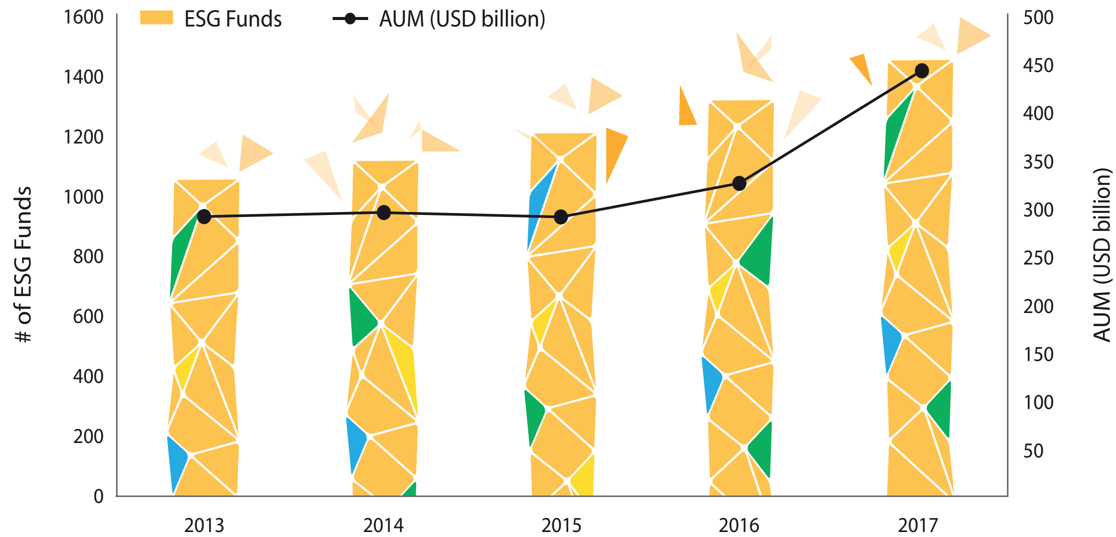
Source: Schroders' "Understanding sustainable investment and ESG terms"

** Source: India Sustainable & Responsible Investing Landscape 2017, cKinetics.*

Surge in ESG investments

ESG assets and funds have accelerated since 2015 in the wake of growing demand for such strategies. According to a Bloomberg Intelligence study, ESG asset growth accelerated to 37% in 2017, outpacing the 23% uptick in assets under the MSCI World Index. Similarly, the number of funds created in 2017 were twice that of 2014. While ESG investing is relatively niche today, it is progressively getting mainstream.

ESG asset growth accelerates to 37% in 2017



Source: Blomberg Intelligence

Where ESG assets reside — Europe leads

ESG investing is very large, and the Global Sustainable Investment Alliance (GSIA) suggests assets worth USD 23 trillion were managed under 'responsible investment strategies' globally in 2016—a spike of 25% vis-à-vis 2014. India's share in this is a miniscule 0.1%. But where have these assets originated globally, and what are its geographic and growth trends? Europe is the pioneer of ESG consciousness and investing, and the dominant driver of perky growth in ESG investing. Even today, more than 50% of its investments are ESG-sensitive or benchmarked, and well ahead of comparable geographies.

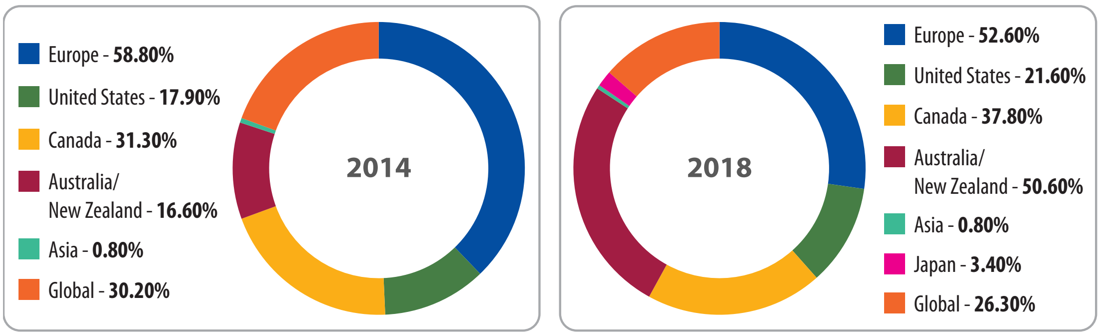
Europe is the pioneer of ESG consciousness and investing, and the dominant driver of perky growth in ESG investing

That said, ESG investing is catching on in other major geographies of the world with the share of ESG-sensitive funds taking off over the last few years. Australia/New Zealand have about 50% of assets under the ESG umbrella and Canada over a third. The US has been a relative underperformer so far with less than a quarter of ESG-tagged assets. It is, however, catching up and could well make the most rapid strides in such investing in the years ahead.

Asia lags

Asia makes up the tail with only a miniscule share of ESG assets. This probably reflects the nascent state of its capital markets and relatively hard focus on growth and opportunities in respective economies. Or it may have been broader ESG challenges in Asian markets, which diminish the attractiveness of such investment. It should, however, also suggest a tipping point in ESG investing may not be far away in Asia as the market awakens to such shifts and changing investor needs.

SRI assets as % of total managed assets in their respective regions



Source: GSIA, 2016 Global Sustainable Investment Review

ESG investing in India: Nascent; global investors dominate

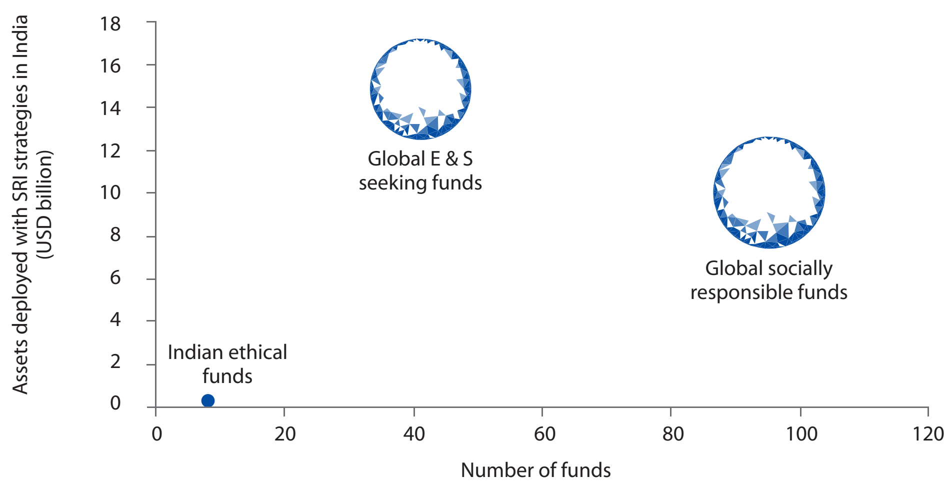
It's still early days for ESG investing in India. There is one large, and only somewhat prominent, domestic ESG fund. We believe there is another on the anvil, but that is likely to be more focussed on global pools of capital. This would change in our view, albeit the start and getting the momentum going is typically the most challenging phase, and this is where domestic ESG assets are currently positioned.

95 global socially responsible funds have invested in India and allocated on an average 18.5% to Indian companies (their total fund corpus is USD 25 billion)

Nevertheless, ESG funds have not shied away from investing in India. According to the GSIA, as many as 41 Global E&S seeking funds (aggregating USD 15 billion) have invested on an average 25% of their funds in Indian equities. 95 global socially responsible funds have invested in India and allocated on an average 18.5% to Indian companies (their total fund corpus is USD 25 billion). This is sizeable, and reflects the hectic activity among these funds. And that assets mandated under the ESG umbrella are likely to spike in India seems to be a foregone conclusion.

India's share in global investing is a relatively modest proportion—a 7–8% benchmark for emerging markets and about 1% for global pools. India's share of investments in global ESG funds is, however, higher, and accounts for 19% of such funds. It would aggregate about USD 25 billion in ESG-benchmarked equity investments. This is a little under 7% of the total foreign institutional equity investment in India. We contend this is not insignificant, and suggests ESG-benchmarked investing is gaining ground in India, but not appreciated adequately by businesses and the investing community at large. While we expect global investors to continue to get more ESG-sensitive, it is possibly the domestic Indian investor that could see the more sizeable shifts towards such an investment approach, not to mention expansion in ESG-themed asset-raising.

Categorisation of assets deployed with SRI strategies in India



Source: cKinetics Research

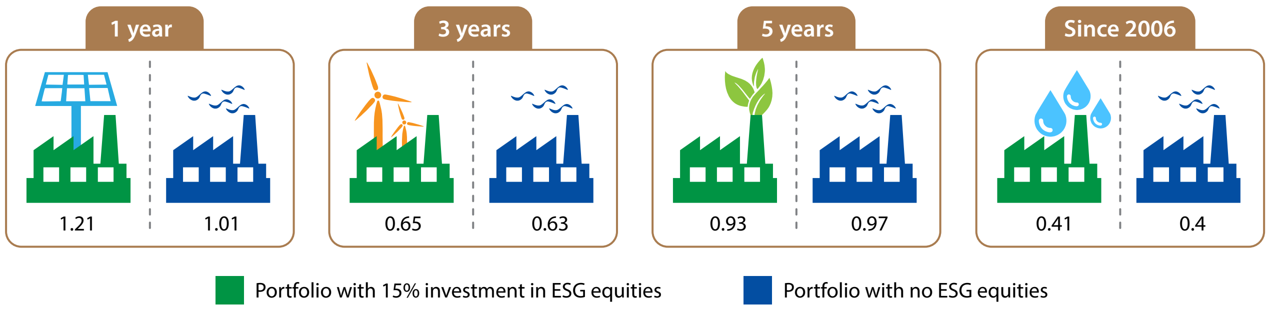
Note: Bubble size represents the cumulative size of the funds.

b. The ESG edge

Sufficient evidence of superior returns at lower risk

Several empirical studies indicate that investors and markets reward companies that score highly on ESG parameters. For instance, MSCI ESG Indices for India and overseas have consistently outperformed their respective broader benchmarks delivering superior risk-adjusted returns. Similarly, we note that ESG-focused companies not only command valuation premiums, but portfolios comprising strong ESG companies have sustainably outperformed non-ESG portfolios, generating greater risk-adjusted returns and showing lower drawdown risks. In fact, most well-known global MSCI ESG indices have outperformed their respective broader country indices over periods of three–five-years.

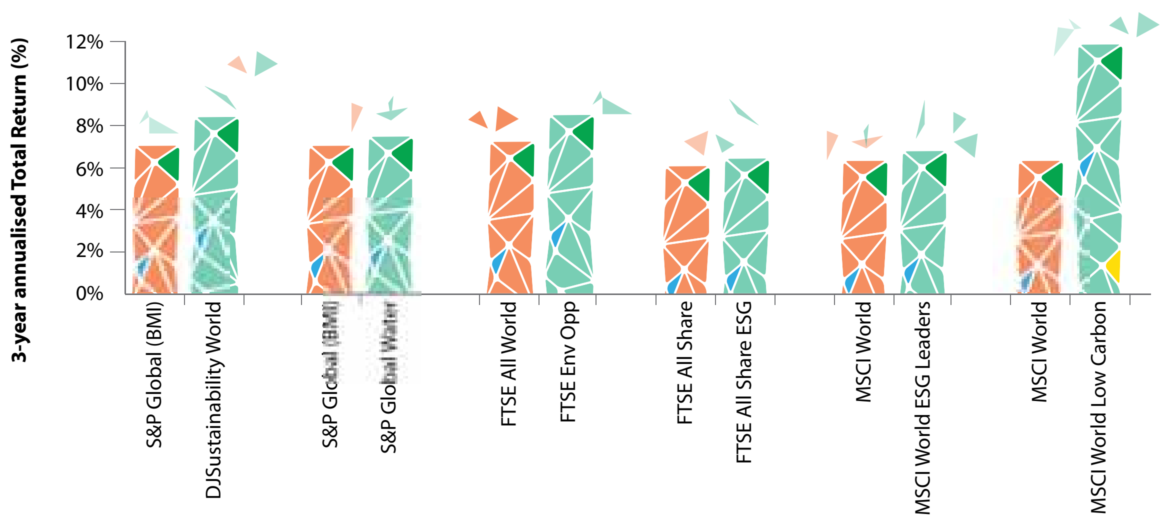
ESG portfolios generally offer better risk-adjusted returns (Sharpe ratio)



Source: Standard Chartered, ESG investing: What is it and will it give me better returns?

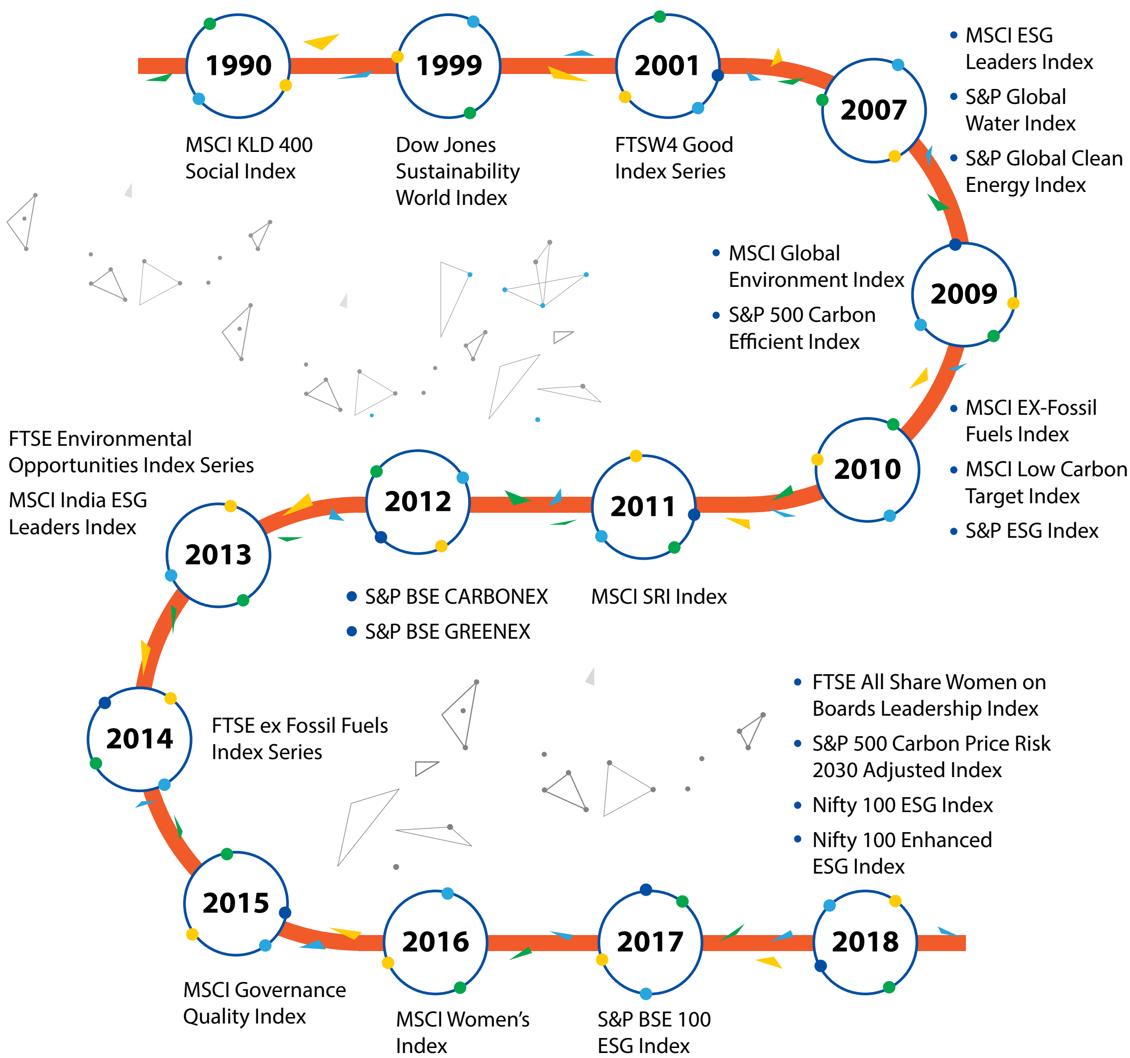
How long have ESG investments been in place? A glance at the launch timeline of ESG indices globally clearly suggests that the US and Europe have been at the forefront. For instance, ESG indices in the US were launched in early 1990s—MSCI KLD 400 Social Index in 1990 and several thereafter over the next 15 years. In India, ESG indices debuted only recently in 2012. Five additional indices have been launched since, which suggests the groundwork and the institutional framework for more rapid growth for this asset class is in place.

Key global ESG indices pip respective broader country indices



Source: www.ftserussel.com, www.us.spindices.com, www.bseindia.com, www.nseindia.com, MSCI

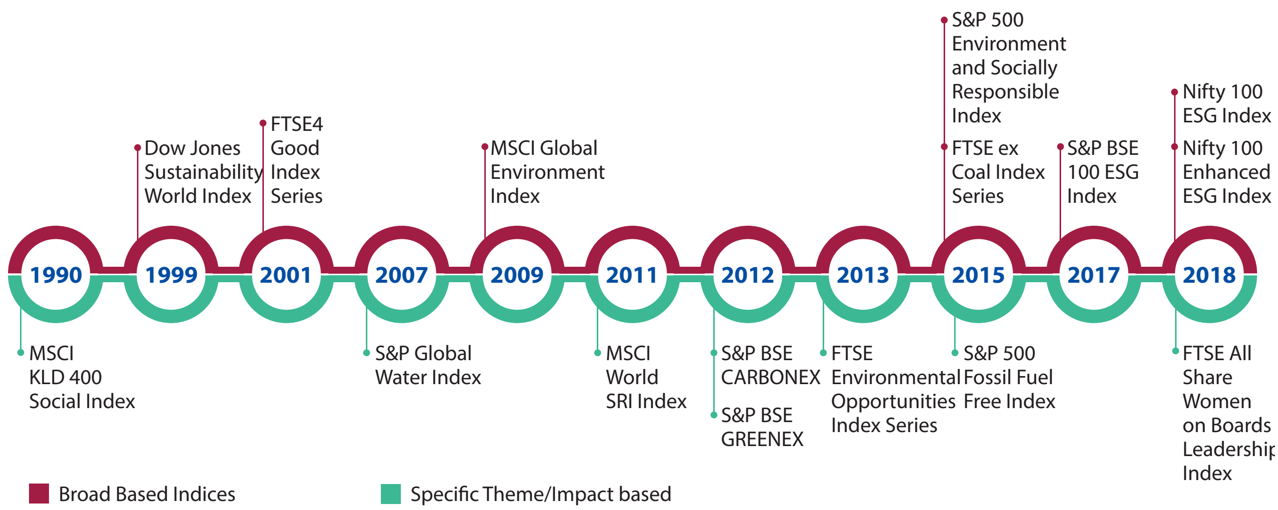
Chronology of prominent global ESG indices



Source: Edelweiss Research

We observe interesting trends in the evolution of global ESG indices. The initial ones were broad-based with focus on 'Environmental' issues. Unsurprisingly the 'negative screening or exclusionary' ESG strategy was more popular then. The recent ESG index launches in the US and Europe are based on specific social or governance themes or impact investing. Thematic ESG indices show that the two geographies are ahead of the curve, also indicating an investment shift away from broad-based indices. India, currently in the nascent phase of ESG investing, understandably shows a skew towards broad-based ESG indices.

A snapshot of ESG indices: Broad-based versus specific theme/impact-based

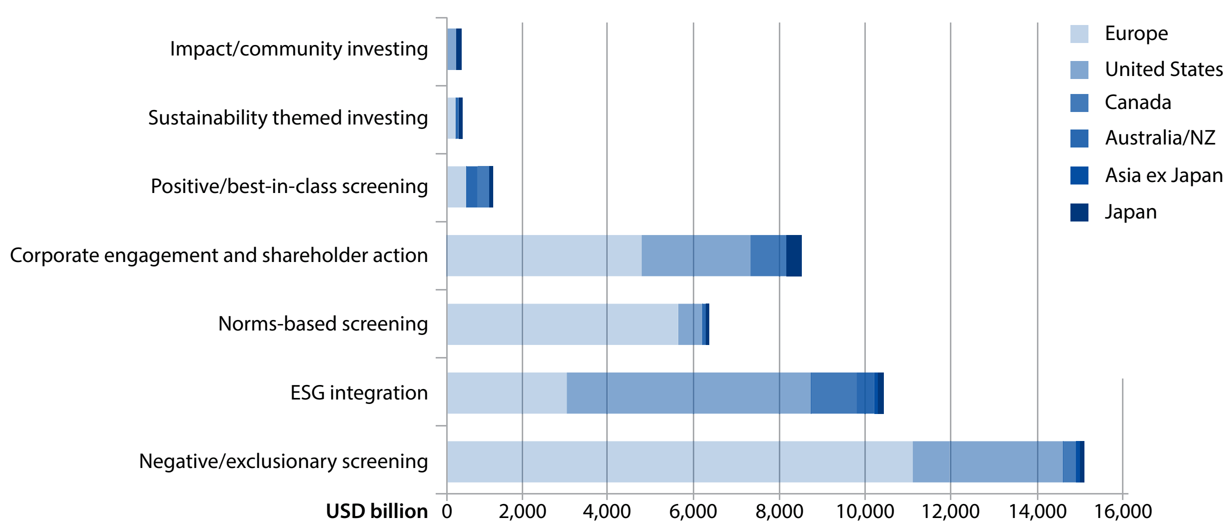


Source : www.ftserussel.com, www.us.spindices.com, www.bseindia.com, www.nseindia.com, MSCI

c. ESG investment strategies – Traditional exclusionary dominates

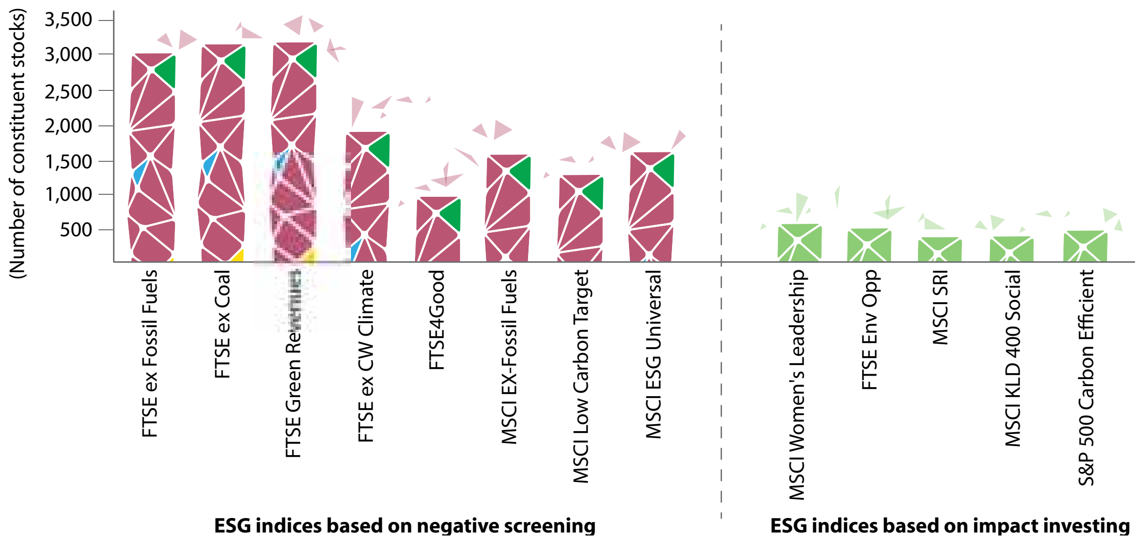
Investors typically classify ESG-based strategies into seven pockets, out of which negative screening/exclusion currently dominates. Negative screening involves exclusion of certain sectors or companies or practices based on specific ESG criteria prohibiting investments in businesses such as tobacco, liquor, mining and defence. That said, we spot a gradual but discernible shift from negative screening to progressive preference for positive and actively managed ESG funds. The launch of varied theme-based ESG indices and benchmarks shows that ESG investing is becoming nuanced and sophisticated.

Sustainable investments by strategy (USD billion)



Source : GSIR 2016

ESG index constituents: Many in broad-based, fewer in theme-based



Source: www.ftserussel.com, www.us.spindices.com, www.bseindia.com, www.nseindia.com, MSCI

Styles of sustainable investment

The GSIA defines sustainable investing as an approach that relies on ESG screening in portfolio selection. This is now accepted as the global standard of classification in sustainable investing and is classified into:

1. **Negative/exclusionary screening:** It involves steering clear of sectors, companies or practices based on certain ESG criteria, e.g. refraining from investments in tobacco and liquor companies.
2. **Positive/best-in-class screening:** It advocates investments in sectors, companies or projects with positive ESG performance, e.g. ones with track records of enhancing stakeholder value via periodic ESG disclosures.
3. **Norms-based screening:** Screens investments based on minimal standards of business practices, much like negative screening, but strikes out ones that do not comply with norms such as the Koyoto Protocol.
4. **ESG integration:** Systematic and explicit inclusion of environmental, social and governance factors into financial analysis by investment managers.
5. **Sustainability themed investing:** Investment in specific themes or assets related to sustainability such as clean energy, green technology and sustainable agriculture.
6. **Impact/community investing:** Aimed at solving social or environmental problems by directing capital towards underserved individuals or communities, and is typically seen in private markets.
7. **Corporate engagement and shareholder action:** This approach favours companies whose strategies are susceptible to investor activism via direct corporate engagement, proxy voting based on ESG guidelines, etc.

Source: GSIR 2016

ESG investing will be categorised into a mix of investment purpose, economic returns, social good and influence, i.e. the balance between financial and non-financial asks

ESG's place on investment horizon

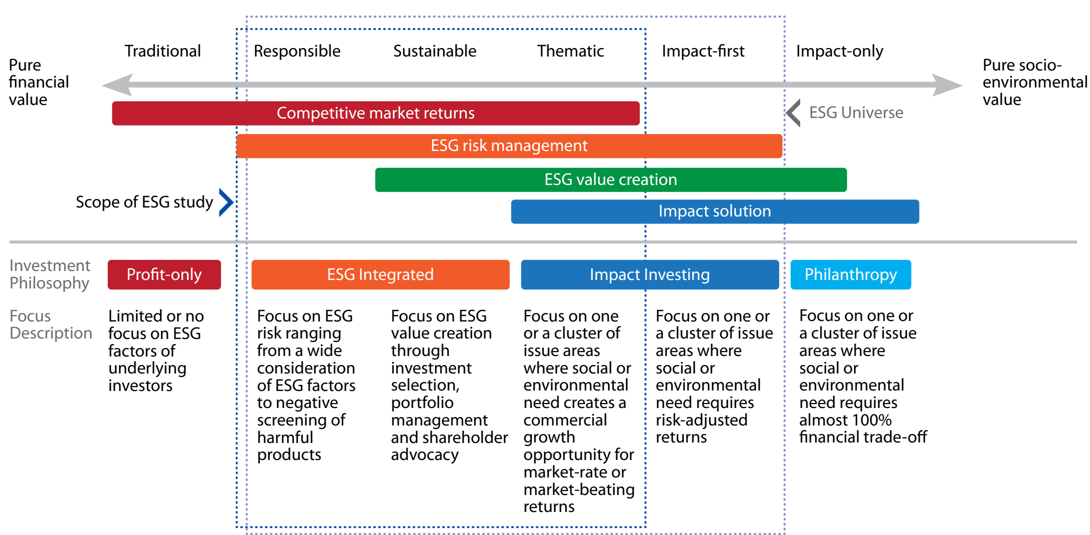
While ESG has been variously defined, described and tagged, where exactly is it positioned in the world of investing, and how does it compare with other more traditional forms of investing? We argue ESG investing is not straight-jacketed, and it is a continuum. And we do believe its definition will continue to evolve.

We also believe it will be differently defined, and positioned, by the investing community. This will effectively mean that ESG investing will be categorised into a mix of investment purpose, economic returns, social good and influence, i.e. the balance between financial and non-financial asks. These definitions and measures will also be graded, rather than being binary. In effect, ESG will continue to be widely defined, leaving it subject to interpretation and vast in scope. It will also differ based on the perspective it's looked from: the business, investor or regulator.

Halfway house

One way of plotting ESG on the investment spectrum is to place it between a purely financial returns-based approach and a decidedly philanthropic perspective. The scope for ESG investing falls in between these poles: balancing returns and impact, with some convergence, whichever end you might approach it from. This approach also suggests that ESG investing typically moves from a predominantly profit-only motive towards one that is initially more responsible and more sustainable. This is where investing the *ESG Way* finally settles and creates value. The investing spectrum eventually moves to impact and then philanthropic investing, where financial returns fall beyond the purview of ESG investing.

Spectrum of ESG investing



Source: Mercer Responsible Investment, MMC APRC analysis

Another perspective on ESG investing is the trade-offs and its stages. This suggests that the first move to ESG investing entails certain costs and trade-offs. But as one progresses along the spectrum to intermediate stages, there are in effect no real costs. Further headway down the ESG Way of doing business eventually enhances financial returns. This investment approach focuses on a tightly-defined ESG scale.

Roadmap of ESG Investing journey

Call to action	**Early-stage** "Embark on the ESG investing journey"	**Intermediate-stage** "Become an ESG expert"	**Advanced-stage** "Advocate ESG Investing"
ESG adoption	Low		High
Return expectation *F* = Financial, *E* = Environmental, *S* = Social, *G* = Governance	F vs. G S E	F + G S E	F G S E
	Trade-off between financial returns and ESG impact	No trade off, financial returns and ESG impact are achievable	ESG lens enhances financial performance
Investment approach *Based on G SIA investment strategies*	Negative screening (i.e. exclusions)	In addition to early stage: positive screening, ESG integration and thematic investing	In addition to intermediate-stage: corporate engagement (direct or through investment manager)
Guiding principles	Limited, some consideration of external resources	Internal frameworks combined with external information as overby	Sophisticated analytical models and frameworks built in-house
Challenges	Mindset, knowledge, awareness	Performance track record, education	Supply, e.g. investment managers and products

Source: AVPN-Oliver Wyman Analysis

Our approach to the ESG Way, by definition, allows that it is more comprehensive than some of these approaches suggest. This will allow investors and businesses to approach ESG in a more broad-based way, and effectively widen the business, and some of their components, that will allows investors to convincingly treat them as ESG opportunities, and will be more inclusionary than exclusionary.

ESG EVOLUTION

As a concept, ESG investing dates back to January 2004, when former UN Secretary General Kofi Annan wrote to over 50 CEOs of major global financial institutions, inviting them to participate in a joint initiative under the auspices of the UN Global Compact. The primary goal was to find ways of integrating ESG philosophies into capital markets. A year later, the term "ESG" was coined in a landmark study titled *Who Cares Wins*. Since then, ESG investing has come a long way, currently accounting for almost a quarter of all professionally managed assets (USD 23 trillion) in the world.

Beyond SRI

In early days, ESG did face headwinds as institutional investors largely believed maximisation of shareholder wealth – regardless of their environmental or social impacts, or broader governance issues – as their sole fiduciary duty

To reiterate, ESG is a successor to SRI, but unlike SRI, which uses negative screens, ESG investing has underpinnings of financial viability. The *Who Cares Wins* report by Ivo Knoepfel and the *Freshfields* report by UNEP/FI emphasise the financial importance of embedding **E**nvironmental, **S**ocial and **G**overnance factors in capital markets. These two reports were precursors to the Principles for Responsible Investment (PRI) at the New York Stock Exchange in 2006 and the Sustainable Stock Exchange Initiative (SSEI) in 2007.

In early days, ESG did face headwinds as institutional investors largely believed maximisation of shareholder wealth – regardless of their environmental or social impacts, or broader governance issues – as their sole fiduciary duty. Another major barrier to *Seeking Growth – The ESG Way* has been sketchy data and lack of necessary tools to size up ESG avenues or prospects. Over time, empirical studies have crystallised the rewarding "ESG Way", which has engendered willingness among stakeholders across businesses and the investment fraternity to integrate ESG in decision-making.

United Nations shows the way: 17 Sustainable Developmental Goals

ESG has gained currency in the past decade, particularly with the United Nations Organisation (UNO) formulating a list of 17 Sustainable Development Goals (SDGs). In 2015, leaders from 193 countries deliberated and adopted the 2030 Agenda for Sustainable Development. The SDGs are exhaustive and adopted by the UN as the basis for sustainable development—and are increasingly being used by governments, businesses and investors too as benchmarks for their sustainability initiatives.

The SDGs, also known as the Global Goals, are also a universal call to action to end poverty, protect the planet and ensure peace and prosperity for all. They are built on the Millennium Development Goals (MDGs), include pressing topics such as climate change, economic inequality, innovation, sustainable consumption, peace and justice, among others. While these MDGs typically apply to countries and societies across the board, they are likely to be more specifically used by businesses and investors. They do also have a more social and environmental bias, with governance being more of an offshoot.

But are these SDGs only a response to more challenging times for the world at large, and only a defensive response to things getting tougher, for people at large? That's debatable. There is a growing view that the world has, across a range of parameters, actually changed pretty fast and sustainably over the last few decades. The idea is forcefully argued by Hans Rosling in his provocative book *Factfulness: Ten Reasons We're Wrong About the World – and Why Things are Better Than You Think*. The author points out that, the extent and pace of improvement across most social and gender parameters is unprecedented. We therefore contend that SDGs are really an effort to raise the quality of life across the planet, limit the risks to environment, and support a more equitable socioeconomic system.

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UNO's 17 Sustainable Developmental Goals—A snapshot

India is in sync with the UNO's SDGs. The country's top planning body NITI Aayog has fine-tuned the 17 SDGs to Indian realities and inked a Sustainable Development Framework (SDF) for 2018–22 with the UNO

India's sustainability goals

India is in sync with the UNO's SDGs. The country's top planning body NITI Aayog has fine-tuned the 17 SDGs to Indian realities and inked a Sustainable Development Framework (SDF) for 2018–22 with the UNO. It is entrusted with implementing 'Transforming our world: the 2030 Agenda for Sustainable Development Framework' (called SDF). The SDF covers 17 goals and 169 related targets thrashed out at the UN Sustainable Development Summit over 25–27 September 2015 over the 15-year period. More than anything else, the SDF is a reflection of India's commitment to attaining SDGs.

Sizeable budget to promote sustainability goals

The Government of India has earmarked a sizeable budget of INR 110 trillion for the programme. The focus areas: post are poverty and urbanisation; health, water, and sanitation; education; nutrition and food security; climate change, clean energy and disaster resilience; skilling, entrepreneurship and job creation; and gender equality and youth development. The task at hand for NITI Aayog is not merely to collate data on SDG, but to act proactively to fructify the goals and targets quantitatively while maintaining high ESG standards. The Ministry of Statistics and Programme Implementation (MoSPI) has already undertaken a parallel exercise—it interacted with various ministries to formulate measurable indicators for SDF.

All such initiatives show the government's clear intent to abide by the framework given its huge likely influence on aspects such as Environment (all the more relevant given India's mammoth population), Social (disparities due to economics, history, culture, diversity, etc), and Governance (need for strong institutions and frameworks). While some of these commitments will be politically and economically challenging to execute, its need is probably more paramount than for most, given problems and complexities of a large nation with more than a billion inhabitants.

ESG – THE INDIA EXPERIENCE

So how does India stack up against ESG benchmarks? Our bottom-up analysis of India's NIFTY 50 companies shows that ESG initiatives as well as disclosures have shot up, but still lag global standards. The tightening reporting standards uncover serious ESG shortfalls at several leading corporates—a grim reminder that major ESG disasters in the recent past are not freak or one-off accidents, but gaps in business models, and that more accidents are waiting to happen. We see these gaps, at the country level, narrowing. The ESG gaps and standards vis-a-vis developed markets are also narrowing, but remain too large for comfort and calls for accelerating India's ESG quotient if it is to close out these gaps in the medium term.

1) A Bottom-Up Aggregation: India's Rising ESG Scores

a) **ESG disclosures steadily rising.** The Social disclosure levels more than doubled from 2010 through 2017; *in fact, India dramatically outscores USA on Social disclosures.* The country's Environmental score too has improved over the years and is set to improve further amid rising awareness. While regulatory push and the government's pull (read 'incentives') are marshalling companies into compliance with ESG standards, corporate India's newfound willingness to adopt cleaner business processes too is an encouraging dynamic pushing up compliance.

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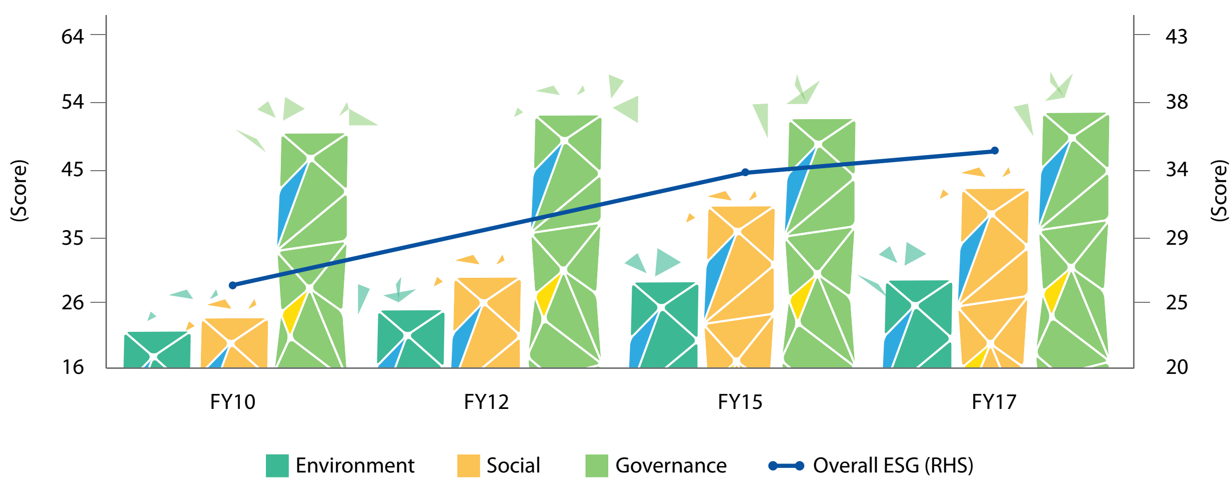
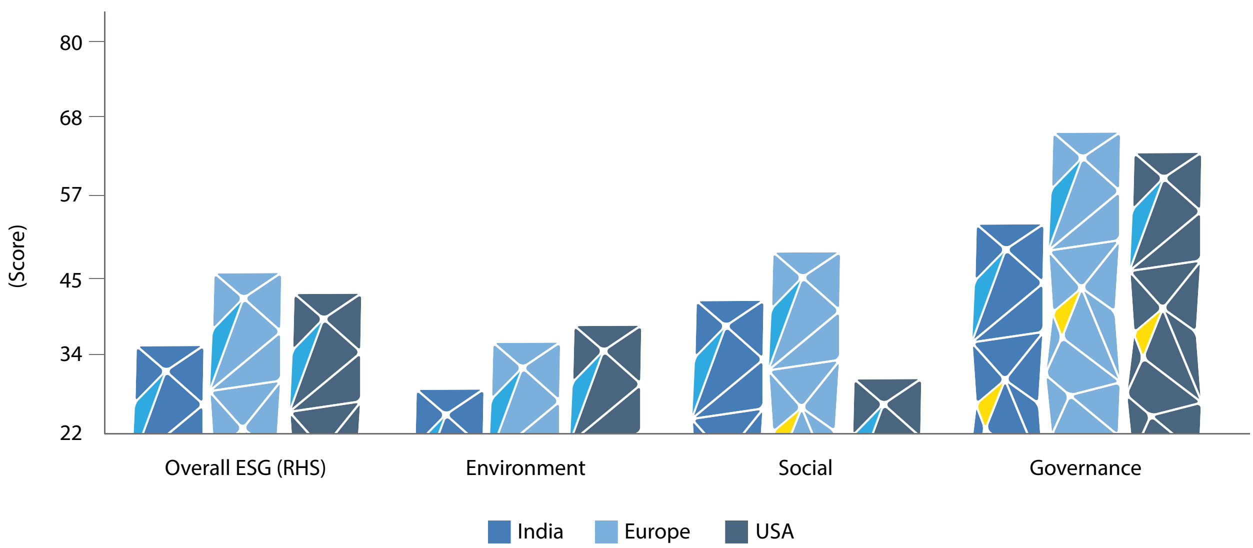
India's ESG disclosure score – Improving rapidly, but environmental disclosures lag materially



Source: Bloomberg, Edelweiss Research

b) **India lags global standards.** In spite of hectic activity in corporate boardrooms for an urgent need to develop businesses sustainably, India by far lags on the Environment and Governance parameters. And being a signatory to the Paris Treaty and the COP21 Conference, India must abide by the stringent environmental targets it has set for itself. This may look overly optimistic currently, but we contend India is catching up fast and should close out the gaps in Environment score vis-à-vis global peers—including Europe, which fares the best on ESG. On the country's Governance quotient, we believe many subtle but far-reaching revisions to the Companies Act and stricter board norms have raised the bar and that eventually corporate India's track record should not fall far behind.

Global ESG disclosure score – India lags global ESG disclosures



Source: Bloomberg, Edelweiss Research

2) Examining key ESG micro parameters for Indian companies

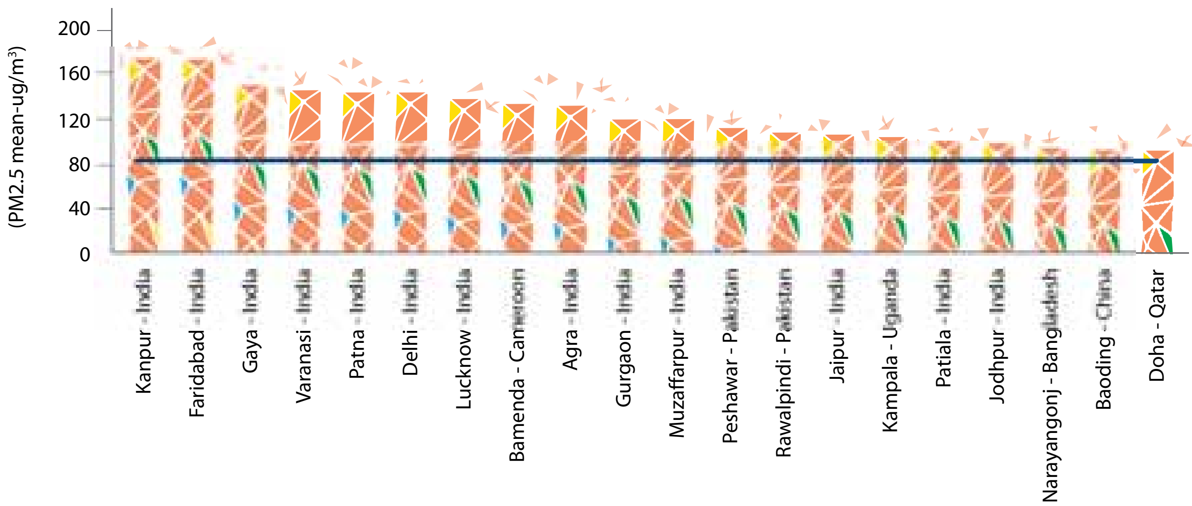
a) ENVIRONMENT

Environment is palpably India's weakest link – in standards, impact and the seriousness with which it is taken at the government, business and monitoring levels

Notoriously high pollution ails India…

Environment is palpably India's weakest link – in standards, impact and the seriousness with which it is taken at the government, business and monitoring levels. A case in point is the alarming air pollution in the country—vehicle emissions alone account for about one-fourth. According to the World Trade Organisation, capital New Delhi ranks a notorious 6th among the most polluted cities of the world with an annual mean PM2.5 reading of 143ug/m^3. The WTO pegs this health hazard equivalent to smoking about ten cigarettes a day.

India hosts 14 of the 20 most polluted cities



Source: World Health Organisation Database

We therefore, believe Environment is also where regulation will shift the most and implementation cost on business will be the highest (but benefits will be most quantifiable). That some of these challenges are not necessarily driven by scale and organised business (i.e. small businesses, agricultural practices) makes it politically tougher to tackle them, more so through legislation, and will raise the risk for and need of large businesses to overcompensate.

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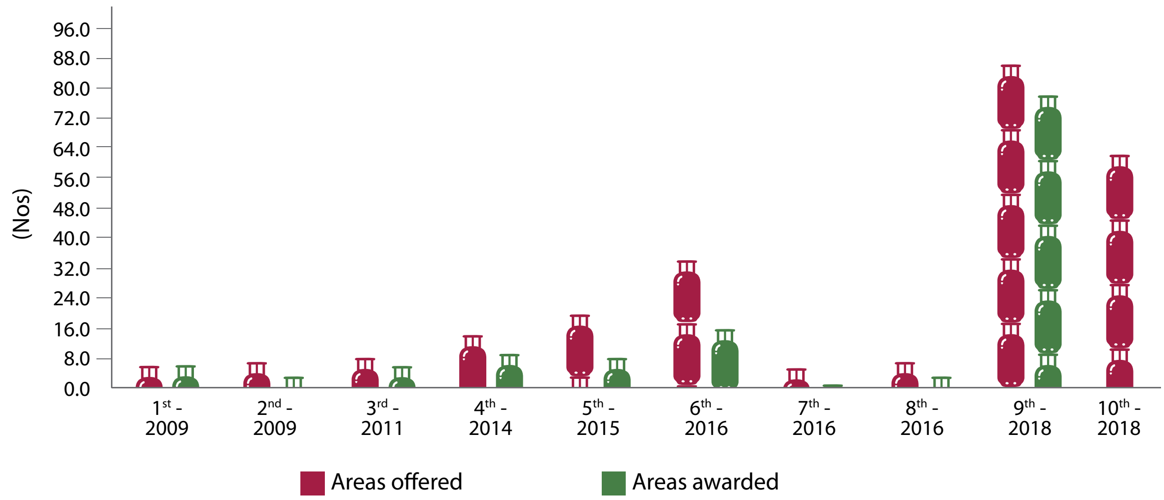
...but heave a sigh of relief

The Indian government has taken note and is expediting the rollout of city gas distribution (CGD) to new geographies—one of its several initiatives to remedy the worsening pollution levels. To be precise, the number of geographies for CGD licensing has doubled over four years through 2018. In 2015, the government announced the country would leapfrog from Bharat Stage IV emission norms for vehicles to Bharat Stage VI by 2020—a laudable move in our opinion. Such initiatives would notably curtail pollution levels in a few years.

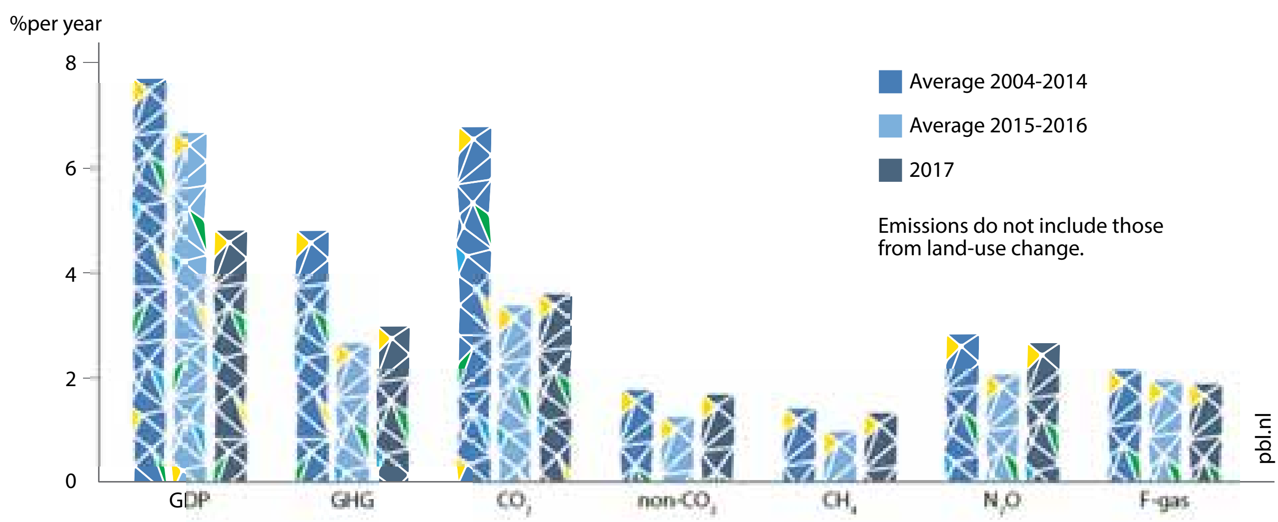
Stepping on the gas: Licenses for new CGD geographies being rolled out rapidly



Greenhouse gas emissions in India trending down

Government regulations and awakening towards sustainable development among bellwethers of corporate India have clamped down GHG and CO_2 gas emissions of Indian companies over the past decade. The regulatory push towards curbing emissions is being powered by Bharat Stage VI emission standards, the National Air Quality Index, and introduction of FAME II Scheme for EV, which together pave a pathway for India's future devoid of harmful greenhouse gases. That emission improvements are now visible on a sustainable basis, reflect tightening policy and implementation, and a corporate shift towards the same.

Annual increases in GDP and greenhouse gas emissions in India (2004–17)



Source: World Bank, IMF

b) SOCIAL

The CSR push in India

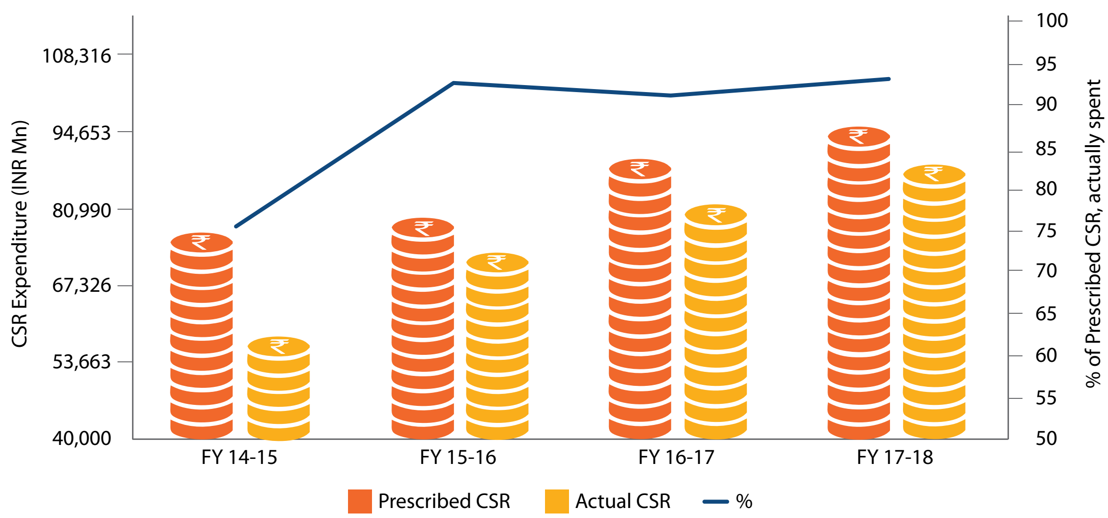
India promulgated a landmark CSR law in 2014. It changed the landscape and approach to social support that businesses provide. The law stipulates that companies of a particular scale and profitability must spend 2% of average profits for preceding three years towards a wider defined set of social activities and objectives. The law further specifies that CSR initiatives must be run under the direct supervision of a board committee.

India promulgated a landmark CSR law in 2014, which changed the landscape and approach to social support that businesses provide

While the law seeks to sustainably funnel a sizeable corpus towards social funding, it has – importantly and most likely inadvertently – made such spends centre stage for corporate CEOs and brought in significant attention and focus to the task. Programmes pertaining to women empowerment, girl child, education, etc have thus spawned across corporate India and are run either independently or under the guidance of reputed non-governmental organisations. We understand funding for CSR initiatives is significant and should fundamentally grow ahead of India corporate sector profitability as businesses increasingly toe the statutory line and growing companies fall into the ambit of CSR framework.

The actual CSR spend moved up progressively to almost INR 90 billion in 2018 and is rising. In addition, businesses are increasingly meeting their minimum requirements, up from 75% to 92% over the last three years. While there is still a gap, it's only moderate 8%, and is typically on account of glitches and execution issues rather than intent. The corporate sector always did have social initiatives and commitments, but CSR has boosted and widened these spends, and in many ways coalesced and quantified them.

Actual CSR expenditure versus prescribed for 359 big companies

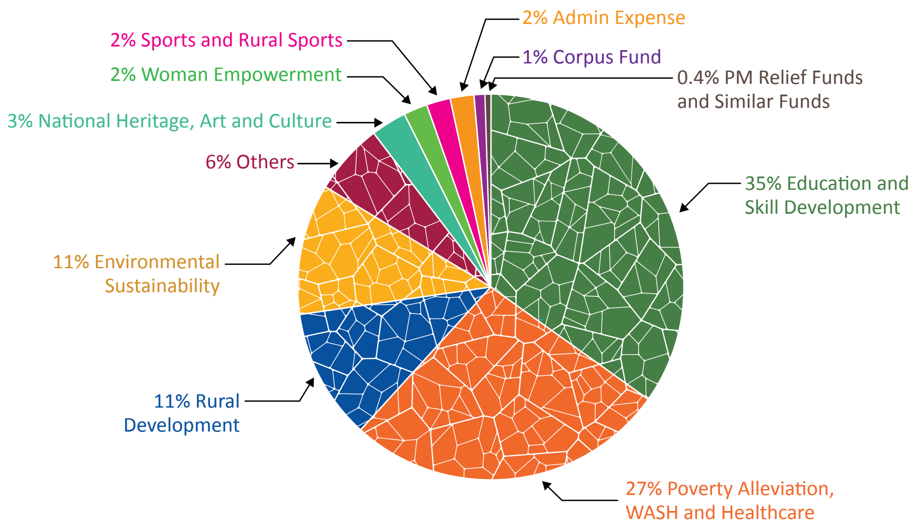


Source: India CSR Outlook Report 2018

Interestingly, as much as 60% of India's CSR spends go toward education and skill development

Actually, the social efforts of businesses go much beyond spend; such capital commitments also reflect a social bias. Interestingly, as much as 60% of India's CSR spends go toward education and skill development. This not only zooms in on one of the glaring gaps in the India socioeconomic framework, but the needs that are most prominently felt by business. In addition, this indicates an investment in society bias, rather than band-aid spending, which continues to be seen as more the domain of the government. There is, however, a wide range of spends and we would argue the opportunities and spaces will only tend to widen. In fact the large availability of funding over the recent years has in pockets actually created a POP – problem of plenty – marked by a lack of enough development ground-level entities (e.g. NGOs), which can effectively channel this money appropriately.

Thematic distribution of CSR funds



Source: India CSR Outlook Report 2018

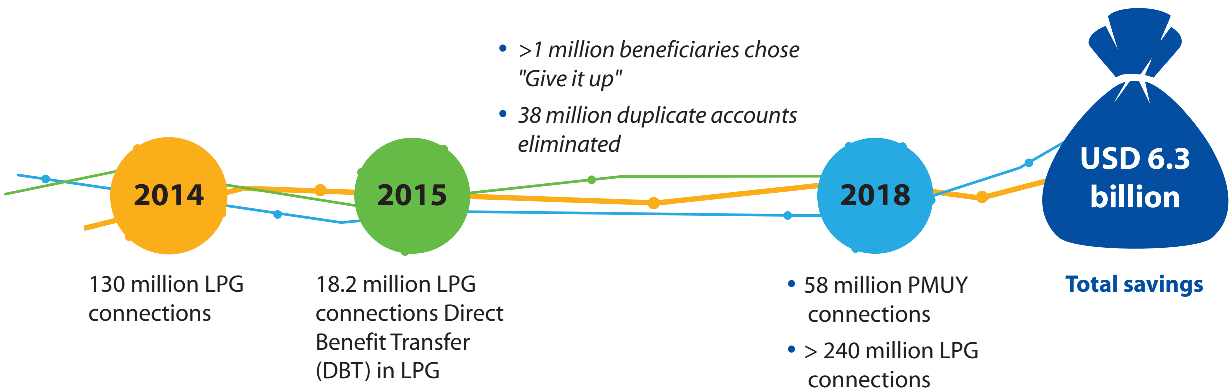
Government leads…

While the government is responsible and leads social spends, a few initiatives go hand-in-hand with the private sector. One such initiative has yielded enormous health and environmental benefits, and is reflective of the opportunity that the Indian economy offers. This one called the Pradhan Mantri Ujjwala Yojana (PMUY) seeks to eliminate harmful cooking fuels such as firewood and coal, which are big sources of carbon emissions in India and put women and children at great risk. The Yojana or scheme encourages well-to-do households to give up LPG subsidies while extending subsidised connections to those dependent on unconventional cooking fuels.

...corporate India follows through

Oil marketing companies, in particular, have been at the forefront of executing this scheme, not just because it is government mandated, but for the improved economics (and better financial health) it promises. The scheme leverages digital payments established by Aadhaar identification and is one of the prime examples of financial inclusion. It has nearly doubled LPG connections in the country to 240 million households, saves the government a neat USD 6.3 billion every year, and is at the forefront of environmental, health and social gains.

Government gas push saves money and the environment



Source: Edelweiss Research

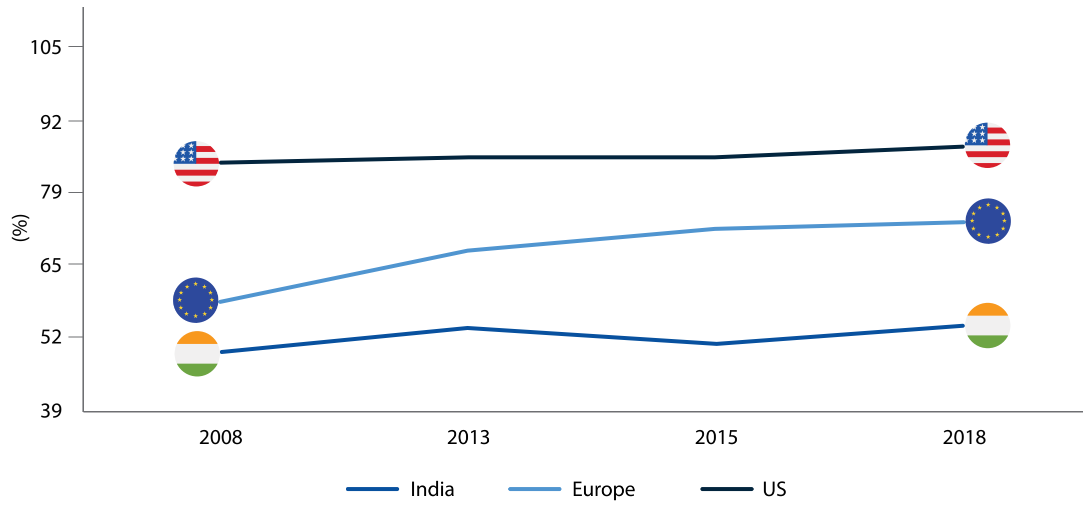
c) GOVERNANCE

India's mixed record

Daunting corporate governance challenges – with some prominent ones recently – are a clarion call for stringent governance norms, including board independence, stronger audit committees and stricter disclosure norms. For example, the proportion of independent directors in India vis-à-vis Europe and the US is dismally low. That said, we expect this aberration to continue to correct given Indian companies' newfound realisation about corporate governance, which is driving greater transparency and overall better governance.

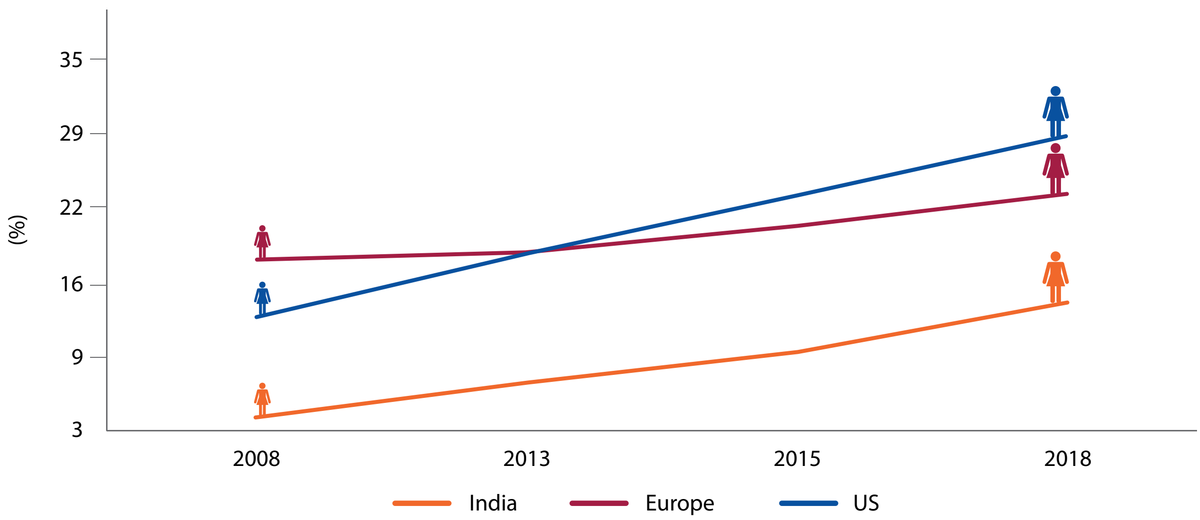
Daunting corporate governance challenges – with some prominent ones recently – are a clarion call for stringent governance norms, including board independence, stronger audit committees and stricter disclosure norms

Proportion of independent directors in India has plateaued and lags global standards



Source: Bloomberg, Edelweiss Research

Proportion of women directors has doubled in India, but still half of global standards

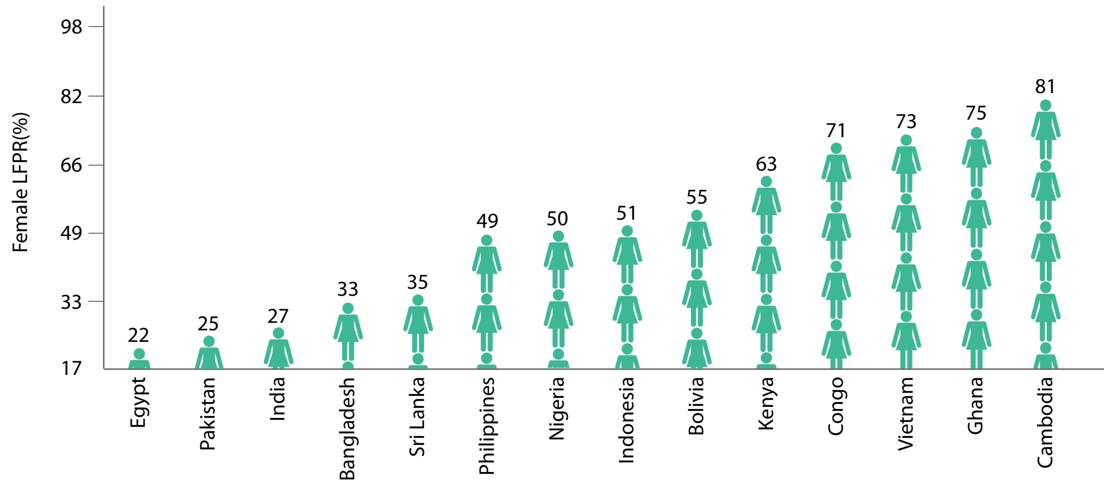


Source: Bloomberg, Edelweiss Research

Women participation in labour force in India too falls behind

Gender divide is stark in India due to cultural and historical reasons, but nowhere so much as in terms of female labour force participate rate (LFPR): 27% in India vis-à-vis countries such as Cambodia that have a female LFPR as high as 81%. Even smaller neighbouring economies Bangladesh and Sri Lanka outclass India on female LFPR. All of this indicates the need to awaken societal consciousness, particularly in remote areas where female participation in labour force is discouraged to avoid social stigma.

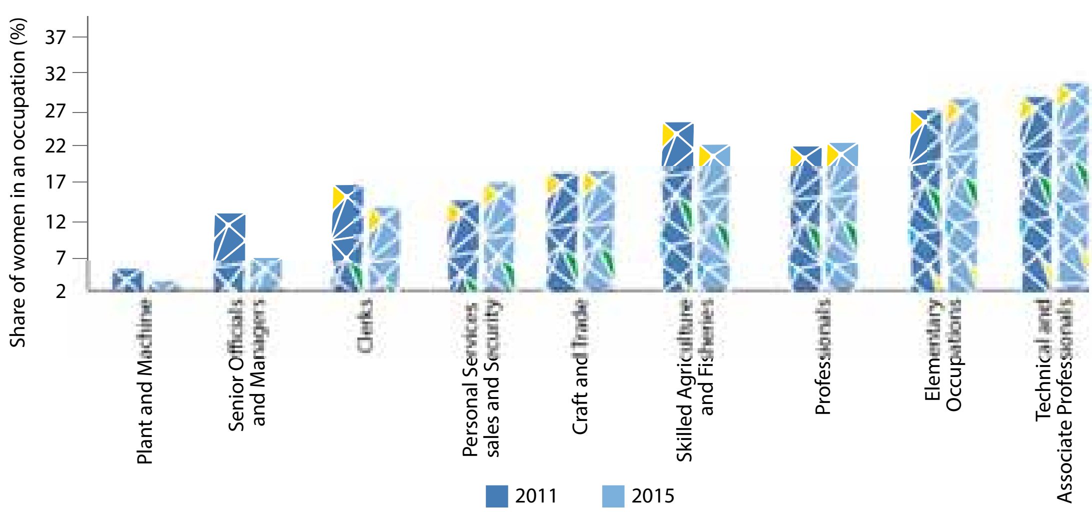
Female labour force participation rate: India's gender divide striking (2017)



Source: Report on State of Working in India 2018 by Azim Premji University

Given the scale and complexity of the issue, the government must lead from the front to facilitate greater female participation across businesses—services or manufacturing. But businesses must show the way. While women underrepresentation clearly shows the need to extend equal opportunities to women, it has a payoff for businesses and the economy at large—higher female LFPR would widen the pool of labour, now untapped for centuries! A report on *State of Working in India 2018* by Azim Premji University shows women participation in India rose, albeit marginally, across elementary occupations, professional roles and technical employment over 2011–15.

Women participation by occupation rises over 2011–15, but undignified



Source: Report on State of Working in India 2018 by Azim Premji University

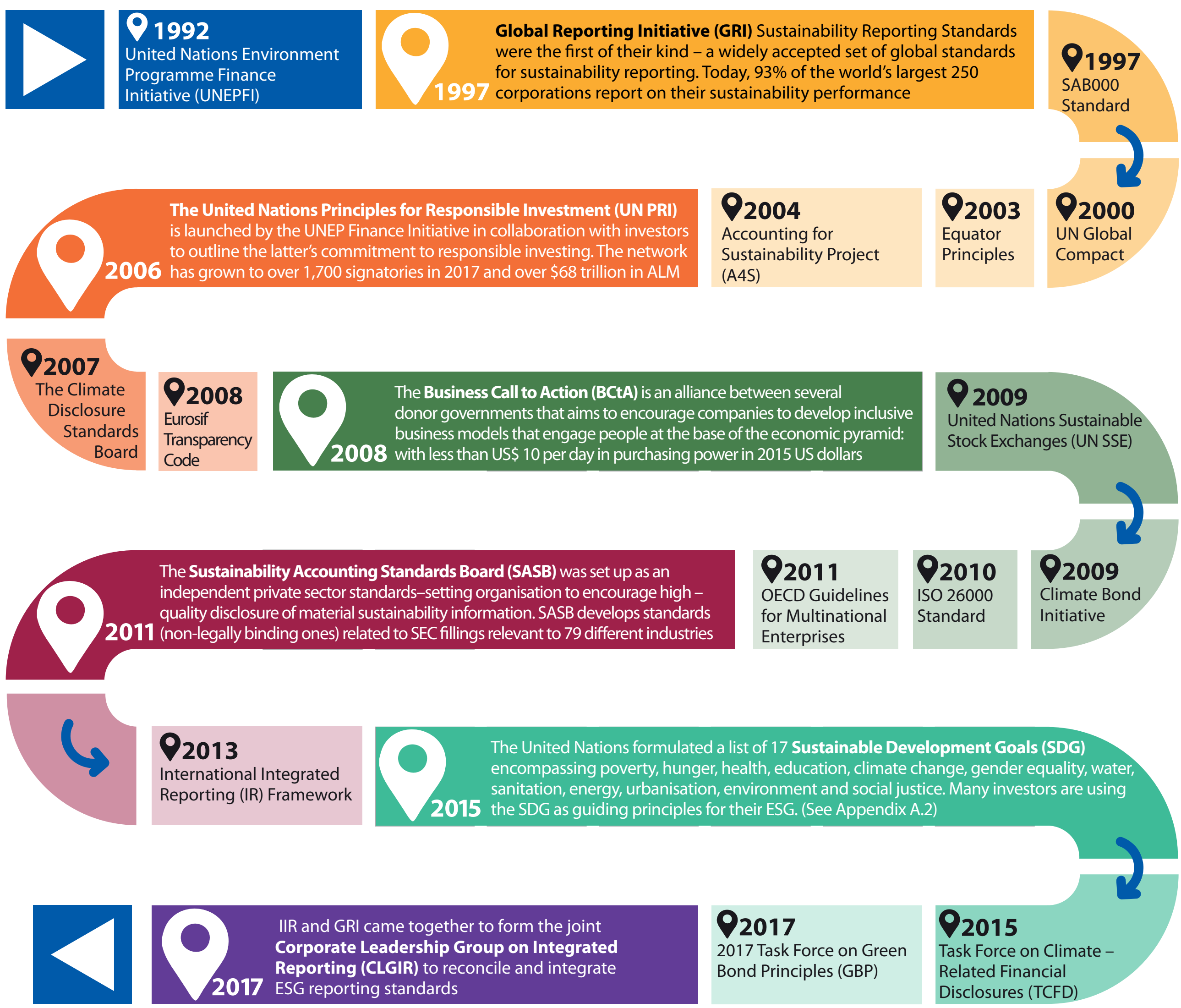
The Global Reporting Initiative (GRI) Sustainability Standards were formulated way back in 1997. Today, more than 90% of the world's largest 250 corporations report sustainability performance

REGULATORY AND REPORTING FRAMEWORKS

Globally, reporting requirements and frameworks – particularly for companies – have been evolving. Basic guidelines to limit pollution and appease stakeholder needs were laid down in 1990s. The key among them, the Global Reporting Initiative (GRI) Sustainability Standards were formulated way back in 1997. Today, more than 90% of the world's largest 250 corporations report sustainability performance.

The vanguard of corporate India too is actively adopting ESG-based business strategies. A case in point is standalone and weighty sustainability reports (up to 100 pages in some cases) published by leading corporates. Our interviews of other leading companies also corroborate that chairpersons and CEOs are increasingly devoting a disproportionately higher amount of time and energy "Seeking Growth – The ESG Way".

Evolution of international standards and initiatives have come a long way



Source: "Driving ESG Investing in Asia", Oliver Wyman and AVPN

REPORTING FRAMEWORK – INDIA'S ATTEMPT TO EMULATE GLOBAL STANDARDS

Reporting frameworks and requirements have evolved over the past two decades. The Global Reporting Initiative Sustainability Reporting Standards (GRI) – a set of modular reporting standards that any organisation can use to report its impact on the economy, the environment, and society – is considered among the highest standards globally.

(A) Global standards for sustainability reporting

Global standards for sustainability reporting – GRI, one of the leading standards

GRI, an independent international organisation, has pioneered corporate sustainability reporting since 1997.

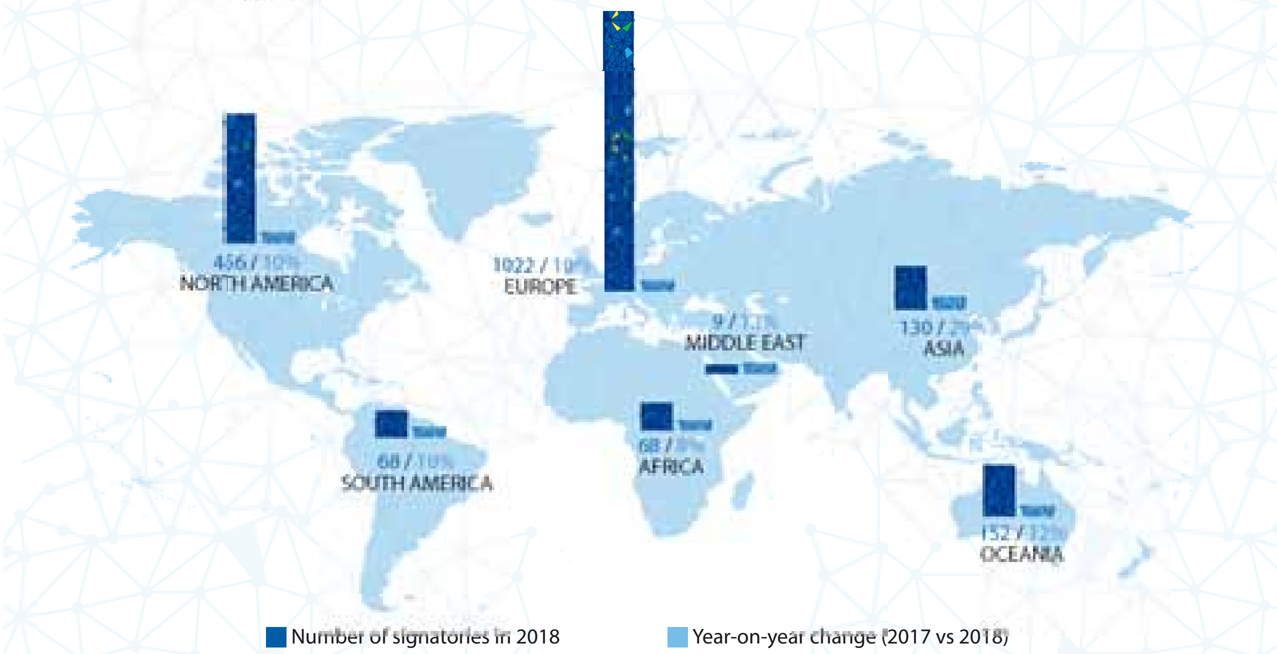
The GRI Standards is a set of modular reporting standards that can be used by any organisation to report its impact on the economy, the environment, and society. The set includes three universal standards applicable to all organisations: GRI 101: Foundation; GRI 102: General Disclosures; and GRI 103: Management Approach. In addition, there are 33 topic-specific standards, which are classified into Economic, Environmental, and Social categories that organisations can select from to report on their material topics.

The GRI Standards are developed through a transparent, multi-stakeholder process and are issued by the Global Sustainability Standards Board (GSSB), an independent standard-setting body created by the GRI. Thousands of organisations in more than 90 countries currently use the GRI Standards to report sustainability information. The GRI Standards are also referenced in policy or regulation in more than 40 countries and regions, and by more than 20 stock exchanges worldwide.

In 2006, the UNO launched the Principles for Responsible Investment (PRI) based on the notion that an ESG approach can affect the performance of investment portfolios and should, therefore, be considered alongside more traditional financial factors if investors are to properly fulfil their fiduciary duty

In 2006, the UNO launched the Principles for Responsible Investment (PRI) based on the notion that an ESG approach can affect the performance of investment portfolios and should, therefore, be considered alongside more traditional financial factors if investors are to properly fulfil their fiduciary duty. The PRI signatories are expected to follow these principles, thereby aligning investment activities with interests of the society. We see great scope for PRI adoption in furthering the ESG cause.

PRI signatories: Breakdown by region along with increase since 2017



Source: PRI Annual Report 2018

(B) India's evolving regulatory and reporting framework

The SEBI BRR Framework – The Indian market framework for sustainability reporting

In August 2012, securities regulator SEBI issued Business Responsibility Reporting (BRR) norms for the top 100 listed entities, thereby stipulating non-financial reporting by corporate India. The BRR captures an organisation's non-financial performance across economic, environmental and social factors.

This reporting requirement is in line with the 'National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business (NVGs)' notified by the Ministry of Corporate Affairs, Government of India, in 2011. These guidelines contain comprehensive principles to be adopted by companies as part of their business practices and a structured business responsibility reporting format requiring certain specified disclosures, demonstrating the steps taken by companies to implement the said principles.

Later, via a circular dated 30 November, 2015, SEBI extended the BRR mandate to the top 500 listed entities by market capitalisation, as of March 31st of every year.

(C) India's evolving governance framework

India, with its entrenched bureaucracy and multitude of overlapping regulations, has come a long way in embedding robust governance practices in corporate culture to create positive sentiment in the minds of investors and the public at large. It has been led by determined efforts by the government, SEBI and stock exchanges. Overall, corporate governance norms in India have fairly tightened with focus on corporate boards, auditor accountability, and shareholder approval for key transactions and enhanced disclosures.

Evolution of India's corporate governance framework

1999–2000

- Establishment of **Securities and Exchange Board of India (SEBI)**
- Introduction of CII Code for Desirable Corporate Governance
- **Birla Committee:** Revisions to listing agreement, code of corporate practices, etc.
- **"Clause 49" in Equity Listing Agreement:** Board composition, code of conduct, etc.

2000–2010

- **Corporate governance:** Recommendations on International Financial Standards
- OECD releases **Principles of Corporate Governance**
- **Chandra Committee:** Mandatory audit partner rotations, Quality Review Board, etc.
- **N R Narayan Murthy Committee Report:** Responsibilities of Audit Committee, shareholder approval for non-executive directors' compensation, code of conduct
- **Corporate Governance-Voluntary Guidelines 2009:** Partial participatory approach to address contemporary corporate governance issues in India

2010–2018

- **Companies Act 2013:** Landmark change in corporate governance landscape
- **Adoption of IND AS** a structural shift in reporting norms to global standards
- **SEBI LODR** regulation changes
- **Implementation of Kotak Committee recommendations on corporate governance**
- **Insolvency and Bankruptcy Code (IBC)** enacted to resolve the NPA crisis, etc.
- **Whistle Blower Mechanism:** Mandatory requirement for listed companies

Source: Edelweiss Research

The most recent Indian development

The most recent corporate governance development is the SEBI-driven and Mr Uday Kotak (CEO, Kotak Mahindra Bank) led SEBI committee on corporate governance in June 2017. It was formed in recognition of the need for higher standards, challenges and events in recent years, and the scale of India's markets. This committee report was also to plug gaps in the existing framework, and practices that need closer scrutiny. In its findings, the committee cited numerous studies to make a somewhat counterintuitive point that the *payoff from good corporate governance manifests both in operating results of listed companies and their market capitalisation.*

Other key recommendations of the Committee were introduction of stringent norms on board composition, accounts and auditor accountability, related-party transactions and disclosures. The recommendations also define minimum director requirements and maximum directorships that a director can hold, and stipulates at least one independent woman director on the board. Besides, the committee outlined the enhanced role of the Audit Committee, the Nomination and Remuneration Committee and the Stakeholder Relationship Committee. The committee also recommended greater scrutiny and requirement of shareholder approvals for most related-party transactions and stricter disclosure norms to improve governance standards.

ESG ADOPTION – PUSH AND PULL

To its credit, the Government of India has formulated many regulations and offers great incentives for promoting environmental, social and governance standards. To be precise, on the one hand, there are a myriad of incentives and subsidies in the form of business opportunities to embrace environment friendly businesses and practices. On the other hand, the government enforced stricter regulations and norms to drive home its intent on the matter. The number of such mandatory government regulations and incentives throw ample light on the broad scope of ESG in India.

The Government of India has formulated many regulations and offers great incentives for promoting environmental, social and governance standards

Ranging from the Bharat Stage VI Standards (pollution emissions) to the Namami Gange Project, the Government of India has been introducing schemes, regulations and incentives to preserve the environment. The two-pronged countervailing approach comprises regulatory norms for curbing hazardous business practices with severe penalties for non-compliance and incentives for promoting environment-friendly businesses.

Environmental regulations (disincentives) and incentives

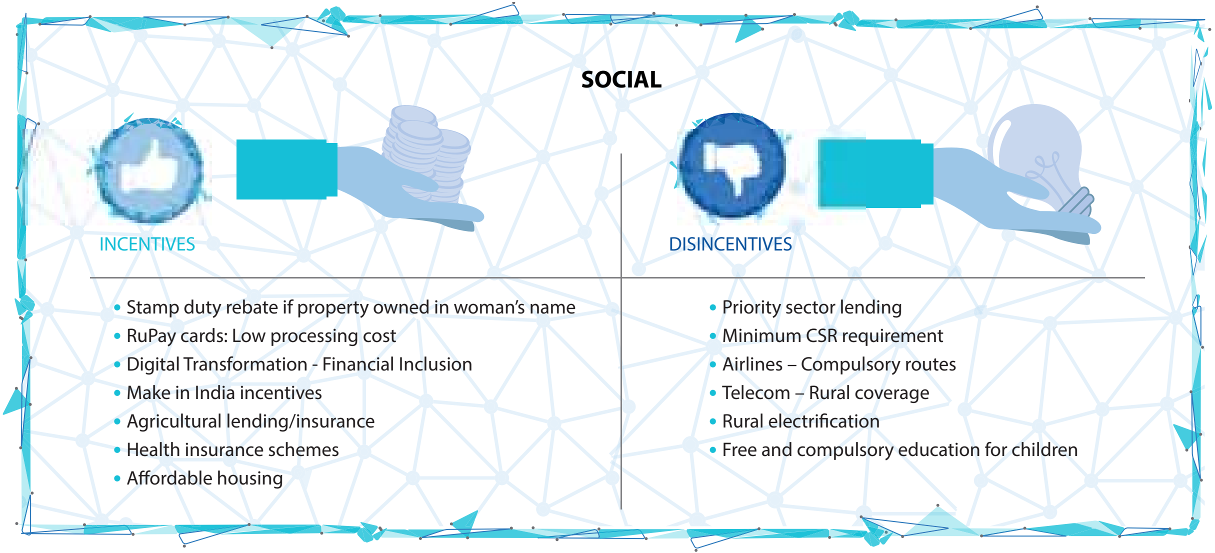
ENVIRONMENT

INCENTIVES	DISINCENTIVES
• FAME II scheme for EV adoption	• Pollution emission standards
• Urea subsidy	• Paris agreement
• Custom duty elimination on solar tempered glass	• Ban on import of firecrackers
• Exemption from road permit for EV and CNG vehicles	• COP 21 climate conference
• Renewable energy subsidies	• Industry effluent standards
	• Phase out of 15 yr old diesel vehicles in Delhi
	• Mining bans

Source: Edelweiss Research

In contrast to the environmental-related norms and incentives, the social cause has zoomed into focus only over the last decade. From mandatory priority sector lending requirements, minimum CSR expenditure to a slew of initiatives for financial inclusion, affordable housing and medical insurance, to name a few, the government has been very active on the social front. It is mandating, cajoling and incentivising the private sector to play a more proactive social enhancement role.

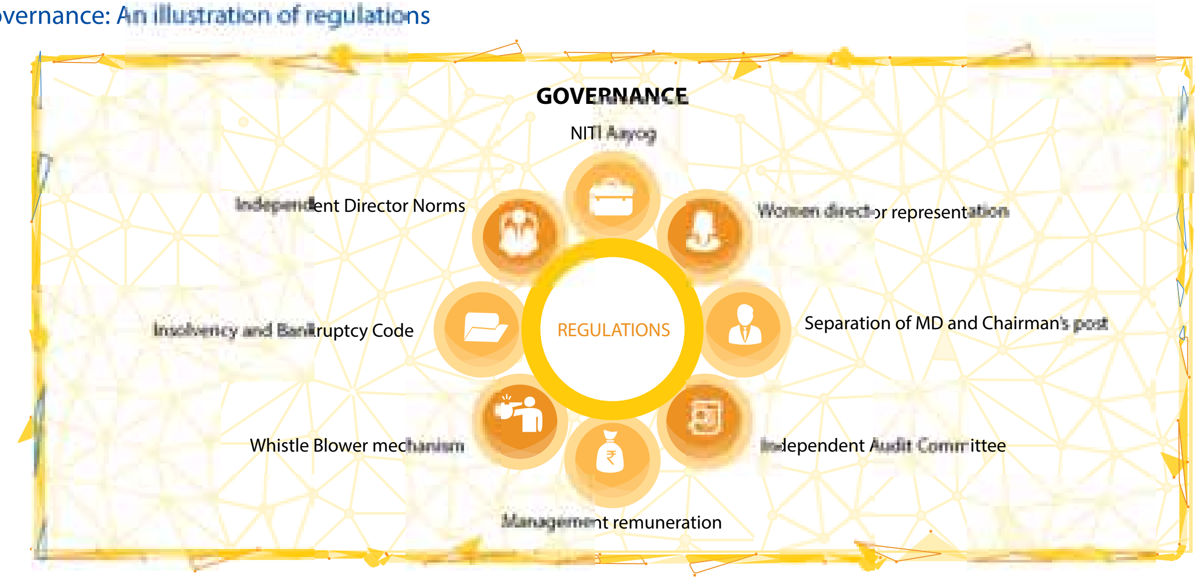
Proactive role in enhancing societal well-being



Source: Edelweiss Research

On the governance front, practices and disclosures have improved over time, plugging loopholes, grey areas of dispute and potential conflicts of interest. The outcomes of various committees, namely the Kumar Mangalam Birla Committee, NR Narayan Murthy Committee and the Kotak Committee have been instrumental in tightening regulatory requirements towards greater business transparency in general and for the board proceedings in particular. That has not stopped meaningful gaps from emerging, but a sustained trend towards higher transparency and governance standards is clear.

Governance: An illustration of regulations



Source: Edelweiss Research

ESG – CORPORATE INDIA'S EXPERIENCE

Corporate India embedding SDGs in strategic values

India's securities watchdog Securities and Exchange Board of India (SEBI) has mandated the top 500 listed Indian companies to report non-financial parameters. Such companies must, therefore, generate a Business Responsibility Report (BRR) capturing their non-financial performance across economic, environmental and social factors. Forward-looking businesses are proactively adopting ESG-based strategies, evident from the weighty (up to 100 pages) sustainability reports they publish.

Our interviews of captains of industry too suggest chairpersons and CEOs are putting in disproportionately greater time and effort "Seeking Growth – The ESG Way". We also interacted with several ESG thought leaders, consultants, philanthropists and investors, and, therefore, recognise first-hand that forward-looking business groups are in fact going beyond the mandatory BRR reporting.

We showcase three case studies below as a microcosm of what India's leading home-grown conglomerates are doing across some of their business (and have traditional Environment sensitive lines of business and exposure)

Purpose beyond environment

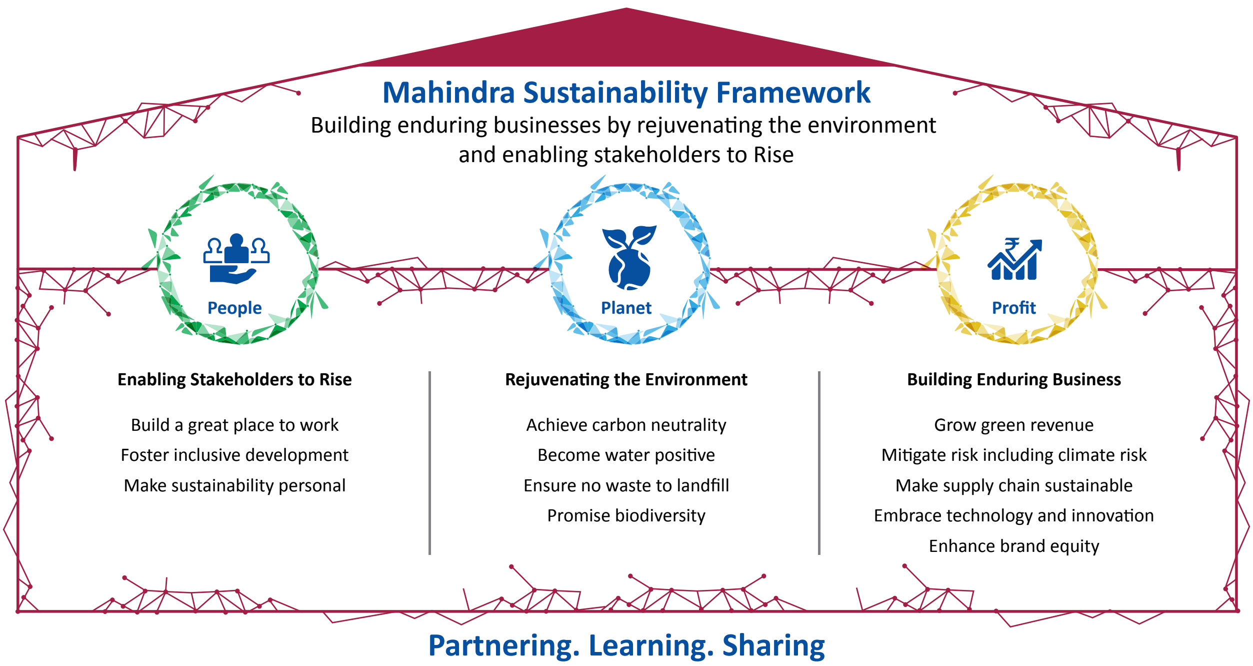
Our findings on sustainability strategies are also based on three leading Indian conglomerates: The Mahindra Group, The Reliance Group and the Aditya Birla Group. Each of their sustainability frameworks are interwoven into respective business strategies. Not only are these companies making rapid strides in the more traditional environmental aspects of ESG, but also diversifying into businesses that seek to fill the much-needed gap pertaining to the Social and Governance aspects of ESG.

We showcase three case studies below as a microcosm of what India's leading home-grown conglomerates are doing across some of their business (and have traditional Environment sensitive lines of business and exposure). We do believe a rising proportion of businesses are training focus on SDGs. While part of this does likely emanate from regulatory pressures – either current, or inevitable – we argue much of this push is being driven by evolving belief systems among corporate India. We explore their goals, belief systems, and approach to sustainability, or their ESG Way of running the business.

Case Study I: Mahindra Group – An early starter

The Mahindra Group has been among the pioneers in corporate India embracing *The ESG Way* to growth.

The group kick-started its Sustainability Reporting Journey in 2007 with an "Alternative Thinking" of proactive alignment of business operations to exponentially rising social and environmental demands, and new economic opportunities. Incorporating sustainability as an important ingredient in its 'Rise' philosophy, the Mahindra Group has time and again tried to make responsible growth a way of business. Spearheading strong governance standards by introducing Sustainability Reports alongside multiple initiatives centred on environmental sustainability, the Group's corporate journey ticks off the much-need social checkbox and is impacting the society in a meaningful way.



Mahindra was among the first ones to champion the cause of sustainability by creating awareness on the matter – right from boardroom to the shop floor – in order to successfully marry its business processes with sustainable practices. It enforced stricter monitoring mechanisms on the one hand and set targets for reduction of non-renewable energy uses on the other, thereby creating a sustainability blueprint for all companies in the Group. The Group also leverages innovation to drive home the sustainability cause. For example, to abide by its commitment to slash greenhouse gas (GHG) emissions by 25% over three years through 2019, the Group introduced the novel concept of internal carbon price charged per tonne of carbon emitted by unit.

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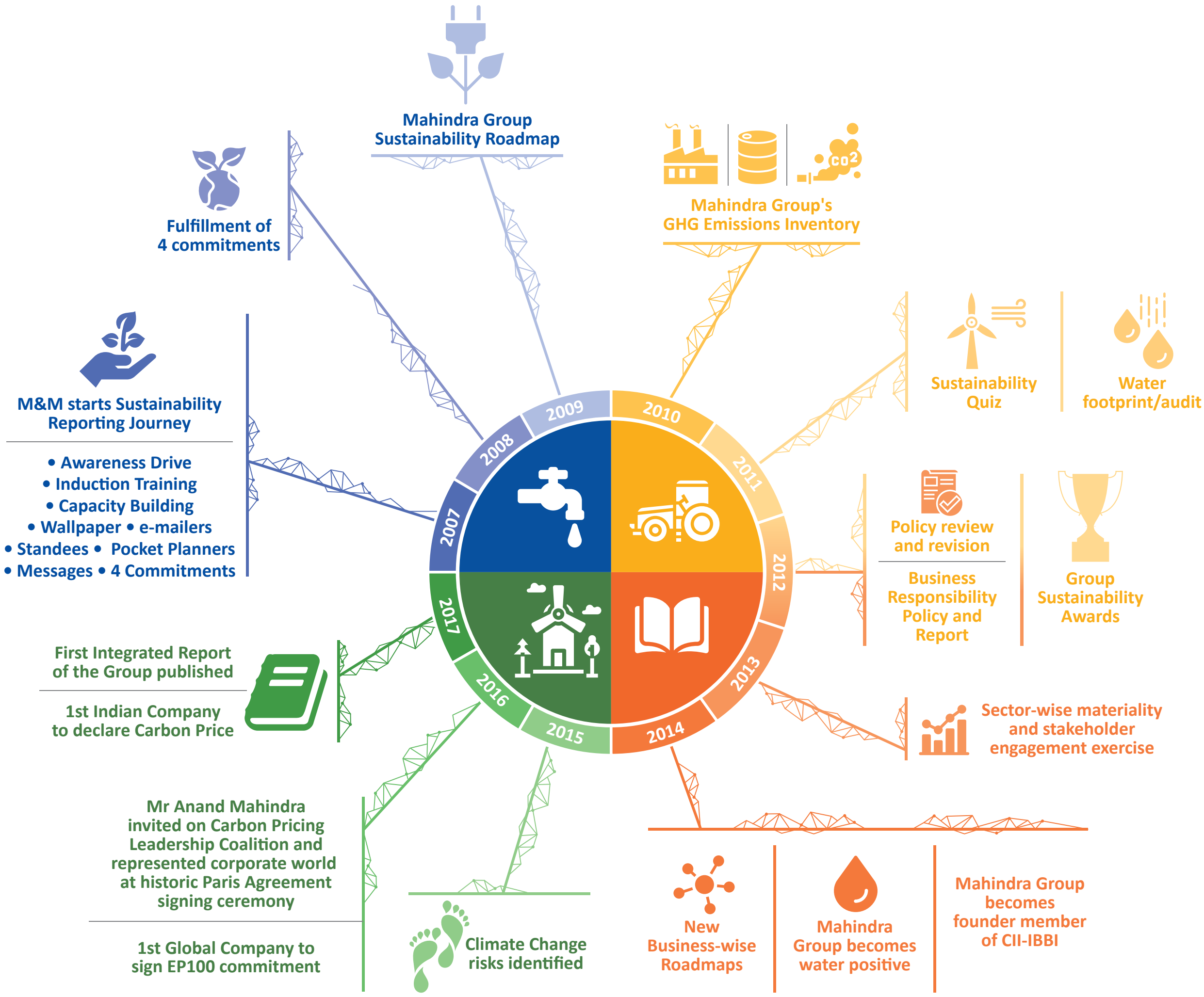
A notable effort of the Group in preserving the environment is 16.5MW of in-house renewable energy capacity. It also achieved Water Positive Status in 2014, having reduced water consumption by 1,34,696 m^3 over 2016–18. On the social front too, the Mahindra Group has made commendable strides with particular focus on improving gender diversity in workforce and generous CSR contributions for its girl child programme called Nanhi Kali. Other domains that the Group is actively involved in are education, agriculture, farmers and youth.

The Mahindra Group's integrated approach of developing a sustainable business has been ahead of time, in our view, and sets a precedent for corporate India.

A decade's journey

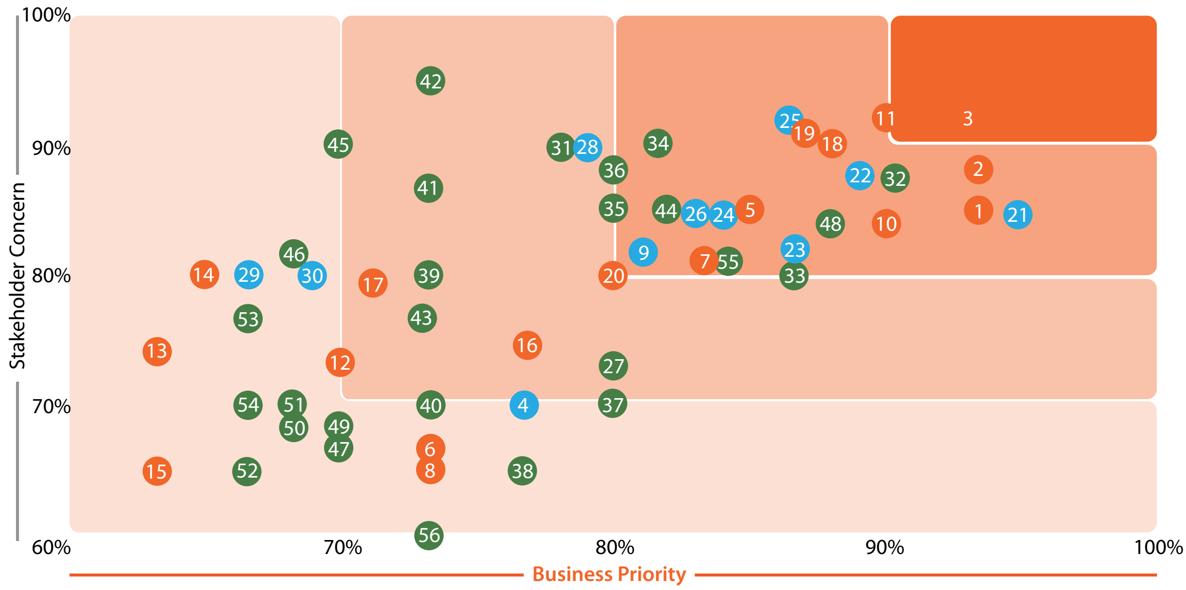


Source: Ten Years of Alternative Thinking – The Mahindra Approach to Sustainability, 2008–18

It is interesting that strategic decision-making at the Mahindra Group pre-emptively takes into consideration stakeholder concerns, thoughts, attitudes and ideas towards social, environment and economic issues. The importance of involving shareholders at this stage instils a sense of trust and belonging, and finds relevance in the larger scheme of things. Periodic evaluations of such material concerns, and marrying them with business processes helps in shaping the company's future course of action inclusively and efficiently.

Mahindra maps material shareholder concerns with business priority

AUTOMOTIVE DIVISION



BUSINESS **ENVIRONMENT** **SOCIAL**

PARAMETERS OF HIGH IMPORTANCE (TOP QUARTILE)

Business	Environment	Social
1 Cost Control and Profit Margin	9 End of Life Management	32 Customer Satisfaction
2 R&D Impetus	21 Water Intensity	33 CSR Management
3 Fuel Efficiency	22 Energy Efficiency	34 Employee Productivity
5 Risk Assessment and Compliance	23 Recyclable/Recycled Material	35 Health and Safety
7 Market/Product Competition	24 Waste Generation	36 Product Safety
10 Sustainable Mobility: Electric/Hybrid/H, Vehicle	25 Climate Change and GHG Emissions	44 Training and Education
11 Product Quality	26 Pipe Emissions and Reduction	48 Gender Diversity
18 Supply Chain Optimisation	28 Life Cycle Management	55 Grievance Mechanisms
19 Logistics Optimisation and Sustainable Logistics		
20 Emerging Market Needs		

PARAMETERS OF LOW IMPORTANCE

Business	Environment	Social
6 Solution Selling beyond Products	4 Renewable Energy	27 Attrition
8 Integrated Sourcing	29 Packaging	31 Employee Capability (Agility)
12 Light Weighting	30 VOC Emissions in Paint Shop	37 Succession Planning
13 Green Dealers		38 Supplier Education
14 Modularity in Design		39 Customer Education
15 Dealer Profitability		40 Traffic Safety
16 Sustainability IT Tools		41 Appeal to Customers
17 Product Obsolescence and Phasing Out		42 Talent Retention
		43 Dealer Consistency (Talent Retention)
		45 Customer's Satisfaction with Service
		46 Urbanisation and Labour Scarcity
		47 Average Age of Plants
		49 Brand Image of Mahindra
		50 Social Media
		51 Shared Value
		52 Supplier Satisfaction (Forecast Accuracy)
		53 Strong Visionary Goals on Sustainability/ Strategic Consideration
		54 Employer Attraction
		56 Average Age of Plants

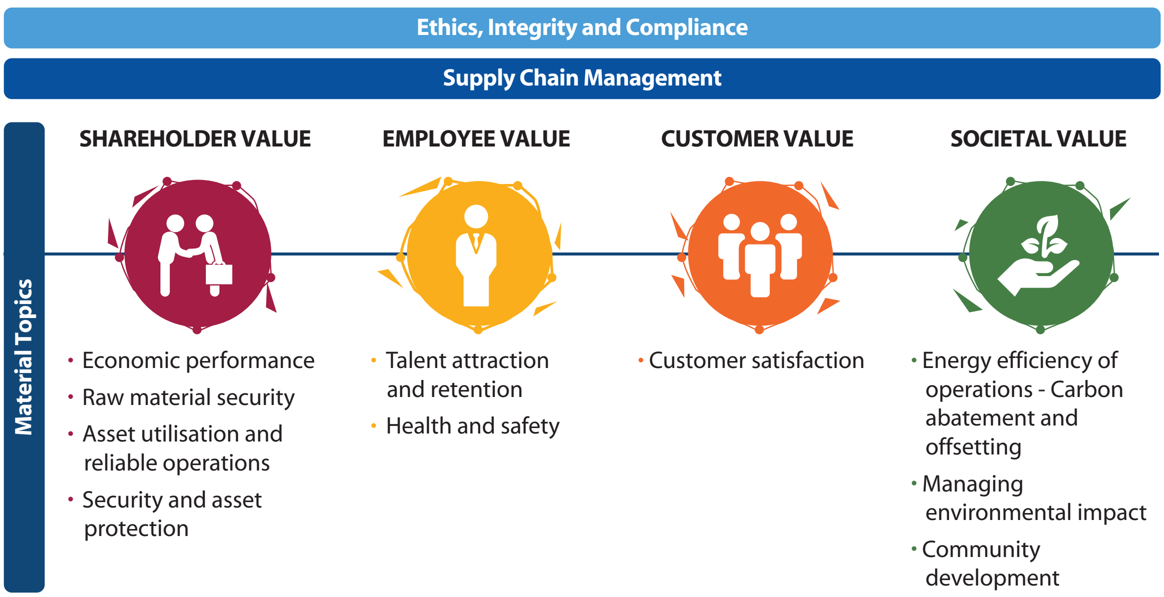
Source: Mahindra Sustainability Report for 2017–18

Case Study II: Reliance Industries – Linking UNO's 17 SDGs with stakeholder values

We cite the sustainability framework adopted by Reliance Industries Limited (RIL) as a model for clear ESG enunciation for corporate India. The conglomerate's sustainability strategy is interwoven into the overall business strategy. The underlying objective is profitable growth through continued improvement in performance while creating value for stakeholders by seeking their insights and perspectives to identify, understand, address and exploit risks and opportunities.

The conglomerate's sustainability strategy is interwoven into the overall business strategy

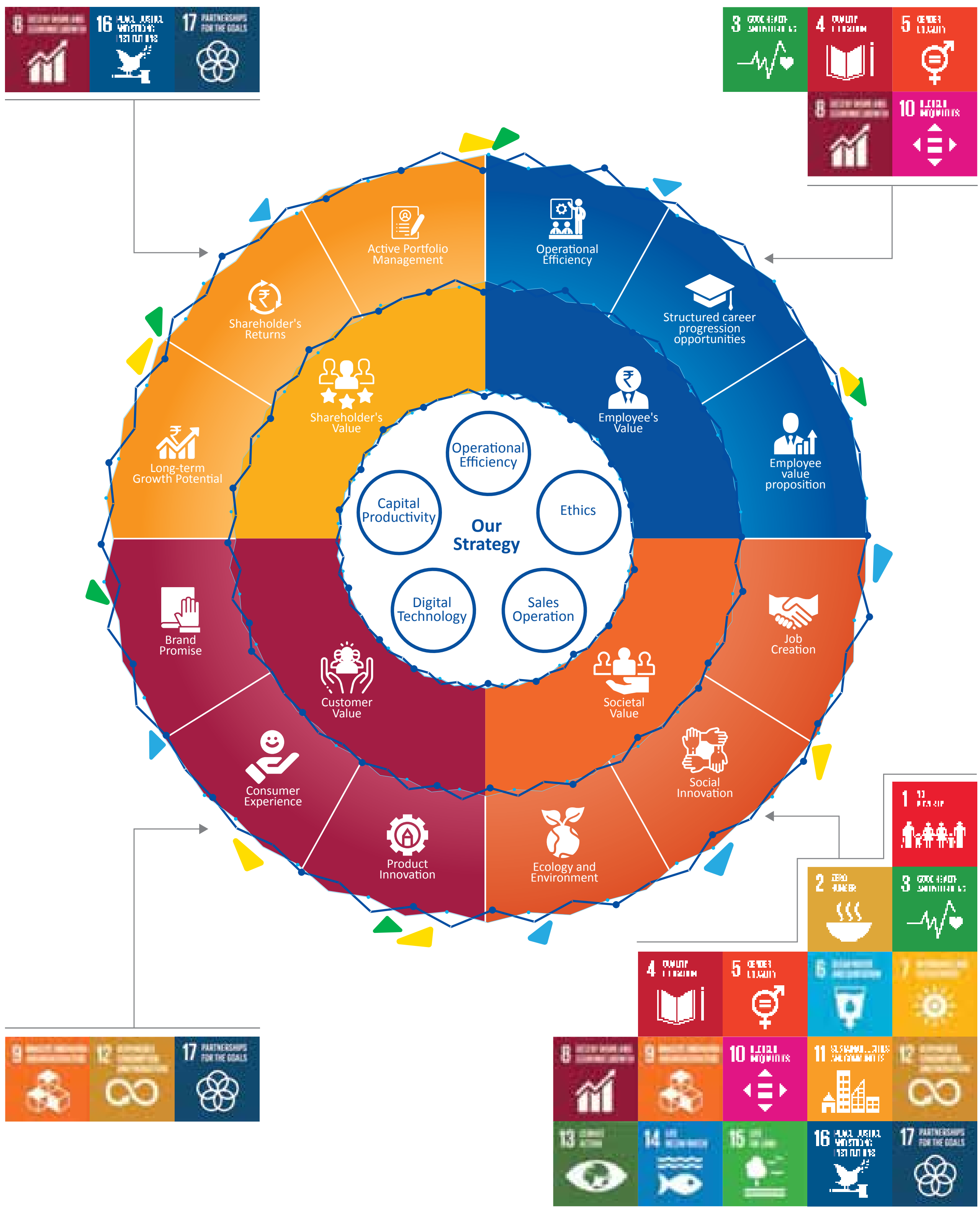
Reliance Industries identifies areas of greatest significance by stakeholder



Source: Reliance Industries

The company seeks to foster holistic development wherever it operates. Fostering rural prosperity is part of its mission and the company, therefore, runs an array of CSR programmes. The programmes link material topics to strategic levers to align the core business objective of creating shareholder value, employee value, customer value and societal value. This helps to identify specific areas of improvement and address each of them effectively.

Reliance Industries links SDGs with strategic values



Source: Reliance Industries

RIL's materiality assessment process and matrix optimises ESG with stakeholder value

RIL has identified material topics through a structured 'materiality assessment' exercise. The materiality assessment is a mechanism to seek inputs from various stakeholders through continued interactions for decision-making. It is a three-step approach involving:

1) Identification of material topics based on global material issues and peer group benchmarking, which is married to risks and opportunities at the organisational level;

2) assessment of material topics; and 3) their prioritisation. RIL thus developed a *Materiality Matrix* report, which marries stakeholder assessment and decision-making with economic, environmental and social impact.

Reliance's Materiality Matrix

Source: Reliance Industries

Case Study III: Aditya Birla Group – "Think about Tomorrow, Today!"

The Aditya Birla Group embarked on the path of sustainability relatively late in 2012, but with a comprehensive roadmap and a clear intent to shape up sustainable businesses. Chairperson Mr K M Birla defined the Aditya Birla Group Sustainability Vision and set up the Group Sustainability Cell with the goal of achieving the vision. The Group institutionalised a sustainability framework based on three strategic pillars – Responsible Stewardship, Stakeholder Engagement and Future Proofing – that each of its businesses must embrace, embed and execute.

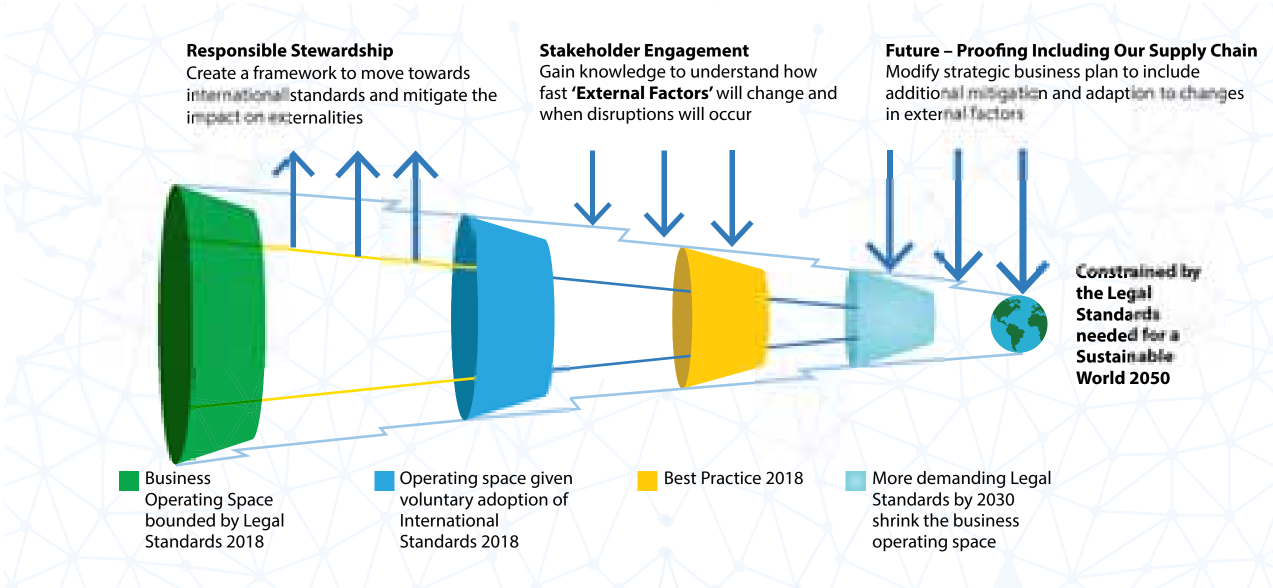
The Aditya Birla Group Sustainability Vision

Source: Aditya Birla Group Sustainability Model

The framework evolved into the Aditya Birla Group Sustainability Model, which summarises the need for sustaining growth as: "A sustainable business is one that can thrive within the needs and constraints of a sustainable world. *A business that can reduce its impact on externalities...as well as one that can adapt to external factors that are driven by global megatrends that will inevitably affect it.*" In 2017, the Group mapped the UNO's SDGs to three key levers of its Sustainable Operational Excellence (SOE) strategy, namely People, Product and Process.

The Group has outlined a three-step approach to future-proof its businesses the ESG Way as illustrated below.

Future-proofing businesses as ESG narrows operating landscape



Source: Aditya Birla Group Sustainability Model

Responsible Stewardship focuses on building a framework of policies and technical and management standards that are aligned with international norms defined by organisations such as International Finance Corporation, Organisation for Economic Co-operation and Development, and United Nations Global Compact, among others. Integration of these standards into the business processes and systems will enable the Group to excel across the major triple bottom-line parameters of their operations.

Stakeholder Engagement involves building strong relationships with 'strategic stakeholders', enabling a broader and more forward-looking perspective on macro scenarios such as climate change, human rights and safety. This would help the Group anticipate trends that can have potential major impact on its business and take corrective or preventive action.

Future Proofing essentially implies weaving sustainability in the blueprint of strategic business plans of each unit to minimise risks while looking out for new or innovative opportunities; it therefore seeks to prime the pump for the group at large to deal with the rapidly changing business environment as far as 2030 or 2050.

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