COVID-19 and ESG Investing in the MENA Region

Corporate sustainability is the concept of creating long-term stakeholder value through designing and implementing business strategies that consider how a business is run. Corporate sustainability covers three key areas, including environmental, social, and governance (ESG) practices. These factors are increasingly recognized as essential elements for protecting and creating value for companies while positioning them for a better future.

This paper is intended to:

- Examine recent international developments in ESG investing.
- Assess the readiness of listed companies in the Middle East and North Africa (MENA) region to tap into international ESG funds.
- Set out how regional boards may wish to approach ESG issues in their companies.

COVID-19 and ESG Investing

Corporate sustainability is at an inflection point. The world-altering events of 2020 — a global pandemic and growing movement for racial equality — have increased concerns about ESG issues. There are growing expectations for companies around the world to be proactive in integrating ESG matters into their operations and strategies. The demands are widely shared, being voiced by governments, communities, customers and employees alike. According to Bank of America, 92% of Generation Z consumers would switch to a brand that supports ESG issues versus one that does not. Similarly, ESG is important for companies in attracting talent as the same survey found that 94% Generation Z respondents believe companies should address ESG issues.[1] But arguably the most powerful driver of the *current* ESG momentum is the investment community.

The year 2020 was a watershed year for ESG investing. The disruption caused by the Covid-19 pandemic highlighted the importance of building sustainable and resilient business models based on ESG considerations. Recent events have demonstrated on multiple fronts ranging from Me Too and Black Lives Matter movements to the pandemic, that companies ignore ESG at their own peril.

They have also illustrated the importance of looking beyond what is most people's first thought when considering ESG – climate change – to other critical matters such as corporate culture, workplace wellbeing, the fragility of supply chains and inequality. The impact of these is that ESG is no longer a 'nice to have' but rather an operational and strategic imperative, at the heart of any business's ability to compete and succeed in the long term.

This recognition has resulted in unprecedented inflows into ESG funds, which quadrupled in 2020 according to figures from the Investment Association.[2] According to Morningstar, the longer-term flow picture looks even more striking, with inflows into European sustainable funds almost 5 times higher in 2020 than they were in 2017.[3]

The Rise of ESG Investing

ESG investing has witnessed a dramatic rise over the recent years. Once a niche in which responsible investors would have excluded or boycotted companies that were involved in activities at odds with the values of the shareholders, today's ESG investing is based on the assumption that ESG issues can have medium and long-term consequences for a company's financial performance and potential value. For example, according to a 2017 survey[4], 65% investors stated that their motive for taking ESG issues into consideration was to help manage investment risks.

Simply put, investors have recognized that incorporating ESG in the investment decision process is good for the bottom line. This view has been supported by 60% of the more than 2000 academic studies published since the 1970s on the link between financial performance and ESG show a positive correlation.[5]

Today, investors with $100 trillion of assets under management (AUM) have signed on to the United Nations Principles for Responsible Investment (PRI), as noted below, which advocate for a greater focus on ESG issues in investing. It is estimated[6] that approximately $45 trillion of these assets are following ESG approaches.

Principles for Responsible Investment

- Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.
- Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.
- Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- Principle 4: We will promote acceptance and implementation of the principles within the investment industry.
- Principle 5: We will work together to enhance our effectiveness in implementing the principles.
- Principle 6: We will each report on our activities and progress towards implementing the principles.

ESG Investing in a Nutshell

ESG is a broad concept covering or linked to other concepts such as sustainable investing, impact investing, carbon footprint initiatives, green funds, and many others.

At the most basic level, the 'E' in ESG seeks to measure the environmental impact of a company. This typically includes analysis of how companies monitor and reduce their carbon footprint as well as areas such as water consumption, waste and biodiversity.

The 'S' in ESG relates to the overall social impact, both internally and externally, of the business and its products in the communities it serves. Does it have policies to combat discrimination of employees based on gender, religion, age or any other relevant basis for example? Or does it have programs in place to assist the communities in which it operates?

The 'G' in ESG is focused on governance. This element entails assessing how the company is governed and how shareholder rights are protected typically covering issues such as the role of the board versus management, clarity around accountabilities and decision rights, and the degree of board independence or independence in the audit relationship.

ESG investing has traditionally been focused on equities (representing approximately half of total ESG investments), but it is increasingly expanding to other asset classes and in the fixed-income ESG market, green bonds are by far the fastest growing market.

ESG Reporting in MENA

Countries in the MENA region, and particularly in the GCC, are ramping up efforts to attract global investors and to diversify their economies. These efforts have resulted in a growing prominence of GCC countries among international investors, which has been reflected in the inclusion of the United Arab Emirates, Saudi Arabia, Kuwait and Qatar in leading emerging market indices.

However, this inclusion will also mean that there will be extra scrutiny on regional companies and increasing demands on their transparency and disclosure practices by international institutional investors driving meaningful ESG reporting.

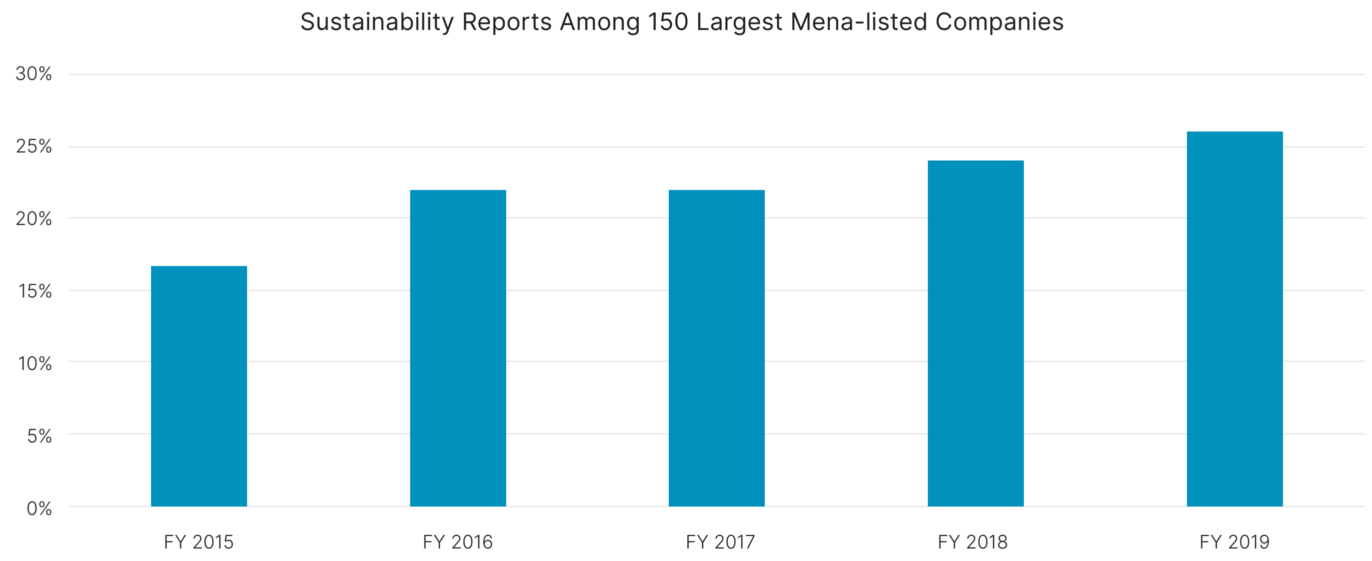
Just as a company would produce financial reports, ESG or sustainability reports provide a summary of quantitative and qualitative disclosures supported by analysis of performance across these ESG factors and specific metrics.

As Hawkamah's previous reports have shown, whereas governance reporting in the MENA region has improved significantly over the years (partly as a response to the issuance of corporate governance codes and mandated disclosures in the region), environmental and social reporting remains weak.[7]

This is an area in which the MENA regions has significant room to improve. This is a concern because investors are conditioning large capital investments on the existence and quality of a company's ESG program, while overlooking those companies that do not provide ESG reporting or may even be unable to articulate what ESG means to them.

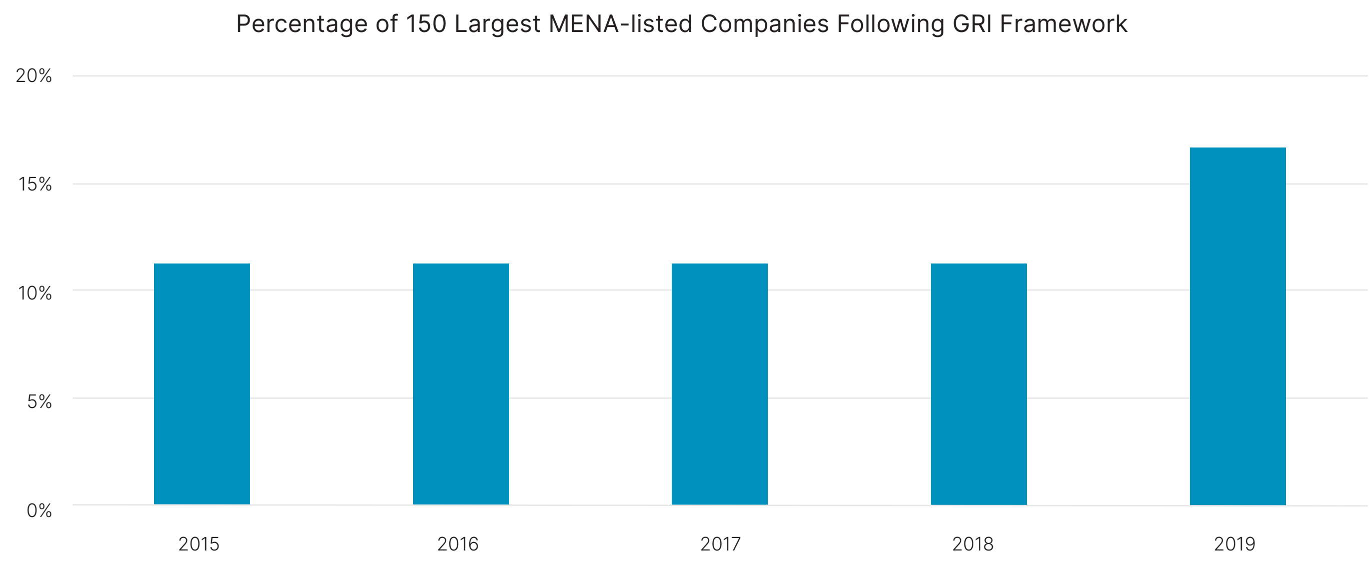
However, it is noteworthy that the percentage of MENA companies producing meaningful sustainability reports, whether as stand-alone reports or as part of annual reports, has increased significantly over the past five years.

While the significant increase in the number of MENA-listed companies issuing sustainability reports is commendable, the overall level of sustainability reporting remains very low in the region when compared to developed markets. For example, according to the Governance & Accountability Institute's 2021 Sustainability Reporting in Focus, 92% of the S&P 500 companies published a sustainability report in 2020, up from 90% in 2019 while 70% of the Russell 1000 companies published a sustainability report in 2020, up from 65% in 2019.



Although there are global efforts underway to try to harmonize different frameworks and standards, there are currently several main reporting frameworks that aim to guide companies on how to measure, assess and report on their ESG initiatives, risks and opportunities. These include the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), and the Task Force on Climate-Related Financial Disclosures (TCFD) standards. Other significant frameworks include those developed by the International Integrated Reporting Council (IIRC), the UN Global Compact and related Reporting on the Sustainable Development Goals (SDGs), the CDP (formerly the Carbon Disclosure Project) and the Climate Disclosure Standards Board.

It is often a challenge for companies to decide which framework to follow. The largest US listed companies often report against some portion or a combination of frameworks. According to research by the Governance & Accountability Institute, 51% of the S&P 500 reporting companies use GRI. In the MENA region, 16.7% of the 150 largest listed companies use GRI.[v]

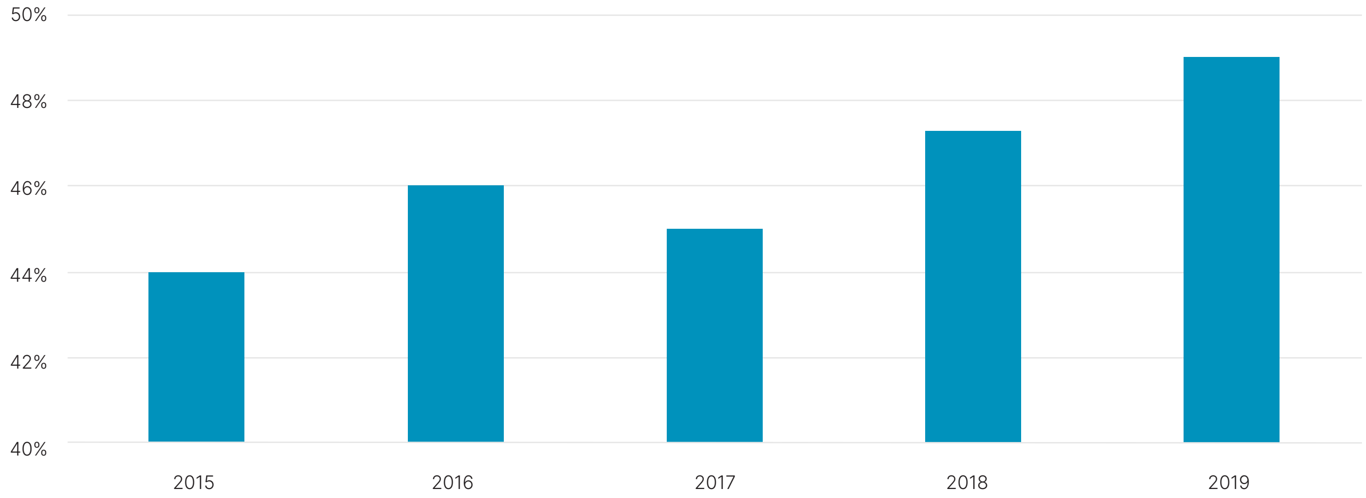


Approximately half of the 150 largest MENA listed companies are now disclosing their environmental policies. However, it is how such policies are implemented – and reporting on progress – that gives credibility. "You can't manage what you don't measure" and investors and other stakeholders are interested in the 'how' as much as the 'what'.

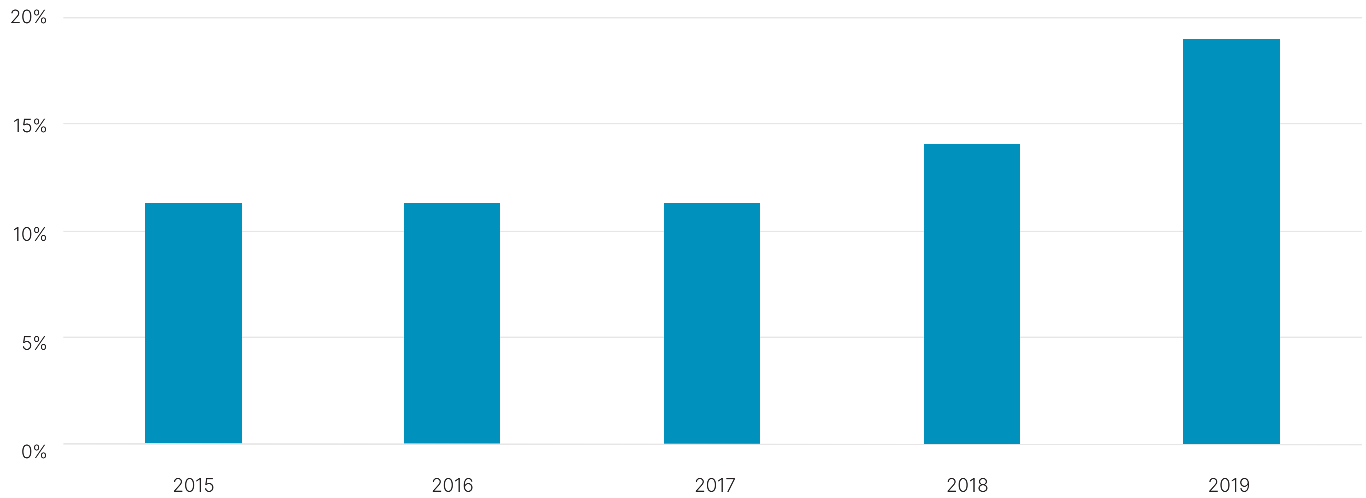
For example, less than 20% of the MENA companies under review disclose their greenhouse gas emissions. This is a case for concern as the MENA region is particularly vulnerable to climate change. It is one of the most fragile ecologies on earth and one of the most vulnerable regions to global warming, reduced precipitation and rise in sea levels. At the same time, the MENA region is becoming a significant contributor in terms of greenhouse emissions.

The situation is similar when it comes to water consumption. Water supply sources in the Arab world, two-thirds of which originate outside the region, are being stretched to their limits. The level of water scarcity is the highest in the world and is rapidly growing, threatening to lead to confrontation, to 'water wars.' Yet currently only 17% of companies in our universe report on their water consumption.

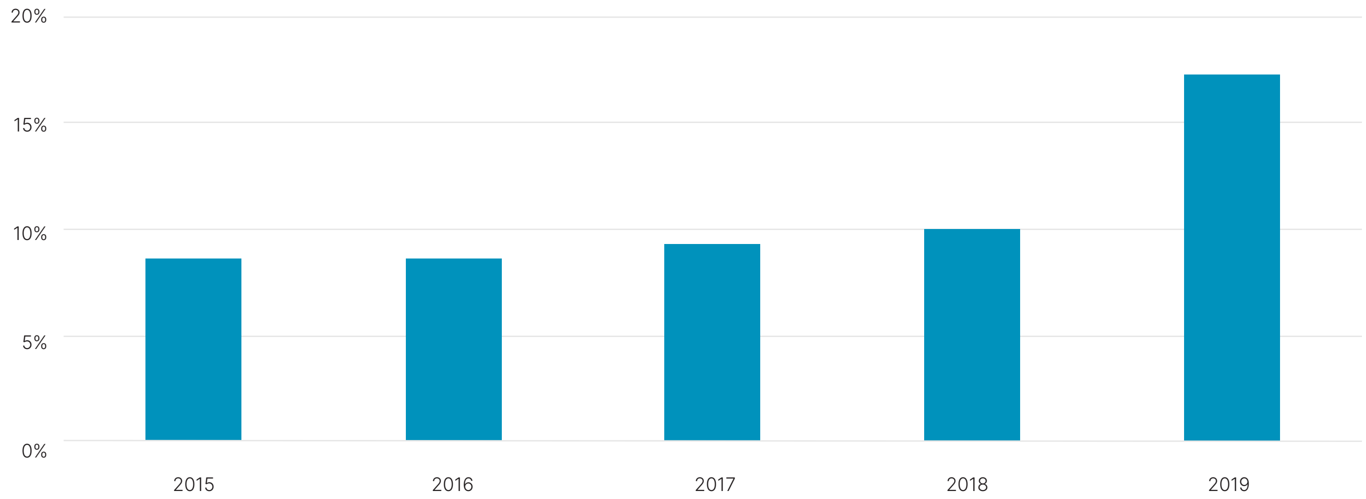
Percentage of 150 Largest MENA-listed Companies Disclosing Their Environmental Policy



Percentage of 150 Largest MENA-listed Companies Disclosing Their Greenhouse Gas Emissions



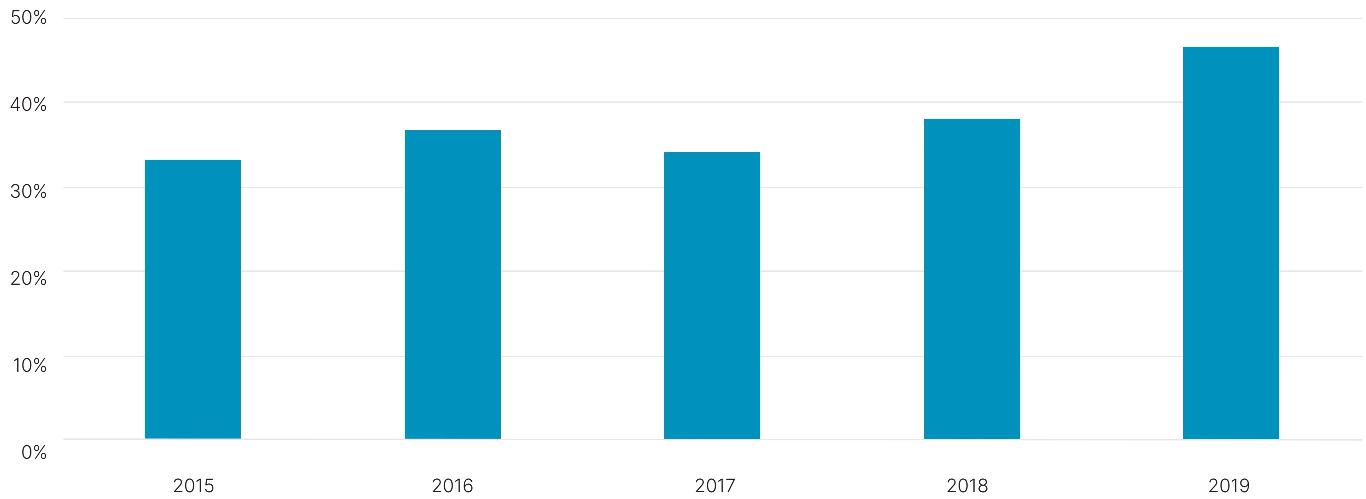
Percentage of 150 Largest MENA-listed Companies Disclosing Their Water Consumption



Employee issues are likely to play an increasing role in ESG analysis following the Covid-19 pandemic as well as the Me Too and the Black Lives Matter movements highlighting the importance of topics such as diversity, health and safety, harassment and corporate culture.

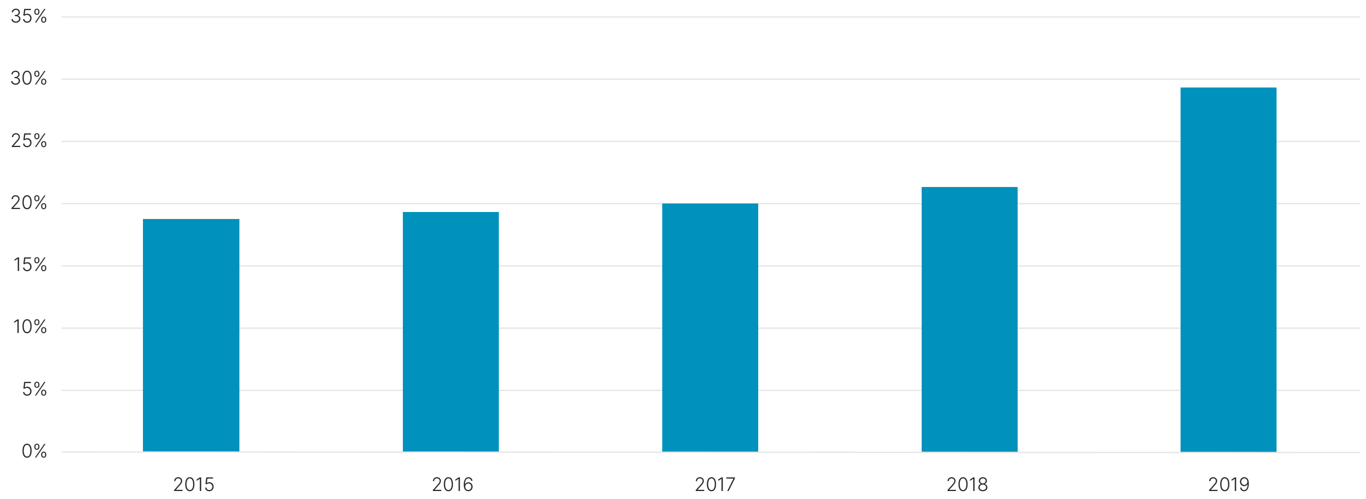
Public disclosure on such issues by MENA-listed companies is generally rather weak. This is illustrated by the fact that less than half of the listed companies in our universe report on basic matters such as having a health and safety policy.

Percentage of 150 Largest MENA-listed Companies Disclosing Their Health and Safety Policy



Disclosure practices around gender diversity is another topic which illustrates that the region's companies have much room for improvement. Currently approximately 30% of the companies provide a breakdown of the employees based on gender. However, it should be noted that there has been progress on this front over the recent years.

Percentage of 150 Largest MENA Listed Companies Disclosing Gender Breakdown of Their Employees



Implications for MENA Boards

ESG issues should be a priority for boards of directors of MENA-listed companies. The advantages of proactively tackling ESG issues are significant. A robust ESG program can open up access to large pools of capital, build a stronger corporate brand and promote sustainable long-term growth benefitting companies and investors. It is also likely that companies that proactively manage their ESG issues will get ahead of regulation by preparing their businesses for potential future regulations and mandatory reporting requirements.

ESG should not be viewed as static, discrete information, but as an enabler for boards to ask pertinent questions about the company's long-term business strategy.

Identify the Key Issues

ESG is a broad concept covering a multitude of topics and it is easy for companies to get lost in the variety and number of issues. It is critical that companies develop a focused approach to ESG by identifying the most impactful metrics for them. These should be aligned with the expectations of the company's various stakeholders, including its investors, as well as the company's strategy and risk profile.

Questions for boards in this regard include:

- Do we understand who our various stakeholders are?
- Do we have a process in place to monitor the expectations and concerns of our stakeholders, and the impact our decisions may have on them?
- Do we identify and monitor ESG risks, and do we have an appropriate appetite in relation to them?

Track and Oversee Performance

Boards should ensure that their companies track their performance on the key issues. The performance can often be benchmarked against industry peers. This information should be part of the board information packs feeding into the board meeting agenda.

Questions for boards in this regard include:

- How often should we discuss ESG matters?
- How can we make our discussions on ESG more productive or impactful?
- Are we receiving adequate information on ESG performance?

Integrate Sustainability Issues into Strategy and Risk Discussions

Boards should apply a "sustainability lens" through which to analyze their corporate strategies and risk profiles. This process is not only likely to uncover risks and opportunities that would otherwise be overlooked, but this also ensures that sustainability becomes a normal part of the company's operations.

Questions for boards in this regard include:

- Do we have an approach to integrating ESG considerations into our strategy formulation process?
- Are ESG risks integrated into our overall enterprise risk management framework including appetite and tolerances?
- Do we identify business opportunities based on our ESG analysis?

Ensure Top-Level Commitment

Boards should consider the governance around their sustainability practices to ensure that there is top level commitment. Some practices include setting up board-level sustainability or ESG committees; the appointment of a chief sustainability officers with a reporting line to the board or the CEO; and setting up management-level sustainability committees with C-suite membership. While there may be different arrangements in place, the key is to ensure that sustainability is addressed at the top levels of the organization.

Questions for boards in this regard include:

- Who "owns" sustainability in our organization?
- Are sustainability issues adequately addressed at the top levels?
- How do we as a board articulate and demonstrate our commitment to ESG to the organization and our other stakeholders?

Report on ESG Performance

It is in the organization's interest to provide robust ESG disclosures. Firstly, investors rely on company disclosure to make investment decisions. When disclosure is lacking, they are likely to assume the worst and simply invest elsewhere. Secondly, disclosure puts companies in control of their own ESG narratives.

Boards should ensure that their companies provide meaningful statements of their activities, not as a compliance activity, but to demonstrate awareness of risks and their skill in managing them. By reporting on ESG performance, companies send a signal to investors that they can manage risks and generate sustainable long-term financial returns.

Questions for boards in this regard include:

- How does our ESG disclosure compare to our peers?
- Does our ESG reporting present a comprehensive sustainability and value story?
- Do we have a process in place to monitor disclosure trends and investor expectations?

Engage with Stakeholders on ESG Matters

Investors are increasingly engaging with companies on their ESG performance. This may take several different forms, ranging from letters to the company secretary to meetings with board members. It is crucial for a board to ensure that these channels are open and that the company itself proactively engages with key shareholders.

Questions for boards in this regard include:

- Who in the company has a day-to-day responsibility for engaging with investors on ESG issues?
- Do we have processes in place to establish relationships with ESG investment funds?
- What should be the role of board members in engaging with shareholders on ESG?

Revisit Board Composition in Light of ESG

A recent study on the boards of 100 largest US companies found that of 1,188 directors, just 6% had "relevant credentials" in environmental protection and only 0.3% had expertise in either climate- or water-related issues. This is a skills gap in boards around the world, but a board wishing to drive the company's sustainability agenda should consider seeking future board members with ESG expertise.

Questions for boards in this regard include:

- Do we, as a board, have a strategic understanding of ESG issues?
- Should we identify sustainability expertise as an element in our skills matrix?
- Can an ESG skills gap in our board be mitigated with relevant training sessions for our board?

Integrate ESG into Executive Remuneration

The idea of tying executive remuneration to ESG objectives to help drive business sustainability is gaining traction. According to the latest Edelman Trust Barometer Special Report, more than two-thirds of institutional investors would like to see this link in place.

Questions for boards in this regard include:

- Have we identified relevant KPIs linked to our ESG goals?
- Are these KPIs important to, and meaningful for, our company's long-term strategy and purpose?
- Would it be feasible to integrate these KPIs to annual bonus schemes or long-term incentive plans?

1 Bank of America (2020) Why ESG Reporting Is Essential For Your Business. https://www.ul.com/news/why-esg-reporting-essential-your-business

2 The Investment Association. https://www.theia.org/campaigns/sustainability-and-responsible-investment

3 Morningstar (2021) European Sustainable Funds Landscape: 2020 in Review. https://www.morningstar.com/content/dam/marketing/emea/uk/European_ESG_Fund_Landscape_2020.pdf

4 CFA Institute (2017) Environmental, social and governance survey. https://www.cfainstitute.org/-/media/documents/survey/esg-survey-report-2017.ashx

5 Gunnar Friede, Timo Busch & Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies, Journal of Sustainable Finance & Investment, 5:4, 210-233. https://doi.org/10.1080/20430795.2015.1118917

6 J.P.Morgan (2020) Why COVID-19 Could Prove to Be a Major Turning Point for ESG Investing. https://www.jpmorgan.com/insights/research/covid-19-esg-investing

7 Hawkamah (2017) Review of ESG practices in the MENA Region 2007-2017. https://www.hawkamah.org/files/shares/Hawkamah_Report_EM.pdf

8 Governance & Accountability Institute (2020) 2020 S&P 500 Flash Report. https://www.ga-institute.com/research/ga-research-collection/sustainability-reporting-trends/2020-sp-500-flash-report.html

About Hawkamah

Hawkamah is a world-class corporate governance institute, affiliated with Dubai International Financial Centre, working to improve corporate governance practices of governments and companies across the MENA region. Hawkamah helps build sound organizations, reform corporate sector, assist banking and financial sector, and promote good governance. Hawkamah also assists companies to develop sound and globally recognized corporate governance frameworks. Moreover, Hawkamah helps in building qualified directors and top executives who are able to apply corporate governance in their organizations. Strength lies in Hawkamah's research and years of experience in the region, its world-class experts, and proximity to the countries and companies of the MENA region. Hawkamah has partnerships with most of the leading corporate governance institutions regionally and globally.

About the Nasdaq Center for Board Excellence

The Nasdaq Center for Board Excellence is a community and collaboration environment, in which board engagement is deepened and experiences are shared. By introducing leaders across organizations, industries, and regions, the Nasdaq Center for Board Excellence offers the opportunity to gain informed insights and promote board excellence. Leaders who join the community have access to participate in, contribute to, and learn through exclusive interactive events, educational resources, and engaging experiences.

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