endeavour vision

Part 1 UNDERSTANDING ESG AND HEALTHCARE INNOVATION:

WHY ESG MATTERS

This is the first in a series of papers that intends to take investors and healthcare leaders on an “ESG journey”— what it is, why it matters, and how to put ESG into practice. In this paper, we discuss why taking steps to incorporate ESG principles into business strategies is essential to improving healthcare companies and creating a better world.

What is ESG?

Environmental, social, and governance (ESG) is an approach to business which helps companies behave in responsible, beneficial ways, positioning them for success in the sustainable economy. It is a way to manage the external opportunities and risks that arise outside of the market, and incorporates ethics into the running of a company.

Since the term 'ESG' was first used in the mid-2000s, the concept has gained significant momentum. The idea that it is a company's fiduciary duty to apply the lens of ESG throughout its decision-making is now well-established in business, investment, and political spheres, and public awareness of ESG continues to grow. This has been largely driven by highly publicised policy initiatives such as the UN Global Compact, the UN Sustainable Development Goals (SDGs), and the 2015 Paris Agreement, as well as the climate change-driven increase in extreme weather events.[1]

More recently, a range of mandatory and voluntary ESG reporting standards and ESG rating agencies have appeared that support companies and investors with their ESG efforts. Some of the current ESG reporting standards include: the European Commission's Corporate Sustainability Reporting Directive (CSRD); the framework provided by the Sustainability Accounting Standards Board (SASB); and the Taskforce on Climate-related Financial Disclosures (TCFD). ESG ratings provide a measure of a company's impact on its external environment, and the ways in which the company's management addresses ESG risks and opportunities.

SUSTAINABLE DEVELOPMENT GOALS

Created in 2015 by the United Nations, the **Sustainable Development Goals** (SDGs) are a collection of 17 interlinked global goals to be achieved by 2030. They were designed to serve as a roadmap toward a sustainable future, with 169 specific targets that, for companies, can be used to inform ESG targets, manage ESG reporting, and create long-term financial value.

PARIS AGREEMENT

Adopted in 2015, the **Paris Agreement** is an international treaty on climate change that covers mitigation, adaptation, and finance. Its primary goal is to limit the increase in average global temperature to well below 2 °C above pre-industrial levels—and ideally to below 1.5 °C. It states that global greenhouse gas emissions should be reduced to net zero by 2050 and, to achieve the 1.5 °C goal, by roughly 50% by 2030.

UN GLOBAL COMPACT

The **UN Global Compact**, the world's largest corporate sustainability initiative, is a non-binding pact that encourages businesses to adopt sustainable and socially responsible policies and report on their implementation. The Compact states ten principles in the areas of human rights, labour, the environment, and anti-corruption. Its objectives are to mainstream the ten principles in business activities around the world and to catalyse actions in support of broader UN goals.

ENVIRONMENTAL, SOCIAL, AND GOVERNANCE

ESG is an approach to evaluating the extent to which a company works on behalf of goals that go beyond the role of a corporation to maximise profits on behalf of its shareholders.

Environmental: often representing externalities, environmental concerns include climate change, biodiversity, and waste management.

Social: such as diversity, human rights, consumer protection.

Governance: the structures and processes that direct and control companies while making them more accountable and transparent to investors.

IMPACT INVESTING

Impact investing is an investment methodology that aims to deliver positive social and environmental impact alongside financial returns by investing only in businesses that do good for society and the planet.

SUSTAINABLE INVESTING

Sustainable investing refers to a range of investment strategies that aim to create long-term wealth by focusing on ESG criteria. Such strategies are based on the premise that companies that employ environmentally and socially sustainable practices tend to generate better returns.

1. Carrington D. Critical climate indicators broke records in 2021, says UN. *The Guardian*. 2022. https://www.theguardian.com/environment/2022/may/18/critical-climate-indicators-broke-records-in-2021-says-un (accessed 02 June 2022).

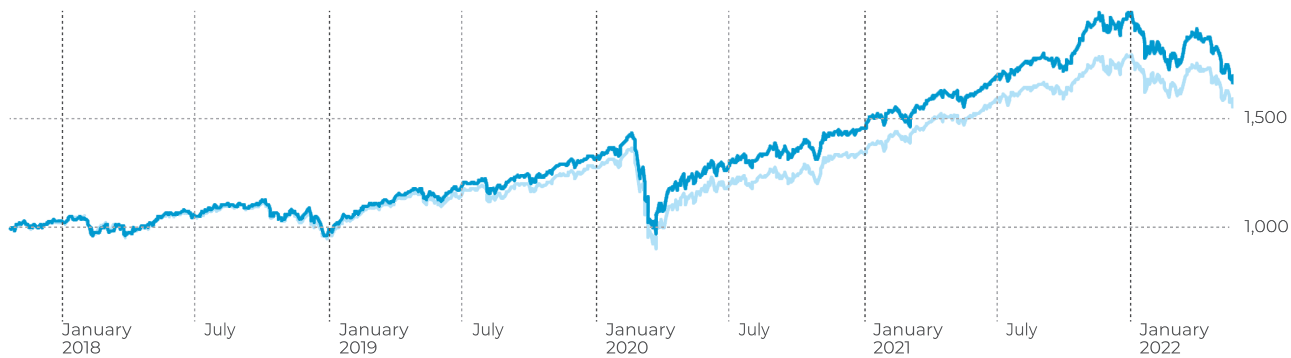
Why focus on ESG?

1 INVESTOR DEMAND

The biggest driver of ESG has been demand from investors looking for companies that will perform well, not only in the short term, but also in the medium and longer term. Studies show that robust ESG practices are associated with lower earnings volatility and market risk,[2] while greater disclosure is associated with fewer capital constraints[3] and fewer analyst forecast errors.[4] Sustainability is, therefore, a crucial strategic differentiator for businesses operating in every sector of the economy, and can even result in higher returns on investment as shown below:

THE FOUR MAIN DRIVERS OF ESG

1. Investor demand
2. Responsibility
3. Governments and regulators
4. Workforce demand



Performance of iShares MSCI World SRI UCITS ETF EUR (Acc) [dark blue] vs. Xtrackers MSCI World UCITS ETF 1C [light blue] showing total returns on a £1,000 investment. Socially responsible investing (SRI) exchange traded funds (ETFs) employ an ESG approach, and largely outperform their benchmark non-ESG ETFs. The graph above shows that the ESG-compliant MSCI World SRI ETF (dark blue) outperformed the benchmark (light blue) over the past 3 years.
Source: https://markets.ft.com/data/funds/uk/compare (accessed 08/06/2022).

Growing investor interest in companies with good ESG practices has led to the popularity of sustainable investment strategies in recent years. Similarly, there is a shift towards impact investing – healthcare companies are recipients of such investments given their positive social impact. VC funds, like Endeavour, aim to make such companies attractive for sustainability investors by having them incorporate ESG measures in their day-to-day business practices. As a result of these various trends, ESG is now included in the majority of investor analyst coverage.

In allocating funds, institutions such as asset managers, pension funds and endowments also rely on ESG scores. An ESG score is a measure of a company's exposure to long-term environmental, social, and governance risks that are often overlooked in traditional financial analyses. ESG scores are calculated by ESG rating agencies (e.g., Sustainalytics, MSCI ESG Research, S&P Global) as well as by asset managers' own in-house ESG research teams, based on their own methodologies and using data from sources such as securities filings, voluntary business disclosures, governmental databases, academic research, and media reports. A high ESG rating indicates that a company manages its ESG risks well in comparison to its peers. ESG evaluations and scores, when combined with financial analyses, can help investors better understand a company's long-term potential.

USD 17 trillion assets
that, as of 2020, are professionally managed according to sustainable investing strategies, up 42% from 2018 and representing a third of all such assets in the US[5]

Fund managers who focus on sustainable investments must now also account for increasingly stringent ESG reporting requirements, leading to more comprehensive ESG data requests from their portfolio companies in the coming years. As a result, the extent to which a company focuses on ESG, and its ability to fulfil investors' ESG reporting demands, has a direct impact on the amount of capital it can access.

2 Giese G, Lee L et al. Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance. *The Journal of Portfolio Management*. 2019;45(5). **3** Cheng B, Ioannou I, Serafeim G. Corporate social responsibility and access to finance. *Strategic Management Journal*. 2014;January:1–23. **4** Dhaliwal D, Radhakrishnan S, Tsang A, Yang Y G. Nonfinancial disclosure and analyst forecast accuracy: International evidence on corporate social responsibility disclosure. *The Accounting Review*. 2012;87(3):723–759. **5** Report on US Sustainable and Impact Investing Trends. *US SIF Foundation*. 2020. https://www.ussif.org/trends. (accessed 03 June 2022).

2 RESPONSIBILITY

Individuals and groups are becoming more aware of their responsibility to improve society. With the link between sustainability and global issues—including rising temperatures leading to unprecedented heatwaves, natural disasters, and the COVID-19 pandemic—becoming increasingly recognised, ESG is only becoming more salient for companies as well as the general population.

This responsibility is held not only towards society at large, but also towards those invested in companies' future success. Investors, governments, employees, consumers, and citizens increasingly expect businesses to measure their performance in terms of ESG, as well as their bottom line. Companies that deliver on ESG will therefore be those best positioned to thrive in the societies and markets of tomorrow.

3 GOVERNMENTS AND REGULATORS

ESG reporting requirements are growing, especially in Europe. Current EU rules on non-financial reporting apply only to large public-interest companies with more than 500 employees. However, change is underway. In April 2021, the European Commission adopted the Corporate Sustainability Reporting Directive (CSRD),[6] which means that all EU companies will have to abide by its sustainability reporting standards—large companies from fiscal year 2023, and small and medium-sized companies from 2026.[7] Meanwhile, although the overall market reaction to the EU's announcement of mandatory ESG disclosures was negative, it was positive for companies that already have superior ESG disclosures in place.[8]

Recent European reporting initiatives with implications for private equity and venture capital:

The Sustainable Finance Disclosure Regulation (SFDR), adopted by the EU in 2019, aims to **enhance transparency** around sustainability claims made by financial market participants (e.g. asset managers) about financial products (e.g. funds) to **prevent greenwashing**. The measures include adverse sustainability impact reporting—requiring cataloguing of metrics and their risk on climate and social matters. The complete disclosure requirements will apply from 1 January 2023.[9]

The ESG Data Convergence Project is an effort initiated by leading global general partners (GPs) and limited partners (LPs) to agree on a standardised set of ESG metrics and mechanisms for comparative reporting. It aims to streamline the collection and reporting of ESG data to create a critical mass of meaningful, performance-based, comparable ESG data from private companies.[10] This would decrease the reporting burden on companies, which often have to complete different ESG questionnaires from various GPs, diverting precious resources from the main business of the company.

6 Corporate sustainability reporting. *European Commission*. https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en (accessed 03 June 2022). **7** How the EU's new sustainability directive will be a game changer. *EY*. 2021. https://www.ey.com/en_no/assurance/how-the-eu-s-new-sustainability-directive-will-be-a-game-changer (accessed 03 June 2022). **8** Grewal J, Riedl E J, Serafeim G. Market Reaction to Mandatory Nonfinancial Disclosure. *Harvard Business School*. 2017;Working Paper, No. 16-025. **9** Infographic on Sustainable finance disclosure requirements. *Eurosif*. https://www.eurosif.org/news/infographic-on-sustainable-finance-disclosure-requirements/ (accessed 03 June 2022). **10** ESG data convergence project. *ILPA*. https://ilpa.org/ilpa_esg_roadmap/esg_data_convergence_project/ (accessed 03 June 2022).

While it appears that Europe is ahead, the US is fast catching up, with the Securities and Exchange Commission (SEC) having already prepared a consent regulation draft and completed a public consultation on new regulations that will impose ESG reporting requirements on publicly listed companies.[11] Therefore, it is in the interest of all publicly listed companies, as well as those preparing to take on public investors, to stay ahead of upcoming ESG reporting regulations.

Reporting trends

ESG reporting is still a relatively new discipline that continues to be refined. The primary areas of focus to advance ESG principles are:

1. What data to collect to satisfy investors, regulators, and other stakeholders

2. How to standardise data collection within and across industries

3. How to collect data to minimise the burden of reporting while preserving rigour.

The backlash against greenwashing

The intensification of market competition around ESG and the growing importance of third-party assurance is forcing companies to increase the rigour of their ESG reporting. As a result, greenwashing—the practice of making a company look more sustainable on paper than it is in reality—is in decline. Allegations of greenwashing are taken increasingly seriously, with companies facing investigation, prosecution, and/or large penalties over misleading sustainability claims.[12, 13]

11 Hodge M. SEC proposes climate reporting and assurance rules. *KPMG*. 2022. https://frv.kpmg.us/reference-library/2022/sec-proposes-climate-reporting-requirements.html (accessed 02 June 2022). **12** German officials raid Deutsche Bank's DWS over 'greenwashing' claims. *Reuters*.2022. https://www.reuters.com/business/german-police-raid-deutsche-banks-dws-unit-2022-05-31/ (accessed 03 June 2022). **13** BNY Mellon unit pays $1.5 million over ESG fund misstatements, SEC says. *Reuters*.2022. https://www.reuters.com/markets/us/us-sec-charges-bny-mellon-investment-adviser-misstatements-over-esg-policies-2022-05-23/ (accessed 03 June 2022).

4 WORKFORCE DEMAND

Finally, ESG is becoming a consideration for employees when it comes to choosing an employer, and the extent to which a company is focused on ESG may affect its ability to attract and retain talent. According to Willis Towers Watson, 58% of employees consider a potential employer's social and environmental commitments when job-seeking, while 55% of employees would choose to work for a socially responsible company even if it meant accepting a lower salary.[14] Moreover, a Marsh & McLennan study found that employers with relatively high ESG scores also tend to have greater employee satisfaction.[15]

ESG and the healthcare sector

A key mission of healthcare companies is to improve patient care, consistent with goal 3 of the UN SDGs: "*Ensure healthy lives and promote well-being for all at all ages*".[16] As such, the healthcare sector delivers a positive social impact that compares favourably to other sectors. Investors therefore tend to give the social dimension of ESG—which includes product safety, affordability and pricing, employee health and safety, diversity and inclusion, human capital development, employee benefits—the highest weighting when assessing a healthcare company's likelihood of experiencing stronger financial performance relative to its sector peers in the future.

In general, healthcare investors assign the lowest weighting to the environmental (E) aspect of ESG. However, the environmental aspect receives a heavier weighting when assessing biotech, pharmaceutical, and life sciences companies, due to the need to responsibly dispose of potentially hazardous environmental waste; despite this, the social (S) and governance (G) aspects still outweigh environmental aspects.

In spite of the positive nature and business of healthcare companies, research shows that healthcare companies lag behind in terms of ESG disclosures when compared to other sectors and this is apparent across each of the three E, S and G pillars.[17]

14 Norton J and Summers H. Engaging your people as the advocates and enablers of ESG change. *Willis Towers Watson*. 2020. https://www.wtwco.com/en-MY/Insights/2020/07/engaging-your-people-as-the-advocates-and-enablers-of-esg-change (accessed 02 June 2022). **15** Bailey R, Yeo J, Jiang L, Ferguson A. ESG as a workforce strategy. *Marsh & McLennan*. 2020. https://www.marshmclennan.com/insights/publications/2020/may/esg-as-a-workforce-strategy.html (accessed 02 June 2022). **16** Sustainable Development Goals: Health and Population. *UN*. https://sdgs.un.org/topics/health-and-population (accessed 03 June 2022). **17** Subramanian S, Sullivan M, Ahmad T, de Bruin D, Cherny M, Fischbeck K et al. An ESG read on Health Care with ESGMeter™. *ESG Matters* – US. 2021;March:1–3.

Addressing ESG challenges for growth-stage healthcare technology companies

Growth-stage healthcare technology companies tend to score lower than their more mature peers on all ESG factors. There are two primary reasons for this: 1) growth-stage companies are less developed and organised than mature companies, and have different priorities, and 2) they tend to have less direct control over factors that will affect their ESG rating, such as their premises and outsourced manufacturing processes. Despite these constraints, it is important for these companies to focus on developing their ESG capabilities and pushing for improvement from their suppliers and intermediaries.

Investors can play a crucial role in helping growth-stage companies to establish ESG policies and build the capabilities needed to implement them effectively. In May 2019, Endeavour Vision became a signatory of the UN Principles for Responsible Investing (PRI), which requires us to incorporate ESG considerations into our investment decision-making and actively engage with our portfolio companies on sustainability. We do this by adhering to a sector exclusion list, conducting pre-investment ESG scans and post-closing ESG health checks, and creating strategic roadmaps.

In the rest of this series of papers, we will share more of our experience and expertise on how, even with limited resources, companies can make significant progress on ESG and begin reaping the benefits.

For more information about Endeavour Vision's approach to Impact & ESG, visit. https://www.endeavourvision.com/impact/

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