Why *sustainability* still matters

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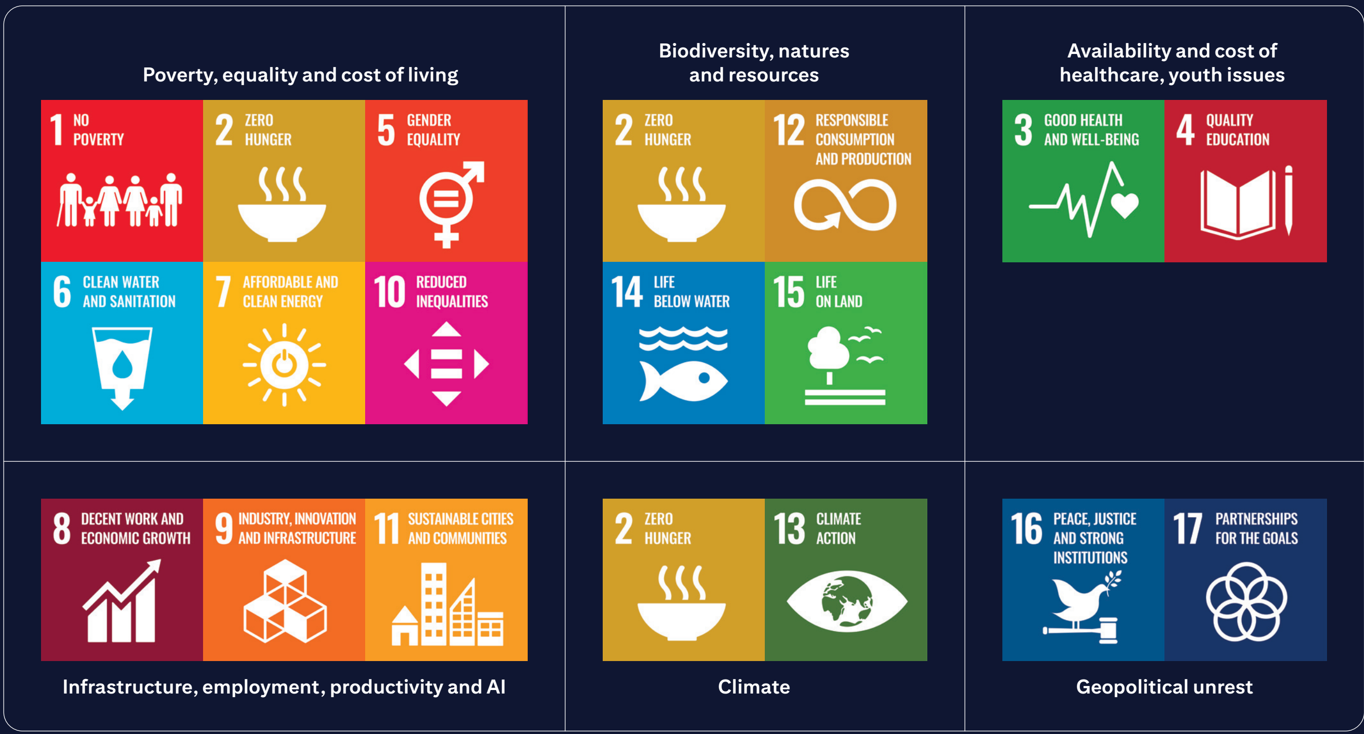
Against a tougher economic backdrop and reduced business certainty, should sustainability still matter to treasurers, or should it take a back seat? In this short note, we examine why sustainability-related themes are not just alive and well, but at the very heart of strategies to navigate this.

Lessons from history tell us that shorter-term dislocations often accelerate longer-term transitions – so being prepared is critical to support future business. Sustainability simply represents a broadening of the lens through which corporates need to think about strategic opportunity and risk. Nowhere is this more true than for small- and medium- enterprises, who make a up a critical element of the business ecosystem, and often represent a material part of their customers' 'scope 3' emissions, or are critical to helping their counterparties reach their own sustainability goals. We also examine why these issues remain so important for treasurers, and how they can take the lead in aligning the financing function with overarching drivers and goals, at every level of the balance sheet, placing the treasury operation at the heart of their business transition.

A tougher world

As the world grapples with a slower economy, high levels of indebtedness, inflation, higher interest rates, and geopolitical tensions, some have questioned whether integrating sustainability and ESG into business strategy is a luxury that we can afford. The world may understandably be focusing on shorter-term priorities such as keeping the lights on, the mortgage paid and food in our bellies, but ESG spotlights long-term issues that may accelerate in the transition to a more sustainable, resilient, and inclusive economy. Separating the signal from the noise has resulted in confusion and uncertainty about where to step in for corporates, particularly in the mid-market.

Figure 1: Sustainability-related themes remain at the heart of current challenges



Source: UN

Sustainability themes remain front and centre

There is little doubt that 'ESG' has evolved. While some investors and companies had thought of ESG as a tick-the-box approach to achieving sustainability scores and ratings, that approach rewarded transparency over business impact. Today, the themes identified by ESG increasingly make up the megatrends which will drive the economy, society, politics, business and the environment over the coming decades, as shown in Figure 1 above.

For example, the United Nations' Sustainable Development Goals are a way to envision these megatrends developing across the globe. If we break the SDGs up into thematic buckets, we can see that far from being 'dead', sustainability is actually at the very heart of the key issues facing business and the wider world currently. Environmental issues such as climate change remain front and centre, while social issues such as the cost of living crisis, poverty and inequality, encapsulated by food security/food price inflation and rising energy costs/ energy security remain high on the political, economic and social agendas. From geopolitical tensions to the implications of Artificial Intelligence (AI) on employment, all of thesethemes are related to sustainability and resilience.

Getting the right exposure and alignment to these themes can align businesses with enormous and long-term growth trends, while conversely, getting it wrong could represent an existential risk for business and missed opportunities to future-proof for growth. While many mid-sized businesses might feel their day-to-day is somewhat removed from the talk of 'trillions of dollars of investment' and 'megatrends', the reality is that businesses all exist in ecosystems and value chains where these are the key driving themes, particularly for their customers, be they larger corporates, sovereigns, supranationals, or indeed individual consumers. The same is true for mid-market owners and investors, and for their regulators. These themes are effectively a broadening of the lenses through which businesses need to think about strategic opportunities and risk, and are becoming part of fiduciary duty.

Shock-driven acceleration

Sustainability and ESG issues can be drivers of market risks and opportunities, though it can be hard to predict exactly when they will have an impact on business, raising the importance of resiliency-focused strategies to help manage ESG and sustainability-related volatility. History tells us that while short-term dislocations can slow the pace of transition, they often result in a longer-term acceleration of these trends.

For example, jump back 50 years to 1973, and we find a world in economic turmoil driven by an energy price shock ('73 oil crisis), itself driven by a conflict , which led to food price inflation, higher levels of inflation generally, and subsequently rising rates aiming to tackle that inflation. Alongside this, industrial unrest increased dramatically with widespread strike action in countries like the UK, culminating in the so-called winter of discontent.

But what were the longer-term effects? This dislocation also drove various initiatives launched in the 1970s, for example Nixon's Project Independence aimed at energy self-sufficiency, the Messmer Plan in France, which explains why France is largely nuclear, and the Proálcool programme in Brazil, which explains why domestic autos run on ethanol. These global events also kickstarted a move to more fuel-efficient imported cars in the US – each one an acceleration of a green theme.

The EU's reaction to the Black Sea conflict in 2023 provides a more recent example, in that while it led to a shorter-term increase in carbon emissions, due to a temporary reliance on more coal, consequently it also accelerated and increased renewable energy and energy efficiency targets, in the name of energy security. So while these dislocations can provide short term headwinds (i.e. keep the lights on no matter the cost in carbon emissions), they can actually accelerate fundamental shifts (e.g. energy security) which in many cases can play into sustainability themes. Accordingly, it is a business imperative that SME's understand not just the short term impact of these dislocations, but also their longer term implications for strategy. To stay competitive, SME's need to understand how their customers – often larger corporates, governments and regulators – are focusing on these transitions, as they sit in the middle of these value chains where incentives, goals and policies are changing.

Implications for strategy and finance

So what does this all mean for corporates, for C-Suites, and for treasurers in particular?

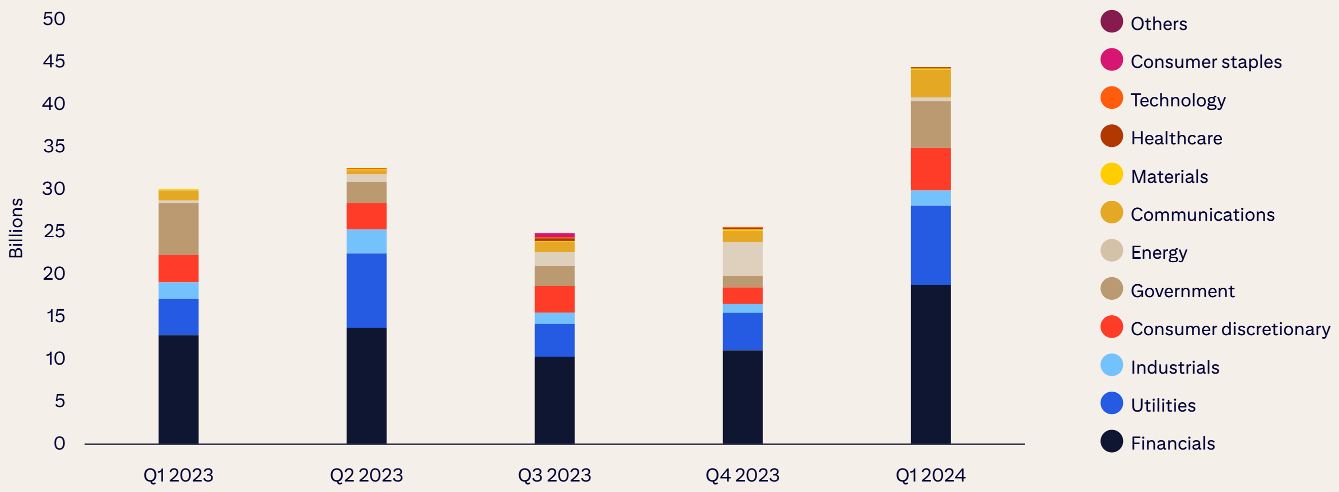
The most obvious impact is a strategic one, in terms of ensuring that businesses remain aligned positively with these fundamental transitions (looking beyond short-term dislocations), and not exposed to associated risks such as stranded assets or shifting customer & consumer sentiments, or indeed regulatory change. Being engaged in understanding these macro shifts can help act as an early training system and to build expertise ahead of potential impacts. While SME's may feel removed from many of these shifts, they are often, for example, a significant part of a corporate's scope 3 emissions, meaning that they risk supply chain lock-out if their buyers conclude that they aren't well aligned to their own sustainability goals. Conversely, companies can competitively differentiate themselves from peers by proactively disclosing strong credentials.

As an example, in addition to seeking data on the CO_2 intensity of products, larger corporates from a variety of sectors, such as construction, furniture, fashion & retail, paper & packaging and others, are increasingly demanding their suppliers present evidence of the chain-of-custody certification by the Forest Stewardship Council 'FSC' to demonstrate focus on minimising nature & biodiversity impacts. In the food & agriculture sector, strong attention is paid today to the Roundtable on Sustainable Palm Oil 'RSPO' and Roundtable on Responsible Soy 'RTRS' certifications, to name but two. Increasingly, failure by mid-sized companies to obtain the various costly ESG certifications comes at the peril of being exiled from the supply chain."

Strong disclosure, reporting and the right narrative regarding a company's sustainability journey is key here, and this is an area where treasury can take the lead. Finance and treasury have great insight into the factors that are truly material for a business, providing another opportunity for treasury to take the lead.

This is true not just from a reporting perspective, but also in embedding and reinforcing the importance of sustainability-related KPIs – linking the measures of success for the business' sustainability strategy to financing. This is key; clearly a primary task for any treasurer, alongside maintaining liquidity, and managing working capital and debt maturity etc, is to minimise the cost of capital, thereby maximizing return spreads for the business, and this can work hand in hand with sustainability. This can be accomplished through various means, including sustainable supply chain solutions, trade loans, as well as other innovative financing solutions. At its heart, a more resilient and efficient business which is 'sustainable' over the longer term could be considered lower risk, and all things being equal, could benefit from a lower cost of capital or at least find themselves on a path to achieving it.

Green, sustainable, and sustainably linked debt, by industry



Bloomberg data including loans and bonds from corporates with rev of issuers between 10m-3bn, including private loan deals & tranches. Totals are aggregated by sector. Government related entities are included. The total shown for each is sum of Amt Outstanding for each quarter.

Note: The chart above shows outstanding value (USD), over a period of five quarters. The amounts are aggregated by BICS Level 2 Classifications, and include any facilities labelled sustainable, sustainably linked, use of proceeds sustainable, or green, as defined by Bloomberg Fixed Income Screener. This includes securities (loans and bonds) from corporates with revenue of issuers between 10m-3bn, including private loan & tranches. Government related entities are included.

Source: Bloomberg

Capital is needed in many ways, but there are two key areas that we will focus on below:

1. Transition finance for existing businesses, either in the form of working capital, or for capex, and;
2. Growth financing for sustainability innovators, such as renewable energy and clean technologies

Transition finance

For example, an equipment manufacturer looking to move to a more circular approach to resources, by switching to an 'as-a-service' business model

Growth finance

For example, a wind and solar developer with a large pipeline of products

The good news is that enormous 'new' pools of capital exist which actively look to finance sustainable investments – and want the metrics to be able to demonstrate the impact that they are achieving. The frustration most investors have is not that the capital isn't there, it is that the appropriate vehicles to allow them to *deploy* that capital don't exist at the scale needed. Hence, employing innovative forms of sustainable finance can provide access to pools of capital often new to companies, while serving to diversity their funding base and provide financing vehicles that investors are looking for.

There is an enormous opportunity here for treasurers to access new pools of capital, often via the use of innovative new finance products or structure. This isn't just limited to green bonds. Sustainable finance is important to, and offers opportunities for every single line in the balance sheet, reinforcing why this theme should be so important to treasurers, not just the C-Suite or CSO.

If we focus on the fixed asset investments needed in many enterprises, we can see clearly how getting strategic calls wrong can lead to write-downs or indeed write offs.

While this might not seem particularly pertinent to sustainability per se, let us consider the issue of stranded assets (e.g. coal) in the energy industry, which has resulted from the transition to cleaner fuels and technologies. But it isn't just energy – think shipping, aviation, steel plants, apparel manufacturers in water stressed areas, or agriculture suffering as a result of conflict (food security is obviously a key sustainability issue). From a regulatory perspective, the Taskforce for Climate-Related Financial Disclosure (TCFD) treatment of physical and transition risk on assets makes this case as well. So, assessing exposure to the key themes listed above, and managing (systemic) risks can be key to maintaining asset values.

Assets

Non-current assets
- Goodwill
- Intangible assets
- PPE
- Investments in Assocs/JVs

Current assets
- Inventories
- Accounts receivables

Stranded asset risk
Commodities & carbon credits
Sustainable deposits
Sustainable supply chain finance
ESG-linked FX and rates
Tax
Provisions/risk
Export agency finance
Green, social, KPI/sustainable bonds
Sustainable commercial cards
Sustainable (trade) loans
Access to capital pools
Cost of capital

Liabilities

Current liabilities
- Short-term debt
- Accounts payable
- Tax liabilities
- Provisions
- Stock options liabilities

Non-current liabilities
- Convertible bond
- Other long-term debt
- Provisions (warranties)
- Deferred tax

Shareholder equity
- Minority interests
- Pension deficit/surplus

Source: Citi Global Insights

This is apparent in the evaluation of working capital. As sustainability has moved from a purely 'own operations' perspective to a 'scope 3' mentality, where companies are responsible for the impacts of their supply chains, and use of their 'product', the focus on supply chains has grown dramatically. A key method to influencing supply chains to help corporates reach their sustainability targets (and potentially even to provide funding for) is via sustainable supply chain finance. Simplistically, a company may offer incentives in terms of days payable or rates thereon, to encourage suppliers to hit targets (and to achieve better terms from customers on the receivables side).

Case study 1

An APAC based company in the industrial & consumer space wished to boost supply chain resilience via better liquidity, while improving its 'scope 3' sustainability credentials from a supply chain perspective. This was achieved by adopting a sustainable supply chain finance programme, which attracted a broader range of suppliers and provided preferential financing for suppliers with strong or improving sustainabilty credentials.

Tax liabilities might seem to have little to do with sustainability, but it is nevertheless important from a governance and social responsibility/corporate citizenship perspective with an increasing focus for some corporates on where they are paying tax, and how much. Tax can also play a key role via tax credits provided by public policy such as the US Inflation Reduction Act (IRA), which provides numerous tax credits and subsidies for clean energy manufacturing and includes over $370 billion in investments for clean energy and innovation.[1]

Provisions of course encapsulate risk (as well as opportunity), which is at the heart of ESG and sustainability. Commodities hedging for key inputs & outputs, be they rare earth minerals or Power Purchase Agreements (PPAs) are important, and we can now add the generation and trading of carbon credits, or indeed plastic credits, to the range of instruments for sustainable finance.

Case study 2

A renewable energy manufacturer, committed to carbon neutrality across its supply chain, sourced carbon credits generated from the supply of efficient cooking stoves in Vietnam, replacing wood-burning stoves. As well as offsetting emissions, while the company works on longer term solutions to reduce those emissions, there are broader social and environmental benefits to funding projects that might otherwise be deemed 'hard to bank', such as improved health."

In terms of long and short-term debt, the opportunities are obvious – from sustainable RCF's, to green, social, sustainable, or even blue bonds (as defined by the Green Bond Principles by ICMA, for projects with environmental benefits, or social, combined, or ocean related).

While these bonds are Use-of-Proceeds instruments, KPI-linked bonds can provide a link from the financing function with the overall sustainable goals of the business – another opportunity for treasury to take the lead. If the KPI's are material, correctly focused, and ambitious enough, their achievement should reduce risk, hence (all things being equal) could reduce the cost of capital – hence why some agreements include a coupon step-up for non-achievement of KPI's.

Case study 3

A commercial real estate company, committed to reaching Net Zero carbon by 2040, a target validated by SBTi chose to align its financing strategy with the firm's overarching sustainability principles by incorporating ESG KPI's in the revolving credit facility. The Sustainability goals agreed with the bank included:

ESG KPI #1: Reducing greenhouses gas emissions in line with the transition plan, validated by SBTi

ESG KPI #2: Ensuring real estate facilities occupied by the company obtain sustainability certifications

Whilst supporting ongoing strategic business operations, the facility provided financial incentives to the company in a form of a coupon discount on meeting the ESG KPIs, with the debt becoming cheaper if those targets are met.

This brings the conversation back to equity. We all know the impact that alignment with sustainability themes can potentially bring to a stock (and vice versa). There have been numerous studies on this but most recently, MSCI have come out with a study concluding that higher ESG rated companies saw a lower cost of capital, including future cost of capital, and the reverse being true for companies who were downgraded to lower ESG ratings.[2] In fact, all of the above elements of the balance sheet, not least long-term debt instruments, can build on commitment to a sustainable business, which (if positioned correctly) can reduce risk and hence potentially the cost of capital – this could effectively read across to the cost of equity.

For those more fortunate and less reliant on external capital, liquidity management presents an area where Treasurer's objectives can be directly aligned with the overall sustainability objectives of the business. By investing excess cash in deposits which are deployed towards environmental and social projects, treasurers can play their part and generate returns whilst supporting the company's sustainability objectives.

Summary

As we have seen in this brief snapshot of the state of sustainable finance, sustainability-related themes are very much alive and well, and even shaping the future economic, political, and social macro trends. While short-term dislocations may slow progress in the near-term, they are unlikely to change the longer-term direction of travel, and indeed may accelerate it. Aligning business strategies with these fundamental transitions offers the potential to provide lasting avenues of growth, as well as reducing risk. Aligning financing and strategy with these themes offers potential to align supply chains and business ecosystems with corporate goals, and may also have a positive impact on the cost of capital, as well as potentially opening up access to new pools of capital – with the opportunity for engaged and forward-looking treasury operations to be at the heart of these transitions.

1. https://www.whitehouse.gov/wp-content/uploads/2022/12/Inflation-Reduction-Act-Guidebook.pdf
2. https://esgnews.com/msci-study-finds-higher-esg-ratings-lower-cost-of-capital-for-companies/