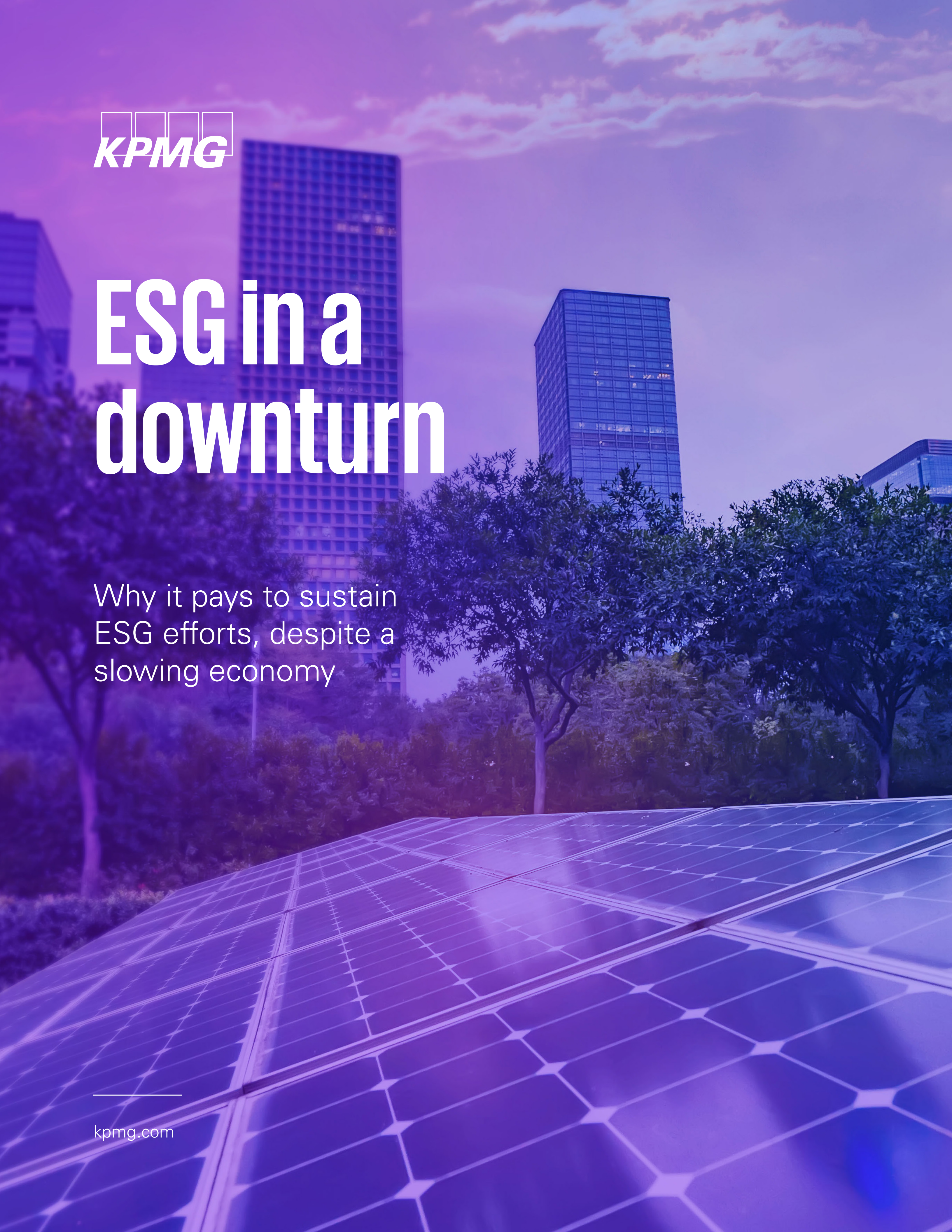

ESG in a downturn

Why it pays to sustain ESG efforts, despite a slowing economy

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Introduction

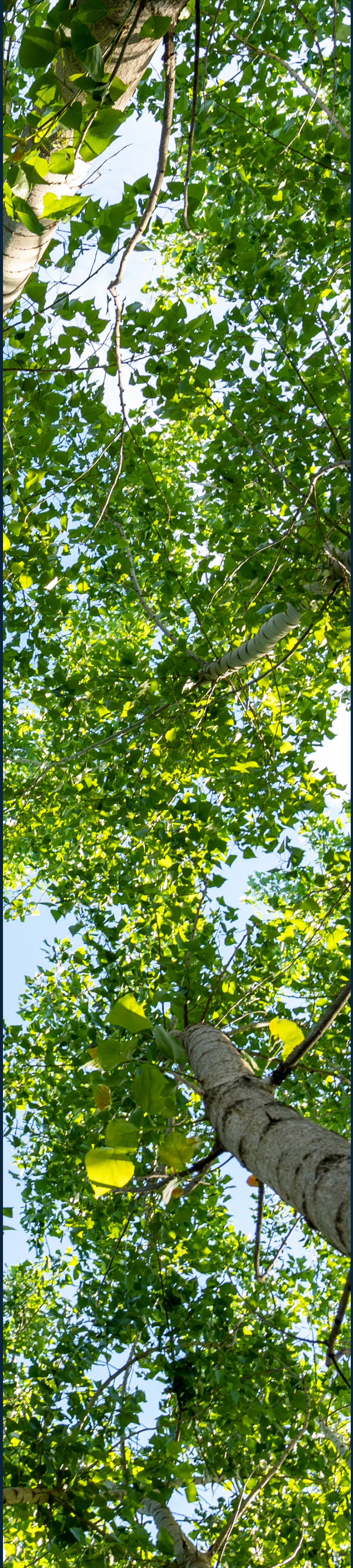
In the past few years, business leaders have faced a series of rapid-fire challenges—the pandemic, the Russia-Ukraine war, disrupted supply chains, talent shortages, and soaring inflation. At the same time, many companies have expanded their commitments to environmental, social, and governance (ESG) goals by working to reduce their carbon footprints, improving diversity in hiring, and other initiatives.

Now facing the prospect of a slowing global economy, some executives consider ESG an easy cost-cutting target. In KPMG's 2022 CEO Outlook survey, 59 percent of U.S. CEOs indicated they would consider reducing or pausing ESG programs to lower expenses in a downturn.[1]

While it is understandable that CEOs are looking for ways to preserve profits in 2023, we believe this is the wrong moment to lessen ESG efforts. Companies could face a loss of momentum on ESG initiatives, such as progress toward net zero, be less prepared to meet the new Securities and Exchange Commission (SEC) carbon reporting requirements, disrupt supply chain relationships, and receive lower ESG scores.

There could also be vital lost opportunities. The Inflation Reduction Act (IRA), for example, provides many extra incentives for investments in renewable energy. The combination of the IRA and the new SEC reporting requirements have already encouraged many companies to accelerate their decarbonization processes, realize more energy savings, implement subsidized clean energy projects, and create innovative supply chain solutions.

This paper looks at the risks of cutting back on ESG now, the benefits gained by maintaining ESG efforts, and ways companies can trim or postpone ESG costs.



[1] KPMG LLC, "KPMG 2022 U.S. CEO Outlook: Growth strategies for turbulent times," 2022.

What is at risk if companies scale back ESG

There have never been so many driving forces behind ESG or stronger convictions about its benefits. In the same 2022 survey where a majority of CEOs said they were likely to cut ESG programs, 70 percent also indicated that ESG is crucial to their company's growth and financial health (up from 37 percent in 2021).[2] CEOs recognize that a strong showing on ESG metrics directly affects company performance and yields crucial financial benefits, enhancing stock valuations, improving credit ratings, and reducing energy costs.

A series of legislative and regulatory actions have also added to the urgency behind ESG programs. The Infrastructure Investment and Jobs Act (IIJA), and the release of the Federal Sustainability Plan in 2021, include goals and incentives for building a resilient infrastructure and using it to address social issues. The SEC announced their highly anticipated proposed ESG reporting rules in May 2022, and the IRA passed in August. At the end of 2022, the U.S. government, the world's largest purchaser of goods and services, proposed the Federal Supplier Climate Risks and Resilience Rule, which would require eligible suppliers to report emissions data and climate-related risks.[3]

In 2021, 37% of U.S. CEOs said ESG is crucial to their company's growth and financial health.

In 2022, 70% of U.S. CEOs said ESG is crucial to their company's growth and financial health.

Risk to value chain relationships

Increasingly, companies must show solid performance on ESG issues, such as carbon emission reduction programs and ethical labor practices, to qualify as suppliers. Many large customers have already made significant commitments to reduce Scope 3 emissions (which include supply chain partners' emissions). This has spurred companies in their value chains—both public and private—to at least start evaluating their emissions so they can supply data, if needed.

The requirements of doing business with large global customers can extend far beyond responding to data requests. If they haven't already, many suppliers will now have to make significant investments in ESG or risk losing accounts that represent a considerable portion of their annual revenue.

For those suppliers with multiple customers with similar (or divergent) directives, it can be an initially daunting but necessary task. Those that choose not to act will likely see their contracts terminated and be ill equipped to compete for replacement customers when compliant suppliers are far more competitively positioned to win new business. If the proposed Federal Supplier rule goes into effect, all federal contractors with more than $7.5 million in annual contracts must measure and report on their Scope 1 and 2 emissions and Major federal suppliers—defined as those with more than $50 million in annual contracts—will have to report on their Scope 3 emissions to continue to do business with the U.S. government.[4]

[2] KPMG LLC, "KPMG 2022 U.S. CEO Outlook: Growth strategies for turbulent times," 2022.

[3] KPMG LLC, "Proposed rule to require Federal Contractor Disclosure of Greenhouse Gas Emissions: FAR Case 2021-015," 2022.

[4] KPMG LLC, "Proposed rule to require Federal Contractor Disclosure of Greenhouse Gas Emissions: FAR Case 2021-015," 2022.

Diminished competitive edge with consumers

In a 2022 KPMG global survey of 30,000 consumers, 86 percent said they believe everyone should adopt sustainable habits like reusing and recycling, 69 percent of consumers will pay more for products if the company has principles similar to their own, 76 percent think environmental conservation is more important than growing the economy, and 64 percent want visibility into the environmental impact of the products they buy.[5] In past years, we found that consumer ideals did not match their buying patterns. Most continued to purchase unsustainable products while claiming to be environmentally conscious. Now, consumers are increasingly purchasing sustainable goods and services from companies that reflect their values.

If consumers believe a company is turning away from ongoing ESG commitments, the company risks erosion of its brand promise and trust. Consumers have fewer dollars to spend during a downturn and will be more judicious about where to spend them. Loyalty lost due to greenwashing accusations might never be regained.

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Decreased valuations

A 2022 global ESG study found that 87 percent of investors now consider ESG companies with robust ESG commitments to be a critical part of their portfolio strategies.[6] Although ESG funds and the Standard & Poor's (S&P) 500 had a difficult year in 2022, over the long term, ESG funds have performed consistently well and ESG investments continue to be very attractive to investors and fund managers.[7] In the past year, investment firms have become increasingly knowledgeable about ESG, no longer relying on fund managers to guide them toward sustainable investments.[9]

Scaling back on ESG efforts could result in lower ESG scores for companies at a time when investors have a steady influx of competitors to consider. For companies that are beginning a merger, acquisition, or initial public offering (IPO), a lower valuation at that extremely critical time could have a significant impact.

Missed Inflation Reduction Act opportunities

There have long been tax credits and other financial incentives for investing in energy savings and renewables such as LED lighting or rooftop solar. Now the IRA has introduced a raft of additional incentives, including tax credits, to offset a company's own taxable income, or to offset a buyer's income when sold to third parties. Additionally, there are substantial IRA incentives for using American-made materials and employing U.S. apprentice workers.[10] Conversely, for companies that don't take advantage of the IRA, it could be one of their biggest missed financial opportunities.[11] Companies that fail to keep their ESG commitments could not only leave a lot of money on the table, but also lose out on a chance to change the direction of their business toward more sustainable processes.

[5] KPMG International, "Me, my life, my wallet: How to serve the sustainability conscious consumer," 2022.

[6] Capital Group, "ESG Global Study 2022," 2022.

[7] D. Korth, "Big ESG Funds Underperforming the S&P 500," NASDAQ, December 8, 2022.

[8] Capital Group, "ESG Global Study 2022," 2022.

[9] Capital Group, "ESG Global Study 2022," 2022.

[10] KPMG in Belgium, "Inflation Reduction Act changes the game for energy transformation," Plugged In: Power and Utilities Magazine, 2023.

[11] KPMG LLC, "Analysis and observations: Tax law changes in the "Inflation Reduction Act," August 16, 2022.

Loss of talent and knowledge

The combination of the ongoing talent shortage and nascent ESG career fields makes finding and keeping skilled ESG employees especially difficult. If companies reduce the size of their ESG team now, the loss of knowledge could impede progress on ESG targets and replacing that ESG expertise could take much longer than the length of the downturn.

Increasingly, more and more professionals feel strongly about joining companies that align with their values, especially related to ESG. In 2022, 74 percent of KPMG ESG survey respondents agreed that robust environmental sustainability practices improve employee productivity and reduce turnover.[12] Another 2022 study found that when employees align with their company's mission and values, 70 percent are more likely to recommend their employer as an exceptional place to work and develop a personal feeling of accomplishment from their professional efforts.

One-third (33 percent) are also less likely to be thinking about changing employers, while nearly half (46 percent) of employees whose values do not match their employers are thinking about leaving. More than half of employees (56 percent) say they would not even consider a job at a company if they disagreed with their values.[13] Considering how many employees will view a loss of ESG momentum is critical for companies to keep in mind, particularly as they are already facing a long-term talent shortage.

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Don't defer your DEI commitments

After making strong promises to increase their diversity commitments, companies cannot afford to dial back on diversity equity and inclusion (DEI) efforts. Investors are looking at progress on diversity when evaluating companies and those with a strong DEI program are more likely to fill jobs and keep talent in a tight labor market. In a recent survey, 54 percent of global companies reported that the inability to find and retain skilled employees is preventing them from achieving organizational goals.[14] Millennials and Gen Z are the two largest generational cohorts currently in the U.S. workforce. As customers, job applicants, problem solvers, and current and future business leaders, they expect authentic DEI commitments and care as deeply about social issues as they do about the environment. Finally, since women, people of color, people with disabilities, and those in the LGBTQ+ community collectively comprise the majority of the workforce, businesses need to continue to foster inclusive environments to attract this sought-after talent. The more diverse a business's future workforce is, the more likely it will cultivate creative, high-quality ideas and innovations to take them into the future.

The Alpha Generation (2010-2024) has not reached high school yet, but globally 2.5 million of them are born each week. Early studies predict they will not only be the most diverse generation to date, but they will also have more access to information and their consumer choices will consistently reflect their values. In fact, their brand influence already sways 81 percent of their parents' purchasing decisions.[15] Businesses that continue their upward DEI trajectory and remain committed to their ESG goals will be well-positioned to pique their interest and capture their coveted dollars.

Lost momentum in building ESG capabilities

With the advent of the SEC regulations, regulators will scrutinize dwindling progress on ESG, as will investors. Companies could lose the time and resources they have invested over the past few years. Pause ESG too long, cut too much, or delay any further and the lost momentum could allow competitors to speed ahead and create a gap that might be difficult, or impossible, to bridge in the future.

[12] KPMG LLC, ESG Survey, 2022.

[13] Qualtrics, "Employees who feel aligned with company values are more likely to stay," April 25, 2022.

[14] Caroline Castrillon, "Why U.S. Talent Shortages Are At A 10-Year High," Forbes, September 22, 2021.

[15] Mark McCrindle, "The future of sustainability for Gen Alpha," McCrindle, 2021.

What is to be gained by sustaining ESG efforts now

As companies explore opportunities in the IIJA and IRA while working to comply with the new rules and regulations rolling out, ESG momentum is picking up speed again.

Access to tax credits, bonus tax credits, and more tax credits

Businesses could begin to see higher tax bills in 2023. Some of the 2017 tax cuts, like bonus depreciation, are expiring or beginning to be phased out. The credits and incentives in the IRA could not only offset those losses, but also result in positive gains. The IRA allows companies to qualify for tax credits for meeting certain project conditions and increases the value or amount of those credits if they meet or exceed other conditions.

Companies are eligible for a tax credit of up to 30 percent of the installation costs of transitioning to solar power or other renewable energy sources. The IRA offers expanded clean energy tax credits for using renewable energy and clean fuels and implementing carbon capture projects. Businesses can qualify for bonus tax credits if they pay American workers a "prevailing wage" (a wage commensurate with other workers in similar roles in the same region of the U.S.) and participate in a registered apprenticeship program. This enables businesses to make low-risk investments in training American workers for well-paying jobs in green energy careers. Companies can also qualify for extra tax credits if they use a certain percentage of American-made materials.

Tax credits go up yet another 10 percent for clean energy projects in communities historically reliant on fossil fuel extraction and processing as their primary source of employment. This will create new green jobs and revitalize economic development in these communities as our economy transitions away from fossil fuels. For solar projects in federally subsidized affordable housing projects, tax credits increase by 20 percent, and there is another 10 percent bonus credit if the projects are in low-income communities.[16]

In the spring of 2023, the U.S. Treasury Department is launching and managing a program to disperse the first $10 billion to companies taking advantage of IRA opportunities. They will be accepting applications beginning May 31, 2023.[17]

Winning supply contracts

Customers that have already defined Scope 3 goals are raising the bar for the companies in their supply chain. Further, they are substantially increasing not just the risks for the noncompliant, but also the opportunities and rewards possible for those that embrace ESG.

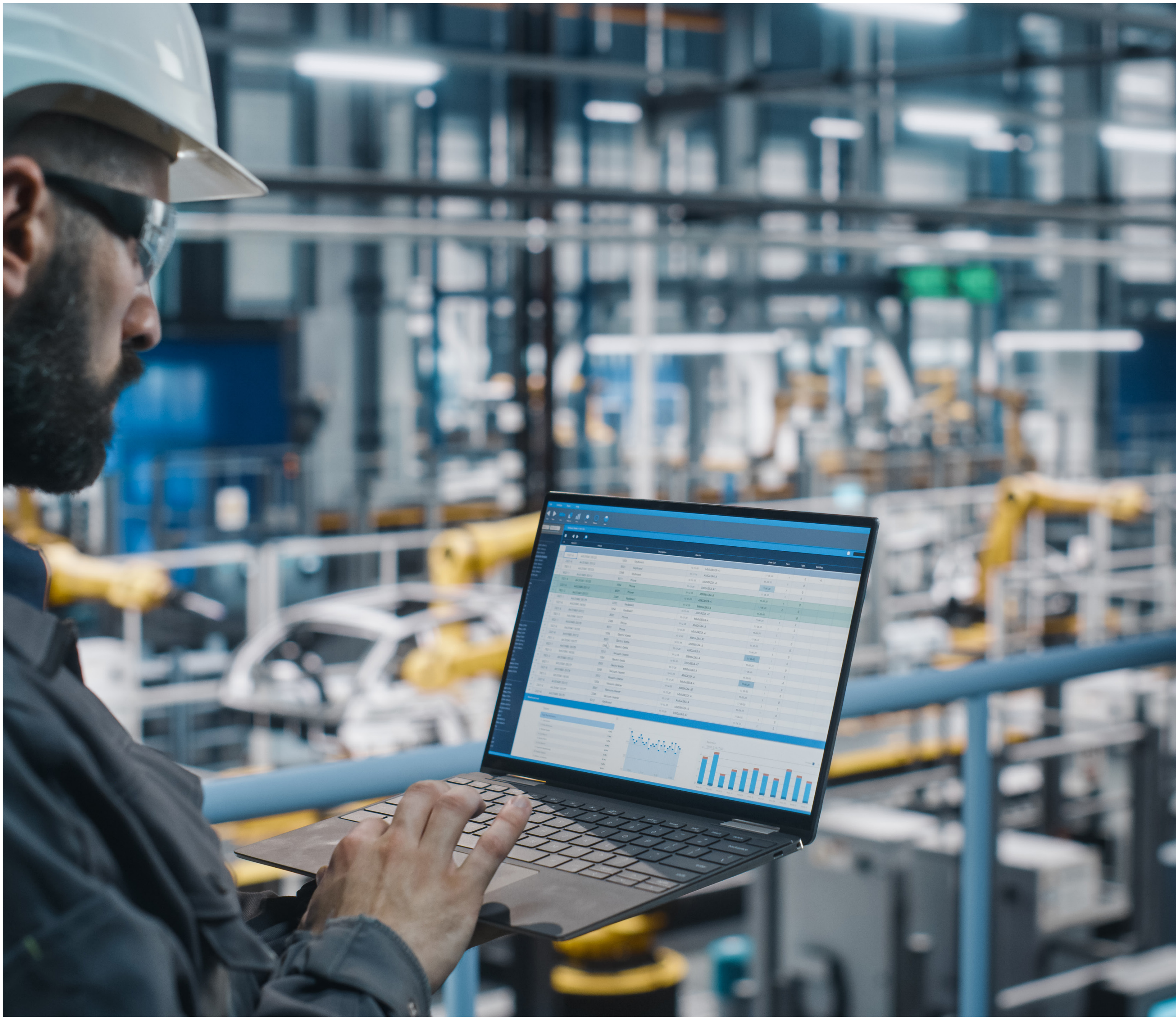
This dynamic is creating openings for suppliers to differentiate themselves and win new business by not only meeting customers' technical and commercial specifications, but also helping them meet their Scope 3 targets. Both customers and suppliers encountered many obstacles during past efforts to decarbonize their supply chains, but this renewed push, galvanized by legislation and regulations, is leading to more collaboration and progress.

Customers are asking suppliers for ESG data, such as life cycle assessments (LCA), to better understand their carbon footprints. At the same time, third-party suppliers are capitalizing on these requests to inspect their own value chain, and in turn, are asking fourth- and fifth-party suppliers for their emissions data, and so on. However, instead of simply pushing requirements downstream, we are seeing more partnerships between customers and suppliers working together to reduce emissions, meet ambitious goals, and become more competitive.

[16] The White House, "Inflation Reduction Act Guidebook," 2022.

[17] Richard Rubin, "New $10 Billion Program for Energy Subsidies Set for Rollout by Treasury Department," Wall Street Journal, February 13, 2023.

Customers are also benefiting by gaining access to supplies made with sustainable processes and materials, with the added value of helping suppliers meet their emission reduction targets. As they work to meet increasing customer sustainability requirements, suppliers not only have new opportunities to offset their investment costs via IRA incentives, but they are also realizing significant competitive advantages leading to more business, increased demand, and, in some circumstances, higher prices for their sustainable products. Customers are also motivating suppliers to join them on their sustainability journeys by offering innovative partnerships with perks like longer contracts, better contractual terms, more demand cycle visibility, and other creative enticements. Despite the economic downswing, suppliers that invest in decarbonization have solid growth options and the potential to forge lucrative, long-term business partnerships.



More access to capital

Companies that expand their efforts to increase energy efficiency, minimize their carbon footprint, and address a whole host of social issues from diversity to health equity to human rights, are likely to receive higher ESG ratings and scores. Higher scores communicate to investors that the company is a sound investment risk and open more paths to accessing capital as well as better interest rates.

Green bonds. Green bonds are issued specifically for ESG-friendly projects—such as installation of onsite renewable energy—and can provide a lower cost of capital than general purpose corporate bonds. Green bonds also refer to the category of green, social, and sustainability bonds. In 2021, green bond issuance reached almost $400 billion, or nearly six percent of global corporate bond issues, up from less than one percent in 2014.[18]

In 2022, when interest rates soared, the global bond market took a steep dive, with the U.S. market posting their worst year on record.[19] Despite this freefall, green bonds still totaled five percent of the global bond market.[20] Green bonds are expected to bounce back in 2023 as companies look for ways to fund their sustainable initiatives, reduce emissions, and continue to transition to renewable energy sources.

On average, green bonds currently offer an eight-basis-point advantage over corporate bonds.[21] Comcast recently issued a 10-year, $1 billion green bond, and invited investors to support their environmental efforts as they work toward their goal to be carbon neutral by 2035.[22]

Better credit rating and lower interest rates. A higher ESG rating usually translates into a better credit rating for companies. A solid ESG performance often demonstrates good governance, lower operational costs, and consistently strong financial returns, making it a good financial risk. Lower interest rates due to a better credit rating are a critical advantage any time, but when rates are rising or persistently high, lower rates are a pivotal asset.

More private equity interest in ESG due to IRA incentives. The IRA is changing the economics on private equity capital investments in renewable energy projects. Private equity firms are sitting on a lot of cash and looking to make investments that align with their goals. Before the IRA, tax incentives for renewables were not often enticing to private equity investment firms. The law is extending term incentives for domestic materials manufacturing, making financing more attractive to private equity investors and opening another avenue of possible funding during tight economic times.

More resilience. Investors are looking for businesses to be more resilient and actively work toward insulating themselves against future disruption. Resilience is a common factor among companies that weathered past recessions mostly unscathed.

Recent events have highlighted vulnerabilities related to supply chains, processes, physical and financial assets, and people.

Historically, risk management found known risks and formed relatively short-term contingency plans. No one could have predicted the severity, length, sweeping scope, and sheer number of catastrophes that have impacted businesses in the past few years. However, now it is time to apply those lessons learned.

Resilience is not built with temporary workarounds but fostered through a long-term strategic plan to increase a company's ability to adapt to unexpected disruptions and maintain or restore operations while protecting assets and people. What if a major climate event occurs during the downturn? Weather disasters do not care about economic slumps. A true risk management test in these times would be to determine if an organization could recover from such a one-two punch.

Accelerated decarbonization progress and increased energy savings

As companies take advantage of the array of new and existing renewable energy-related incentives, we expect to see substantial decarbonization progress in the next few years, with more adoption of low carbon fuels and renewable energy. Although this energy transition sometimes involves significant financial investment, the IRA offers the best deal to date, allowing companies to bank on a guaranteed partial return on their investment by the next tax year. Energy efficiency improvements have always been cost effective in the long term, but tough to afford upfront. Companies that invest now could offset their initial costs sooner while realizing a significant difference in both emissions and operating costs.

[18] John Caramichael and Andreas Rapp, "The Green Corporate Bond Issuance Premium," Board of Governors of the Federal Reserve System, June 2022.

[19] Greg Iacurci, "2022 was the worst-ever year for U.S. bonds. How to position your portfolio for 2023," CNBC, January 7, 2023.

[20] Sarah George, "Global green bond market faltered amid challenges of 2022, Climate Bonds Initiative confirms," edie, February 1, 2023.

[21] John Caramichael and Andreas Rapp, "The Green Corporate Bond Issuance Premium," Board of Governors of the Federal Reserve System, June 2022.

[22] BusinessWire, "Comcast Issues $1 Billion Green Bond to Fund Clean Energy, Infrastructure Projects," February 9, 2023.

What to do now

Leaders face many tough decisions about where to focus resources and budgets within the ESG realm during a downturn. Companies that focus on the most impactful programs and initiatives will be best positioned to continue their growth trajectory when the economy bounces back. As our business climate continues to change rapidly, our approach to ESG must change, too. It is time to look at the ESG journey through the lens of a downturn.

An evolving economic landscape requires an evolving ESG journey

Assess: Analyze your current state of ESG and prioritize critical areas

- Review material priorities and revisit the business cases for your ESG efforts. How are you performing on each? What progress have you made?
- Review risks to real estate assets, equipment, and employee safety from climate change and extreme weather events. Find the most vulnerable spots in your organization and its supply chain.

Design: Integrate current and future state into goals that drive strategy

- Make ESG part of your organization's DNA. Priorities will vary, but in most sectors, companies can set attainable carbon-reduction goals that have an immediate payoff. However, with the unique challenges and disruptions of the past few years and wider range of options and opportunities, other priorities and solutions might also rise to the top.
- Consider expanding your ESG governance structure. It is an effective way to strengthen ESG processes, get more people involved, and develop innovative, cost-effective ideas. Best of all, it requires minimal or no financial investment.

Operationalize: Actuate initiatives that align with ESG focal points

- Look for ways to get a dual benefit from ESG efforts. If a customer requires a life-cycle assessment and increased data transparency to do business, use the opportunity to develop strong processes to meet the reporting demands of all customers and regulations.
- Search for financial opportunities in the IRA and IIJA that align with your priorities around infrastructure modernization, renewable energy sourcing, and conservation. Determine if legislation incentives and credits can extend your ESG-allocated funds and strengthen the case for keeping ESG initiatives.
- Embed, as appropriate, ESG into business processes and roles.

Measure and report: Continuously review performance and plan for future ESG-related disclosures

- It is an opportune time to invest the time and money to implement solid ESG data controls and collection processes that can scale up in the future.
- Keep abreast of all new ESG reporting requirements (SEC, U.S. government, and international), ensure compliance and avoid financial or reputational penalties.

Conclusion

Less than a year ago, a majority of U.S. CEOs were weighing the value of their ESG initiatives and considering reallocating time and resources to other competing priorities. While ESG efforts have proven to be financially beneficial for companies over time, implementing and reporting on ESG is still a significant, company-wide effort, and the path forward has not always been clear.

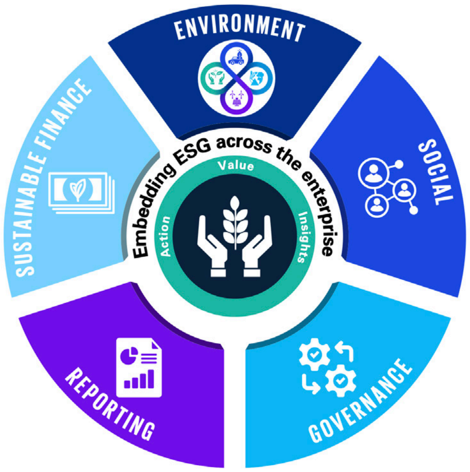
However, with the passage of the IIJA and IRA, recent and pending regulations, and relentless scrutiny of ESG momentum, the consequences of pausing ESG have become much riskier. In contrast, the benefits of prioritizing ESG have increased substantially. Business disruptions have become a constant during the past few years, but the business climate in 2023 so far shows promise for climate-related progress. With the wide range of possibilities now available, the scales tilt heavily in favor of continuing and expanding ESG initiatives.

How KPMG can help

KPMG meets clients where they are on their ESG journey and works with them from assessment to strategy to funding to reporting. We can help prepare materiality and maturity assessments, assess market positioning, and set ESG targets. We take a practical approach to our cost-benefit analysis to help prioritize ESG initiatives that enable our clients not only to meet their sustainability goals, but also to create financial value and a positive return on investment.

Whether it is setting a decarbonization strategy to meet net zero targets, create a more ethical supply chain, or build resilience, we have the capabilities to help operationalize ESG programs. We also advise our clients on ways to offset the cost of these investments through tax credits and incentives and favorable borrowing rates. We have extensively analyzed recent legislation and can recommend how to structure ESG initiatives to reap the maximum benefits. We have comprehensive experience in ESG and responsible investing strategy development and navigating emerging regulatory standards.

Our approach also incorporates a risk management strategy to meet increasing pressures from stakeholders and develop plans to minimize the impact of future climate change events on our clients' businesses. We assess current reporting capabilities, ensure material topics are aligned to reporting frameworks and standards, and develop reporting strategies to enhance the ESG narrative. KPMG helps clients achieve ESG value creation and do the right thing for the planet and its people.



This report is part of the KPMG ESG series covering topics under Environment, Social, Governance, ESG Reporting, and Sustainable Finance. Our ESG content series demonstrates that embedding ESG across the enterprise will turn ESG aspirations into action by leveraging insights from data to create value for your organization. This paper focuses on the linkage between all five topics and value creation. For more on these, visit the KPMG ESG website.

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Rob is responsible for building holistic solutions that pave a clear path to purpose-led, sustainable business to build resilience and drive profitable and measurable growth. These services and capabilities focus on key ESG themes, such as sustainable finance, climate change, and reporting, with a wide range of data-driven solutions, technology tools, and deep industry experience to navigate and simplify the complexities of every stage of our clients' ESG journey.

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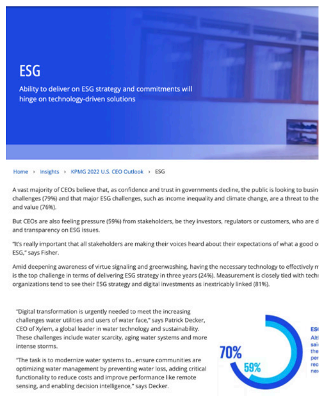

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