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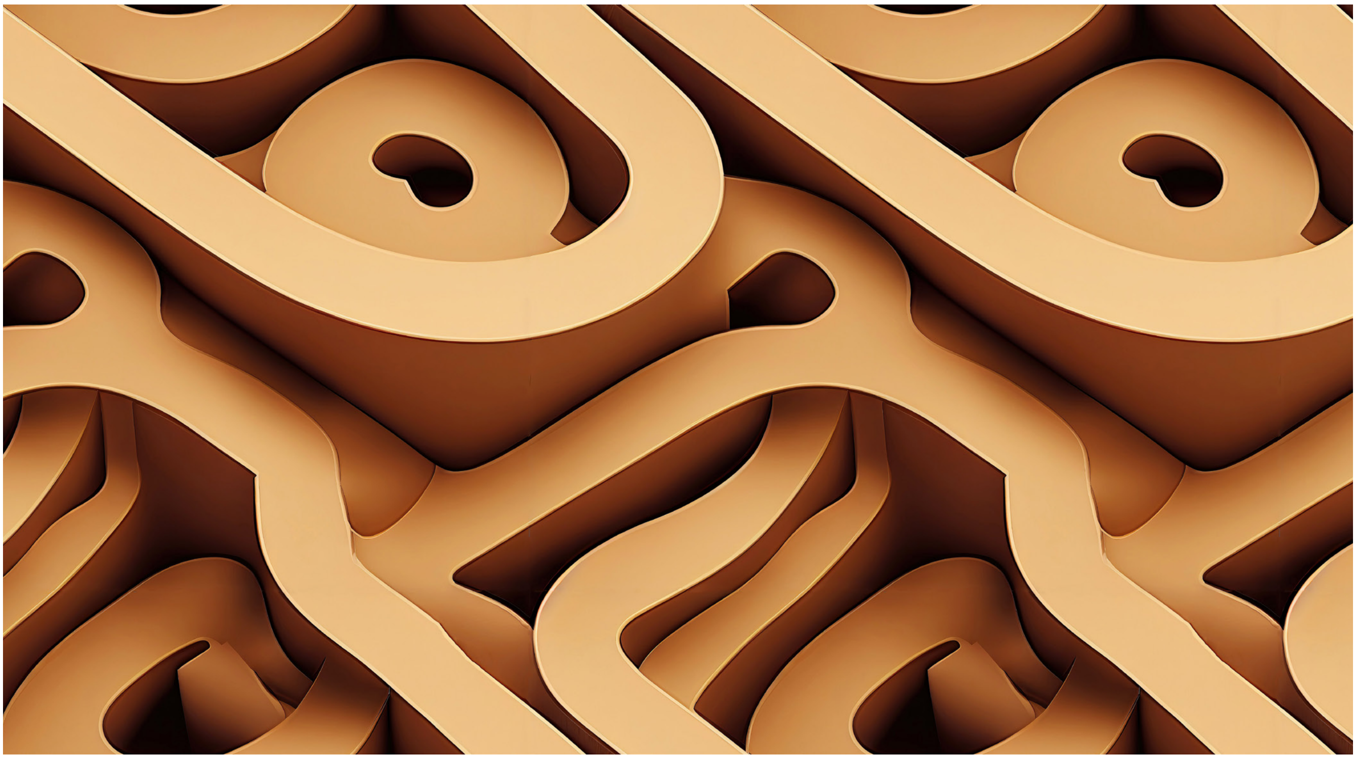
# STUCK IN THE MIDDLE?

## UNLOCKING ESG INVESTMENT IN AUSTRALIA 2024

# Climate first, but not only

## ESG evolves as 'S' closes in on 'E' according to new report from Herbert Smith Freehills



Australian companies are more profoundly aware of their corporate responsibilities and reputation than ever before. Environmental, social and governance (ESG) considerations continue to increase in importance as part of the equation when making investment decisions. In part, this reflects increased expectations from customers, employees and shareholders, but also the rising tide of domestic and international regulation, and other external vectors.

Embracing ESG in a measured, practical and authentic way can help businesses tap into aligned investors, elevate their employee value proposition and reposition brands.

There is an appetite among many Australian companies to be ambitious in setting their strategy and targets around material ESG issues, but it is tempered by the complexity of the regulatory landscape and the risks (real and perceived) associated with aiming too high and falling short. Failure to properly take account of ESG-related risks, or misrepresenting a company's ESG credentials, can cause reputational damage and leave companies and boards vulnerable to adverse action and, in some cases, litigation.

In early 2024, we conducted our second major ESG survey to gauge how businesses are grappling with the rapidly changing ESG landscape. We wanted to explore the areas of focus in an area sometimes perceived as amorphous, as well as to re-test business sentiment following years of geopolitical, economic and climate-related disruption.

Our survey this year coincided with a period of substantial ESG-related regulatory shifts in Australia. Climate-related concerns still top the issues that companies identify as being the subject of ESG reviews by a significant margin, however it is notable that 'S' issues have gained prominence. Legislative reforms addressing sexual harassment and psychological safety in the workplace have been introduced, alongside mandatory gender pay gap reporting.

The ASX's Corporate Governance Principles and Recommendations also necessitate certain 'S' disclosures, with further revisions concerning stakeholder interests and diversity objectives under consultation.

Beyond the workplace, the *Modern Slavery Act 2018*, post-review, received 30 reform suggestions, including the introduction of due diligence requirements. Conversations around Aboriginal and cultural heritage, social licence, and the value of a just transition are also intensifying.

It's a much more complex world in 2024 and that's what we wanted to draw out, says Herbert Smith Freehills Environment, Planning and Communities Partner Melanie Debenham. "That is not to say that 'E' issues – and particularly climate change – have been left behind". Notably, a Bill to implement mandatory climate-related financial disclosure was introduced in the Australian Parliament in March 2024. While the current focus of this legislation is on climate reporting, other topics under the environmental sustainability umbrella are not far away. This aligns with the recent broader reform agenda for key environmental laws in Australia.

"There's been a huge amount of regulation across the board. The law is requiring companies to do more and to put in place the frameworks for managing a broad range of environmental and social issues," says Herbert Smith Freehills Partner and ESG Lead, Australia Timothy Stutt.

The 'G' is the common thread that weaves through all the 'E' and 'S' issues, adds Herbert Smith Freehills Partner Carolyn Pugsley, who specialises in corporate governance and board advisory. "Boards and management teams are looking for guidance not just on the content of new regulation, but on how to bring it to life within their organisations. Issues of accountability, resourcing, information flows and integration of ESG issues into organisational decision-making are cropping up across all the 'hot button' areas including climate change, human rights and cyber."

This report highlights the main findings from our survey of 161 business leaders, including C-suite executives, board directors, company secretaries, general counsel and senior management.
It combines survey data from business leaders with insights from our ESG lawyers, to give shape to the challenges and opportunities Australian businesses face amidst escalating ESG regulations and stakeholder expectations. The landscape is constantly shifting, and while businesses have been grappling with 'E' and climate change issues for some time now, the 'S' in ESG is increasingly becoming a focus and, with it, evolving ways of understanding and managing risk, opportunity and impact."

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**TIMOTHY STUTT, PARTNER AND ESG LEAD, AUSTRALIA**

## About Us

Herbert Smith Freehills has a longstanding reputation as thought leaders across the evolving ESG domains. We advise across the full breath of ESG considerations, from target-setting, to alignment with voluntary or soft law frameworks and standards, as well as the myriad of mandatory regulatory regimes in Australia, governance and oversight and reporting lines, market practice, managing reputational concerns and maintenance of social licence, responding to stakeholder expectations, and enforcement and litigation.

# Our survey results at a glance

## The Top 3 issues

1. Climate change and carbon transition
2. Human rights including modern slavery
3. Privacy, cyber and data governance

**72%**

said **investment criteria/ diligence processes** expressly included ESG considerations

**79%**

believe **'S' factors are an opportunity for their business**, with the top opportunities cited:

1. Improving employee value proposition
2. Customer/brand loyalty
3. Differentiation from competitors

**70%**

said 'S' issues and opportunities **understood and prioritised,** but only

**1/4** **have integrated them** into their activities

**62%**

said their organisation is **publicly reporting on 'S' targets and performance**

**71%**

said **regulations** are influencing **sourcing and supplier management**

**80%**

said the **CEO/Exec/Board are now accountable** for 'S' issues

ONLY **56%**

have a **human rights risk management** system in place

**65%**

had **net zero commitments**, but just

**2/3**

had **integrated** them into their activities

**34%**

said their net zero commitments **don't reflect scope 3** emissions,

**27%**

have **no net zero** commitments

**2/3**

don't know how much **additional ESG aligned investment** their organisation would need to meet net zero commitments

**54%**

**consider Australia in the 'late majority'** in progressing toward ESG ambitions, but

**32%**

**consider their organisation in the 'early majority'**

**25%**

say **project approval lengths are a barrier** to ESG investment

## Top 4 Barriers to investment

1. Lack of stable financial return (45%)
2. Lack of proven technologies (41%)
3. Government policy (30%)
4. Access to capital (25%)

# What lies ahead for ESG?

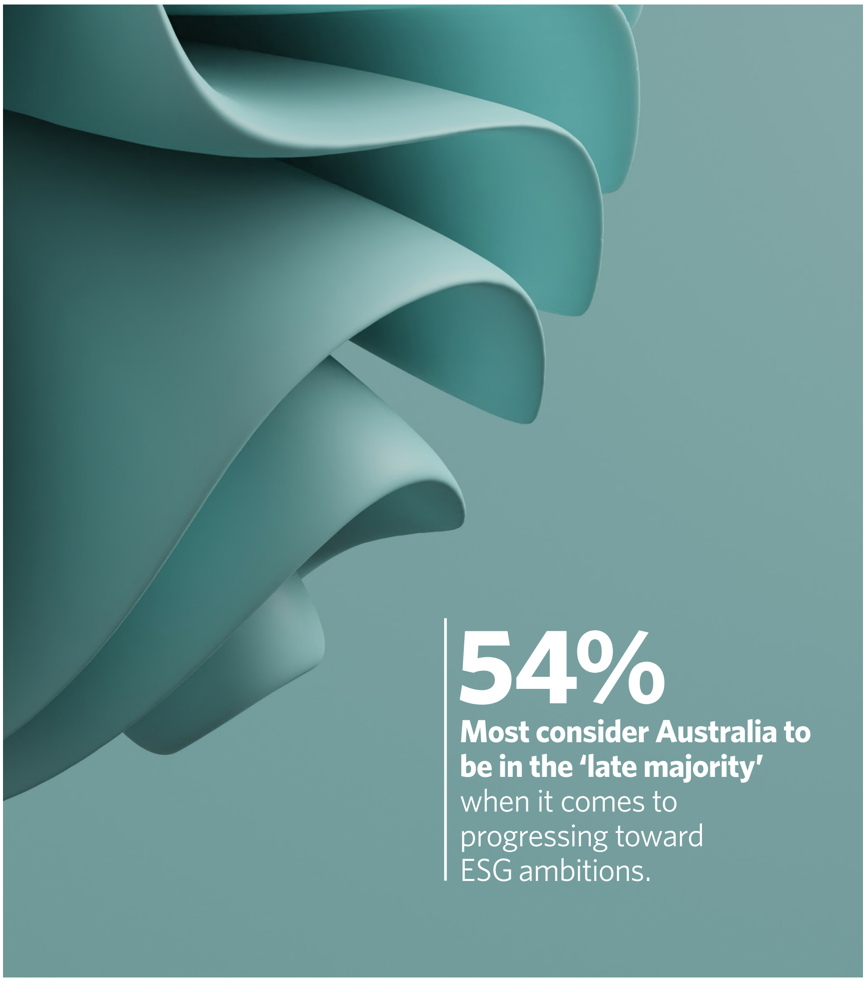
## Rising with the tide

While there has been a wide range of new laws and regulation introduced in the past 12 months, our survey shows a clear sentiment that Australia remains behind the global frontrunners in regulating and practicing ESG. Across the globe we are seeing regions pushing forward at different paces. This presents a particular challenge for Australian corporations with global footprints, both to understand the pace of change required of them, and to reconcile a multitude of overlapping regulation.

Even companies with purely domestic operations are likely to be swept along with the rising global tide, for example if they are seeking capital from offshore, or exporting products to customers based in Europe, which is leading the charge on higher ESG standards.

Antony Crockett, Herbert Smith Freehills Partner and ESG Lead, Asia whose specialisations include business and human rights law, notes that some Australian businesses will need to develop ESG systems and management approaches in response to more stringent regulation in other jurisdictions. This has implications both for local firms looking to join global value chains, as well as those seeking interest from overseas investors.

For example, a European company considering investing in Australia is likely to perform significant human rights due diligence of its local counterpart. This incudes requesting information about policies and processes to avoid adverse human rights impacts. “When you receive a due diligence questionnaire, you want to be saying that you have all of the right things in place,” Crockett says.




“Some Australian businesses will need to develop ESG systems and management approaches in response to more stringent regulation in other jurisdictions.“

**ANTONY CROCKETT, PARTNER**

**13%**
say Australia is an **‘early adopter’**

**20%**
**consider Australia a ‘laggard’** and **0%** consider Australia an **‘innovator’**.

## Realism about ongoing barriers

Incorporating ESG risks and opportunities in deciding where to allocate resources has become business-as-usual in Australia. A total of 79% of respondents say ESG is important for new strategic initiatives, 74% for operational decisions, 58% for capex expenditure and 51% for M&A and broader investments.

Nonetheless, our survey also uncovers realism about ongoing barriers. Lack of stable financial return, proven technologies and access to capital are all seen to inhibit greater investment. Where regulatory uncertainty was seen back in 2022 as the primary barrier to entry and a uniquely Australian issue, the main barrier now is financial. "You are being driven to an extent because the regulation requires you to, but other than doing compliance, economic return is front and centre for most organisations," Debenham says.

Longer time horizons and challenges in quantifying impact and return means that many organisations are evolving the ways they justify, articulate and measure the benefit of their ESG investment activity. Government partnership and support have a role to play. For example, Herbert Smith Freehills Partner Lucy McCullagh describes how Commonwealth grants, loans and availability programs are helping make the capital structure attractive for investors and super funds that want to invest in social and affordable housing.

McCullagh, who acts for banks, financiers and investors, believes the gradual evolution of local regulatory requirements – particularly around mandatory sustainability reporting – will give greater confidence to the investor market. So will the development of common environmental taxonomies, likely resulting in a rise in sustainable investments, businesses, products and outcomes. "Banks look at a borrower's financial reports. And once they become mandatory, sustainability reports will also form part of the investment analysis," she says.

Above all, where ESG is concerned, the market in Australia is interested in moving from promises and platitudes to real results. As one survey participant observed, "The collective expectation of shareholders, customers, employees and regulators is 'show me, don't just tell me'. It all may look great in the company's annual report, but what have you actually done, how is it tracking and what will it look like in three years' time? People want to know that your focus on ESG is actually making a difference."

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**LUCY MCCULLAGH, PARTNER**

**72%**

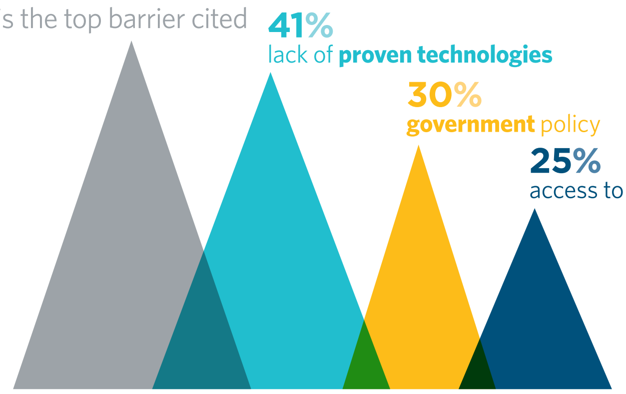
of respondents say their business investment criteria or due diligence **expressly include ESG considerations**

**66%**

however 66% say **barriers remain to ESG-aligned investment**

**45%**

**Lack of stable financial return** is the top barrier cited



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