Short-and Medium-term ESG Liabilities for Medium-sized Companies

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Everybody is talking about Environmental, Social and Governance (ESG) nowadays, however, it's not immediately apparent what the real implications are for medium-sized companies. Gábor Szendrői, Managing Partner, and Judit Pókos, Organizational Development Manager, at Concorde MB Partners – IMAP Hungary took a deep dive into the current regulations, as well as conducted a series of interviews with SPAR Hungary, a large food retailer and MOL, an international oil group, along with the Hungarian National Bank, Hungarian Stock Exchange and other several key players in the Hungarian economy, in order to better understand what ESG really means in terms of obligations and repercussions for medium-sized companies. They share their findings on the indirect, yet highly important aspects of ESG regulations with Creating Value.

Following our research, it turns out that while ESG may not directly impose obligations on medium-sized companies for the time being, because they come into contact with stakeholders who are subject to strict reporting regulations, indirectly ESG will in fact have ramifications and impose occasional obligations on medium-sized companies, as well as their customers, bankers, and subsidies.

European Union (EU) Targets & ESG Reporting

One milestone in the fight against climate change was the acceptance of the Paris Climate Convention in 2015, which was signed by 195 countries. The objectives of the Convention are to keep the global average temperature increase below 2°C compared to pre-industrialization levels, to achieve adaptability and low emissions, and to provide the necessary financial resources. In conjunction with this, separate goals have been set for the EU. There, the goal is to reduce greenhouse gas emissions by 55% by 2030, and to achieve climate neutrality by 2050. To achieve these goals, a considerable change is required, which will also significantly affect how companies operate. In some sectors this means specific numerical intervention (think of the carbon quotas of the largest emitters or standards for fleet-based emissions for car manufacturers), however, from a company's point of view, this takes the form of sustainability and ESG reporting, as well as compliance criteria. ESG's three pillars aim to identify the non-financial risks inherent in companies and present opportunities for development. More and more ESG reporting obligations are emerging, and investors and financiers are already applying filters in their decisions. Therefore, it is important for companies to prepare for change to avoid potential problems ahead.

Current EU Regulation

The most important element of the EU's ESG regulation is related to corporate reporting. Currently, the EU requirement for non-financial reporting is the Non-Financial Reporting Directive (NFRD); in each EU Member State, accounting laws govern the publication of sustainability reports. These are only mandatory for companies with public interests and more than 500 employees. At an EU level, a total of approximately 11,000 companies are currently affected, including all banks and insurance companies.

The mandatory report must briefly present the company's environmental, social, human rights and anti-corruption policies and activities. Of course, there are companies, large and SMEs, that provide much more detailed reports on their environmental impact and actions to reduce it. The number and format of the so-called sustainability reports are also numerous, but there are no mandatory requirements for their content yet. Many companies are following non-mandatory but standardized frameworks, e.g., Global Reporting Initiative (GRI), as these are widely recognized by the markets with the intention and expectation that uniform regulation in this area will emerge over time.

Change in Regulation - Taxonomy Decree & Corporate Sustainability Reporting Directive (CSRD)

There is a lot of talk about the EU's Taxonomy Regulation. This regulation (and its technical details, six in total, two of which are currently in force) is set out in a thematic breakdown in line with EU climate and other environmental targets, along with which economical activities can be considered compatible with environmentally sustainable goals (more simply: green activities) and which can't. Taxonomy Regulation and its technical ancillary regulations are not simple legislation intended for everyday use, but worth knowing for those who are affected or have an interest in the subject, as they are the basis for all EU sustainable policy. The EU Taxonomy Regulation provides for a much more detailed reporting obligation than at present but does not extend the reporting obligation to further companies yet. Those currently affected already face related tasks this year and from 2023 onwards must present what percentage of net sales, OPEX and CAPEX comes from sustainable activities and demonstrate how their activities support the EU's sustainability goals. In addition, the Taxonomy Regulation will require financial institutions to disclose the proportion of their green loans and to draw up a detailed plan for greening their loan portfolios. As green lending will increasingly be a monitored performance indicator (KPI) therefore, increasingly stringent sustainability conditions for bank loans are expected.

The Corporate Sustainability Reporting Directive (CSRD), the new European Commission proposal issued last year but still under negotiation, makes an even bigger change, introducing yet more detailed reporting requirements according to uniform EU standards, and greatly expands the number of companies concerned by reporting obligations. All companies listed on a regulated market (except micro-enterprises) and all large companies identified with a much broader definition[1] will be required to prepare a report. Hence, the European Commission estimates that this will affect almost 50,000 EU companies. In addition to the standards for large companies, separate, proportionate (presently voluntary) standards will be developed for SMEs, which will be adapted to the capacities and resources of such companies. According to the original plans, EU Member states should implement the directives by December 2022 and should ensure that they are applied from January 2023 (i.e., from the 2024 report onwards). However, some delays can be expected due to its very quick introduction.

[1] At least two are exceeded on the balance sheet data (DIRECTIVE 2013/34 / EU): Balance sheet total: EUR 20,000,000, Net sales: EUR 40,000,000, Average number of employees: 250

Bad news for SMEs as new regulations will affect all companies in some indirect form

Report Requirements Based on the CSRD

Companies covered by the CSRD must publish a standardized sustainability report along with the financial statements issued starting from 2024. The impact of the company's operations on the environment must be presented in accordance with: international standards; the impacts of climate change; the resulting risks; and the steps taken to address them. The exact standards are being developed by the European Financial Reporting Advisory Group (EFRAG) and are expected to be available in October 2022. An audit of the standardized sustainability report will also be mandatory. These companies will henceforth be covered by the Taxonomy Regulation as well. As a consequence, ESG reporting obligations will increase significantly and more compliance criteria can be requested from the companies.

Impact on Companies not yet Required to Report

So, based on the above, can medium-sized companies be reassured that they have nothing to do? Since large companies do not operate in a vacuum, but in cooperation with medium-sized companies, the bad news is the answer is no. Indeed, although regulation will not yet be mandatory for a significant proportion of SMEs, experts say the new regulation will affect all companies in some indirect form, including through the following channels:

- **Value chain:** Larger companies will have expectations of their suppliers
- **Banking system:** Banks apply sustainability filters when granting loans and prefer green investments, they can also offer more favourable conditions to those who comply with the new regulations
- **Investors:** Sustainability will become increasingly important to investors who will prefer sustainable companies
- **Financing through the Stock Exchange:** A sustainability report is required for all companies listed on the stock exchanges. Also, in the case of bond issuance, ESG considerations are becoming increasingly important
- **Government/ EU grants:** ESG aspects may appear in the application scoring and sustainable investments will be preferred
- **Consumer and employee pressure:** With the emergence of younger generations of consumers and employees, environmental awareness, i.e., the search for ESG qualities, is increasing

The most significant impact is expected to be in the case of value chains, as sustainability becomes increasingly important and emphasized in large companies. It already has been in many places, but the new regulations unify the thinking and attitudes of large companies. Large companies want to see their environmental and social impact in more detail, for example, not just their direct greenhouse gas emissions (scope 1) but their indirect emissions too (scope 2 and 3) and a significant portion of this is accounted for by their suppliers. Accordingly, SMEs supplying large companies will also need ESG information on their operations. Sooner or later, value chain screening will be mandatory, but even without an obligation, there will be a need for them. A draft EU directive on Corporate Sustainability Due Diligence (CSDD) already exists for ESG due diligence of suppliers. Thus, there is a growing demand from large companies for ESG data to be provided for midcaps, as well as for suppliers to become sustainable.

Companies not adequately prepared for new ESG regulations will clearly be at a disadvantage

Practical Implications in the Value Chain

As the need for more detailed reporting or stricter compliance by large companies grows, so must SMEs adapt. To get a better understanding of this, we talked to two large Hungarian companies (SPAR Hungary, a large food retailer and MOL, an international oil Group) to find out how ESG principles are applied in their case. At SPAR, for the past five years, the issue has been taken very seriously at the request of the Austrian parent company. They now have a dedicated team and a detailed ESG strategy, and the reduction of plastic packaging and support of the circular economy has become very important for them. No specific ESG criteria have yet been formulated for their suppliers, however, they have regulations on packaging and other ESG-related requirements. Moreover, they invest into raising SME's awareness and support their upgrade in this sense through training programs and recommendations.

MOL has been producing sustainability reports for a long time, and its situation is special in that its operation is considered as a non-environmentally friendly industry. The experts interviewed explained that this is why they need to pay special attention to ESG and sustainability. Part of their everyday work is to consider and develop these aspects, among other things, and their goals include decarbonisation, ending the flaring of waste gases, and using more hydrogen-based solutions. In addition, they want to participate in the development of the circular economy in Hungary, with the development of waste processing and related industries. Furthermore, in accordance with the group's business strategy, MOL 2030, they launched a responsible procurement program. As part of this, potential suppliers for example, must fill in a sustainability questionnaire asking them about CO_2 emissions.

The results of the questionnaire will be taken into account in the selection process and there will be a sustainability clause in the supplier contracts. The list of expectations for suppliers is expected to expand in the future. Based on this, SMEs emerging as suppliers must also be prepared for sustainability if they do not want to be at a disadvantage.

Impact of ESG Requirements in Bank Financing

Banks will play a significant role in the sustainable transformation of the economy, as they provide the financial resources needed for investment. Under the Taxonomy Regulation, banks are required to disclose in detail what polluting and sustainable activities they are financing. In addition, for risk management reasons, funding for polluting activities should be gradually reduced. Therefore, companies requiring funding need to be able to demonstrate their environmental and ESG impact for evaluation at some level. Failing this, they may lose their loans.

ESG Regulation Considerations for Investors

ESG considerations are becoming increasingly important to investors. Investment funds and fund managers are required to demonstrate compliance with ESG principles in their fund raising and in the

use of funds. Shareholders can "vote" on the ESG compatibility of certain investments by buying certain shares or by explicitly avoiding or selling other shares.

As transaction advisors, we want to comply with this by highlighting ESG in the Information Memoranda (IM) we prepare for the sale of a company, or if we support investors on the buy side, we also bring the issue to their attention.

Ramifications of ESG Requirements in Stock Market Financing

As per the above, companies that want to use some form of stock exchange financing are strongly affected by the regulation. In the case of a planned share issue, the strict reporting requirements already described must be met. In the case of entering a less regulated market, the reporting obligations are not yet complete, but it is still worth preparing for them. The issuance of green bonds is also becoming more and more popular, for which various international standards already need to be met and the sustainable use of the resource must be reported in detail.

How ESG Requirements Impact Government or EU Subsidies for Medium-sized Enterprises

Experts and participants of the tenders have found that more and more aspects of sustainability are emerging in various government or EU tenders. In addition, more and more grant tenders are expected to be issued specifically related to sustainability, including for example energy efficiency. At the same time, the support framework is being transformed on an activity basis: it is becoming increasingly difficult or completely impossible to get grants for polluting activities.

Consumer and Employee Attitudes to ESG Requirements

A trend is emerging, both concerning sustainability and environmental awareness, among customers and employees. For the younger generations, this may be even more significant. As large companies are required to do ESG-related tasks anyway, they also try to advertise from a customer and HR marketing perspective that they are already addressing the issue. However, medium-sized companies must not be left behind in this competition, as they may suffer a long-term disadvantage. Even if they do less on the subject for now, it is important to communicate the requirements so that those involved are aware of them.

Our Advice for Medium-sized Companies

As can be seen from the above analysis, although medium-sized companies will not directly face ESG obligations for some time, it is important to prepare and be ready. Reducing the burden on the environment and improving their own environment and economic ecosystem is a very complex task, for which they will have no time to prepare when finally required by law. If they can position themselves well on this issue, it might even give them a competitive advantage in front of their customers and their financing bank. At the same time, the future is not so far away, when it will be a real disadvantage for those not dealing with sustainability and ESG.

It is worth considering what steps mid-market companies can take to make ESG a fundamental part of their corporate strategy and, as a first practical step, they could start with the help of experts to assess their company's environmental impact and identify their real greenhouse gas (GHG) emissions. ■