

# CULTIVATING ESG IN CANNABIS: CAN ESG HELP GROW INSTITUTIONAL INVESTMENT?



*As cannabis companies grow, they will need to attract the large pools of patient capital offered by institutional investors who are increasingly taking ESG into consideration in investment decision-making. What ESG risks and opportunities does the industry face, and how can company boards advance ESG?*

## The cannabis industry is emerging at a time when ESG is becoming the norm for institutional investors

Cannabis prohibition ended just as institutional investors considering environmental, social and governance (ESG) factors in investment decision-making became the majority in Canada.<sup>1</sup> Investor interest in ESG is driven by evidence that companies managing material ESG issues effectively have lower risk, lower cost of capital, better financial performance across a range of operational measures and better share price performance. It is also being driven by increasing client demand and regulatory ESG initiatives around the world.

In the year since prohibition was lifted in Canada, investors in the cannabis industry have experienced significant share price volatility. Many institutional investors remain hesitant to invest in cannabis companies, citing a range of concerns that include corporate governance approaches and environmental and social risks. Those that have invested may seek to address ESG issues through proxy voting and engagement with investee companies.

## Cannabis is exposed to a wide range of ESG factors at the specific company level and as an industry

Material ESG risks and opportunities facing cannabis companies fall into two broad categories: those related to a company's own strategy and operations, and industry-wide considerations.

To build trust within the capital markets for an emerging industry, it is critical for cannabis companies to demonstrate strong corporate governance by addressing board quality issues such as director independence, expertise and diversity. The board must also establish systems for effective oversight of material risks and opportunities, including material environmental and social factors. As companies graduate to senior exchanges, their governance practices will be compared to those of long-established public companies in other industries, not just other cannabis companies. Institutional investors have long recognized the importance of good corporate governance and may apply "bright line" tests when deciding whether to invest and in voting their shares once invested.

Cannabis companies are also exposed to a wide scope of material environmental and social factors. In terms of environmental risk, like other companies across industries, they need to respond to investors' growing attention to climate-related risk and opportunity as a systemic financial stability issue. They also need to think about their products' and/or operations' impact on the environment in the face of changing consumer preferences and carbon pricing (e.g. plastic packaging and energy management).

In terms of social risk, effective human capital management and building a culture that supports workplace diversity and fosters regulatory compliance are universally material ESG concerns that present a special challenge for fast-growing companies in a newly-regulated industry.

<sup>1</sup> For more information about ESG, see our brief "A Material Difference: The Distinction Between CSR and ESG" [www.esglobaladvisors.com/insights](http://www.esglobaladvisors.com/insights)

Additionally, at various stages of the cannabis value chain, companies are undertaking a diverse set of activities resembling those of other established industries, such as agriculture, pharma, and alcohol and tobacco, and consequently they face similar environmental and social risks. For example, cannabis companies and regulatory bodies have been grappling with product quality and safety issues relating to the use of pesticides. In Canada, class action lawsuits have been launched due to exposure to contaminated products, and increased testing for illegal pesticides and banned chemicals has been introduced.

The cannabis industry as a whole faces reputational and regulatory risk arising from intense scrutiny of its products and their potential impact on society. There are continuing uncertainties about the therapeutic benefits and potential negative impacts of products, a consequence of lagging research into cannabis under prohibition. Public perception will play an important role in shaping the regulatory environment, which will determine the future success and growth of the industry. Sound ESG risk management will be important in controlling the industry's narrative and preserving its social license to operate.

## ESG oversight in cannabis: questions for board directors

The board of directors plays a key role in ensuring that their company meets emerging capital markets expectations on ESG. The board has responsibility for oversight of material risks and strategic opportunities, including environmental and social factors.

In beginning to explore cannabis ESG, directors may wish to consider the following questions:

- How do the company's basic governance practices compare with the best practice expectations of institutional investors?
- Have the company's material environmental and social risks and opportunities been explored and identified? Have they been integrated to the risk management and strategy processes?
- Does the board have the right structures, expertise and advice in place to provide oversight for material ESG factors?
- What metrics and targets will need to be put in place to track ESG performance?
- Is the company disclosing how material ESG factors are identified, monitored and overseen by the board and/or management? Is it providing timely, decision-useful information that meets the expectations of institutional investors?
- Are the board and management prepared to engage in dialogue with institutional investors on ESG factors?

A thoughtful approach to ESG, communicated through robust disclosure and effective dialogue, may help companies attract the institutional investors they will need to grow, while minimizing shareholder dissent once they have invested.

## ABOUT ESG GLOBAL ADVISORS

ESG Global Advisors bridges the gap between companies and investors on environmental, social and governance (ESG) factors. A multi-disciplinary team with significant investor and corporate experience, we are uniquely positioned to offer expert advice to companies and investors on material ESG factors that drive long-term value, including climate change. We assist companies and boards of directors with:

- Understanding how investors integrate ESG factors into investment processes and stewardship
- Developing strategies for managing material ESG factors to generate superior long-term value
- Developing approaches to ESG-related disclosure and engagement with shareholders

Learn more at [www.esglobaladvisors.com](http://www.esglobaladvisors.com).



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