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ADOPTION AND IMPACT: The rise of ESG initiatives in the middle market

OPPORTUNITY ABOUNDS FOR FIRMS THAT CAN ADAPT TO SHIFTING PRIORITIES

THE GROWING IMPORTANCE of environmental, social and governance issues has reached an inflection point in the middle market, even in the face of the dramatic economic fluctuations of the last year and a half, proprietary research from RSM US LLP shows. Stakeholders’ increased focus on ESG will continue to present immense business opportunities for organizations that position themselves to adapt to these shifting priorities.
Familiarity among middle market executives with the use of ESG criteria to evaluate the performance of businesses, organizations and/or investments rose significantly in the third quarter of 2021 compared to the fourth quarter in 2019, according to the third-quarter RSM US Middle Market Business Index survey, which polled executives from July 8 through July 26 on ESG- and climate change–related questions. In the last part of 2019, 39% of executives were very familiar or somewhat familiar with using ESG criteria to evaluate performance, and in Q3 2021, that figure was 69%. The 30–percentage-point increase over that time is “just a dramatic change and indicative of how much interest there is today for ESG within the middle market,” says Anthony DeCandido, a partner at RSM US and a lead advisor in the firm’s ESG consulting practice.

And the rise of ESG is about more than just awareness—a majority of survey respondents indicated that their organizations are taking action to incorporate these issues into their operations.

It is in the economic interest of the U.S. economy in general—and the business interest of middle market firms, in particular—that the integration of ESG practices into core operations becomes essential. Organizations can no longer wait and hope for the best. They need to act decisively and prepare for a different regulatory framework while shaping market-driven demands going forward.

Joe Brusuelas
Chief Economist, RSM US LLP
Thirty-two percent of executives at companies with formal ESG plans said environmental issues were included in those plans, making it the top-ranking issue out of the options included in the survey. The next three issues were fair trade and/or sourcing (25%), community health and wellness (24%), and educational support (23%). Other areas in respondents’ ESG plans included gender equity, support for the LGBTQ community and racial justice.

As gender equity, climate, racial inequality, income disparity and other social issues gain national prominence, the role of corporations around social imperatives has come to the fore. It’s not surprising that middle market businesses have now elevated ESG measures as a priority for their businesses.

“There are a lot of social changes happening very rapidly that are really affecting everyone’s businesses and everyday lives,” says RSM Canada economist Dr. Tu Nguyen, whose focus areas include ESG. “Whereas ESG issues were more distant and abstract 10 to 20 years ago, now they are nearly impossible to ignore. And businesses have customers and employees who are demanding more.”

Demographics are also likely a significant factor given that millennials are the largest cohort of workers in the U.S. labor force, says Alex Kotsopoulos, a partner at RSM Canada.

“I think millennials are quite progressive when it comes to environmental issues and social issues, as well as diversity, equity and inclusion,” he says. “Accordingly, I’m not really surprised to see the awareness and adoption of ESG increase.”

Social issues at the forefront

Familiarity with using ESG criteria to evaluate performance of organizations, businesses or investments

BASE = TOTAL SAMPLE

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Source: RSM US Middle Market Business Index, Q3 2021

ARROWS: Significantly higher/lower than $10M-$50M at .05 level of significance

SQUARE/CIRCLE: Significantly higher/lower than previous quarter, respectively, at .05 level of significance
Still, not every company has developed a formal plan on the ESG front. But even those who haven’t are examining whether they should; among the 28% of respondents who said their organization does not have a formal ESG plan or strategy in place, 22% said they were currently assessing the need for such a plan, 18% said they were currently developing a formal ESG plan, and 14% said they have an informal plan.

Plenty of companies are choosing to embrace ESG initiatives because they believe it is the right thing to do, the survey data indicates. Of the respondents who were somewhat or very familiar with ESG and supported such issues, some of the top considerations that motivated their organizations to embrace ESG initiatives or reporting—which respondents selected from a list provided in the survey—were:

- Reducing our environmental impact
- Supporting ESG initiatives is the right thing to do as an organization
- Enhancing or maintaining our working environment and culture
- Communicating our values to the public
- Supporting local or nonlocal communities

Middle market perspective

Middle market companies may take a bit longer to adopt ESG initiatives compared to their larger counterparts, given that midsize companies often lack the people and financial resources to make immediate changes. However, they may also be at an advantage in some ways because they can be nimble and more flexible, says Dr. Nguyen, who adds that middle market organizations are in a “sweet spot” to get into ESG.

Another advantage is that midsize businesses “can look at the models of some of the larger companies that can afford to make mistakes in the area, and they can take what works from that;” says Jon Caforio, a principal and national strategy practice leader at RSM US.

Growing pressure around issues of social inequity is catalyzing the ESG movement, and climate change has created greater urgency for organizations to reduce their carbon footprints. As these pressures continue to mount from a variety of stakeholders—including customers, employees, industry peers and even regulators—demanding that companies have clear commitments to ESG issues, we expect such plans to take on even greater importance in business operations and to have a bigger impact on financial performance.

“The pandemic is an inflection point and, in many respects, is going to accelerate some trends that were clearly already happening. And what the MMBI data is telling us is, this isn’t a fad,” says Kotsopoulos. “ESG is here to stay.”

The pandemic is an inflection point and, in many respects, is going to accelerate some trends that were clearly already happening.

Alex Kotsopoulos
RSM Partner, ESG Advisory
Along with the adoption of ESG initiatives, the use of metrics to measure success around these goals has grown over the last two years, results from RSM’s survey show. The increase in such formal evaluations would seem to indicate that ESG is no longer a peripheral or “nice to have” element of business, but rather is becoming a central pillar interwoven throughout companies’ operations.

Of respondents whose organizations are aware of ESG and support such causes, the share who said their companies use ESG measures to a great extent to evaluate their own performance increased from 26% in the fourth quarter of 2019 to 36% in the third quarter of 2021. Likewise, executives’ use of such measures to evaluate other organizations’ performance rose from 26% to 37% during that time.

Of the companies that have formal plans around ESG, 58% of respondents said their organization is committed to a corporate structure and reporting that incorporates social responsibility and/or environmental initiatives “to a great extent,” and another 40% said they were committed “to some extent.” Sixty-six percent said their organizations have dedicated senior executives whose primary responsibilities include establishing and achieving ESG visions. There was a notable difference, however, based on size cohort; among larger middle market companies, 72% of respondents had a senior executive dedicated to ESG, whereas that figure was 54% among smaller middle market companies.

Leadership teams may find it difficult to navigate how best to evaluate their organizations’ ESG performance because there is no universal reporting framework for ESG metrics. Rather, there is a patchwork of various frameworks from organizations such as the United Nations, the Sustainability Accounting Standards Board and others.

“I think the biggest challenge is the lack of uniformity around standards right now, which hopefully in the next few years will change,” says Dr. Nguyen.

As metrics become more standardized, there will also likely be a need for independent verification of companies’ ESG reports and disclosures, says DeCandido. That will be important to instill a level of public trust in the progress organizations make.
Seventy-eight percent of those respondents somewhat familiar or very familiar with ESG said they include diversity and inclusion policies in the initiatives they report on externally, 59% said they include ethnicity pay gap initiatives in such reporting, and 55% include gender pay gap initiative information.

Given the diversity of topics reflected in middle market organizations’ ESG plans, it may not be surprising that middle market executives cite using multiple standards for external reporting of their organization’s performance against their ESG initiatives. It is beyond the scope of this research to determine whether multiple reporting standards will continue or as ESG efforts evolve, whether consolidation of reporting standards will occur. Specifically, among middle market organizations that provide external ESG performance reporting, executives indicated they use the following standards:

- **52%** Sustainable Development Goals (a collection of goals set by the United Nations)
- **45%** Climate Disclosure Standards Board
- **41%** UN’s Principles of Responsible Investment
- **40%** Sustainability Accounting Standards Board

Of respondents using ESG to evaluate performance, 77% said their organization provides external reporting on ESG performance.

65% are gauging the broader potential impact that achieving ESG goals has on the environment or society.

Of respondents using ESG to evaluate performance, 65% are gauging the broader potential impact that achieving ESG goals has on the environment or society.
It’s important to note that ESG disclosure on its own does not drive positive financial performance, RSM professionals say; organizations need to be proactive about fully integrating ESG priorities throughout their operations. Taking a thoughtful, holistic and targeted approach can also combat criticisms of greenwashing—the notion that companies might portray themselves as more sustainable or progressive than they actually are.

“The spirit of ESG is that it’s an element of corporate strategy and not a response to risk or compliance,” says DeCandido. “ESG is effectively another language business leaders need to learn how to speak to conduct business.”

Reaching a point where ESG issues are truly woven into an organization’s strategy, however, can be a big hurdle for middle market companies. It takes time to build a common understanding among leadership teams about why such initiatives are important, develop a clear vision around which issues the company wants to prioritize, and get executive buy-in.

“In the middle market, it’s fragmented,” says Bill Kracunas, RSM US principal and national management consulting leader. “Some companies are working on diversity or social or governance—but is there an overall program? Is it a holistic function? Companies are trying to figure out what it means to them and how to approach it.”

Also important to note, Kracunas says, is that a company embracing ESG doesn’t mean it is suddenly taking a position on every issue. Rather, it means the organization is seeking to understand areas where it can help and have an impact.

“You don’t have to do everything, but you need to do something,” says Caforio.
While ESG initiatives encompass a wide range of issues, those focused on the environment are of paramount importance, especially as more consumers and businesses factor sustainability into their buying decisions and as the Biden administration has prioritized net-zero emissions targets and other environmental goals. As such, pressures and shifts related to climate change continue to shape business planning for the future.

Many companies anticipate climate change will also present opportunities over the next three years. Twenty percent of respondents said climate change presents significant opportunities, with a notable gap based on size cohort; 9% of smaller middle market companies see significant opportunities, while that figure was 28% for larger middle market companies. Overall, 28% of respondents said climate change presents significant challenges, and 27% said it presents both significant opportunities and challenges.

The fact that middle market firms are “much more exposed” to environmental and climate issues—along with social issues—than their larger counterparts means it is even more urgent that they adopt ESG strategies, says RSM US economist Dr. Tuan Nguyen.

“They don’t have a lot of capital; they don’t have the leverage. So they have to act,” he says. “And given that growing risk and competitive pressure...
from bigger firms that are adopting ESG, the middle market should consider implementing ESG as soon as possible.” Doing so can also provide some downside protection during social or environmental crises.

In specific categories of business, such as supply chains and the workforce, respondents expect sizable adverse impacts from climate change. Sixty-nine percent of respondents expect the prices of raw materials or commodities to be affected to either some extent or to a great extent; 67% expect supply chain reliability to be affected to some extent or a great extent; 66% expect such effects on higher operating costs, and 64% expect climate change will pose an adverse impact to some extent or a great extent when it comes to government actions to regulate carbon emissions (other than carbon pricing or taxes).

In terms of companies’ enhanced ability to attract workers and to retain workers, 58% and 57% of respondents—respectively—said climate change presents opportunities, either now or in the future, to some extent or to a great extent. Fifty-six percent said climate change presents opportunities around positive public relations from being a leader on climate issues either to some extent or to a great extent.

“There is a shortage of talent right now, and companies can leverage their focus on ESG to help stand out and attract key people,” says Kracunas. “More and more workers are becoming versed in ESG issues. I think for some of the younger workforce—it’s something they look for that really resonates.”
A majority of survey respondents—68%—said in the third quarter of 2021 that their organization was either making efforts to reduce their net carbon emissions or has already reduced such emissions to zero. Examined by size cohort, this figure was 82% for organizations with annual revenues between $50 million and $1 billion and 48% for those with revenues between $10 million and $50 million.

Here is a breakdown of what survey respondents said were some of the most and least important considerations that factored into their decision to reduce their carbon footprint:

Of respondents whose companies have formal ESG plans, 66% identified energy management as an objective included in their environmental plan or policy, 58% said reducing carbon emissions was an objective and 55% said reducing waste was an objective.
A U.S.–UK comparison

Business familiarity with and adoption of ESG initiatives varies a fair amount between organizations in the United States and those in the United Kingdom, RSM’s research shows. Nearly two-thirds of U.S. respondents—64%—claimed familiarity with ESG criteria, significantly more than the level claiming familiarity in the U.K., which was 56%.

However, among those familiar with ESG criteria, more U.K. respondents than U.S. respondents indicated their organization or business had formal (i.e., written) ESG plans or strategies; 74% versus 65%, respectively.

While RSM’s survey did not gather data that could be used to compare the United States to the European Union, the firm’s professionals noted that many EU countries are more advanced in their ESG reporting because they have top-down mandates on the matter. In the United States and Canada, “it’s more bottom-up, driven by stakeholders,” says Kotsopoulos.

Reducing environmental impact was the top consideration that motivated organizations to embrace ESG initiatives or reporting in both the United States (where 40% of respondents said it was a consideration) and the U.K. (where 46% of respondents said it was a consideration). The next top considerations respondents identified in the survey were that supporting ESG initiatives is the right thing to do, supporting local communities and enhancing or maintaining efforts to recruit/retain employees.
ESG is here to stay

RSM’s survey data offers a crucial look into where the middle market—which accounts for more than a third of U.S. employment and about 40% of the country’s gross domestic product—stands on ESG matters and how executives are responding to growing stakeholder demand for attention on these issues.

Organizations that want to further develop their ESG framework should consider doing an assessment of the business to see where its ESG priorities stand. While the associated upfront investment may be daunting, it will pay off in the long run. Additionally, the cost of ignoring the rise of ESG and not meeting these growing demands far outweigh the cost of actually implementing a strategy around these issues.

“Much of the future economy will be based on people wanting to do good work and work for good companies,” says Kracunas. “And being a steward of the community and doing good business don’t have to be mutually exclusive.”

Executives who feel overwhelmed at the breadth of ESG issues and possible ways to address them may want to begin by focusing on low-hanging fruit. That might come in the form of making buildings more energy efficient or implementing other discrete sustainability programs, for instance, while also working on long-term plans to address other challenges. Those short-term wins can help build momentum.

However organizations decide to start their ESG journey, the key is to start—now.

“Be early and be committed,” says Dr. Tuan Nguyen, RSM US economist. “If you’re an early mover, you can capture market share; you can be the leader. And only when you are committed will you see financial results.”

If you’re an early mover, you can capture market share; you can be the leader. And only when you are committed will you see financial results.

Dr. Tuan Nguyen
RSM US Economist
Methodology

The RSM US Middle Market Business Index survey data was gathered from RSM’s proprietary panel of 700 executives recruited by The Harris Poll using a sample supplied by Dun & Bradstreet. All individuals qualified as full-time executive-level decision-makers working across a broad range of industries excluding public service administration. The businesses have annual revenues of $10 million to $1 billion, and financial institutions have assets under management of $250 million to $10 billion.

These panel members have been invited to participate in four surveys over the year that include special issues-based question sets. The survey for this report was conducted from July 8 to July 26, by The Harris Poll, and 413 executives completed the final survey. The U.S. Chamber of Commerce is a partner in this research.
U.S. Chamber gathers feedback on ESG regulation

As the interest of investors and market participants has turned to environmental, social and governance factors, so too has regulatory attention shifted to ESG. The U.S. Chamber of Commerce has been engaged in conversations with the Securities and Exchange Commission, administration officials, members of Congress, and the business community to increase understanding about the opportunities and challenges presented by ESG.

Soon, the Securities and Exchange Commission will propose new regulations requiring public companies to disclose more ESG information about topics ranging from climate change to workplace safety and diversity. Through a series of proposed rulemakings, updated guidance and enforcement actions, the SEC will change the reporting landscape for public companies in a way that could affect market segments well beyond the sphere of public markets.

The Chamber has been working closely with its members—participants in both public and private markets—to better understand ESG principles and reporting in U.S. markets. Recently, the Chamber led a survey of 436 public companies to learn more about current practices and sentiment around climate change and ESG reporting. Respondents to the survey represented a wide range of industries, with 67% having a market capitalization below $5 billion. The survey found that in the last decade, most companies have increased the amount of climate-change disclosure they provide and are communicating with and incorporating input from their shareholders about climate-change risks and opportunities. Moreover, companies overwhelmingly agree that they should continue to be afforded flexibility in their ESG-related disclosures moving forward.

New requirements for ESG disclosure are sure to have direct implications for public companies but will also likely create new pressures on private markets to provide ESG-related information. While the Chamber continues to monitor the state of regulation, it’s clear that companies have responded accordingly to investor and stakeholder calls to provide more ESG information.

It is important to recognize the work the business community has done to meet investor interests, and the Chamber looks forward to continuing to serve as a resource for businesses of all sizes and markets in understanding ESG practices and policymaking decisions.
Awareness about environmental, social and governance among middle market companies is greater than ever, RSM US Middle Market Business Index data shows. But translating awareness into action is more difficult, says Anthony DeCandido, an RSM partner and senior financial services analyst whose specialties include helping midsize organizations develop ESG strategies.

“In the middle market, it’s rare that someone is defined as an ESG or sustainability officer,” he says. “Somebody is doing this in between their day job.”

More often than not, a company’s chief financial officer, marketing leader or human resources representative is assigned to carry the ball. DeCandido and his team can work with that individual to develop an ESG baseline by aggregating existing data from the company’s cloud-based enterprise resource planning (ERP) tools, HR data, supply chain records and the like, as well as from interviews with business unit leaders, suppliers and customers. Along with comparative information from other businesses in the space—the bulk of which is gleaned from public company disclosures—this creates a well-rounded picture of where the business stands on issues ranging from diversity to fair trade and carbon emissions.

“We gather that information through an exercise called stakeholder mapping,” he says. “It lets us determine who cares and why.”

This so-called “rapid assessment” can be completed in a matter of weeks, DeCandido says. It offers transparency for the C-suite and the board and allows the business to build a foundational plan toward achievable ESG goals, which typically begins with the issuance of an ESG report for stakeholders.

Says DeCandido: “They get an outline, a road map of the immediate actionable items, as well as the things they should do in the short, medium and long term.”
Fostering strong social connections has been integral to the culture at RSM, whose deep ties to the communities it serves date back to its founding as a small Midwestern firm nearly a century ago.

Today, against the backdrop of heightened awareness around racial and gender equity, income inequality, the environment and other growing social issues, the firm is taking steps to drive change, including putting a growing emphasis on environmental, social and governance (ESG) initiatives and developing the means to track progress within the firm. The firm published its first diversity report this year.

“RSM has a long history of stewardship, which we define as leaving things better than we found them,” says Doug Opheim, RSM chief financial officer and chairman of the RSM US Foundation, which has raised funds for causes focused on education, hunger, housing and health since its establishment in 2014. “This applies to our firm, our community and the world in which we live.”

To that end, RSM earlier this year launched the Middle Market Collaborative for Understanding, a group that brings together senior middle market executives from RSM’s client roster to discuss diversity, equity and inclusion. It also sponsors six CEO Action for Racial Equity Fellows, who are working to advance racial equity through policy and business leadership.

“RSM has an established program to foster a culture of diversity, equity and inclusion within our firm,” says Tracey Walker, RSM national leader of culture, diversity and inclusion. “We were pleased to add these external programs to further engage our client base and support broader action to advance equity in our nation.”

RSM has recently turned its attention to environmental strategies and is currently completing work that entails baseline measurements of its environmental impact, defining goals and deploying programs across its offices to ensure consistency and continuous improvement.

As the research in this MMBI special report shows, midsize organizations are now well-versed in ESG, and ready to embrace social and environmental business initiatives increasingly demanded by investors, customers, employees, vendors and other important stakeholders. These moves have not only proven to be good for society, but in the end, they make for better business.

“The significant challenges we have seen in our society during the last 18 months due to the COVID-19 pandemic, racial injustice, extreme weather events and more have left a lasting impact,” says RSM Principal and Chief Communications Officer Sara Webber Laczo. “They have made business leaders open their eyes to the importance of ESG—asking not only what they can do to make their business more successful but also more sustainable in the future. At RSM, we’re committed to doing our part for the mutual benefit of our firm, clients, people and the communities and world in which we operate.”
For more middle market insights, subscribe to RSM’s The Real Economy, our monthly economic report.