Environmental, Social, And Governance:

How We Apply Our ESG Evaluation Analytical Approach: Part 2

June 17, 2020

Key Takeaways

- We are committed to increasing the transparency of our ESG Evaluation scoring and data.
- Enhancements to our Analytical Approach do not affect our published ESG Evaluations.
- Analyses of the value chain and externalities are material for ESG Evaluations.
- Governance factors can carry more weight in our ESG Evaluations compared to Environmental and Social.
- Our macro sector and regional ESG analysis underpins our globally consistent scoring.

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We have updated our analytical approach for S&P Global Ratings' environmental, social, and governance (ESG) Evaluation. Below, we explain the changes in the updated version, and why we do not anticipate revising any of the ESG Evaluations we have already published. We anticipate further enhancements to strengthen the quality of our ESG analysis, and how we communicate our ESG opinions, based on feedback we have received and the experience we have gained.

This article builds on "How We Apply Our ESG Evaluation Analytical Approach," published on April 10, 2019, by showing real and hypothetical examples.

For the updated version of our analytical approach, please see "Environmental, Social, And Governance Evaluation Analytical Approach," published June 17, 2020, on Ratings Direct.

We are committed to increasing transparency

As we gain experience using our ESG Evaluation framework, we intend to disclose additional details of our analyses. First, we will refresh our ESG Risk Atlas analysis and, for the rest of this year, release supplementary deeper dives into each sector. As part of these deeper dives, we intend to explore further relevant environmental and social issues, look at which environmental and social key performance indicators are most important, and assess the relative importance of different factors for each sector. For example, land use is very important for agriculture but less so for software services. As we release these sector-specific deep dives we will request comments on the KPIs and factor weights we are using, with the aim of concluding the feedback exercise early next year with further communication about the scoring and weights we use to determine an ESG Evaluation.

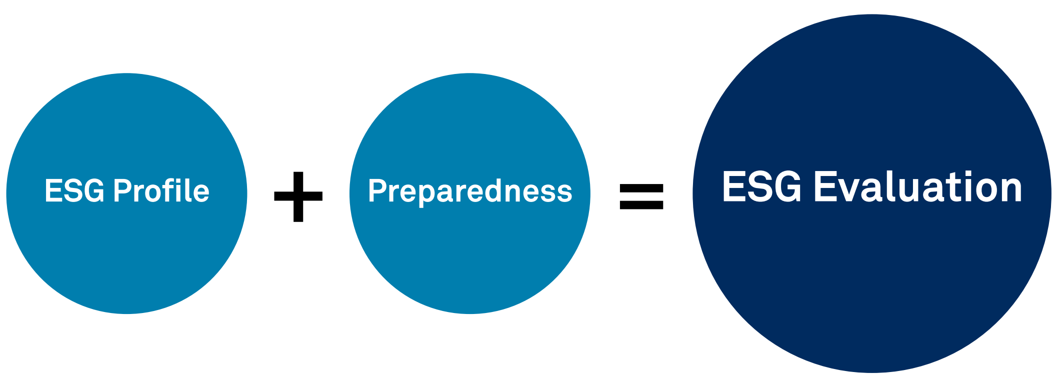
We expect to release a new ESG Evaluation Report template where we plan to include additional comparative data, charts, and tables to support our ESG analytical opinions. We can do this because SAM, with its coverage of 7,200 companies across all sectors, has joined S&P Global. We have discontinued using the ESG Diagnostic; instead, we will draw ESG data from public sources, Trucost, and from company responses to SAM's Corporate Sustainability Assessment questionnaire.

All completed ESG Evaluations are subject to monitoring by S&P Global Ratings. This means that we conduct periodic monitoring reviews of our analysis and, for public ESG Evaluations, event-driven reviews in response to ESG controversies and other business disruptions. For example, we reviewed the portfolio following the intense disruptions caused by the COVID-19 pandemic (see "ESG Evaluations Remain Unchanged For Now In Light Of COVID-19," published April 7, 2020).

What is an ESG Evaluation?

S&P Global Ratings' ESG Evaluation is a cross-sector, relative analysis of an entity's capacity to operate successfully in the future and is grounded in how ESG factors could affect stakeholders, potentially leading to a material direct or indirect financial impact on the entity. ESG factors typically incorporate the entity's impact on the natural and social environment and the quality of its governance. Our ESG analysis goes beyond a traditional financial analysis and includes some risks and opportunities that are more qualitative. Our definition of stakeholders for a particular entity goes beyond shareholders to include employees, the local community, government, regulators, customers, lenders, borrowers, policyholders, voters, members, and suppliers, among others. A high ESG Evaluation score indicates an entity is less prone to experiencing material ESG-related events, and is better positioned to capitalize on ESG-related growth opportunities, compared to lower scoring entities.

ESG Evaluation



First, we establish an ESG Profile for a given entity, which assesses the exposure of the entity's operations to observable ESG risks and opportunities, and how the entity is mitigating these risks and capitalizing on these opportunities. Second, we assess the entity's long-term Preparedness, namely its capacity to anticipate and adapt to a variety of long-term plausible disruptions.

The ESG Evaluation is not a credit rating, a measure of credit risk, or a component of our credit rating methodology. However, the information we gather for an ESG Evaluation can inform our credit analysis of rated entities.

No revisions to public ESG Evaluations

The most important change to our analytical approach relates to our enhanced governance analysis, explained below. We have run internal impact studies of all the changes to our analytical approach on the portfolio of ESG Evaluations completed to date, and concluded that we do not need to revise any of the existing public scores. We expect to apply the enhanced analytical approach as part of our periodic monitoring of completed ESG Evaluations. So far, we have completed 35 full ESG Evaluations and five pilots. Scores range from 40 to 89 out of 100, a higher score indicating better relative sustainability. Nine companies have chosen to make their ESG Evaluation public and we explain our ESG analysis in reports available
here
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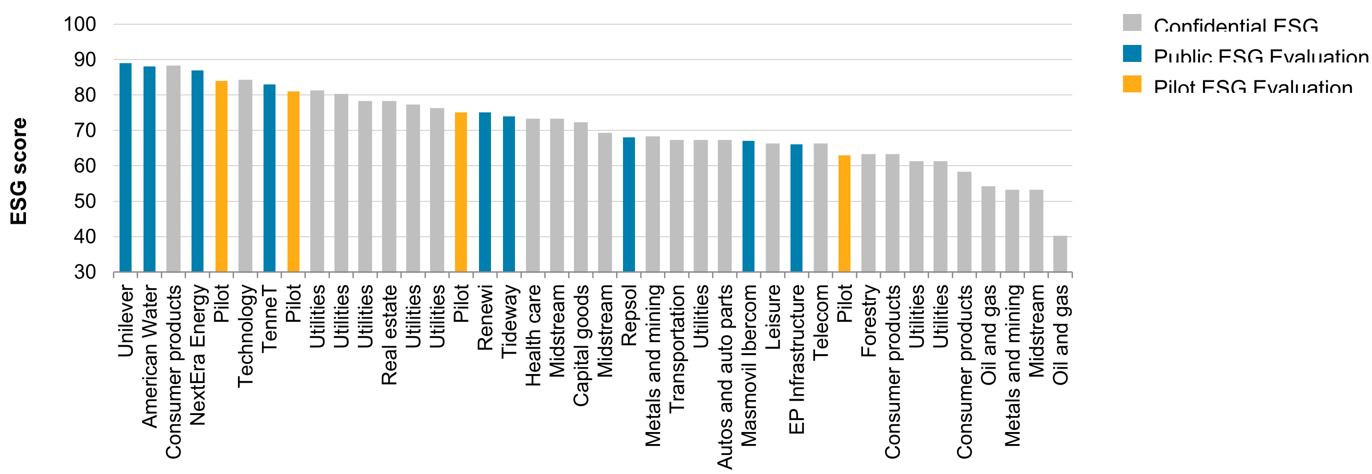
Chart 1

ESG Evaluation Completed As Of June 12, 2020



Source: S&P Global Ratings.

In the above chart, we name our nine public ESG Evaluations, color-coded blue, and identify the remaining confidential Evaluations by sector, grey. Pilot Evaluations are included in the table but not identified by sector, yellow. The number will grow as we complete engagements that are currently in process.

Once we have reached a critical mass of ESG Evaluations across all sectors we will be able to release more-anonymized data and additional details on scoring and factor weights, allowing users to interact with our data and methodology.

ESG Materiality and Value Chain Analysis

We have not changed our ESG Evaluation definitions but we have revised some of the language we use to explain what we view as material for the ESG Evaluation and highlighted the importance of the broader value chain perspective in our analysis, as well as the need to consider environmental and social externalities more explicitly. In this context, the value chain refers to the upstream and downstream activities of an entity and typically includes how a company manages its suppliers and its influence on the entire lifecycle of its products and services. The World Business Council for Sustainable Development defines an externality as "a consequence of an action that affects someone other than the agent undertaking that action, and for which the agent is neither compensated nor penalized. Externalities can be either positive or negative".

Our ESG Evaluation analysis has always considered how an entity's upstream and downstream operations could lead to a direct or indirect future financial impact on the entity. We have revised our language in the quote below to describe materiality for our ESG Evaluation analysis by explicitly referencing externalities and detailing some of the potential routes through which these additional risks and opportunities can affect an entity.

This more explicit focus on indirect activities in supply chains, lending, investments, or insurance helps to explain some of the cross-sector comparisons in our macro sector analysis. For example, the drivers of financial performance for consumer product companies and retailers can be quite different, however our environmental and social factor analysis of retailers is perhaps more closely linked to the suppliers of their products than a more traditional financial analysis. Similarly a bank's direct exposure to greenhouse gas emissions is likely to be a less material differentiating factor than the impact of the choices it makes in lending to, engaging with, or advising clients that emit relatively high levels of greenhouse gases.

> "Our ESG Evaluation analysis is grounded in how ESG factors could affect stakeholders, potentially leading to a material direct or indirect financial impact on the entity. For the purposes of our ESG Evaluation we assess the materiality of ESG related events or issues by looking at the likely financial impact on the entity, including potential impacts from environmental and social externalities. Events and issues are material for the ESG Evaluation when in our view they could meaningfully affect the entity's business operations, cash flows, legal or regulatory liabilities, access to capital, reputation, or relationships with key stakeholders and society more generally, either directly or through its value chain (upstream or downstream). In our assessment we balance different issues that may lead to financial impacts qualitatively and on a likelihood versus impact basis. More likely or near-term issues are typically driven by changes in regulations, laws, and customer behavior. Less certain or longer term issues could have a significant impact, such as a pandemic, or scarcities of natural resources that could lead to structural shifts in market forces and operating dynamics."

Enhanced governance analysis

We continue to give significant weight in our ESG Evaluations to the influence of governance. Our analytical approach focuses on the near-term governance structure and observable facts about an entity's governance today in the ESG profile, and, separately, through the influence of governance on the entity's long-term strategy, planning, and resulting culture in our analysis of Preparedness.

As part of our approach to analyzing the governance profile of an entity, we have expanded the focus of the Cyber Risk & IT Systems factor to include a broader set of risks to consider and renamed the factor as Financial & Operational Risks. Below is an example of the table we publish in ESG Evaluation reports, showing the factors we assess as part of the ESG Profile. The change of factor name in the governance profile is highlighted. 'X' or 'XX' is a place holder for a numerical score. We assess the environmental and social factors as leading, strong, good, lagging, or weak. For governance factors we use developing, instead of lagging.

ESG Profile Factors And Scoring

Environmental Profile	
Sector/Region Score	**XX/50**
Greenhouse gases	Leading, Strong, Good, Lagging, or Weak
Waste	Leading, Strong, Good, Lagging, or Weak
Water	Leading, Strong, Good, Lagging, or Weak
Land use	Leading, Strong, Good, Lagging, or Weak
General factors	X or None
Entity-Specific Score	**XX/50**
E-Profile (30%)	**XX/100**

Social Profile	
Sector/Region Score	**XX/50**
Workforce and diversity	Leading, Strong, Good, Lagging, or Weak
Safety management	Leading, Strong, Good, Lagging, or Weak
Customer engagement	Leading, Strong, Good, Lagging, or Weak
Communities	Leading, Strong, Good, Lagging, or Weak
General factors	X or None
Entity-Specific Score	**XX/50**
S-Profile (30%)	**XX/100**

Governance Profile	
Region Score	**XX/35**
Structure and oversight	Leading, Strong, Good, Developing, or Weak
Code and values	Leading, Strong, Good, Developing, or Weak
Transparency and reporting	Leading, Strong, Good, Developing, or Weak
Financial and operational risk	-X or Neutral
General factors	X or None
Entity-Specific Score	**XX/65**
G-Profile (40%)	**XX/100**

ESG Profile (including any adjustments)	**XX/100**

Source: S&P Global Ratings.

The table summarises the scoring and factors that build up to the ESG Profile score. Each profile is scored out of 100 and combines a Sector/Region score with an entity-specific score. The new Financial and Operational Risks factor allows us to appropriately capture any warning signs that could undermine an entity's status as a going concern and consequently has either a neutral or negative impact on the governance profile. Potential warning signs can be any significant weaknesses we uncover in our analysis that are not captured elsewhere in the framework and could be related to concerns about short-term creditworthiness, internal controls, cyber security, or qualified financial reporting, among other risks. We anticipate assigning neutral to most entities for the Financial and Operational Risks factor; however, when we do identify issues, this new factor helps us ensure that more-vulnerable entities are likely to carry lower ESG Evaluation scores that clearly recognize the magnitude of the impact. ESG Evaluations are not linked with our credit ratings, but a rapid credit deterioration, financial distress, or short-term vulnerability could be a signal that casts doubt on the sustainability of an operation, and is likely to trigger a monitoring review of the ESG Evaluation.

The governance profile accounts for 40% of the overall ESG Profile, and the table below summarizes the impact of Preparedness on the final ESG Evaluation scores we have completed to date.

Table 1

Examples Of The Impact Of Preparedness On ESG Evaluation Scores

	Number of entities	Average change compared to the ESG Profile	ESG Evaluation score		
			Minimum	Average	Maximum
Best in class	4	14	87	88	89
Strong	12	8	68	78	84
Adequate	20	0	53	67	78
Emerging	3	-7	53	55	58
Low	1	-10	N/A	40	N/A
Total	**40**	**3**	**40**	**71**	**89**

N/A--Not applicable. Source: S&P Global Ratings.

Our opinions for Preparedness can be Best-In-Class, Strong, Adequate, Emerging, or Low. Of the 40 ESG Evaluations completed to date, we consider that four are Best-In-Class, though we expect that the proportion of entities we consider Best-In-Class will decrease as the portfolio of ESG Evaluations grows, and will likely end up being close to 5% of all entities evaluated. We expect the majority of entities to be adequate. On average, our ESG Evaluations for entities with Best-In-Class preparedness has been 14 points higher than the score of their ESG Profiles. This compares to 8 points higher for entities with Strong preparedness. The average ESG Evaluation for entities with Strong preparedness to date has been 78, with a range from 68 to 84.

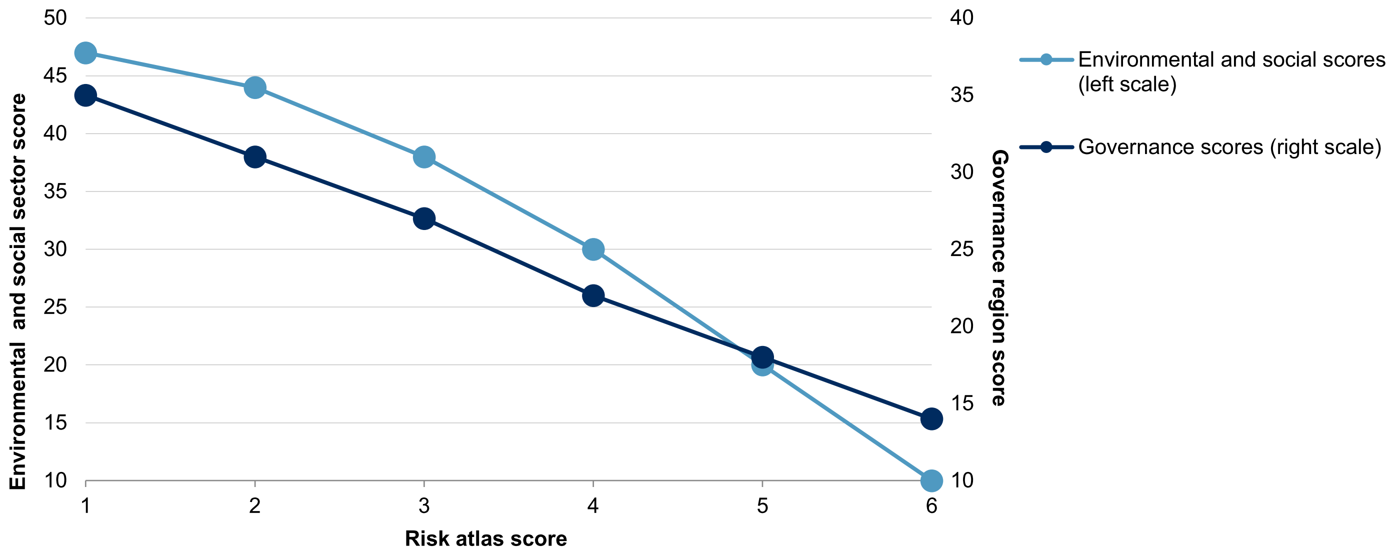
More refined macro ESG sector and regional analysis

More than 40% of the ESG Profile is driven by how we apply our macro sector and regional analysis to an entity, which is what enables the ESG Evaluation score to be consistent across sector and region. The environmental and social entity-specific factor analysis then compares entities to other entities within the same global sector. Entity-specific governance analysis is more globally consistent in nature. The ESG Risk Atlas provides the foundation for our macro sector and regional analysis, which we then apply to the operations of the entity to derive a sector region score out of 50 for environmental and social and a region score out of 35 for governance.

The ESG Risk Atlas provides a relative positioning of sectors to environmental and social exposures and regional analysis of natural disaster risk, social standards, and governance standards using the ESG Risk Atlas. Risk Atlas sector and governance scores are ranked 1 to 6. The chart illustrates how the Risk Atlas ranking is translated into the environmental and social sector scores out of 50 on the left hand scale, and the country governance ranking into regional governance scores out of 35 on the right hand scale.

Chart 2

Translating Risk Atlas Ranking Into Sector And Governance Scores



Source: S&P Global Ratings.

Environmental and social exposures can vary considerably across different segments in a particular sector. A classic case is environmental exposures within the Utilities sector. Consider the difference in CO2e emissions between a power generator, an electricity network, and a water utility. Power generated from burning fossil fuels is completely different from power generated via solar panels or wind turbines. We seek to adapt our macro environmental and social opinions to reflect the specific activities and operations of the entity. First, we break the Risk Atlas sectors into smaller segments when their environmental or social characteristics are different. Second, we map an entity's approximate mix of activities to these sector segments and calculate a weighted average score. We aim to make the sector score specific to the entity, while recognizing that the precise mix of activities varies through time and is based on different measures. Finally, we consider whether the entity has further region- or sector-specific features that could influence relative exposures.

In the hypothetical example below, the entity operates in two sectors, A and B. The rounded mix of activity is 65% in sector A and 35% in sector B. We calculate a weighted average of the different environmental and social sector scores at 32 and 35, respectively. Regional environmental factors could be exposure to physical risks or natural disaster. We also view exposures to natural disasters as social to account for disruptions in the livelihoods of community members, including clients and employees. We can also apply a regional social adjustment to recognize weaker social standards in different countries. Typically, we look for potential future skills shortages, security concerns, and signs of social problems. In this example no regional adjustment is made, which we would expect for the majority of ESG Evaluations. These regional adjustments are unlikely to move a profile score by more than 10 points and are always explained in the new ESG Evaluation Report.

Table 2

Hypothetical Example Of Sector Region Score Application

	Mix	E Sector score	S Sector score
Sector A	65%	38/50	38/50
Sector B	35%	20/50	30/50
Weighted average		32/50	35/50
Regional factors		-3	0
Sector region score		**29/50**	**35/50**

	G Region Score
Home country	35/35
Influence of other jurisdictions	-8
	27/35

Source: S&P Global Ratings.

In our regional governance analysis, we give more weight to the jurisdiction in which the entity's head office is domiciled and adjust when necessary for entities with significant operations in countries with much stronger or weaker jurisdictions and governance norms than in the home country. We consider that the laws and governance standards from the home jurisdiction carry a greater influence on an entity's governance profile. In this example, the 35/35 starting point is the score for the country in which the entity is based. The illustration deducts 8 points for the additional operating risk associated with significant operations in some jurisdictions with weaker governance standards. The region score for governance is out of 35, compared to 50 for environment and social, because the influence of entity-specific governance standards carries more weight in the overall governance profile.

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