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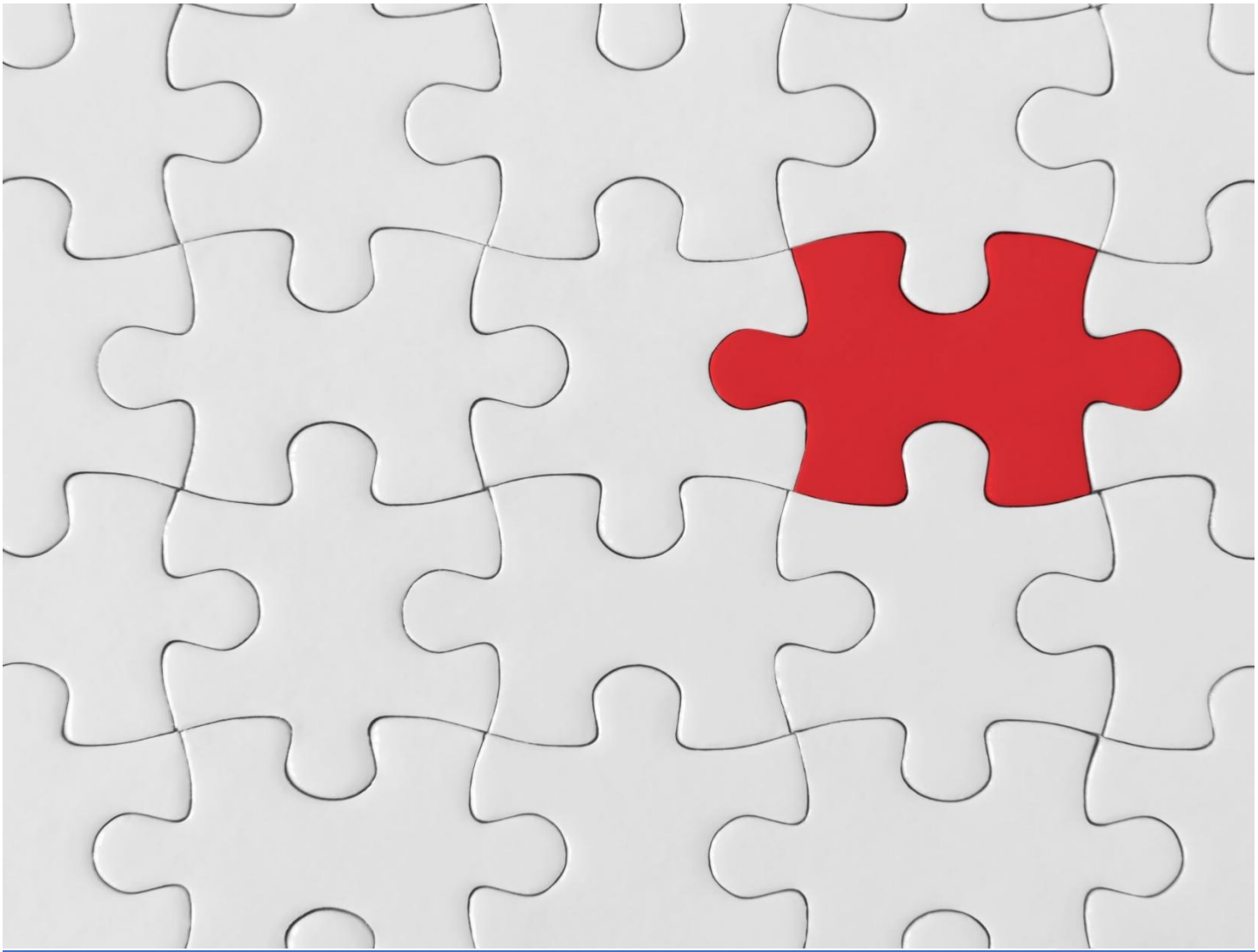

Using the Scorecard to Assess ESG Risks & Opportunities as well as Materiality & Risk Mapping

ESG & Sustainability Transformation

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For example, a credit investment analyst identifies a company that is not ESG rated by a third party and is issuing investment grade bonds. In this case, the analyst would conduct their own internal ESG assessment. A customized ESG self-assessment tool reflecting the industry-specific risk issues relevant to the issuer is created and the company's management or investor relations team is asked to complete the tool. An ESG scorecard based on the self-assessment responses is created with an ESG factor score ranging from 0 to 5, with high or low scores then used in additional valuation or assessment work.

For example, Ethical Marketing could be identified as a key ESG social risk (perhaps through a risk-mapping process, discussed in the following subsection) for three pharmaceutical companies X, Y and Z:

• Company X has no policy and a history of violations, so it is given a score of 0.

• Company Y has a brief policy with no violations, so it is given a score of 3.

• Company Z has a detailed policy and has one minor violation, so it is given a score of 4.

A score of 0 might make company X less attractive and a score of 5 might make a company more attractive to invest in. Additionally, the total score of all factors in the scorecard will be used in subsequent assessment or valuation work.

The scorecard can provide a qualitative assessment of a factor and provide a quantitative score for that factor.

ESG rating agencies can provide scores and scoring formats that are commonly used in commercially available ESG rating services. Analysts can use this information in its raw form or adjust it to reflect their own views. These scores can then be aggregated for use in assessment or idea generation. The scorecard technique can be used for both private and public companies. The challenges in creating private company scorecards are that rating agencies rarely rate and provide ratings for a private company and there is little publicly available information about it.

This scorecard technique could also be applied to scoring countries in the analysis of government bonds or infrastructure and real estate. For example, environmental policies could be scored for infrastructure and commitments to a net-zero carbon plan or the level of corruption could be scored for countries.

In summary, developing a scorecard involves the following steps:

• Identify industry- or company-specific ESG items.

• Break down the issues into a number of indicators (e.g., policies, measures, disclosures).
• Determine a scoring system based on what good/best practice looks like for each indicator/issue.

• Evaluate a company and assign a score.

• Calculate a composite score at the issue level, dimension level (ESG level), or total score level (depending on the relative weight of each issue).

• Evaluate the company's performance against the industry average (optional).

Assessing Materiality and Mapping Risks:

Some ESG issues may be important to companies in a particular industry (e.g., water scarcity may disrupt the operations of mining or beverage companies that rely heavily on clean water in their production processes) but not to companies in other sectors (e.g., water scarcity has little impact on media companies or financial companies).

It is important to note that not all risks are manageable. Material ESG risks that are not being managed by a company fall into two categories: (1) unmanageable risks, which cannot be addressed by the company's initiatives, and (2) management gaps, which represent risks that the company can manage through appropriate initiatives but may not yet be managed.

As explained, some manageable risks, such as workplace injury risks, can be managed, for example, through establishing rigorous safety procedures, having emergency response plans and safety drills, and promoting a safety culture.

Some risks cannot be managed (at all), such as aircraft carbon emissions. An airline may be able to manage some of them (for example, by modernizing its fleet, installing winglets, and developing information and communications technology systems to reduce the time aircraft spend idling on the runway), but it cannot easily manage all of the emissions from its aircraft flights. As a result, the airline has some unmanaged risks in terms of carbon emissions, which will contribute to its unmanaged risk score for that issue.

Unmanaged risks are only one of two components of unmanageable risks. The second component is the management gap, which relates to the portion of a company's material ESG risks that are manageable and reflects the company's failure to adequately manage these risks, as reflected in the company's management score.

For example:

Human Capital:

Human capital is difficult to manage. A company may employ hundreds of thousands of people, and it is difficult to imagine a management program that can eliminate all risks of sexual harassment, morale loss, or high turnover. However, companies are expected to have full control over these policies. Furthermore, Sustainalytics believes that strong policies can effectively promote a work culture that can help reduce the material risks of sexual harassment or toxic workplaces. However, companies have difficulty mitigating risks in the labor supply chain. Therefore, a manageable risk factor is applied to distinguish some risks from the unmanageable problem area.

In terms of a company's ability to manage risks, it can be useful to consider controversial cases.

A contentious case is defined as an ongoing case or situation in which a company's operations or products are alleged to have a negative ESG impact.

Determining which ESG issues are most material is not an exact science, and there can be important differences between what each investor considers most material, even when analyzing the same company. This is because predicting the extent to which an ESG factor or risk factor will impact a financial metric such as future cash flows is often a matter of judgment. Frameworks such as the materiality maps provided by SASB are useful as a guide, but investment professionals often develop their own views on what is most material. These views on materiality are illustrated through the various examples of materiality maps provided in the Figure, which highlight the different views that investors can take.

Example of materiality map of sectors by ESG factors

Source: HSBC (2016).

The figure above highlights the diversity and changing nature of many ESG factors.

A publicly available industry materiality assessment provided by SASB shows that different industries may have different levels of exposure. One can infer that individual companies within the same market-defined sector may be assessed as having different material ESG factors affecting their business. For example, within the insurance industry, a US healthcare insurer will have different factors affecting it than an auto insurer.

Investors may find many direct comparisons useful. In the healthcare industry example, using the SASB materiality map, a pharmaceutical company is assessed as having material exposure to equity marketing practices.

• Pharmaceutical Company A is assessed as having a low risk on this factor because it has up-to-date policies and training programs and has never been warned of regulatory violations.

• Pharmaceutical Company B is assessed as having a high risk on this factor because it lacks a strong policy, has minimal training, and has received numerous fines and warnings from regulators.

• Pharmaceutical Company C is assessed as having no risk on this factor because it is only involved in pharmaceutical research and has no products that are commercially available. Here we can see that although this factor is material to the industry, it has limited risk or is considered to be no risk to the company because the company has no significant exposure.

These pharmaceutical companies can be assessed more directly on this factor than each other. As seen above, the same technique can be applied to entire industries or sub-industries as well as companies. For example, biodiversity as an E factor is not considered to affect the pharmaceutical industry as a whole but may have an impact on the agricultural sector.

Using SASB as a Framework in Assessing Materiality:

An example of when you might want to use SASB as a framework in a fundamental active investment process might be to evaluate a biopharmaceutical company that uses cannabis as its raw active ingredient. (This applies to GW Pharmaceuticals.) "Ingredient sourcing" is not considered a material ESG risk for biotech and pharmaceutical companies.

However, an analyst might assess that a cannabis-derived drug would be a material risk for two reasons:

Growing the plant can be a complex operation with more risks than standard manufacturing.

Regulatory oversight is more complex because both the drug regulatory agency and the narcotics regulatory agency (in the United States, the Drug Enforcement Agency and the Food and Drug Administration, respectively) would be involved. For a standard pharmaceutical, only the drug regulatory agency would be involved.

The analyst may further assess that ESG opportunities exist here because of the technology required to harvest the crop, the protection of knowledge related to that technology, and the barriers associated with having to satisfy two regulatory bodies at the same time.

This may result in longer periods of intellectual property protection (and longer cash flows) as well as higher barriers to entry (and lower competition). In this example, the social impacts may also be more complex to assess, while all other aspects of the company's analysis may correspond to the element that SASB assesses as having the most risk (e.g., energy, water, and waste under Pillar E).

Since 2019–2020, there has been a growing trend in corporate reporting to include more material ESG factors. However, different stakeholders do not agree on materiality and how to report it, so developing proprietary materiality assessments may continue to be an important technique for investors to be able to develop their own analytical frameworks alongside standardized frameworks, such as those of SASB or the Global Reporting Initiative (GRI). As SASB becomes more established as a leading materiality framework, further research may be needed as such standardization requests from stakeholders increase.

ESG Risk Mapping Approaches:

ESG risk mapping can also be done at the research stage. Here, an individual company (equity or credit) or sector is exposed to a specific theme or factor, often one that is assessed as "material".

Risk mapping can also mean mapping a portfolio or investable space against a specific ESG risk (e.g. climate risk, water-related risk) to identify which sectors or companies contribute most to this particular risk profile (e.g. water-intensive or carbon-intensive companies). Examples of risk mapping approaches include carbon foot printing or examining the portfolio against different climate scenarios.

Mapping can also be done for key opportunities (e.g. opportunities as well as risks from recycling or switching to renewable energy). For example, it can be scored on a 10-point scale or given a qualitative label, such as low or high risk. This shows how the scorecard technique (described earlier) can be combined with mapping techniques.

To learn more about ESG and sustainability-related models, please contact **YTT Consulting**!