Benefits of the ESG Impact Assessment

Corporations (Equities & Bonds)

Dr. Regina Schwegler

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Zurich Office
Inrate AG
Binzstrasse 23
CH-8045 Zürich
Tel. +41 58 344 00 00
info@inrate.com
www.inrate.com

Geneva Office
Inrate SA
Rue de Berne 10
CH-1201 Genève
Tel. +41 58 344 00 00
info@inrate.com
www.inrate.com

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1. Why Impact Matters: Impact vs. CSR Assessment

Sustainable portfolios are currently offered in many asset classes, from equity to real estate. Basis for the construction of such portfolios is sustainability analysis.

Current sustainability analysis of companies mostly comprises ESG assessments which are based on assessing a company's CSR (Corporate Social Responsibility). However, these **CSR assessments** miss the point: By focusing on measures as well as management processes and structures, CSR assessments indeed reveal a company's willingness and ability to continually improve its sustainability impacts over time – however, companies with a positive CSR assessment do not necessarily have a better sustainability impact overall. On the contrary – companies operating in industries with high negative sustainability impacts are more likely to have highly professional CSR management systems, and often publish impressive sustainability reports.[1] Thus, "sustainable" best-in-class portfolios relying on CSR assessments potentially contain problematic companies such as coal, oil, nuclear companies.

Such companies, though, are part of the problem instead of the solution. And they carry high **sustainability-related risks**: A negative sustainability impact implies that a company has negative effects on society and/or environment, without having to pay for these in many cases (so-called "external effects"). Sooner or later, stakeholders – regulators, customers, NGOs, media, etc. – will address these issues. Therefore, high negative sustainability impacts can be interpreted as pressure to act if companies want to avoid related business risks. Positive or relatively low sustainability impacts, on the other hand, pose chances.

These risks and chances can hardly be identified with CSR assessments. It takes well-founded **sustainability impact measurements** to identify the positive and negative consequences of a company's activities for society and the environment. To be truly effective, such measurements must include sustainability impacts occurring along entire life cycles of a company's products and services, i.e. during resource extraction, supply chains, production, product usage and disposal. The reason is that in many sectors the most relevant impacts are caused outside companies. In the sectors nutrition, transportation and living for instance, most sustainability impacts occur in supply chains resp. during product usage. Accordingly, an encompassing sustainability impact measurement is the prerequisite to reveal to what extent a company contributes to or hinders a sustainable development. It is also necessary to detect if a company is exposed to sustainability-related business risks or whether it is able to profit from related chances.

2. Inrate's ESG Impact Assessment

To measure sustainability impacts comprehensively, Inrate's ESG Impact Assessment encompasses the following assessments:

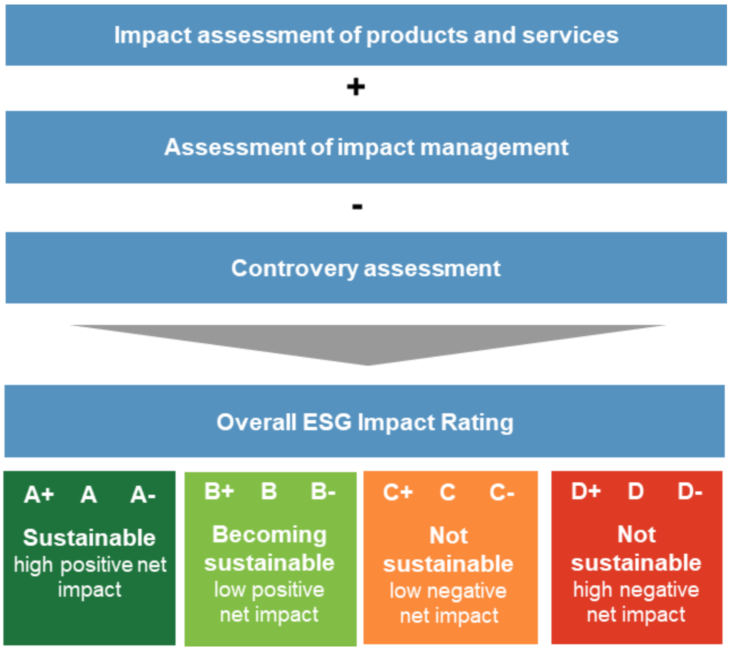
- **Impact assessment of products and services:** First of all, a company is characterized by its products and services. Volkswagen, for instance, produces automobiles, light trucks, offers credits, etc. Then, the sustainability impact of these products and services throughout the entire product life cycle is measured, based on Inrate's proprietary "Impact Matrix" and further indicators.
- **Assessment of impact management**: Secondly, it is assessed how well a company manages its sustainability impacts. This assessment is mainly based on a company's publications. It reveals how effectively a company works to improve its impacts, e.g. if it has set aims and runs programs to increase the energy-efficiency of its vehicle fleet.
- **Controversy assessment**: Thirdly, the assessment of a company's controversies is used to complement and correct the overall assessment. Controversies, such as Volkswagen's "Dieselgate" combustion scandal, show that a company's products and services have a worse impact and that its impact management is less effective and trustworthy.

The indicators used for the ESG Impact Assessment are derived from superordinate industry-specific **sustainability issues**. These name all relevant sustainability issues covered by the UN Sustainability Development Goals (SDGs): climate change, water, equality, etc. The indicators are **weighted**

[1] See for example Crane et al 2017: Measuring Corporate Social Responsibility and Impact, in: Business & Society 56(6), July 2017, pp. 787-795.

according to their importance to the company's overall sustainability impact and largely depends on the company's sector affiliation.

Figure 1 – Structure and rating scale of ESG Impact Ratings



Source: Inrate 2018.

The ESG Impact Assessment produces an **absolute sustainability impact rating** on a 12-step scale from A+ to D- (see Figure 1). This factors in whether, on a net basis, companies satisfy basic societal needs in a more – or less – sustainable way. The ESG Impact Rating provides an **absolute measure** of a corporation's sustainability impacts. It thus permits an assessment of and comparison between companies from different industries and regions, as well as entire portfolios. Volkswagen, for instance, can be compared to other car manufacturers, railway companies, utilities, etc.

As such, the ESG Impact Rating is not only well-suited for traditional "best-in-industry" approaches. It also allows a comparison between companies serving similar basic societal needs, such as transportation needs. Inrate's **Best-in-Service Approach** provides such a benchmarking. Across industries, it compares vehicle manufactures with aviation, shipping, public transportation and bicycle producers. This is possible due to Inrate-defined service sectors that encompass companies satisfying a specific basic societal need. Key service sectors include Nutrition, Housing, Transportation, Communications, Retail & Distribution, Security, Financial Services, Energy, Water, Resources, Disposal & Recycling, etc.

The products and services of companies within the same service sectors and sub sectors can principally be substituted with each other. Consequently, Best-in-Service Benchmarking is significantly broader than the traditional best-in-industry benchmarking. For example, in the Energy service sector the Best-in-Service Approach allows a comparison not only between oil and gas companies, but also between oil and gas, nuclear, wind, solar, and hydroelectric energy companies. On this account, the Best-in-Service Approach identifies those companies which satisfy certain societal needs with a **better overall sustainability impact** than their peers.

An important added value of the Best-in-Service Approach is that it allows to **differentiate** companies according to their **sustainability-related risk profiles**. Business risks and chances do not primarily arise from absolute sustainability impact levels, but from **relative levels**. Both the Energy and Transportation sector are good examples for this: Customers can switch from Diesel to electric cars or to public transportation. Customers can start purchasing green electricity. The competition for lower CO_2 or NO_x emissions is currently in full swing and occurs across industries. This, more generally, reveals that a company's sustainability impact poses a business risk or chance, respectively, if competitors are able to serve the same customer needs with a better/worse sustainability impact. On this account, the Inrate Best-in-Service Benchmarking, based on the ESG Impact Assessment, provides the appropriate benchmark classes to identify potential winners and losers.

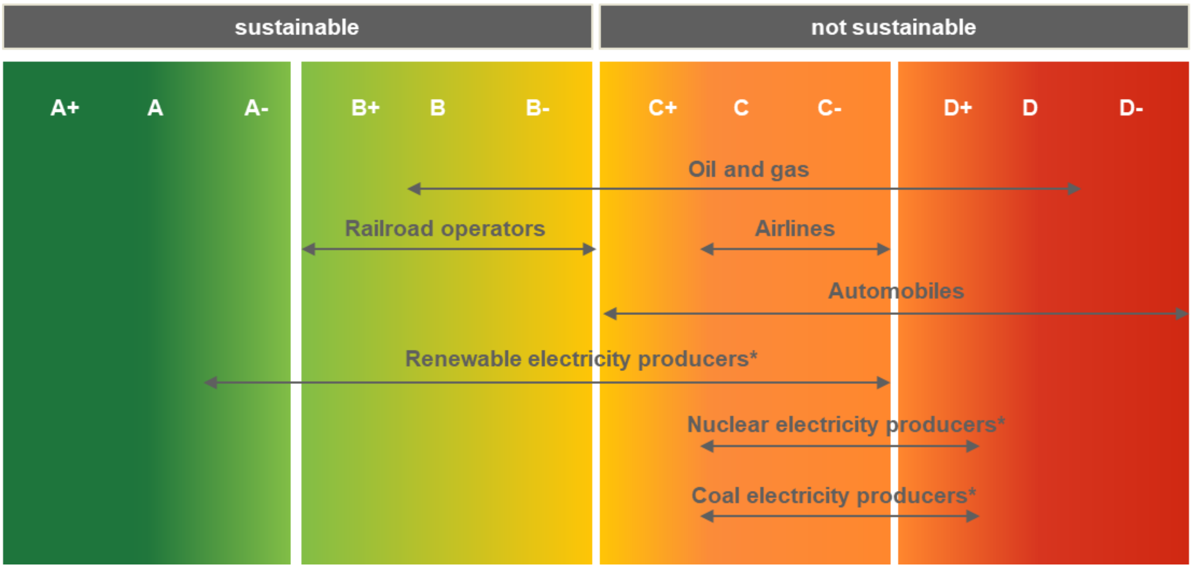
Another added value for investors is that value-based investors or investors concerned about reputations risks can identify companies that **truly contribute to a sustainable development** or avoid the ones that significantly hinder a sustainable development.

ESG Impact Assessments provide transparency for informed investment decisions – for positive and negative selections as well as for engagement and voting activities. This initiates a dynamic that, over time, helps to **improve the sustainability impact** of companies. The shifting of capital to more sustainable companies decreases the capital costs for these companies (sustainability premium) and increases the relative competitiveness of companies contributing to sustainability. In the longer run, this contributes to a structural change towards companies with better sustainability impacts.

3. ESG Impact Rating Examples

Companies from different economic sectors present completely different distributions of ESG Impact Ratings. In the Transportation sector, for example, airlines and automobile manufacturers are not rated as sustainable (at the C and D end of the scale), among others in view of their considerable impacts on the climate. Railroad operators, however, are deemed to be sustainable. Figure 2 illustrates that the absolute ESG Impact Ratings permit a comparison between companies from very different industries.

Figure 2 – ESG Impact Ratings of different economic sectors in the MSCI World Index



Source: Inrate, March 2018.
* Energy producers subsumed in these categories generate at least 25% of their turnover with the stated energy source.

4. Benefits for Investors

As described in chapter 2, the benefits of Inrate's ESG Impact Assessment for investors are multifold. Therefore, ESG Impact Ratings provide an optimal basis for most sustainable investment approaches such as exclusion screenings (norm- and value-based), positive selections (best-in-class, theme-based), ESG integration, as well as ESG-related engagement and voting: Each of these approaches implies one or more sustainability-related or financial motivations that Inrate's ESG Impact Ratings can potentially contribute to:

- **Implementation of ethical standards and norms:** ESG Impact Assessments allow investors to target at truly sustainable companies, be it for ethical or for reputational concerns.
- **Improvement of sustainability impacts:** ESG Impact Assessments allow for impact-related engagement and proxy voting activities and to shift capital to companies with better sustainability impacts. Both approaches contribute to improving sustainability impacts in the economy over time.
- **Risk-return improvement:** ESG Impact Assessments, especially if combined with a Best-in-Service Benchmarking, are optimal to differentiate companies according to their sustainability-related risk profiles: They show how "fit" a company is to compete concerning sustainability-related risks and chances.

Contact:
Inrate AG
Binzstrasse 23
CH-8045 Zurich
info@inrate.com
+41 58 344 00 00

Inrate – a Leading European Sustainability Ratings Agency

Inrate is an independent sustainability ratings provider based in Switzerland. Since 1990, we have been linking our in-depth sustainability analysis with innovative solutions for the financial markets. Inrate sustainability ratings provide a measure of the impacts that a corporation has on society and the environment with its conduct and its products.

Further information: www.inrate.com