MORNINGSTAR | SUSTAINALYTICS

THE ESG RISK RATINGS

MATERIAL ESG ISSUE: RESOURCE USE AND RESOURCE USE SUPPLY-CHAIN

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Sustainalytics' ESG Risk Ratings capture how companies manage the impacts and risks related to resource use, primarily freshwater, excluding energy and petroleum-based products within their own operations and/or their supply chains. Within the Risk Rating framework, Sustainalytics assesses two separate material ESG issues (MEI): 'Resource Use', speaking to the issue in relation to a company's own operations, and 'Resource Use – Supply Chain', focusing on a company's supply chain practices. Sustainalytics' assessments of these two material ESG issues show investors which companies are most exposed to this risk and how well they are managing it. In this backgrounder, we will examine why this issue is growing in importance, analyze which industries are most exposed to this issue and highlight companies that perform well on these material ESG issues.

The growing importance of Resource Use: Water as a systemic material issue

The importance of resource use related risks, in particular water risks, is one of key systemic risks identified year after year by the World Economic Forum.[1] Within its 2022 Global Risk Report[2], 'water scarcity is a key driver of migration because of its impact on health and livelihoods as well as the conflicts it risks triggering.' Access to freshwater is limited, as it accounts for only around 3% of the Earth's water. Most of this is stored in icecaps and glaciers (approximately 63%) as well as groundwater (approximately 36%), while all lakes, rivers and swamps combined account for only a small fraction (approximately 0.4%) of total freshwater reserves[3]. These resources are increasingly exposed to competition among multiple, growing number of upstream and downstream users around the world, often with competing interests as well as the ecosystem itself - leading to an increasing gap between global supply and demand. This is especially true in key hotspot areas where climate change impacts, signs of weak regulation, aging infrastructure or the lack of infrastructure manifest the most.[4] These are all key factors responsible for the deterioration of freshwater ecosystems, with a direct link to biodiversity loss, disruption of food systems, and the economy through global supply chains. The over extraction of these limited freshwater resources can cause massive displacement of people within regions, and lead to potential for conflicts within and among regions and nations.[5] Climate change is expected to impact the quantity, quality and natural cycles of freshwater supplies, often in an unpredictable manner.[6] Therefore, companies need to become resilient and flexible enough so they are able to respond to change and uncertainty.

All key stakeholders, including companies, consumers, investors and regulators are trying to address the issues related to natural resources, both the impacts and risks involved. Companies are becoming more aware that their own resilience means little if the natural and social systems upon which they depend on are disrupted or fail. Better water governance, risk assessment, and water management practices such as water stewardship programs are spreading across various sectors. Access to water and sanitation is a human right, and therefore a social and cultural issue. If this basic right is compromised, brands can be exposed to reputational risk due to direct links to exacerbating poverty, hunger, social exclusion or poor health for individuals and households. Investors are also becoming more aware of the immediate and long-term risks due to the growing evidence for water-related material risks, including physical (i.e. extreme weather events), regulatory (water use restrictions,

[1] https://www.weforum.org/reports/the-global-risks-report-2021
[2] https://www3.weforum.org/docs/WEF_The_Global_Risks_Report_2022.pdf
[3] https://journals.ametsoc.org/view/journals/clim/24/18/2011jcli4171.1.xml
[4] https://en.unesco.org/themes/water-security/wwap/wwdr/2019
[5] https://www.genevawaterhub.org/resource/matter-survival
[6] https://wwf.panda.org/wwf_news/?349774/Valuing-rivers-is-critical-to-global-efforts-to-adapt-to-climate-change

water price fluctuations) and reputational (stakeholder perceptions on company water uses and impacts) risks. The still low level of public corporate disclosure on water metrics, such as water withdrawal, water consumption, or pollutant content of discharged water, can be explained partially by a still low level of regulation to make it compulsory. We expect to see the role of governments grow in importance due to the EU Taxonomy or the SEC climate change disclosure regulation standard, as the European and United States governments spearhead the topic. Also, the Netherlands launched the Valuing Water Initiative, a multi-stakeholder process to bring systemic change in the way water is valued in policy, practice, finance and behavior.

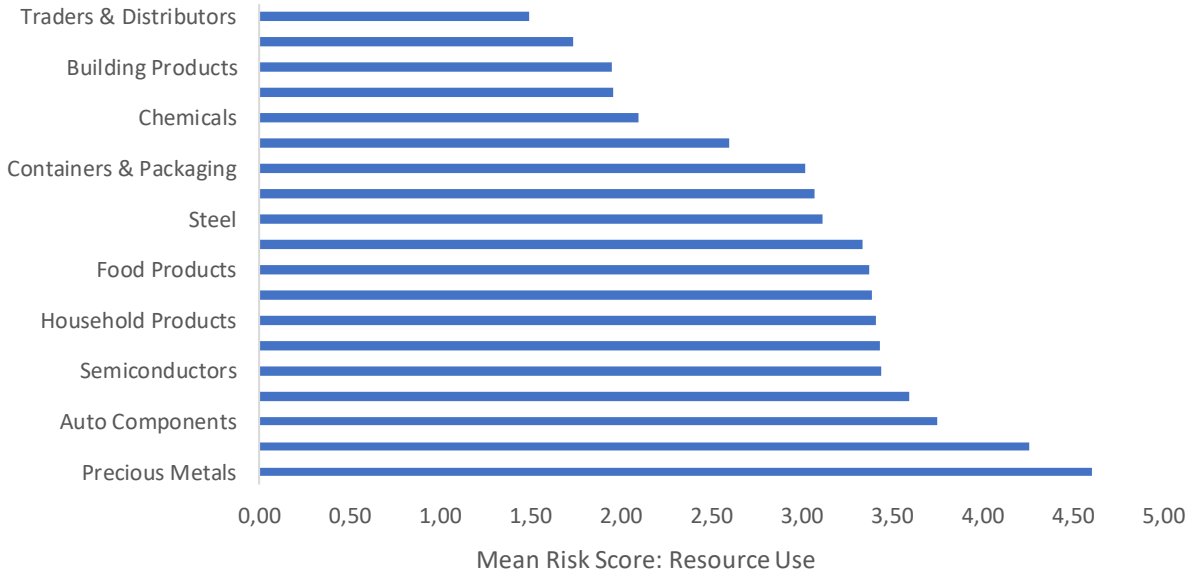
Assessing the Unmanaged Risk of Resource Use

Some industries, such as metals and mining, food products, or utilities are directly exposed to issues of resource use, as they either need water directly within their products or cannot maintain operations without the volume or quality of water they need. However, companies that are not directly dependent on water can still be exposed to considerable risks related to resource use in their supply chain. This is particularly so in the value chains for food products, textiles, or semiconductors.

The ESG Risk Rating for the Resource Use MEIs measures unmanaged risk. Applying our consistent and comparable ESG Risk Ratings model, we see that Resource Use is material for over 2205 companies in our comprehensive universe of more than 4,500 companies, spanning 25 industries and 49 subindustries. The MEI for Resource Use – Supply Chain applies to 524 companies in 6 industries and 11 subindustries.

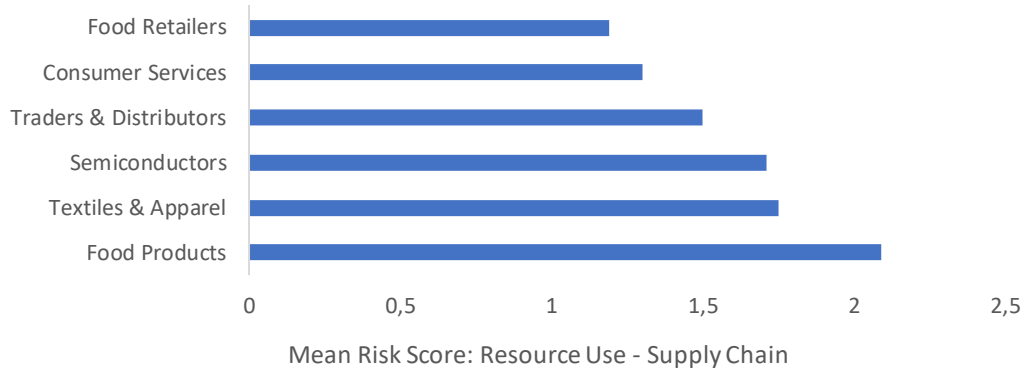
As indicated in Exhibit 1 and Exhibit 2 below, the Precious Metals industry has the highest unmanaged risk scores on average for Resource Use, and the Food products industry on the Resource Use – Supply Chain MEI.

Exhibit 1: Resource Use: Unmanaged Risk by Industry



Source: Morningstar Sustainalytics, June 2022

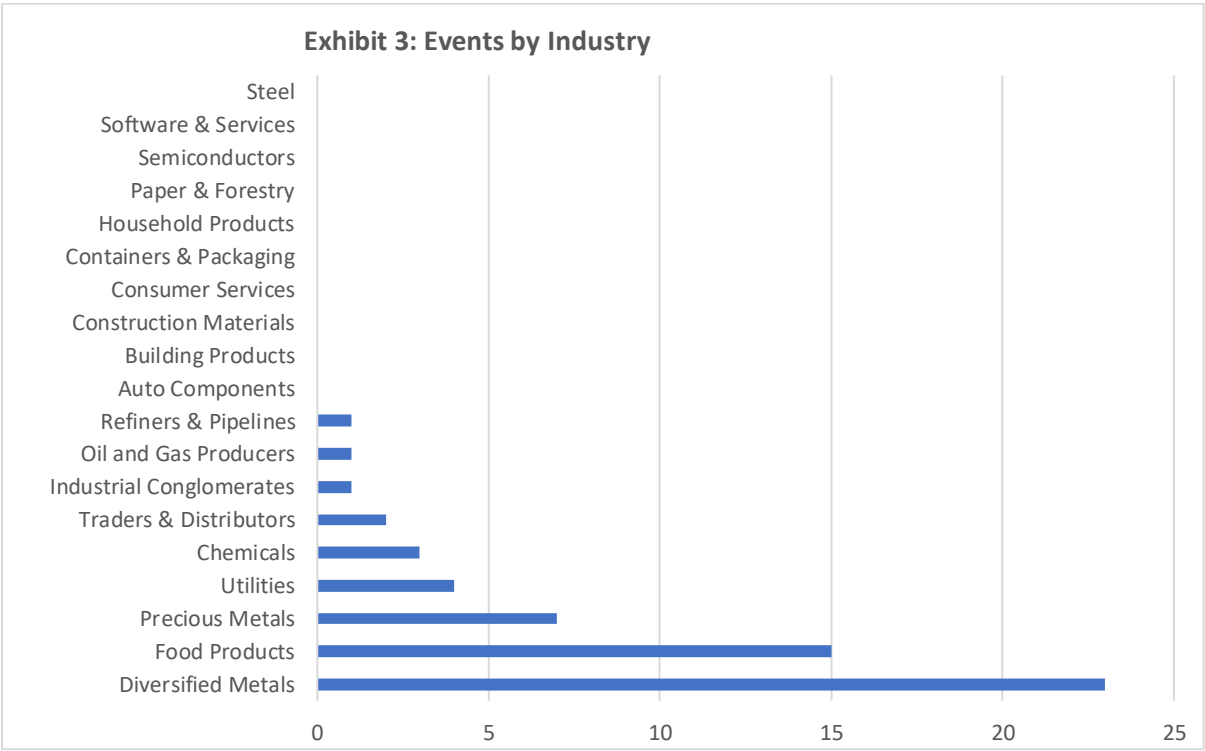
Exhibit 2: Resource Use – Supply Chain: Unmanaged Risk by Industry/Sub-Industry



Source: Morningstar Sustainalytics, June 2022

As seen in Exhibit 3 below, as of June 2022, Sustainalytics has recorded a total of 57 events related to Resource Use, and additionally, another 3 events related to Resource Use – Supply Chain MEI. Such events are captured through our news screening of more than 700,000 news items, third party sources or company and regulator reporting. For Resource Use, events often relate to issues of community opposition and regulatory restrictions (such as withdrawal of water use licenses) resulting from companies' misconduct in extractives and food products sectors, especially in water stressed areas like India, Peru, South Africa, etc. For Resource Use – Supply Chain, events can be concerned with issues such as non-compliance with water-related human rights, for example in the agricultural export sectors, if the production of water intensive commodities compromise the local access to water resources.

Exhibit 3: Events by Industry

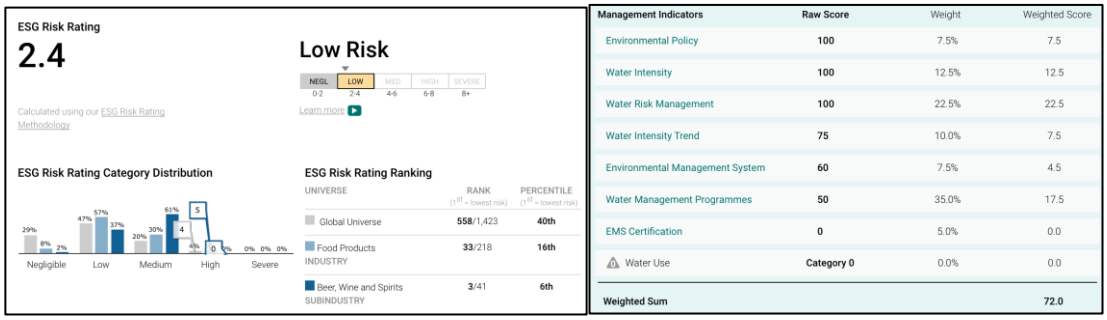


Source: Morningstar Sustainalytics, June 2022

How Sustainalytics' Evaluates Companies on the Resource Use MEIs

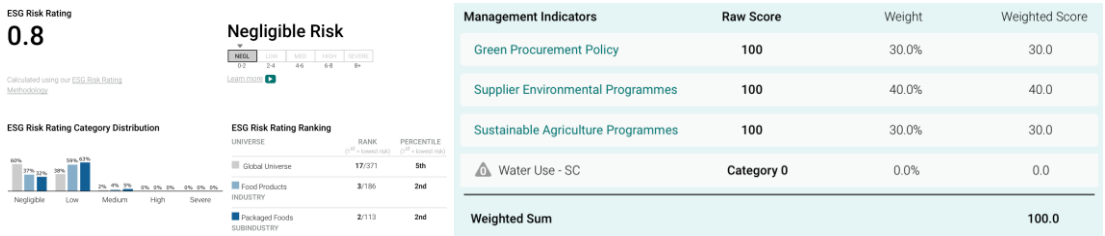
Sustainalytics' ESG Risk Ratings framework scores companies on a set of subindustry-specific exposure and management indicators. For instance, we assess whether companies within a certain sub-industry have exposure to issues related to Resource Use that divert from the sub-industry default because of their business model, or whether exposure to Resource Use is greater in a company's own operations or its supply chain. In assessing management of the issue, depending on the sub-industry, we look at indicators such as water risk assessment, water management programs, environmental management systems, supplier environmental programs and certifications, green procurement policies, among other factors.

One example of a company with strong management of its exposure to the issue of Resource Use regarding its own operations, is the British producer of branded premium spirits firm, Diageo. The company is assessed as low risk based on its overall ESG Risk Rating score of 16.7 as of June 2022. Water is the main ingredient in all their brands; thus the company considers water as a strategic priority. Their management practices include water risk management through, for example, replenishing 100% of water used in water-stressed areas where they operate, setting up adequate governance frameworks, or participation in relevant multistakeholder or industry initiatives, as well as reporting on contextualized water metrics. Diageo is considered the leader in the Beer, Wine, and Spirits sector, with an overall 2.42 ESG Risk score for the Resource Use MEI, owing to its strong management of the issue of Resource Use, as displayed below.



Source: Sustainalytics Risk Rating Report, Diageo, June 2022
For Informational purpose only.

A company that stands out when it comes to the management of the issue of Resource Use in its supply chain is the French packaged foods producer, Danone. The company is assessed as low risk based on its overall ESG Risk Rating score of 19.9 as of June 2022. All their business segments, including essential dairy and plant-based products, specialized nutrition; and bottled water rely on large quantities of water. As agriculture counts for the largest part of their water footprint, Danone demonstrates a high awareness of its water risks despite its complex and long value chains. This is through for example strong supplier environmental and sustainable agricultural programs, assessing water risks along its value chain, for example by closely looking at its fresh liquid milk suppliers and dairy farms, fruits and vegetables in potentially water-stressed areas. Despite having facilities in water stressed regions, Danone has avoided implication in controversies related to the issue. Danone is considered among the top three leaders in its industry and sub-industry, with an overall 0.8 ESG Risk score for the Resource Use – Supply Chain MEI, owing to its strong management of the issue in its supply chain, as displayed below.



Source: Sustainalytics ESG Risk Rating Report, Danone SA, June 2022
For Informational purpose only.

Corporate water disclosure: lacking in highest water stress areas

Given the localized, and geopolitical nature of water resources management, a water crisis can emerge either due to the physical lack of water, or the lack of economic, institutional, or political means to ensure its sustainable supply for all. The looming 'day zero' cases around the world, such as in Sao Paolo, Brazil, or Cape Town, South Africa, or Chennai, India –shows that these are not future risks anymore but are in fact present now. Water risk mapping tools, such as the World Resources Institute's Aqueduct tool, or WWF's Water Risk Filter, exist to support visualizing, localizing and quantifying the scale of physical, regulatory, and reputational water-related risks in key hotspot areas. Interestingly enough, corporate reporting in areas with the highest water stress are lagging the most behind.[7] For meaningful change, both governments and investors are well positioned to help incentivize companies to develop their disclosure and management practices to the highest possible level. More stringent regulation related to corporate climate and water disclosure is expected by the EU Taxonomy and the SEC.

[7] https://www.sustainalytics.com/esg-blog/water-reporting/

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