

ESG Spotlight

Investing in racial diversity: North American equities

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Themes:

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Industries:

Multiple

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North America

Authors¹

David G Frazer

Manager, Engagement Services
david.frazer@sustainalytics.com

Nonvignon Kpadonou, CFA, CIPM

Manager, Product Strategy and Development
nonvignon.kpadonou@sustainalytics.com

Martin Vezér, PhD

Manager, Thematic Research
martin.vezer@sustainalytics.com

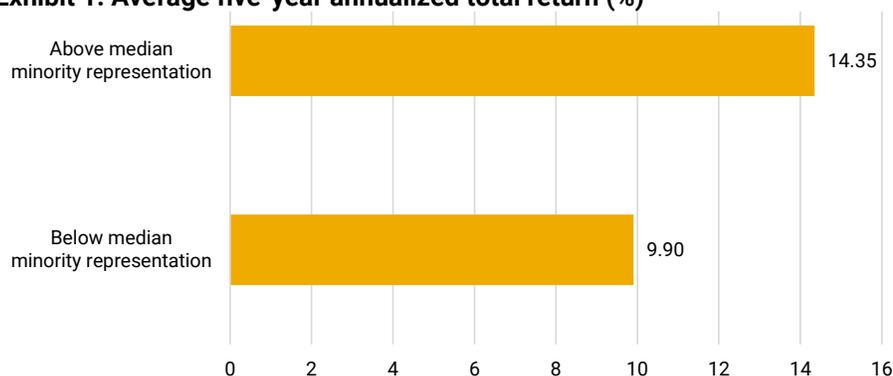
Key insights

- Assessing 685 North American firms, we find a 335% increase in ethnicity disclosures between 2015 and 2019, but still most (61%) disclose no data.
- Only seven of our sampled companies (1%) publicly disclose more than 120 of the 180 data points that would be required for a complete EEO-1 form.
- Of 65 firms that disclose relevant upper management data, those with more diverse teams delivered greater one- to five-year returns in 84% of cases.

Introduction

Several recent reports by human capital leaders have explored the relationship between diverse leadership teams and corporate financial performance, but most focus on gender diversity, while few address race or ethnicity.² One challenge is the dearth of standardized, publicly available data breaking down workforce demographics. In this report, we bridge the demographic data gap by compiling corporate disclosures of employee composition. We sample 685 North American mid and large cap companies and assess available race and ethnicity data related to categories covered by the US Equal Employment Opportunity Commission (EEOC). While we observe that an increasing number of firms are disclosing workforce demographics data, less than half of the firms in our sample provide any racial demographics data. Comparing a subset of 65 firms that disclose racial diversity information about their upper management teams, we find that firms with more diverse upper management delivered greater annualized total returns than less diverse ones on 21 of 25 comparisons over a five-year period (see p. 6). As shown in Exhibit 1, for example, the set of firms with minority representation in upper management above the sample median delivered a five-year annualized average excess return of 4.45% relative to the set of firms below the median.

Exhibit 1: Average five-year annualized total return (%)



n=65 North American firms with data on minority representation in upper management (including C-suite, VP, Director and Associate Director).
Source: Sustainalytics

The growing relevance of demographic information

Investor interest mounting

While diversity has been a focal point of investors for decades,³ notorious acts of discrimination against racial minorities in 2020⁴ and 2021⁵ have drawn many investors' attention to the topic of investing in racial equity. Increasingly, investors are exploring how diverse hiring practices can help create wealth in minority communities and how prosperity can lead to breaking cycles of poverty and violence among marginalized groups. According to a 2020 McKinsey report, since the murder of George Floyd on May 25, 2020, US corporations have committed USD 200bn to racial equity initiatives, with banks representing 90% of total commitments.⁶ Such initiatives may signal a growing recognition of the extent to which structural roadblocks for racial minorities are present and the need for corporations, in addition to governments, to address systemic barriers.

Shareholder response

Considering the mounting consensus about the material benefits of diversity, some investors have come to see the lack of diversity in corporate leadership as a source of portfolio value leakage.⁷ Race related shareholder proposals represented 5.4% of total shareholder proposals in the US in 2020, up from 3% in 2019.⁸ Within the past five years, US shareholder proposals on race have focused on encouraging companies to disclose EEOC data and to increase the level of diversity in upper management specifically. In the 2020 proxy season, 45% of resolutions on diversity disclosures received a majority "Yes" vote.⁹ In some high-profile cases, however, such as those of Amazon and Facebook, such resolutions have generated little support.¹⁰ Although many factors contribute to shareholders' voting decisions, we expect to see more attention paid to demographic concerns in the months and years ahead.

Disclosure regulations tightening

Recent promises by the Biden administration to address diversity, equity and inclusion (DEI) and increase funding to the EEOC may be a harbinger of greater transparency regarding US company demographics.¹¹ While more detailed demographics can help investors assess DEI issues, portfolio companies that are unprepared to meet strengthening disclosure requirements could face increased pressure from investors and regulators.¹² As noted in Exhibit 2, other markets with tightening DEI disclosure rules include Canada and Europe.

Exhibit 2: Demographic disclosure regulations in key markets

Market Regulations

US The EEOC was established to protect employment related articles of the Civil Rights Act of 1964. US corporations with more than 100 employees must disclose racial demographics to the EEOC, but these data do not have to be disclosed publicly.

Canada In Canada, companies governed by the Canadian Business Corporations Act have been required to disclose statistics on visible minorities since January 2020.

Europe Public European firms with more than 500 employees have been subject to the Non-Financial Reporting Directive (NFRD) since 2016. The directive requires a variety of ESG data to be published, including diversity data.

Source: Sustainalytics¹³

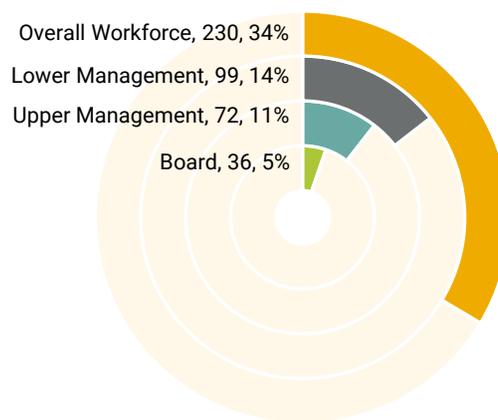
Trends in EEOC related disclosures

To gauge the progress of corporate disclosures related to EEOC data in North America, we sampled 685 firms with workforces in the US and Canada and reviewed their investor relations documents and other disclosures. Our analysis indicates that only 269 (39%) of the 685 North American companies publicly

disclose racial diversity data that would have been collected to fulfil their requirements with the US and Canadian regulations noted in Exhibit 2.

As shown in Exhibit 3, the number of firms publishing management and board level data declines relative to the overall workforce data: 34% of firms disclosed overall workforce data, while 14% disclosed lower management data and 5% disclosed board data. Investors seeking to review the DEI performance of their holdings will find mostly incomplete public data to inform their decisions. The data used in this analysis are based on 2019 reports, which was the latest reporting year of most of the firms in our sample during the data collection phase of our study. We expect higher levels of diversity disclosure in 2020.

Exhibit 3: Disclosure by organizational level (2019)*



*269 out of 685 North American firms disclosed diversity data on at least one org. level. **Source:** Sustainalytics

Assessing demographic disclosures

We assessed the quality of disclosures by considering the completeness of the information companies provide in relation to the 180 total data points required for a complete EEO-1 form – i.e. an Employment Information Report that US firms with more than 100 employees are required to file with EEOC.¹⁴ To provide all 180 data points, companies must break down their workforce into Caucasian, Black, Indigenous, Asian, Hispanic, two or more races, and others at the full workforce level along with the lower management, upper management, and board levels. Few companies release their full government report, which is the gold standard for racial diversity transparency. Many companies simply disclose the percentage of racial minorities, while others provide lower and upper management, as well as board specific information, alongside gender racial information. Reasons for disclosure gaps may include administrative difficulties, such as reaching an internal consensus on how and what to disclose, given the sensitivity on the topic, and the risk of disclosing unfavourable data that may indicate that a firm is below its industry standard.

A minority of firms highly transparent

Even though more firms are reporting EEOC related data, the quality of the disclosures remains low. As of 2019, 260 of our sampled companies only disclosed between 1 and 60 of 180 data points (Exhibit 4). This finding suggests that many companies are reporting a minimal amount of information and that some may be publicizing information selectively, releasing favourable diversity figures while not disclosing unfavourable data.

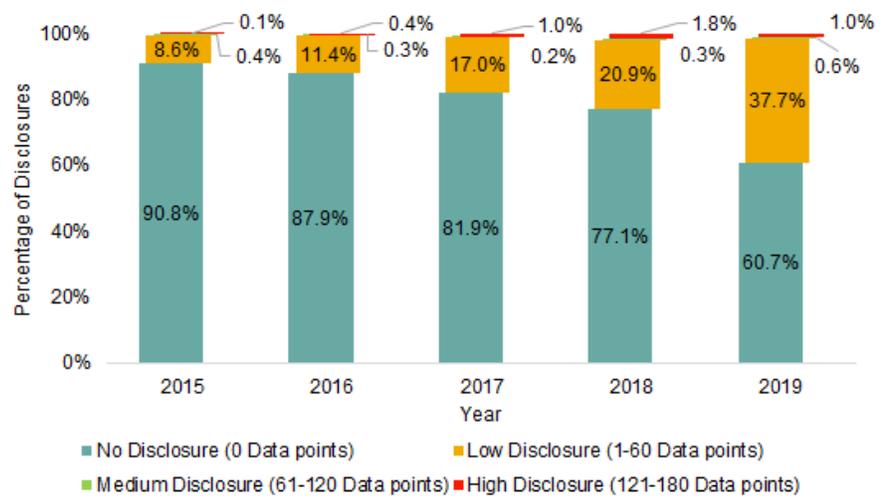
Seven firms with 120+ data points

Only nine (1%) of our sampled companies disclosed more than 120 EEOC data points: Adobe, Apple, BNY Mellon, Intel, Merck Sharp & Dohme, PayPal, PepsiCo, Starbucks and T. Row Price.¹⁵ Additional information that these companies disclose covers distinct racial and gender categories across a range of occupation types. Investors may choose to compare the demographic disclosures of their holdings with these examples.

Staying ahead of the curve

Mandating the publication of a firm’s diversity data, such as the EEOC form, would remove the self selection bias in the data and allow for a more robust analysis.¹⁶ The Biden campaign promised to return at a minimum to Obama era policies that required large and medium size companies to collect and disclose compensation information by race, gender and ethnicity.¹⁷ Investors looking to stay ahead of these strengthening requirements can engage with companies on this topic and assess their preparedness to abide by potential changes to EEOC related regulations.

Exhibit 4: Quality of disclosures related to race and ethnicity, 2015-2019*



*Sample of 685 companies with workforces in the US and Canada.

Source: Sustainalytics, Morningstar

The overall workforce

Hiring practices by sector

Investors may also find it useful to assess the performance of their holdings with respect to hiring practices in specific sectors. Exhibit 5 shows the representation of minorities at different levels of the workforce and compares 11 economic sectors with the EEOC published national averages.

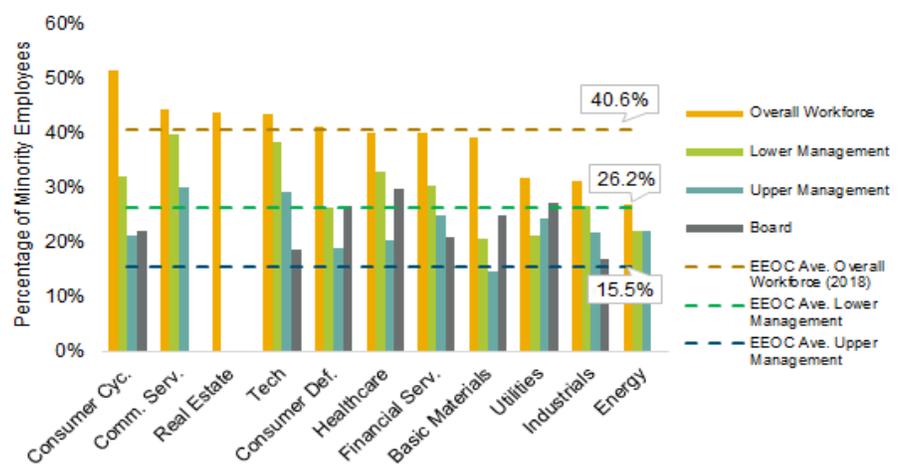
Focus points for engagement

Investors with an interest in improving racial diversity in their holdings could focus their engagements on companies that demonstrate the largest gaps between their overall workforce diversity and senior management diversity. The sectors with the largest gaps in minority representation in upper management compared to the overall workforce are Basic Materials, Consumer Cyclical and Consumer Defensive. These industries may be underutilizing diverse talent more than other firms, given the high level of diversity in their less senior ranks.

Further research

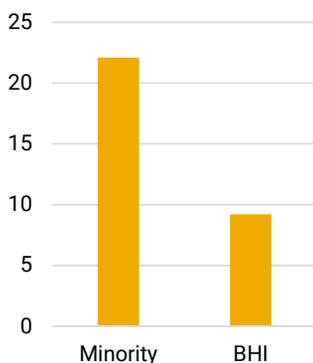
To develop a more holistic assessment of hiring and human capital practices, investors may consider other factors, such as the regional context of each company’s operations. Other points of interest include diversity and antidiscrimination management initiatives and related controversy records.¹⁸

Exhibit 5: Percentage of minorities in the overall workforce by sector, 2019*



Sample of 269 North American firms with racial diversity disclosures. EEOC average for board level data is unavailable. **Source:** Sustainalytics, Morningstar¹⁹

Exhibit 6: Average minority and BHI representation in upper management (%)



n=72 companies that reported upper management data. **Source:** Sustainalytics

Minorities in upper management

Focusing on companies that disclose upper management data, we note a gap between the minority and Black, Hispanic and Indigenous (BHI) populations. The 2019 US Census identified 43.6% of the population as ethnic minorities,²⁰ which is roughly aligned with the overall workforce data in our sample: on average, minorities comprised 40.8% of the workforce. However, while BHI populations comprise 33.4% of the US population, on average they formed only 24% of the workforce in our sample. Moreover, on average, minority and BHI representation in upper management stands at 22.1% and 9.2%, respectively (Exhibit 6).

For investors hoping to reap the full benefits of diversity, data on a broad spectrum of genders, ethnicities and socioeconomic backgrounds, at every level of seniority would be desirable. Strong representation across ethnic groups may indicate that leadership brings diverse perspectives and may be reflective of strong organizational hiring practices. Companies seeking to achieve full representation would include more Black, Hispanic and Indigenous employees in their senior ranks.

Diversity and financial performance

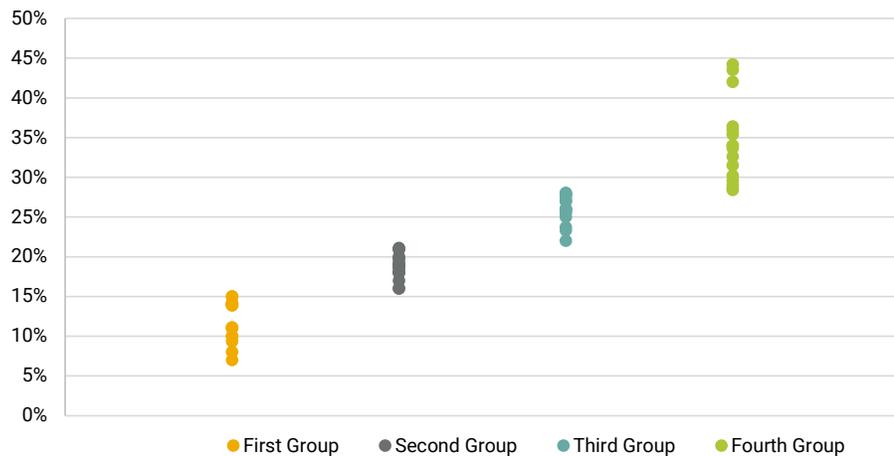
Focusing on upper management

For investors, the benefits of developing a DEI thesis can include creating a positive social impact and gaining exposure to firms that have equitable corporate cultures and upside potential associated with diverse leadership teams.²¹ To assess the relationship between racial diversity in corporate leadership and financial performance, we examined the disclosures of a subset of 65 North American companies that disclose upper management diversity data and that were publicly listed before January 2015.

Eight groups of companies

Using quartiles, the mean and the median, we divided our sample into eight subsets. The first four groups are based on quartiles of minority workers in upper management, as plotted in Exhibit 7.²² The remaining four groups contain firms with minority representation in upper management below and above the sample mean and median.

Exhibit 7: Sample grouped by percentage of minorities in upper management



*n=65 North American companies

Source: Sustainalytics

Eight comparisons

As shown in Exhibit 8, we compared the annualized total returns of these eight groups over a five-year period from January 1, 2015 to December 31, 2019. Out of 25 comparisons, 21 (84%) indicate that companies led by more racially diverse management teams outperformed those with less racial diversity. The largest difference among these groupings is between the above and below median samples on a three-year basis, when the above median group experienced an excess return of 6.85% relative to the below median group.

Exhibit 8: Mean excess return based on racial diversity in upper management

Annualized Total Return	2nd vs 1st quartile	3rd vs 2nd quartile	4th vs 3rd quartile	Above vs below mean	Above vs below median
1-Year	1.10	3.17	-1.29	2.98	3.06
2-Year	2.76	1.68	2.48	4.24	4.26
3-Year	-1.34	5.32	4.37	6.48	6.85
4-Year	0.15	3.54	1.62	4.08	4.43
5-Year	-2.76	5.67	-0.21	4.40	4.45

*n=65 companies; five-year holding period from January 1, 2015 to December 31, 2019. Source: Sustainalytics

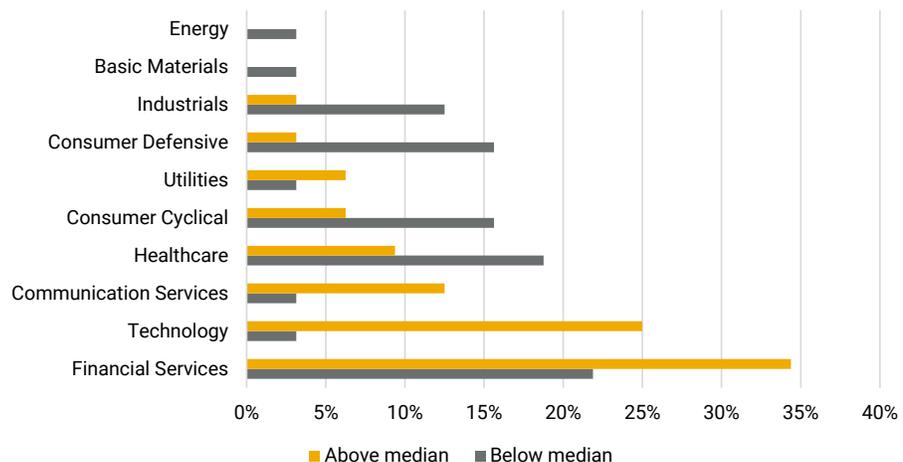
The role of sector composition

The sector composition of each group contributed to its relative performance. For example, the above median group is overweighted in tech companies, with 11 of the 32 firms (34%) in this group being in the Technology sector, compared to eight of the 32 companies (25%) in the below median group. Across all 65 companies, those in the Technology sector had both the highest average percentage of minorities in upper management (31%) and delivered a higher average five-year return than any other sector (17%).

Sectors that are leading and lagging

As indicated in Exhibit 9, Financials, Technology and Communication Services include the largest number of companies with more diverse upper management teams. Investors can explore these sectors to identify leading practices. The Financials sector is also poised to make further headway in this area since, as noted above (p. 2), firms in this sector are investing more in DEI strategies. In contrast, neither Energy nor Basic Materials include any sampled company with minority representation in upper management above the sample median.

Exhibit 9: Sector composition of firms grouped by minority representation*



*n=65 firms divided into two groups: The first has 32 firms with minority representation in upper management above the median; the second has 32 firms below the median. No data for Real Estate. **Source:** Sustainalytics

Intra-sector analysis

To control for sector effects, we analyzed eight sectors that include at least three sampled companies (excluding Energy and Basic Materials). Grouping companies within each sector based on whether their upper management diversity figures are above or below the sector median, we find that firms with more minority representation in upper management delivered higher five-year annualized returns than their less diverse counterparts in five of eight intra-sector comparisons. These sectors include Communication Services, Consumer Cyclical, Financial Services, Technology and Utilities.

Further research

While these findings are consistent with the idea that more diverse companies can outperform their less diverse peers, a combination of other factors, such as subindustry trends and idiosyncratic events, may also account for divergences in financial performance. Investors can explore such considerations by collecting more company data (our sample is small), performing a complete attribution analysis and conducting further research into sectors of interest.

The road ahead

Three challenges

Investors developing strategies that draw on racial diversity disclosures face three major challenges: an overall lack of public disclosures, inconsistent reporting and outdated classification templates.

Lack of disclosures

Although we have seen a marked increase in the number of companies disclosing racial data, the total number remains low, with only 269 of 685 sampled companies disclosing any relevant information. Future studies may provide more robust findings by drawing on larger samples as companies are poised to continue increasing transparency on employee demographics.

Reporting standards

Since companies choose if and how to disclose such information, the lack of standardization makes it difficult to compare them. For example, some companies disclose percentage figures that aggregate minority subgroups, such as women and persons of colour, while others disclose more granular diversity statistics, including specific race and gender figures.

EEOC template

The EEOC template that US firms currently must use when collecting their racial demographics was constructed during the civil rights era when the concept of race was not as well defined as it is today. For example, Indians, Mongolians, Arabs, Middle Eastern, Chinese and Thai are distinguishable ethnicities, but would all be classified simply as “Asian” in the EEOC form and related disclosures.

Conclusion – investing in diversity

Momentum building

The events of 2020 and 2021 related to racial discrimination in North America heightened the interest of investors to seek greater progress on racial equity in the workplace. While the data collected for this study are from 2019, they indicate that racial diversity in North American equities remains low, particularly with respect to Black, Hispanic and Indigenous employees in upper management. As momentum builds on this topic among companies, regulators, industry groups and investors, we expect related disclosures to face more regulations and public scrutiny.

Upside potential

The analysis presented in this report suggests that companies that excel at including diverse backgrounds in their workforces, particularly in upper management positions, tend to deliver outsized returns. Firms leading in DEI may also contribute positive social and reputational effects. A more complete attribution study would be required to assess the robustness of these hypotheses with regard to specific sectors and industries.

Portfolio applications

Investors can build on the approach developed in this report to advance their own DEI thesis. Portfolio strategies could integrate demographic data along with other ESG and financial inputs to help inform company assessments, security selection or capital allocation. While the data used in this study were collected for the purposes of this report, investors can similarly gather information about companies of interest and see how they compare to the trends that we have identified.

Engagement

Investors seeking to engage with the market can encourage companies to release their full EEOC submissions publicly, create quantitative targets to improve ethnic diversity, and implement programmes and policies that boost internal promotion of minorities, especially Black, Hispanic and Indigenous employees. Investors can also hold company leadership accountable for sustained or unexplained underperformance on ethnic diversity by supporting resolutions that promote greater racial equity.

Endnotes

- ¹ Acknowledgements: The authors would like to thank their Sustainalytics and Morningstar colleagues who helped in the preparation of the report. Jangbo Lee provided technical support for disclosure text mining. Tiffany Flaherty and members of the Morningstar Development Program (MDP) supported demographic data collection and analysis – special thanks to Aysu Seekin, Ruitian Yan, Harron Young, Benjamin Slupecki, Emma Bernstein and Muzi Li. Trevor David, Maggie Zhang, Wilco van Heteren, Michelle McCulloch, Sarah Cohn and Simon MacMahon provided helpful guidance and feedback on an earlier draft. Alison Gray copyedited the report. Any errors that remain are those of the authors.
- ² While this report considers issues of race and ethnicity together, the Merriam Dictionary describes the difference between these terms as follows: "The concept of 'ethnicity' contrasts with that of 'race' in that it is concerned with group cultural identity or expression whereas 'race' focuses on physical and biogenetic traits." Merriam Webster (2021), accessed (28.07.2021) at: <https://www.merriam-webster.com/words-at-play/difference-between-race-and-ethnicity>.
- ³ Scorgie, L. (11.11.2017), "Apartheid is Over, But Socially Responsible Investing is Not," Medium, accessed (28.07.2021) at: <https://medium.com/@lesleyannescorgie/apartheid-is-over-but-socially-responsible-investing-is-not-8001bba4f6f1>.
- ⁴ Douglas, D. Chrisafis, A. and Mohdin, A. (05.22.2021), "One year on, how George Floyd's murder has changed the world, The Guardian, accessed (28.07.2021) at: <https://www.theguardian.com/us-news/2021/may/22/george-floyd-murder-change-across-world-blm>.
- ⁵ Hutchinson, B. (6.05.2021), "Asian hate incident data shows discrimination skyrocketing in pandemic: Report," ABC News, accessed (28.07.2021) at: <https://abcnews.go.com/US/asian-hate-incident-data-shows-discrimination-skyrocketing-pandemic/story?id=77539420>.
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- ⁷ Hunt, V. Yee, L., Prince, S. and Dixon-Fyle, S. (18.01.2018), "Delivering through diversity," McKinsey & Company, accessed (14.06.2021) at: <https://www.mckinsey.com/business-functions/organization/our-insights/delivering-through-diversity?cid=other-eml-alt-mip-mck-oth-1801&hlkid=7136f77cb5de4b4e9f1de817d75a042d&hctky=2020225&hdpid=fdef79b6-4f45-4162-ac58-14db7193e4c6>.
- ⁸ Proxy Preview (2020), accessed (28.07.2021) at: <https://www.proxypreview.org/2020/report-cover>; Proxy Preview (2019), accessed (28.07.2021) at: <https://www.proxypreview.org/2019/report-cover>.
- ⁹ Cook, J. (23.07.2020), "3 Areas Where Shareholder Resolutions Can Advocate for Systemic Change," Morningstar, accessed (28.07.2021) at: <https://www.morningstar.com/articles/992699/3-areas-where-shareholder-resolutions-can-advocate-for-systemic-change>.
- ¹⁰ Amazon's shareholders proposal to report on the firm's environmental harm to communities of color received only 6% support by fellow shareholders. Facebook's similar shareholder proposal received 7% support. In 2019 however, the situation improved beyond previous years in terms of shareholders support, when three companies – Gaming & Leisure Properties, Newell Brands and Travelers – all received majority support by shareholders on race related proposals.
- ¹¹ Smith, P., LaBrecque, L. (04.01.2021), "Biden to Seek Pay Data to Help End Gender, Racial Disparities," Bloomberg Law, accessed (28.07.2021) at: <https://news.bloomberglaw.com/daily-labor-report/biden-to-seek-pay-data-to-help-end-gender-racial-disparities>.

- ¹² Jan, T. , McGregor, J., Merle, R. and Tiku, N. (13.06.2021), "As big corporations say 'black lives matter,' their track records raise skepticism," accessed (28.07.2021) at: <https://www.washingtonpost.com/business/2020/06/13/after-years-marginalizing-black-employees-customers-corporate-america-says-black-lives-matter/>.
- ¹³ EEO Data Collections, accessed (28.07.2021) at: [https://www.eeoc.gov/employers/eeo-reports-surveys#:~:text=The%20EEOC%20collects%20workforce%20data%20from%20employers%20with,to%20provide%20the%20data%3B%20it%20is%20not%20voluntary](https://www.eeoc.gov/employers/eeo-reports-surveys#:~:text=The%20EEOC%20collects%20workforce%20data%20from%20employers%20with,to%20provide%20the%20data%3B%20it%20is%20not%20voluntary;); Jaeger, J (30.09.2019), "Understanding Canada's new diversity disclosure requirements," accessed (28.07.2021) at: <https://www.complianceweek.com/boards-and-shareholders/understanding-canadas-new-diversity-disclosure-requirements/27805.article>.
- ¹⁴ The 180 data points cover demographics related to race, ethnicity and gender. See example of EEO-1 form by Facebook Inc, accessed (28.07.2021) at: <https://www.are.na/block/9762716>.
- ¹⁵ Adobe has provided an EEO 1 report every year from 2015 to 2018 however there was no EEO 1 report available for 2019 This company appears to be an outlier in terms of going from a high level of diversity disclosure in 2015 to a lower level of disclosure over time by 2019.
- ¹⁶ To a limited degree, company diversity disclosures depend on the extent to which individual employees disclose their own personal details (race, gender, etc.). However, these gaps would be reflected, when they occur, in the percentage of employees who did not respond to a request for information.
- ¹⁷ Smith, P., LaBrecque, L. (04.01.2021), op. cit.
- ¹⁸ Vezér, M., Flaherty, T. and Lee, J. (20.07.2021), Race, Ethnicity and Public Equity: A Global Snapshot, Sustainalytics Spotlight Series Report, accessed (28.07.2021) at: <https://connect.sustainalytics.com/esg-spotlight-race-ethnicity-and-public-equity>.
- ¹⁹ Organized by Morningstar GECS (Global Equity Classification Structure) sector classifications as of February 2021 accessed (28.07.2021) at: <https://files.pitchbook.com/Morningstar+Global+Equity+Classification+Structure.pdf>
- ²⁰ US Census Bureau, accessed (28.07.2021) at: <https://www.census.gov/data.html>
- ²¹ Hunt, V. Yee, L., Prince, S. and Dixon-Fyle, S. (18.01.2018), op. cit.
- ²² The first group contains the least diverse companies that have less than 16% (first quartile) of minority workers in upper management. The second and third groups are comprised of companies with percentages of minority workers in upper management below the second quartile (21%) and the third quartile (28%), respectively. The fourth group contains companies with minority workers in upper management above the third quartile

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info@sustainalytics.com
www.sustainalytics.com