

## Overview of Sustainalytics' ESG Risk Ratings

Sustainalytics' ESG Risk Ratings are designed to help investors identify and understand financially material ESG risks at the security and portfolio level. To this end, the ESG Risk Rating captures an issuer's **exposure** to material, industry-specific ESG risks and an issuer's **management** of those risks. The ESG Risk Rating provides investors with an overall company score based on an assessment of how much of a company's exposure to ESG risk is **unmanaged**. The more of this risk that is unmanaged, **then the higher the ESG Risk Rating score**.

In this overview we cover the following:

- ESG Risk Rating Methodology
- ESG Risk Rating Score
- ESG Risk Rating Research Process
- Issuer Engagement

### ESG Risk Rating Methodology

#### Exposure to ESG Risk

Sustainalytics has developed a proprietary model for determining a company's exposure to ESG risk.

- Exposure to ESG risk is assessed by the Sustainalytics research analyst team across 138 Sustainalytics-defined **sub-industry** classifications.
- Sustainalytics reviews the potential impact of 20 **material ESG issues (MEIs)** on each of these sub-industries and then through an intensive consultation process the Sustainalytics research analyst team selects up to 10 MEIs per sub-industry.
- Every issuer within a specific sub-industry is initially assigned the same set of MEIs.
- Corporate Governance is applicable to all issuers.
- An issuer's final exposure score includes **company specific adjustments**.
  - An MEI may be disabled if it is not relevant for a specific issuer.
  - Each issuer receives a "**issue beta**" assessment for each MEI that can increase or decrease the sub-industry exposure score on each MEI.
  - Finally, each company faces the possibility of "**idiosyncratic risks**" – i.e., an event-driven risk that emerges due to a severe ESG controversy (category 4 or 5). In these cases, additional exposure is added.

## Management of ESG Risk

Sustainalytics has developed a proprietary model for determining a company's management of its exposure to ESG risk – its **managed risk** score.

- Controversies are also assessed at the MEI level and are considered a breakdown in management. Any controversy results in a decrease in management score, with the decrease being higher for more severe controversies.
- Each issuer faces the possibility of an “idiosyncratic risk” – i.e., an event-driven risk that emerges due to a severe ESG controversy (category 4 or 5) on an issue that is not typically considered material for that company. In these cases, an additional event indicator is added, which reduces the company's overall management score

## Unmanageable Risk

An important feature of Sustainalytics' rating is the introduction of the concept of manageable risk and unmanageable risk.

**Unmanageable risk** is the portion of a company's exposure score that remains a risk to the company regardless of its management practices. For example, tobacco companies cannot fully eliminate the health risks associated with their products.

**Manageable risk** is the portion of a company's exposure score that can be managed through its policies and programmes.

The proportion of manageable vs. unmanageable for each MEI is defined at the subindustry level.

## ESG Risk Rating Score

A company's ESG Risk Rating score is **the sum of unmanaged risk** for each of the company's MEIs.

- The unmanaged risk of an MEI is calculated as exposure minus managed risk.
- **ESG Risk Categories:** An issuer's ESG Risk Rating score is assigned to one of five ESG risk categories: negligible, low, medium, high, and severe. Each category captures a level of material financial impacts driven by ESG factors.

### Exposure

- For each MEI assigned to an issuer, exposure is scored typically on a 0-20 range, with 20 being the highest exposure.
- Each MEI exposure score represents a portion of the overall exposure score, which ranges between 0 and 100

### Management Score

- An issuer's overall **management score** is the sum of the weighted scores of each MEI management score. Weights are determined by the contribution the MEI's manageable risk score makes to the overall manageable risk score.

- For each MEI, the management score is the sum of each weighted management indicator score. The weights for management indicators within an MEI are based on the indicator's relative ability to reflect management's performance on that issue.
- Each management indicator has a raw score between 0 and 100.

#### *Managed Risk Score*

- The overall company MANAGED RISK score is the summation of all MEI **managed risk scores**.
- The MEI managed risk score is determined by multiplying the MEI management score by the MEI manageable risk score.
- Example: If a company has manageable risk of 8 for an issue and the management score is 70 for that issue, its managed risk will be  $8 * 70\% = 5.6$

#### *Unmanaged Risk Score*

- This is the ESG Risk Rating score.
- Unmanaged Risk Score = **unmanageable** risk score + unmanaged **manageable** risk score.

## ESG Risk Rating Research Process

An issuer's ESG Risk Rating is updated via an annual research process by a Sustainalytics' research analyst that includes the following:

- Review of Sources
  - Corporate publications and regulatory filings (e.g. Annual Reports and Corporate Sustainability Reports)
  - News and other media
  - NGO reports/websites
  - Multi-sector information sources (e.g. Global Reporting Initiative, Carbon Disclosure Project reports)
  - Company feedback
- Assessment of management indicators
  - Includes a review of ESG controversies
- Processing any issuer feedback on draft ESG report
- Quality and peer review

### Collection of issuer data

Analysts collect relevant issuer data from public documents available on the issuer website and/or via regulatory authorities, or from direct communication with issuers themselves.

### Review of media and NGO Sources

News screening is conducted daily, and ESG-related controversies are processed within 48 hours. Sustainalytics has an extensive methodological framework that enables thorough, consistent and timely controversy assessments to keep clients informed of ongoing and developing ESG risks in the Sustainalytics coverage universe.

Sustainalytics tracks reports and websites of Non-Governmental Organizations (NGOs) that have a reputation for providing reliable research. On a quarterly basis, relevant information is filtered from NGO reports and used to update management indicators.

## Management Indicator Assessments

For every indicator, our analysts evaluate the degree to which a company meets relevant best practice standards. On this basis, a raw score between 0 and 100 is assigned to every indicator, based on a set of detailed and well-documented internal criteria. In turn, these raw scores are aggregated based on a specific set of weights that reflects the relative importance of an issue and the related indicators.

## Controversy Assessments

Controversies are a measure of company performance. Controversy research, which is updated continuously, is performed by a dedicated team of analysts, whose work is then reviewed by an ESG Ratings analysts prior to publication.

Sustainalytics assesses companies for their level of involvement in controversies that have an impact on the environment or society and the associated business risks companies face from such involvement.

Each controversy is categorized from Category 1 (low ESG impact) to Category 5 (severe ESG impact).

For Category 4 and 5 controversies, efforts are made to engage directly with the issuer prior to our final assessment. An internal committee of senior research analysts and managers reviews and approves the final ratings determinations.

## Quality and peer review

Analysts' indicator assessments are **reviewed** through quality assurances processes, including peer and manager review, as well as automated exception checking and change detection.

## Other Update Processes

Certain indicators are updated on a cycle that vary from the annual update, including:

- Benchmarking indicators such as Carbon- and Water-related quantitative performance indicators, where comparisons to the broad universe require a single aligned update for all companies.
- Corporate Governance indicators related to board constitution, committees, corporate governance disclosure, and audit fees. These are researched by a separate team; the most recent research is included when the ESG report is updated in its annual research cycle, but the ESG reports will be republished when newer governance research is available.

## Issuer Engagement

Issuers have direct access to Sustainalytics analysts and can engage with analysts at any time. In addition, Sustainalytics has a dedicated Issuer Relations team that helps analysts manage their interaction with issuers. Sustainalytics will initiate engagement with an issuer for two basic reasons:

### **Annual Update Feedback Process:**

- **Outreach:** Sustainalytics contacts issuers in our comprehensive universe as part of the annual update of the ESG Risk Rating Report. An analyst contacts an issuer to solicit feedback on their research before the ESG Risk Rating Report is published.

- **Deadline:** Issuers are given two weeks to review the accuracy and completeness of the data collected. If issuers provide feedback within the allotted time frame, this information is reviewed and integrated by the analyst prior to the release of the updated report to Sustainalytics' clients.
- **Post-Publishing Updates:** If an issuer does not respond within two weeks, the updated ESG Risk Rating Report is published without feedback. If the issuer ultimately provides feedback, Sustainalytics will integrate relevant data as soon as possible and republish the ESG Risk Rating Report.
- **Documentation:** The use of issuer feedback is clearly documented in the sources list of the ESG Risk Rating Reports.

***Significant ESG Controversy Assessment:***

- **Outreach:** Analysts contact an issuer if an ESG controversy is downgraded to a Category 4 or 5 (the most severe controversy levels), to provide an issuer the opportunity to review the facts and/or provide details on the management response to the controversy.
- **Deadline:** Issuers are given 48 hours to review the accuracy and completeness of the data collected. The short period of time is necessary to ensure the timely update of controversy assessments to our clients.

**Contact Sustainalytics' Issuer Relations Team at:  
[issuer.relations@sustainalytics.com](mailto:issuer.relations@sustainalytics.com)**

**About Sustainalytics, a Morningstar Company**

Sustainalytics, a Morningstar Company, is a leading ESG research, ratings and data firm that supports investors around the world with the development and implementation of responsible investment strategies. For more than 25 years, the firm has been at the forefront of developing high-quality, innovative solutions to meet the evolving needs of global investors. Today, Sustainalytics works with hundreds of the world's leading asset managers and pension funds who incorporate ESG and corporate governance information and assessments into their investment processes. Sustainalytics also works with hundreds of companies and their financial intermediaries to help them consider sustainability in policies, practices and capital projects. With 16 offices globally, Sustainalytics has more than 700 staff members, including more than 200 analysts with varied multidisciplinary expertise across more than 40 industry groups. For more information, visit [www.sustainalytics.com](http://www.sustainalytics.com).