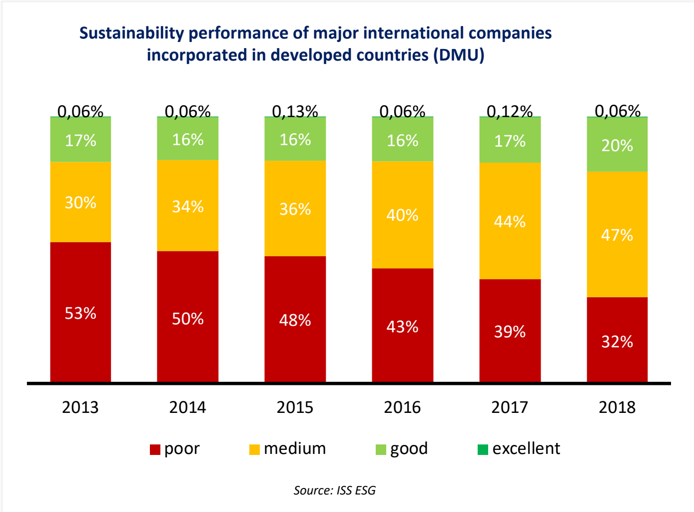
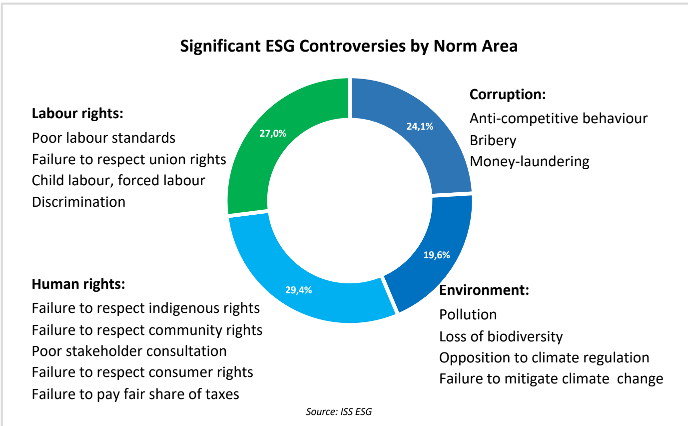
ESG Review 2019:
The State of Play of Corporate Responsibility

ESG continues to gain currency within boardrooms and greater understanding within executive suites across global capital markets: In developed markets, the share of companies assessed with "good" or "excellent" performance saw an unprecedented increase, reaching an all-time high of 20.44 percent, up from just over 17 percent in the previous year. Together with medium-assessed companies, the group rated with "better-than-poor" performance, totals to more than 67.5 percent. Similar patterns can be observed among companies incorporated in emerging markets, albeit on a considerably lower level.

Drivers of this change are varied but regulation features prominently. In March 2018, the European Union's Action Plan defined 10 actions on sustainable finance and in May the European Commission published four legislative proposals relating to taxonomy, fiduciary duties, and disclosure (ESG integration), low-carbon benchmarks, and ESG as part of financial advice (amendments to MiFID and IDD directives). A Technical Expert Group on sustainable finance (TEG) also was set up.



While significant strides have been made as measured by improved corporate ratings in 2018, it is important to note that there is a continued rise in the number of reported controversies across all ESG topics – more than 40 percent over calendar 2018, highlighting a growing misalignment of corporate practices with stakeholder expectations. By the end of 2018, human rights and labour rights together accounted for 56 percent of significant controversies assessed under Norm-Based Research. The increase in volume of reported controversies and corporate malpractice is largely a result of a maturing debate around human rights due diligence, increased awareness about standards, improved monitoring mechanisms, and also reflects the expanding influence and reach of social media.



Looking ahead, we expect the coming months to include a sharper focus on four key areas, including: climate change, responsible consumption and resource use, data security and data privacy, and #MeToo and discrimination. All of these topics are covered in greater detail within this year's report and we encourage you and your colleagues to read about these and other trends as you shape your focus for 2019.

KEY FINDINGS

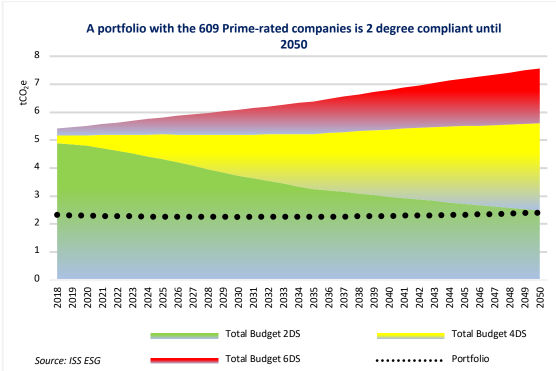
In comparison to the ISS-oekom CR Review reports of previous years, the average sustainability performance of companies continues to exhibit a clear upward trend that is supported by various factors. On the one hand, voluntary initiatives such as the Task Force on Climate-related Financial Disclosures (TCFD) and the SASB reporting standards continue to gain traction. On the other hand, legislators across several jurisdictions are working hard to tighten reporting requirements and to promote sustainable finance (e.g. EU Action Plan on Sustainable Finance, Article 173 in France, etc.). And lastly, rated companies themselves show increased awareness of the materiality of ESG factors.

Broken down into specific industry sectors, the **Household & Personal Products** industry has the highest share of Prime-rated companies with 28.2 percent, followed by **Semiconductors** (26.7 percent) and **Electronic Devices & Appliances** (21.7 percent). Industries with the lowest share are Food & Beverages (6.4 percent), Oil, Gas & Consumable Fuels (6 percent) and Retail (4.8 percent).

In the Corporate Rating, the **top-3 companies** in the Financials/Commercial Banks & Capital Markets industry are NIBC Bank, ABN Amro Group, and Raiffeisen Bank International. The Telecommunications sector sees Deutsche Telekom, Magyar Telecom and Orange as top-3 companies within their industry. The Machinery sector sees three new top-rated businesses (Alstom, Ingersoll-Rand and Komatsu). The same goes for the chemicals industry which is led by Clariant, Borregaard and Air Products and Chemicals.

41 percent of assessed companies contribute positively to the UN SDGs through their products and services – thereof 8 percent to a significant extent. On the downside, the products of 27 percent of assessed companies obstruct the achievement of the SDGs. For the remaining 32 percent, no net impact could be identified.

A **scenario analysis** of a portfolio of all 609 Prime-rated companies which focusses on future alignment with a 2 degree Celsius average global warming reveals that the Prime portfolio remains **2-degree compliant until 2050**.



The continued rise in the number of reported **controversies across** all ESG topics under Norm-Based Research – **more than 40 percent** between January and December 2018 – exemplifies a growing misalignment of corporate practices with stakeholder expectations.

By the end of 2018, failures to respect **human rights and labour rights together accounted for the majority (56 percent) of significant controversies** assessed under Norm-Based Research. This perception is is largely the result of an increased awareness about standards, and improved monitoring mechanisms as well as a maturing debate around human rights due diligence.

Industries that are most exposed to controversies in the Environmental area are Materials companies (22 percent), Energy (20 percent) and Utilities (15 percent). In the Social area, Materials companies are also leading (18 percent), similarly followed by Energy (12 percent) and Capital Goods companies (10 percent). The Governance area sees most controversies within Banks (17 percent), Capital Goods (15 percent) and Pharmaceuticals & Biotechnology (9 percent).

The far largest number of ESG **controversies** have been observed in the U.S. or occurred in the U.S. (19 percent), followed by Brazil, India and Indonesia (4 percent each).

Of the 25,000 companies covered by ISS ESG for their **climate performance**, just 3,100 reported in 2018, measuring their Scope 1 and 2 greenhouse gas emissions. This is a **five percent increase compared to the previous year**, mainly coming from companies located in Emerging Markets, with China and Hong Kong leading the group.

Of the companies reporting their greenhouse gas emissions, 45 percent chose to not disclose to the CDP and only reported via their CSR reports. Nonetheless, **43 percent of companies chose to report emissions** both through annual reports and through the CDP. The number of companies only reporting through the CDP but not through other channels shrinks every year.

Despite the relatively small number of issuers, roughly ten percent of covered companies, reporting their greenhouse gas emissions, there is evidence that the **quality of reporting is improving** for those that do disclose this information. For the MSCI ACWI universe, the ISS Trust Metric shows an average improvement from 76/100 in 2016 to 81/100 in 2018.

TCFD alignment is not widely picked up yet, but it did see some uptake in its first year. **Of all companies reporting to the CDP, 106 also produced TCFD-aligned climate reporting** in 2018. Of those, more than 30 percent of those companies are within the financial sector.

The 609 corporates that received Prime status in the Corporate Rating, making them the top sustainability performers in their respective sector, are also **leaders in terms of climate strategy**. 430 of these 609 companies (more than 70 percent) have set themselves either an absolute or an intensity-based target to reduce their greenhouse gas emissions. Out of these, 157 (36.5 percent) have set concrete, science-based targets to reduce their own emissions in line with the international climate commitment.

When assessing responsible consumption and the use of plastics in the private sector, Norm-Based Research observes that the five industries most associated with plastic pollution in the media are: Beverages (28 percent), Restaurants (22 percent), Household & Personal Care (11 percent), Food Retail (25 percent) and Food / Major Diversified (14 percent).

Taking a closer look at **fast fashion**, data from Norm-Based Research shows that more than a quarter of all **supply chain labour rights controversies** relate to the Apparel/Footwear and Apparel/Footwear Retail sectors. The data also shows that the highest **risk locations for labour rights supply chain controversies** overall remains South East Asia. China, India, Indonesia and Cambodia are also in the top five locations for supply chain labour rights controversies.

In 2018, the Internet Software/Services sector expectedly topped all sectors involved in **cybersecurity controversies**. When surveying all controversies catalogued in the Norm-Based Research for the year, **privacy rights controversies** are the most commonly occurring issues in the technology sector.

Looking at **discrimination and inequality**, as defined by Principle 6 of the UN Global Compact, Norm-Based Research noted a 69 percent increase in the number of significant controversies in this area between 2017 and 2018. Of the broader gender discrimination allegations, nearly 40 percent are in relation to controversies noted in the U.S. The United Kingdom is the second most common location, with the remaining countries in the top-7 being in South East Asia.

In the Corporate Rating, the average assessment of active measures taken by companies to promote **equal opportunities and diversity** ranges from 1.6 (on a total range between 1 and 4) for Pharmaceuticals & Biotechnology and 2.1 for Semiconductors. This is significantly lower than the average rating of policy commitment in the same group of sectors, which ranges from 2.5 for Financials/Asset Managers & Securities Brokerages to 3.2 for Semiconductors.

Corporate Ratings data also illustrates how women are still far from breaking the glass ceiling in many of the sectors in which diversity has been identified by SASB as a material issue. In most of these sectors, the average proportion of women in executive management teams is around 15 percent, with a range from 7 percent for Semiconductors to 26.6 percent for Healthcare Facilities & Services.

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All statistics referenced to in this document are approximate and updated on an annual basis and, unless otherwise noted, relate to the year ending December 31, 2018.