PEFINDO's Approach Towards ESG and its Implications to Credit Ratings

Analysts: Aishantya & Qorri Aina

PEFINDO is of the view that the assessment of a company's environmental, social, and governance (ESG) as part and parcel of a credit risk assessment. In general, the term ESG refers to the examination of a company's ESG practices, their impacts, and the company's progress against benchmarks. We are of the view that the better a company addresses risk (and opportunities) related to ESG, the more sustainable its business and financial performance will be over the short, medium, and long-term. Success in responding to ESG factors could lead to improved competitive position due to the absorption of future demand and distinction from competitors, therefore, increasing the capacity to generate cash flows that exceeds the initial investments. In contrast, failure to respond to ESG factors such as delaying investments could result in the loss of future business opportunities and reduced profitability due to change in market preferences as well as additional charges because of regulatory compliance, hence, weakening the capacity to generate cash flows.

PEFINDO is committed to following the credit rating industry's best practices while also able to respond to market demand for reliable, independent, and objective credit assessments, particularly issues related to ESG, and we have decided to integrate ESG considerations as part of a holistic approach to accessing credit risk. This article will explain our approach in assessing ESG factors and how we integrate these assessments into our existing credit rating methodology. We will focus on factors that may influence the relative risk of a company's industry, business, and financial performance, accordingly, company's capacity to service its financial obligations in full and timely manner from a ESG perspective, having negative (risk) or positive (opportunities) credit impacts. If the ESG factors are not relevant or are less material, we will view it as neutral in our credit analysis.

PEFINDO is of the view that E&S factors tend to be both sector-related as well as company-specific and could be driven by external factors such as regulations or demographic and community changes while the G factor is more company-driven. Therefore, PEFINDO is of the believe that a company-specific analysis will differentiate ESG factors implication to rating.

Environmental (E) and Social (S)

PEFINDO considers the relevance and materiality of the E&S factors and how it may affect a company's business and financial performance, including each company's mitigants in addressing these risks. PEFINDO is of the believe that the time frame aspect in assessing the E&S factors is very critical as our ratings are forward looking opinion. A longer time frame over which such E&S risks are expected to manifest provides companies with greater capacity to take mitigating actions. Near term risks are more meaningful and will have more impact on ratings. The assessment of the relevance, materiality, and time frame of ESG factors may differ widely across sectors and companies. For instance, while the E&S risks could be material, their effect on the credit profile may be subdued because of other credit strengths of the company, including a company's mitigation and adaptation programs in addressing these risks. Another instances, the adverse impact of the E&S risks is expected to manifest over the long term, hence, these considerations do not necessarily weigh negatively on the current rating, with the expectation that when these risks manifest in the distant future, the rated company by then would possibly adapt itself by realigning its business model.

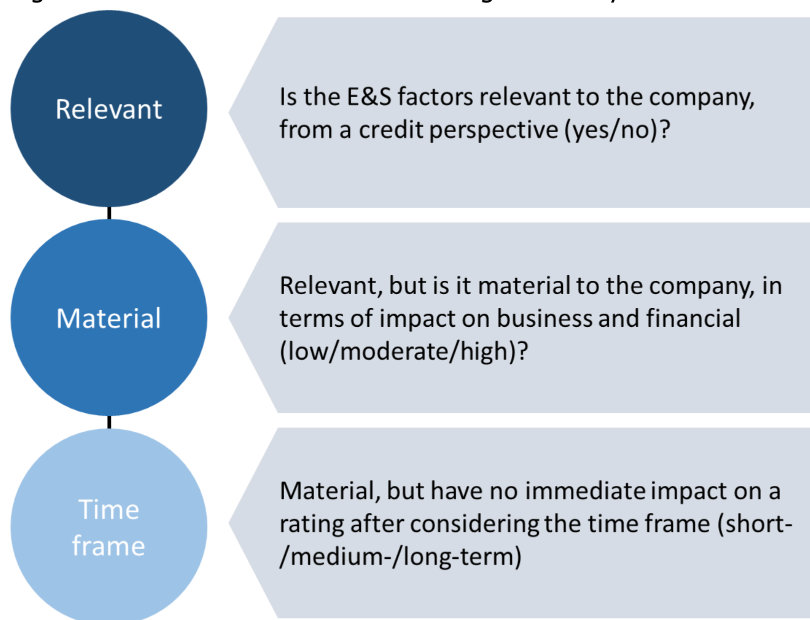
Environmental risks can be divided into two key differences:

- Adverse effects of direct environmental hazards (physical risks)
- Carbon regulations and other policy initiatives that seek to mitigate or prevent environmental hazards (transition

Social development that can impact to credit risk can be divided into two groups:

- Internal social factors (relationship between the company and its people): employee management, health & safety exposure
- External social factors (relationship between the company and the societies in which it operates): consumer and product responsibility, demographic and society trends

Figure 1. Factors to be considered during E&S analysis

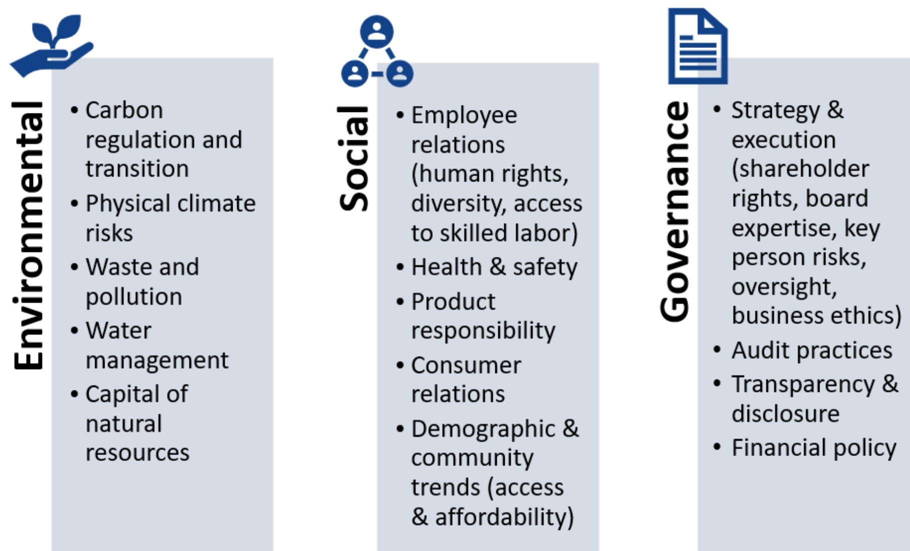


Governance (G)

The concept of governance assessment is not new in the context of PEFINDO's credit rating as we have largely incorporated it under our analysis of a company's key success factors in business risk assessment. Unlike the E&S factors, the analysis of governance is company-specific as we are of the believe that by having an effective governance could shape a company's competitiveness in the market and creditworthiness, as it ensures sustained management performance, efficient allocation of resources, good investment strategy, and reliable reporting. It also helps the company regulate risk and reduce the potential of fraud and scandals, and prevent operational and administrative failures that may pose a material impact on business and cash flow. Governance weakness could lead to deterioration in a company's credit strength, and, eventually, to a default.

As the assessment of governance is very qualitative and largely subjective, the analysis will be based on observations from the availability of information, derived from a variety of sources relevant to creditworthiness, both public information and management interviews that we conduct during the rating process. What benefits PEFINDO the most is that we do interviews with these rated companies over many years, so we can evaluate the effectiveness and credibility of the management team by observing past successes or failures over a period of time. One way to do this is by comparing a company's projections with the actual realization. Financial performance over a period of time provides a useful measure of management ability to execute its operational and financial strategies. PEFINDO also requires its analysts to compare information content and its quality across peer groups and industries, to further support our analysis.

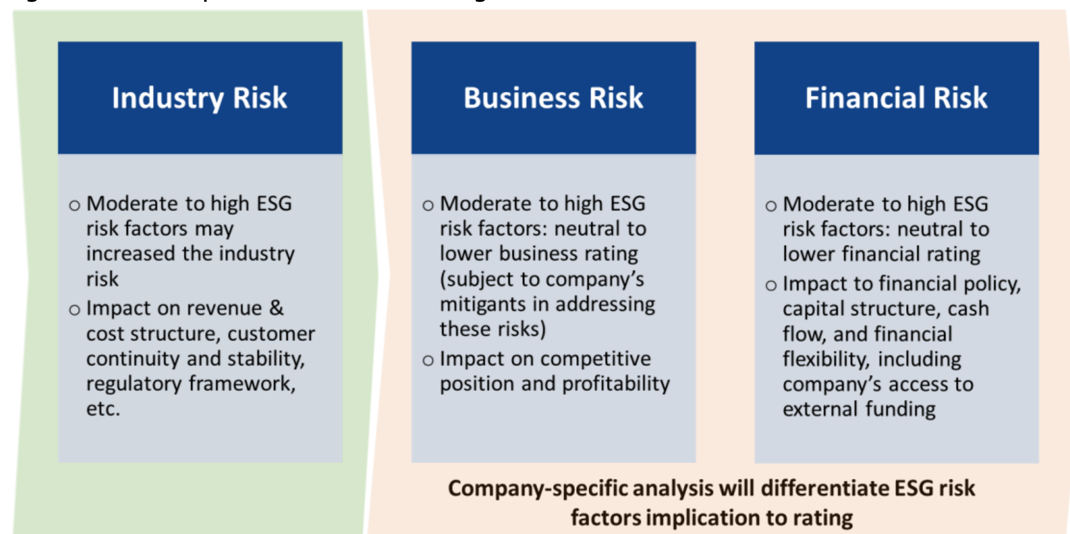
Figure 2. The most relevant ESG factors affecting credit rating



ESG Implication on Credit Rating

After identifying the relevance, materiality, and time frame of ESG factors, the implication to rating could be negative, positive, or neutral. A company may have a neutral ESG impact if the ESG factors that are identified are considered irrelevant and immaterial to its credit risk. Conversely, a company with greater exposure to ESG risks will have a greater impact on the company's credit risk in the future, and hence, may put pressure to the rating subject to the company's mitigation and adaptation programs in addressing these risks and how it will impact its credit metrics in the near to medium term including its financing capacity as well as funding accessibility, the latter of which we believe has become increasingly indispensable as ESG factors have become more important in making investment decisions by creditors and/or investors. In some cases, ESG also reflects opportunities that may strengthen a company's competitive position in the market over the medium to long term.

Figure 3. ESG implication on credit rating



PEFINDO will mention in the rating reports the relevant ESG factors that have been evaluated and only if they are deemed material to the credit risk of a company – impact on the competitive position and profitability or financial position and credit metrics, including capacity to access external.

DISCLAIMER

The rating contained in this report or publication is the opinion of PT Pemeringkat Efek Indonesia (PEFINDO) given based on the rating result on the date the rating was made. The rating is a forward-looking opinion regarding the rated party's capability to meet its financial obligations fully and on time, based on assumptions made at the time of rating. The rating is not a recommendation for investors to make investment decisions (whether the decision is to buy, sell, or hold any debt securities based on or related to the rating or other investment decisions) and/or an opinion on the fairness value of debt securities and/or the value of the entity assigned a rating by PEFINDO. All the data and information needed in the rating process are obtained from the party requesting the rating, which are considered reliable in conveying the accuracy and correctness of the data and information, as well as from other sources deemed reliable. PEFINDO does not conduct audits, due diligence, or independent verifications of every information and data received and used as basis in the rating process. PEFINDO does not take any responsibility for the truth, completeness, timeliness, and accuracy of the information and data referred to. The accuracy and correctness of the information and data are fully the responsibility of the parties providing them. PEFINDO and every of its member of the Board of Directors, Commissioners, Shareholders and Employees are not responsible to any party for losses, costs and expenses suffered or that arise as a result of the use of the contents and/or information in this rating report or publication, either directly or indirectly. PEFINDO generally receives fees for its rating services from parties who request the ratings, and PEFINDO discloses its rating fees prior to the rating assignment. PEFINDO has a commitment in the form of policies and procedures to maintain objectivity, integrity, and independence in the rating process. PEFINDO also has a "Code of Conduct" to avoid conflicts of interest in the rating process. Ratings may change in the future due to events that were not anticipated at the time they were first assigned. PEFINDO has the right to withdraw ratings if the data and information received are determined to be inadequate and/or the rated company does not fulfill its obligations to PEFINDO. For ratings that received approval for publication from the rated party, PEFINDO has the right to publish the ratings and analysis in its reports or publication, and publish the results of the review of the published ratings, both periodically and specifically in case there are material facts or important events that could affect the previous ratings. Reproduction of the contents of this publication, in full or in part, requires written approval from PEFINDO. PEFINDO is not responsible for publications by other parties of contents related to the ratings given by PEFINDO.