Environment, Social, and Governance (ESG) In Credit Ratings – Corporate Sector

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Incorporating ESG factors in the credit analysis has gained attention these past years as increasing awareness of companies' creditworthiness is not only strictly connected to their financial condition but also other qualitative and non-financial measures including environmental, social, and governance factors. ESG is slowly becoming a growing concern for many parties, one of which is investors, as they are concerned about long-term financial growth and at the same time contribute positively to the ESG aspects.

We are of the view that the better a company addresses risks (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 an improved competitive position due to the absorption of future demand and distinction from competitors, increasing the capacity to generate cash flows that exceed the initial investments. ESG implementation also helps minimize the effects of potential crises, accelerate recovery, and spur innovations necessary. 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 changes in market preferences as well as additional charges because of regulatory compliance, hence weakening the capacity to generate cash flows.

ESG in Credit Rating Analysis

Despite the relatively new concept of ESG, we are of the view that the assessment of a company's ESG is part and parcel of a credit risk assessment, and therefore, PEFINDO, to a large extent, has considered the analysis of ESG in our credit rating analysis through our forward-looking qualitative assessments. Nonetheless, in assessing ESG, PEFINDO is committed to following the credit rating industry's best practices while also being able to respond to market demand for reliable, independent, and objective credit assessments, particularly issues related to ESG, and we have decided to disclose in our rating report ESG considerations as part of a holistic approach to assessing credit risk. This article is a continuation of the previous article, "PEFINDO's Approach Towards ESG and its Implications to Credit Ratings," published on April 3, 2023.

Environment

Environmental components play a substantial role in ESG analysis, such as climate change, carbon footprint, and water & waste management. There is a growing concern regarding worsening climate change that has been accelerating these past years. It is reported that the global average temperature is expected to increase by around 1.5 degrees Celsius and may continue to climb over 3 degrees Celsius by 2100, which could inflict permanent harm to global ecosystems. This happens due to numerous factors, one of which is a rise in greenhouse gas (GHG) emissions that causes an annual increase in the earth's temperature. How business operates will have a crucial role in maintaining and resolving this problem. The Paris Agreement has concurred that limiting global warming to 1.5 degrees Celsius requires reductions in global GHG emissions by 43% by 2030 and net zero by 2050. Indonesia is actively supporting these targets as reflected in the Intended Nationally Determined Contribution (INDC), in which Indonesia is committed to reducing GHG emissions target unconditionally to 31.89% and conditionally (with international support) to 43.20% by 2030.

The environmental aspect of ESG in credit ratings measures how the company is affected by the direct natural or physical environmental trends and hazards as well as the consequences of regulations or policies that seek to reduce or prevent environmental trends or hazards. We also take into account the company's utilization of natural resources and the effect of its operations on the environment.

There are four main factors which PEFINDO will examine in assessing the company's exposure to environmental factors:

1. Carbon regulation and transition risk
2. Physical climate risk
3. Waste and pollution
4. Capital and natural resources

Environmental Credit Factors

Carbon regulation and transition risk	Physical climate risk	Waste and pollution	Capital and natural resources
•Current positioning for carbon transition. •Adaptation requirements related to climate change. •Long-term resilience to risk of accelerated carbon transition.	•Event-driven or longer-term shifts in climate patterns which may impact operations and result in financial loss. •Exposure to chronic heat waves, floods, droughts, landslides, hurricanes, rise in sea level, wild fires, etc.	•Issues related to all waste products and other pollutants, including non-GHG air emissions. •Issues related with land-based accidents, spills and leaks. •Risk of pollution-related regulatory violations.	•Level of dependency on goods and services derived from nature (plants, animals, soils, minerals, and air). •Preventive measures and policies to reduce damage to the ecosystem. •Availability, access, and consumption of water. •Innovations to enhance water use efficiency.

Social

Social factors reflect the ability to cope with social trends, both from inside the organization such as employee relationships, gender equality, living wages, and employee safety, as well as externally such as relationships with the societies in which the company operates, consumer and product responsibility, demographic, and society trends.

There are three main factors which PEFINDO will examine in assessing the company's exposure to social factors:

1. Health and safety
2. Employee relations
3. Consumer relations and demographic & community trends

Social Credit Factors

Health and safety	Employee relations	Consumer relations and demographic & community trends
• Track record of health and safety violations that lead to financial and reputational damage. • Exposure to health and safety issues such as mobility restrictions as a result of the pandemic, political unrest, and terrorism.	• Relationship towards employees (practices, rights, diversity) and access to skilled labor (availability of skilled labor or ability to develop). • Exposure to labor unrest which may hamper productivity, thus, capacity to generate cash flow.	• Relationship and product responsibility towards the customer (risk of mis-selling of products). • Shift in behavior that may affect demand for products or services. • Exposure to social resistance such as strikes and boycotts or regulatory actions • Impact of demographic (aging population, gender) and income factors on the need for products or services. • Impact of economic growth prospects and income distribution, which may affect access and affordability of products or services provided.

Governance

Governance in ESG is also a factor that must be recognized and evaluated in depth, since strong governance may have a significant impact on the company's reputation, as shown, for instance, by the dimensions of fairness, accountability, transparency, and responsibility. Assessment of the governance aspect helps to understand the company's view towards shareholders and the responsibilities of the board in effective governance. Good governance is essential for long-term success.

In contrast with E&S, from which we would look at the general exposure to a particular sector, the assessment of governance is based on a company-specific approach as a company with strong governance is more likely to make sound decisions, maintain the trust of its stakeholders, and create value, as it ensures sustained management performance, efficient allocation of resources, good investment strategy, and reliable reporting. On the contrary, companies with weak governance are more likely to face financial losses, reputational damage, and regulatory violations, that may lead to business and financial deterioration.

There are three main factors which PEFINDO will examine in assessing the company's exposure to governance factors:

1. Governance structure
2. Risk management and oversight
3. Transparency and reporting

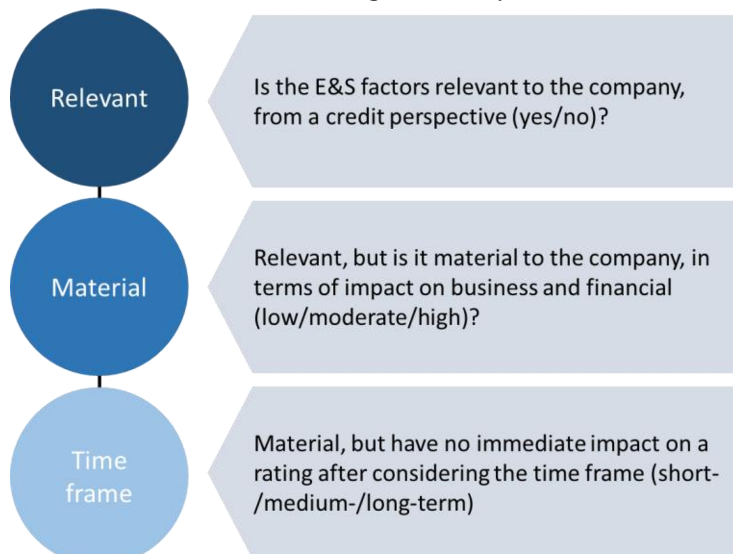
Governance Credit Factors

Governance structure	Risk management and oversight	Transparency and reporting
• Ownership and group structure • Organization complexity and management structure (board composition and independence) • Key person risk	• Management track record and credibility (turnover and skill sets) • Management strategy implementation (effectiveness in executing strategy) • Policies and controls to effectively manage risks	• Quality and reliability of information including accounting policies and disclosures • Timeliness of financial reporting

Consideration of E&S credit factors in the analysis

In the credit analysis, we consider relevance and materiality to be important considerations when factoring E&S factors, to determine the extent to which this impacts the company's performance and its strategy for mitigating the associated risks. Once these two conditions are satisfied, we proceed to examine the time horizon of E&S factors' impact on credit quality, which is one of the critical considerations to be factored in further. Issues stemming from E&S factors tend to be particularly uncertain in both their severity and the time horizon over which they might crystallize and therefore, may mute the effect on the rating. For instance, policy regarding carbon emission reduction will necessitate companies to adjust their own carbon emission reduction strategies. Consequently, companies will be compelled to make prompt investments to mitigate the adverse effects of this new regulation. However, the implementation of such regulation is also dependent on measures taken by policymakers and the performance of the national economy. Thus, we incorporate E&S factors into our credit ratings when we believe they are material to creditworthiness and sufficiently visible. A longer time horizon over which such E&S risks are expected to manifest provides companies with a greater capacity to take mitigating actions. Near-term risks are more meaningful and will have more impact on rating. If we deem these to be the subject of the analysis, we incorporate the effects of E&S credit factors into the key success factors (KSF) that may influence the company's business and financial risk profiles.

Factors to be considered during E&S analysis

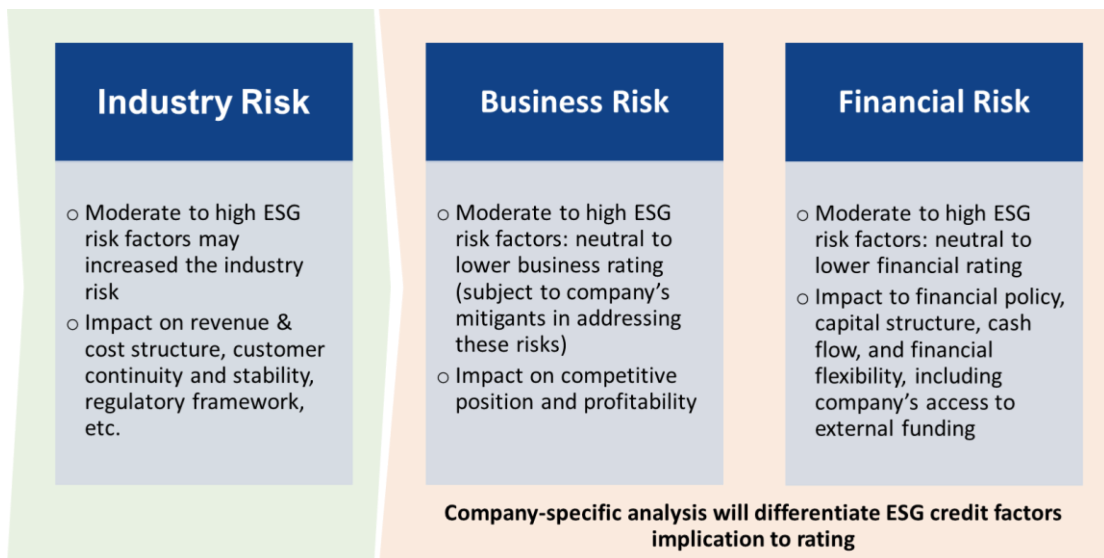


We are of the view that the assessment of E&S factors is more sector-specific as they can affect a company's credit rating through their influence on the analysis of the industry risk such as the growth and stability, revenue and cost structure, as well as regulatory or policy framework; hence, the influence of E&S factors can differ across sectors. For instance, the E&S credit factors that are relevant and material to a mining company are substantially different from those that are relevant and material to a property developer. Nonetheless, even when E&S factors heighten the risk profile or have a materially negative influence on a particular sector, it does not automatically influence a company's credit rating.

We will also perform a company-specific analysis which will differentiate E&S credit factors' implication to the rating. As an illustration, the climate transition risk factor, a company that is exposed to significant CO_2 emissions may experience a decline in profitability due to the carbon tax imposed if it is unable to address such a challenge. This, in turn, will affect the debt service coverage ratio for the cash flow protection aspects and may potentially affect the capital structure, given that it is reliant on substantial capital expenditures to adhere to current regulations. Regarding health and safety, an instance from the Covid-19 pandemic illustrates how social distancing protocols implemented to contain the virus severely impacted a number of transportation operators, travel and tourism companies, and hotel assets whose primary source of revenue was from mobility.

As mentioned above, the governance aspect also encompasses tangible factors that detrimentally affect corporate governance and risk management, such as corruption and lack of transparency. These issues not only undermine risk management but also have the capacity to harm the established brand and reputation of the company, ultimately leading to financial losses.

ESG implication on credit rating



The analysis of ESG factors could potentially generate either favourable or unfavourable outcomes, and the associated risks may be prospective, imminent, or present. Additionally, the magnitude of the impact can be assessed, denoting whether it is positive, neutral, moderately negative, negative, or very negative.

We can also consider ESG factors from a variety of categories and classifications, beginning with event-driven events, such as cyber assaults, accounting fraud, and floods, which can influence a company's creditworthiness. Additionally, we can analyse it in a policy-driven and trend-driven, or we can

incorporate scenario analysis to determine how these ESG factors will affect creditworthiness if it materializes.

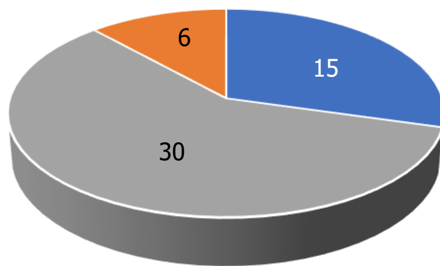
The primary purpose of this indicator scale is to quantify the extent to which ESG factors influence the credit capacity of the company. The impact categories are categorized into five distinct types:

1. Positive: indicates that there is a positive impact in our credit rating analysis, affecting more than one KSF or one significantly.
2. Neutral: if the influence of ESG factors on our KSF is deemed neutral or if it is completely negligible.
3. Moderately negative: If we assume that the ESG factors affect at least one KSF with a negative impact.
4. Negative: if we view that there is a negative consideration in our credit rating analysis, affecting more than one KSF or one severely.
5. Extremely negative: if ESG factors as having a detrimental effect on multiple KSFs (greater than one), or if it affects several KSFs or one very severely.

ESG Sectoral Analysis

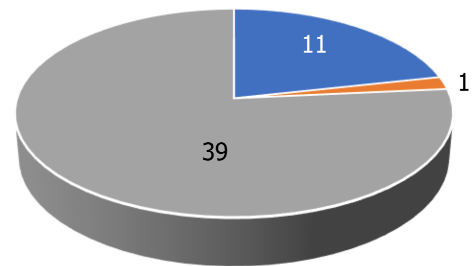
Based on our assessment, environmental factors have a direct moderately negative and negative influence on 21 out of PEFINDO’s 51 rated sectors. We capture carbon regulation and transition risks, physical climate risks, and waste and pollution and capital natural resources risks approaches for environmental risk assessment. In addition, social factors have a mostly neutral impact in PEFINDO’s portfolio, with 38 neutral social impact sectors from 51 total sectors in our assessment, using health and safety, employee relations and consumer relations, and demographic & community trends as approaches for social risk assessment.

Number of Sectors Impacted by Environmental Factor



■ Moderately Negative ■ Neutral ■ Negative

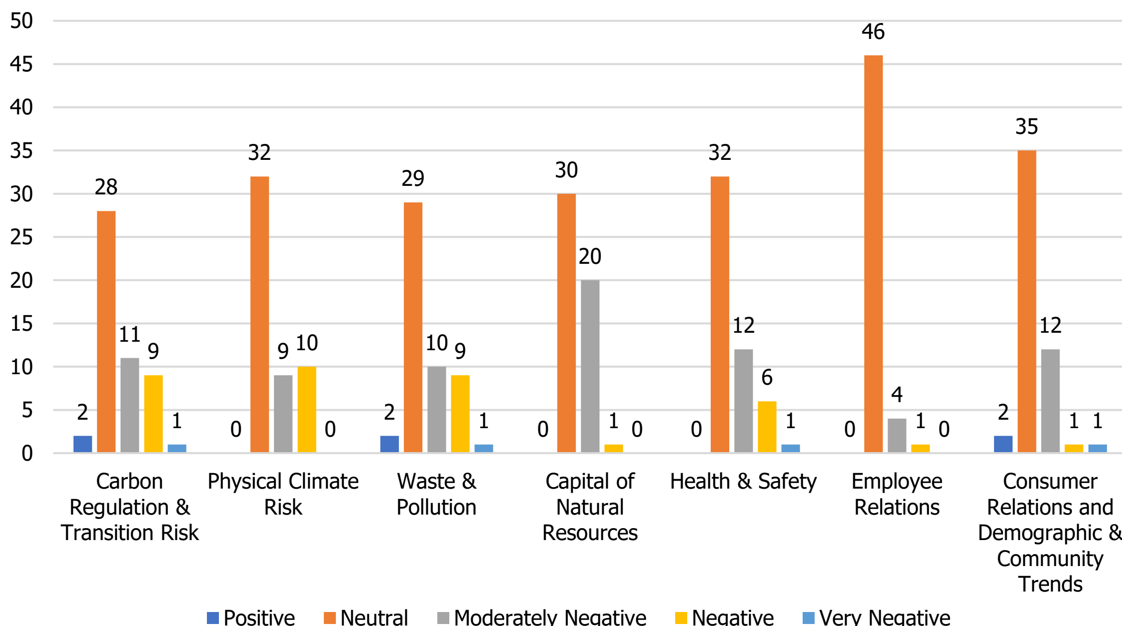
Number of Sectors Impacted by Social Factor



■ Moderately Negative ■ Negative ■ Neutral

Source: PEFINDO Database

Sector exposure to environmental & social factors



Source: PEFINDO Database

Based on our assessment, sectors that are heavily reliant on natural resources such as oil and gas, mining, airline, road transportation, textile and textile products, and cement & building materials, will likely have a moderately negative or negative impact on our environmental analysis. Their exposure to environmental risks, such as those related to exposure to GHG emissions and the increasing pace of the energy transition away from carbon-based fuels or non-renewable energy, as well as their impact on waste and pollution are considered among the biggest emitters compared to other sectors. For instance, cement manufacturers will be required to invest in technology to reduce carbon emissions from their clinker manufacturing in the future, and as a result, we may see a rise in leverage from cement producers. Cement producers may also put much of their financial resources into the research and development for a greener cement product. Failure to comply may result in the imposition of a carbon tax, which could diminish cement producers' profitability. In terms of the social risk aspect, the risk is mostly related to health and safety issues and relationships with the community such as opposition from the community related to business activity or boycott of product. In addition, access and affordability are also an important social factor that is material to credit. Heavily regulated sectors, such as utilities and pharmaceuticals, may face limitations in their ability to adjust pricing, thus exposing their profitability to greater volatility.

Communicating ESG results: Presentation in the report

We will disclose how ESG influences our assessment of a company's creditworthiness with added paragraphs in a specific section in our rating rationale report. As part of the writing structure, we shall commence by composing our overarching viewpoint concerning the adjectives that we employ. Despite the neutrality of the ESG results, it is necessary to document them so that our readers are aware of the impact that ESG factors have on the company. Furthermore, we may note the most relevant ESG factors, together with an estimate of the KSFs that are most prone to the impact. We will also outline how material ESG factors will negatively or positively impact the company's credit rating in the near to medium term.

It Is important to emphasize that our assessment of ESG is not an indicator of a company's sustainability or assessment of its ESG performance or whether it engages in good or bad ESG practices. Rather, our

assessment of ESG reflects the influence that ESG factors have on our credit rating analysis and, therefore, should be reflected in our final credit rating result.

ESG analysis for non-financial companies will be based on the specific industry or sector where it operates, as the analysis will focus on the company's ESG strategy and ability to prepare for potential future risks and opportunities, that will be inherent to each specific sector. In addition, ESG analysis for financial institutions will focus on the degree of sectoral exposure that the company has on its portfolio that will differentiate the company's ESG risk level.

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