

# Morningstar Equity Research

## Integrating ESG into Our Analysis

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Morningstar Research Services, LLC

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# Integrating ESG into Our Analysis

# Morningstar Equity Research



**120+ Researchers, 1,510 Companies, 1 Methodology**

**Americas**  
64 Researchers  
768 Companies

**Europe, Africa, Middle East**  
18 Researchers  
306 Companies

**Asia**  
25 Researchers  
261 Companies

**Australia & New Zealand**  
16 Researchers  
175 Companies

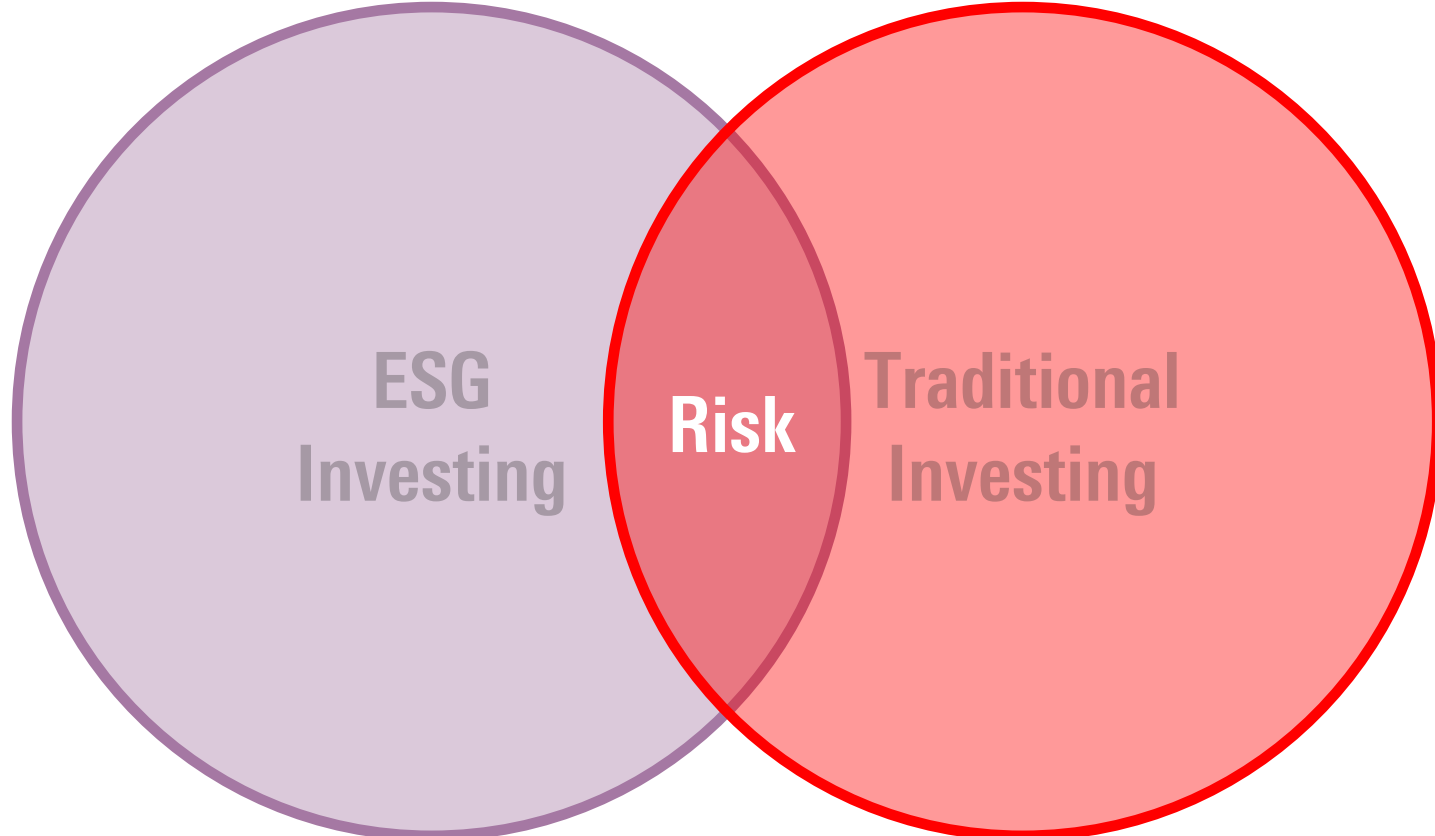
## Methodology

**Fundamentals-Focused | Long-Term Oriented | Objective: Business Valuation**

Data as of December 31, 2021

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# Risk-based approach to ESG *augments* traditional investing.





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## Our Objective

- Analysis of environmental, social, and governance risks is **essential** for long-term investors.
- Identifying ESG risks and estimating their impacts is critical in properly assessing potential investment in individual companies, **informing traditional measures** of cash flow, balance sheet, and earnings.
- We're incorporating ESG into our equity research methodology in a way that aligns with our investment philosophy and long-term mandate.

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## We're integrating ESG into the marrow of our methodologies.

- We are integrating ESG risks into our **Economic Moat Rating** and **Uncertainty Rating**.
- We are using Sustainalytics company-level "Issue Exposure" scores to **focus analyst efforts** on the most **valuation-relevant risks**.
- By capturing ESG factors in our intrinsic value estimate and our required margin of safety, we afford ESG a **central role in our methodology** in a way that **aligns with our valuation focus and long-term orientation**.
- By utilizing existing rating processes and governance mechanisms, we facilitate **scalability** and **comparability**.

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## Integration Summary

We will directly integrate ESG into the following areas of our existing research:

- Cash flow forecasts (if applicable)
- Economic moat rating
- Uncertainty rating

Analysts estimate the **probability** and **materiality** to a company's intrinsic value related to ESG risks.

# Sustainalytics ESG Risk Rating




# Process – Top Material ESG Issues

To begin incorporating the ESG impact on valuation, analysts first refer to the Attribution Analysis from the Sustainalytics ESG Risk Rating Report to identify the most important MEIs.

As an example, here are the Top MEIs from Coca-Cola

## Material ESG Issues

ESG Issues regarded material for the company.

Issue Name	Exposure	Management	ESG Risk Rating
	Score   Category	Score   Category	Score   Category
<b>E&amp;S Impact of Products and Services</b> Significant Events 	5.7 Medium	34.3 Average	<b>4.1 Medium</b>
<b>Corporate Governance</b>	9.0 High	60.8 Strong	<b>3.5 Low</b>
<b>Resource Use</b> Significant Events 	6.0 Medium	57.0 Strong	<b>3.3 Low</b>
<b>Human Capital</b> Significant Events 	4.2 Medium	35.7 Average	<b>2.8 Low</b>
<b>Product Governance</b>	4.2 Medium	37.0 Average	<b>2.6 Low</b>

Source: Sustainalytics. Data as of March 7, 2022.

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## MEIs – Underlying Risks

Within each top MEI, the analyst identifies at least one potential risk, and estimates the probability of materialising.

<b>Estimated Probability</b>	<b>Action</b>
50%+	Included in base case modelling
25% - 49%	Incorporated into scenario analysis bull/bear case modelling
10% - 24%	Incorporated into Economic Moat and Uncertainty framework, along with an estimate of materiality to FVE
< 10%	

# Integrating ESG into our Economic Moat Rating

# ESG and the Economic Moat Rating

To award a company an **economic moat**, we must have a strong conviction that excess returns on capital (1) will persist for 10 years or more and (2) are not subject to a substantial threat of major value destruction.

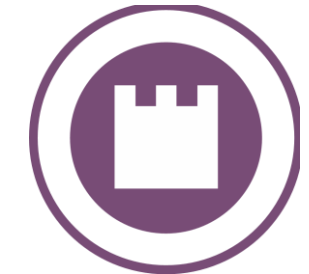
Many ESG risks pose *exactly* that sort of threat and tend to be *long-term* in nature.

Analysts estimate the probability-weighted materiality of ESG risks.

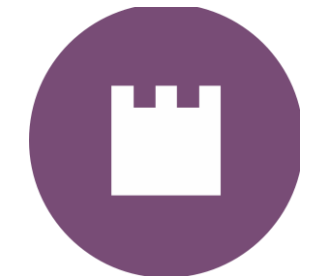
None



Narrow



Wide





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## ESG's Inclusion in Moat Based on Threat of Material Value Destruction

Many ESG risks can carry **sizeable impact** despite a **low probability** of materializing.

Examples include:

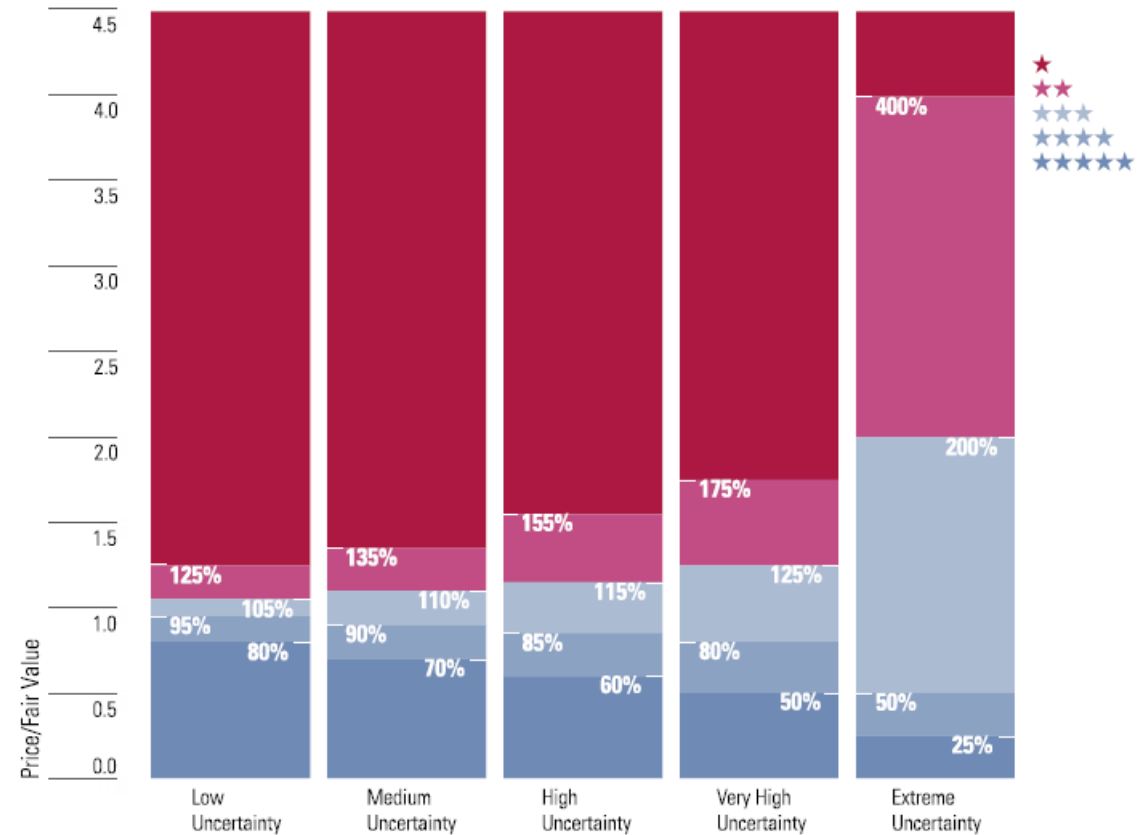
- Idiosyncratic threats, such as reputational risk from environmental damage
- Business risk from reduced consumer demand or increased costs due to social pressure
- Financial health threats arising from poor governance practices

# Integrating ESG into our Uncertainty Rating

# ESG and the Uncertainty Rating

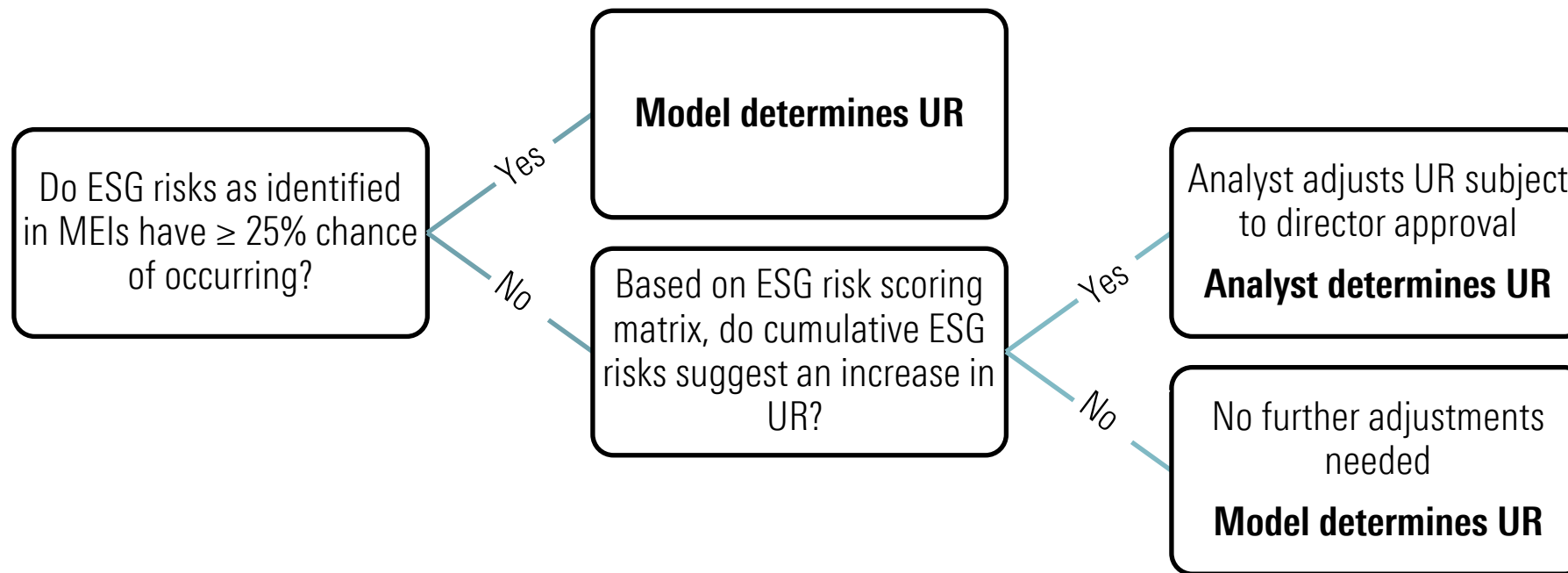
The higher the **uncertainty**, the greater the margin of safety we require before recommending buying or selling.

If the probability-weighted materiality of ESG risks is significant, we'll shift a stock to a higher uncertainty rating.



# Integrating ESG into Our Uncertainty Rating: Process Update

Updated process for determining uncertainty rating incorporates (a) the probability risk materializes and (b) the resultant impact on valuation.



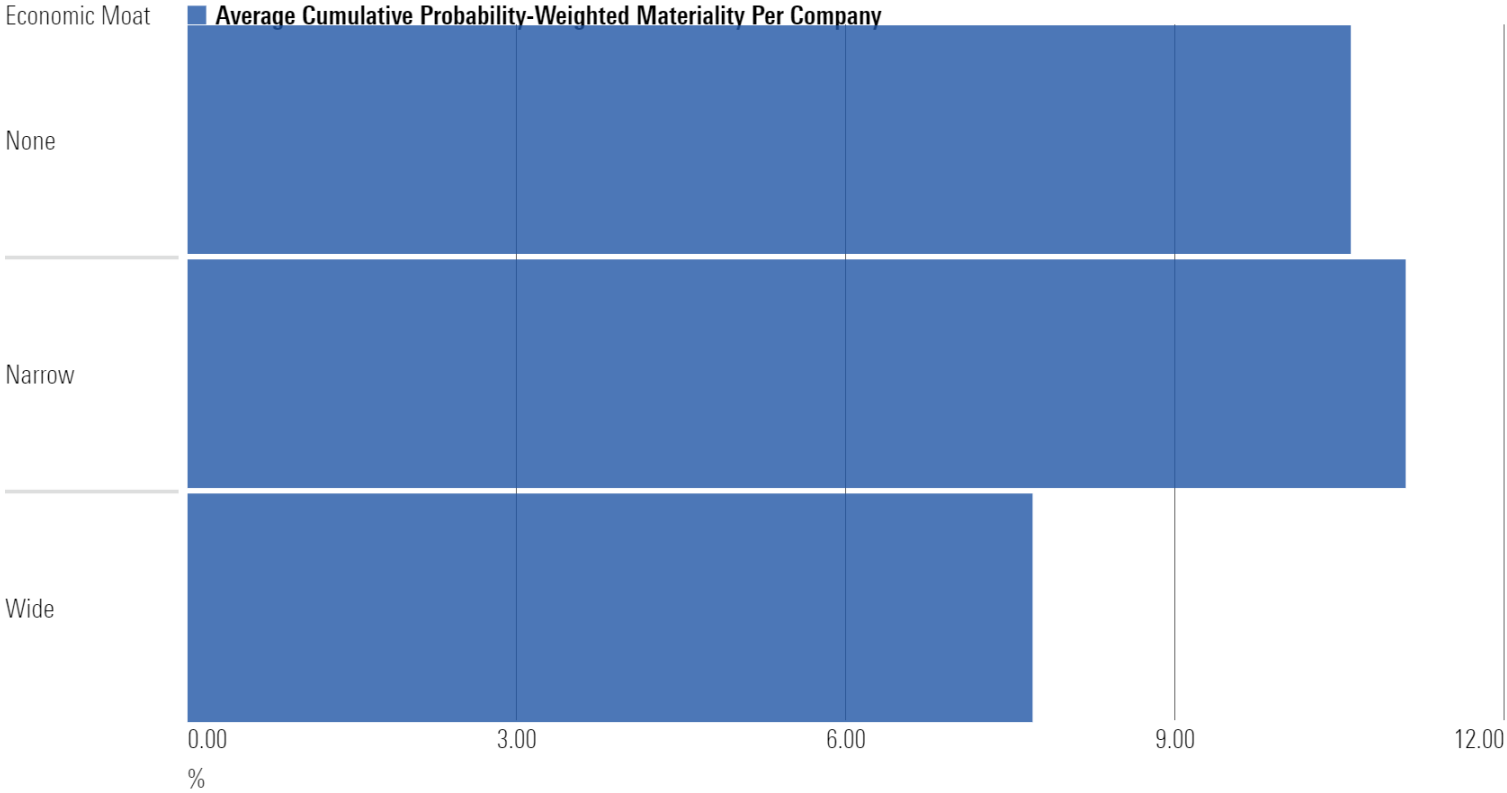
# ESG Insights

# ESG integration has led to differentiated Economic Moat insights

Company	ESG Insights
Enbridge (TSE: ENB)	 → 
Crown Resorts (ASX: CWN)	High → Very High
Deliveroo (LON: ROO)	

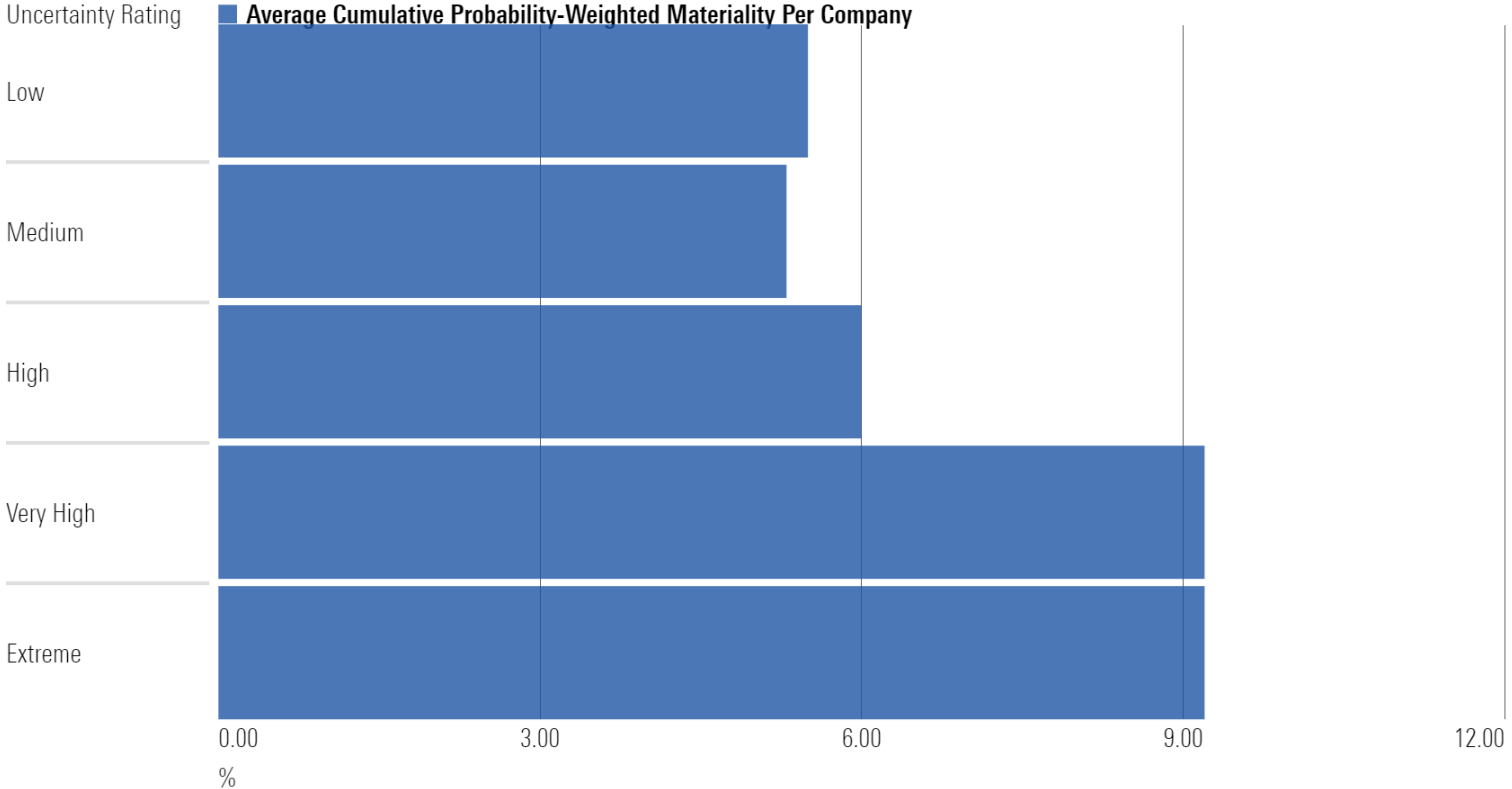
Data as of March 7, 2022. Subject to change without notice. The information on this slide is shown for illustrative purposes only and is not an offer to purchase or sell a security.

# We See Less Cumulative Probability-Weighted Materiality of ESG Risks, on Average, for Wide-Moat Companies



Data as of March 7, 2022. For full details please visit [Equity Research ESG Risk Integration — Initial Takeaways](#)

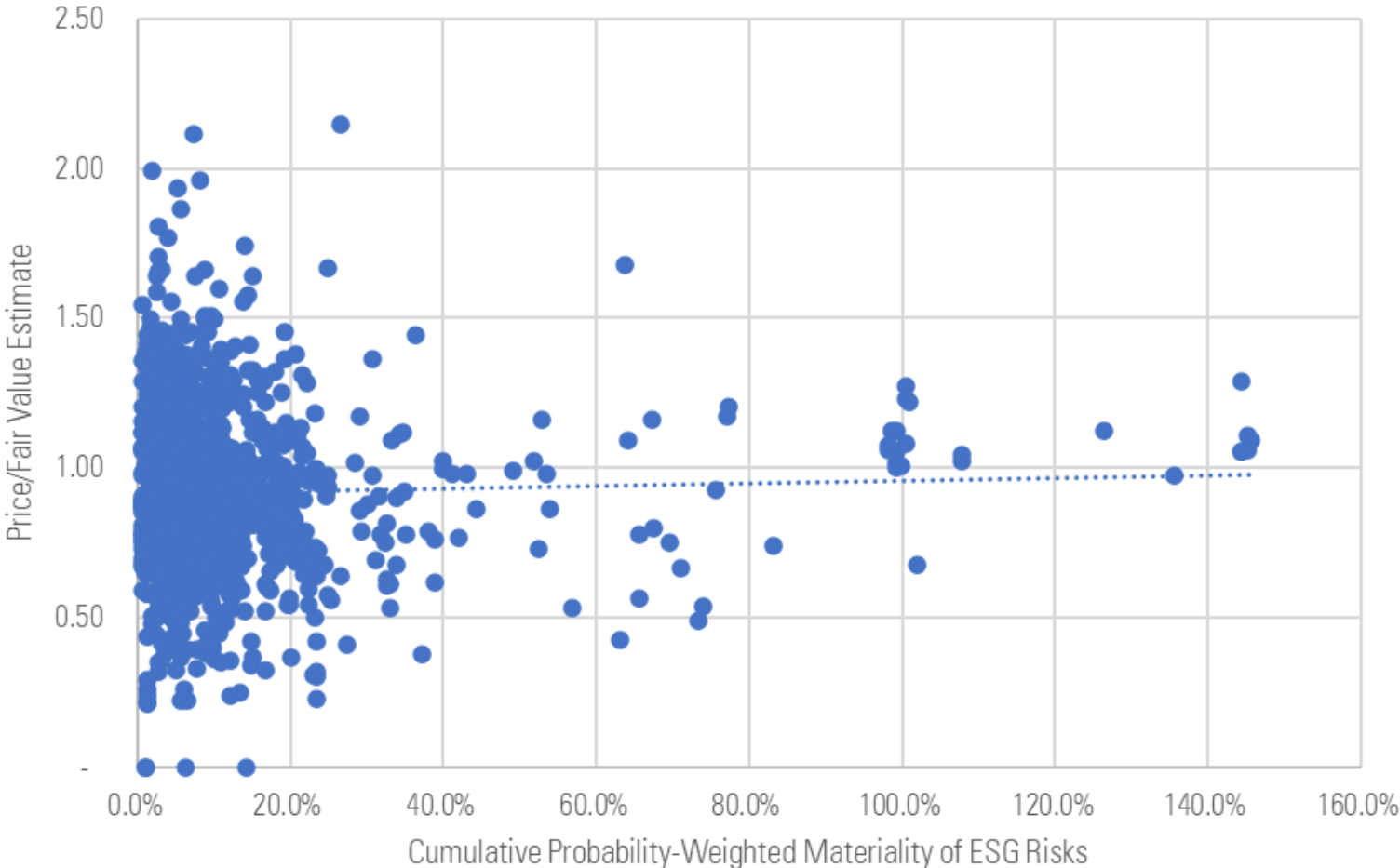
# We See Less ESG Risk, on Average, for Lower Uncertainty Firms (Excluding Base-Case Risks)



Data as of March 7, 2022. Excludes ESG risks with estimated probability > 50%, which are included in the base case and therefore do not impact the Uncertainty Rating. For full details please visit [Equity Research ESG Risk Integration — Initial Takeaways](#)



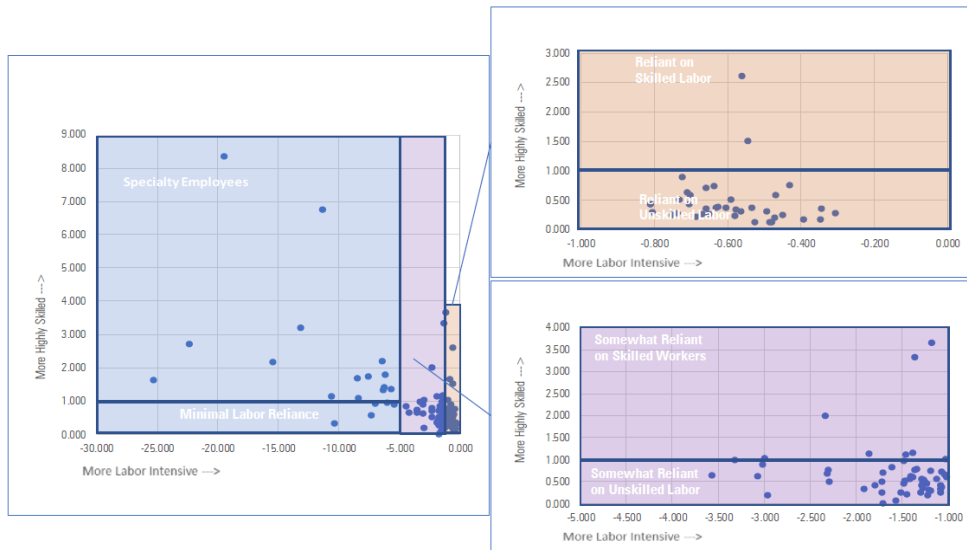
# We See Little Correlation Between ESG Risk and Valuation



Data as of March 7, 2022. For full details please visit [Equity Research ESG Risk Integration — Initial Takeaways](#)

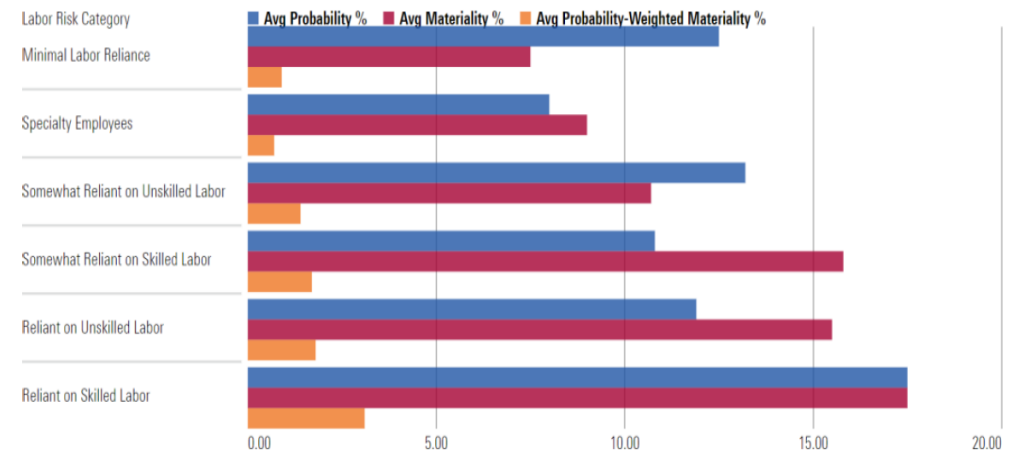
# Human Capital: Determining the Right Metrics – Labor Intensity & Skill

Categorizing Industries' Combined Labor Intensity and Skill Exposure



Source: Morningstar, Sustainalytics

We See the Greatest Probability-Weighted Valuation Risk in Firms With High Labor Intensity and Skill

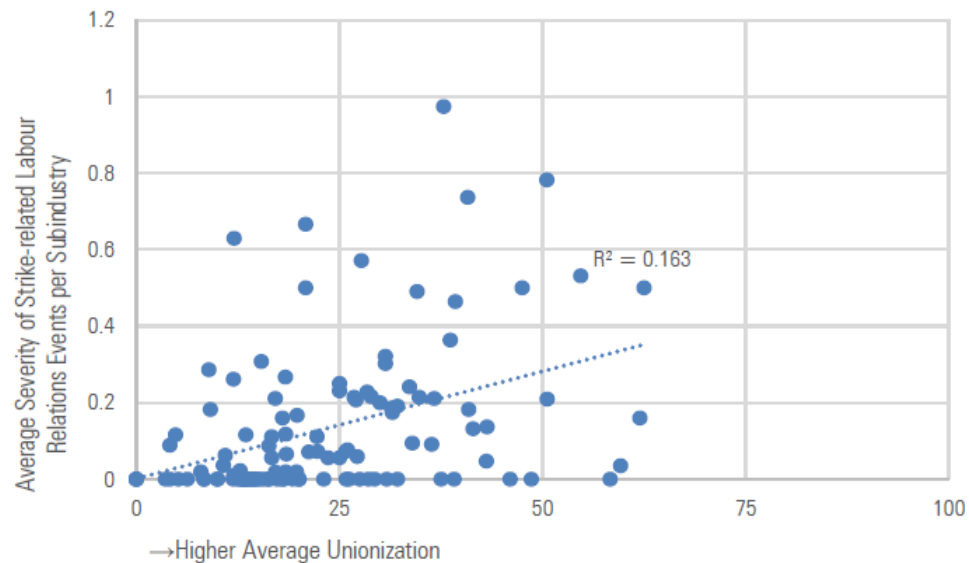


Source: Morningstar, Sustainalytics

Data as of October 18, 2021. For full details of these charts please visit [Human Capital: Making Sense of One of the Most Common Material ESG Issues](#)

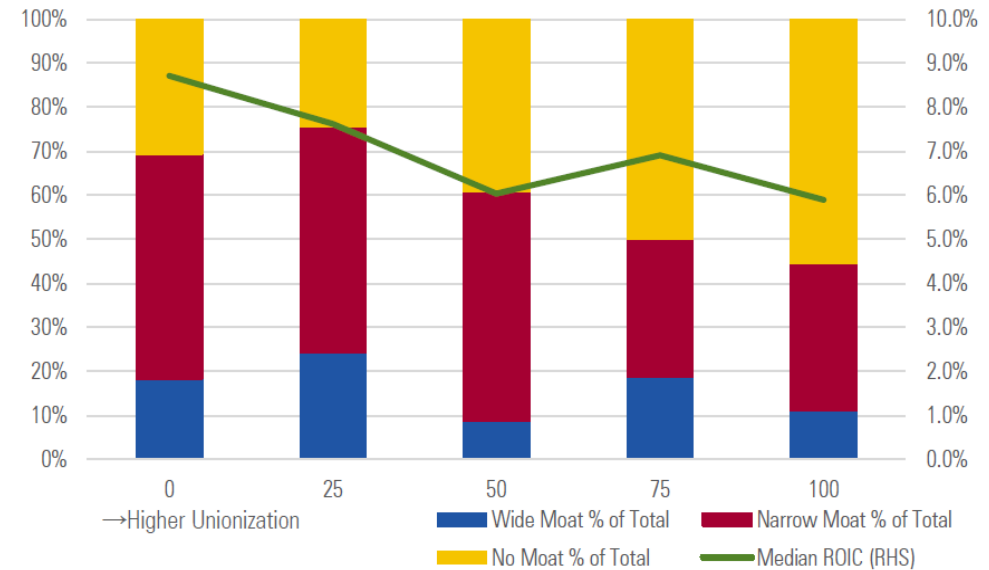
# Human Capital: Determining the Right Metrics – Workforce Relations

At Subindustry Level, Higher Unionization Is Correlated With Higher Severity of Labor Events Related to Strikes



Source: Morningstar, Sustainalytics

We're Less Likely to Award Moats to Companies With Higher Union Levels

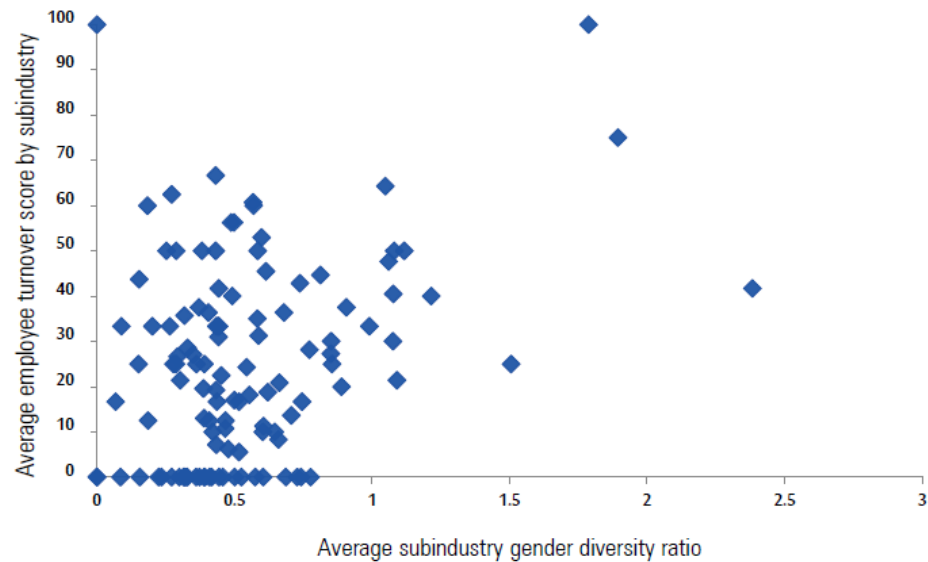


Source: Morningstar, Sustainalytics

Data as of October 18, 2021. For full details of these charts please visit [Human Capital: Making Sense of One of the Most Common Material ESG Issues](#)

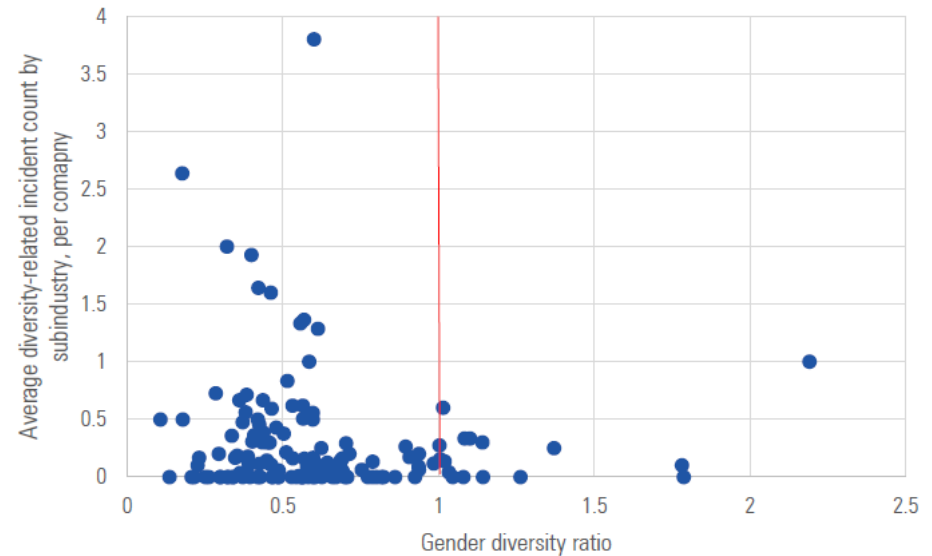
# Human Capital: Determining the Right Metrics – Gender Diversity

Greater Gender Diversity Ratios Correlate With Lower Employee Turnover



Source: Morningstar, Sustainalytics

Subindustries With a Higher Diversity Ratio Tend to Have Fewer Related Incidents



Source: Morningstar, Sustainalytics

Data as of October 18, 2021. For full details of these charts please visit [Human Capital: Making Sense of One of the Most Common Material ESG Issues](#)

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## Additional Equity Research, ESG Reports

- [Integrating ESG Into Morningstar's Equity Research: A User's Guide](#) | October 2020
- [Human Capital: Making Sense of One of the Most Common Material ESG Issues](#) | October 2021
- [Equity Research ESG Risk Integration — Initial Takeaways](#) | December 2021
- [E&S Impact of Products and Services: Today's Design Decisions Can Lead To Significant ESG Risks Tomorrow](#) | January 2022

**Questions?**

# Appendix

## Example: Coca-Cola (KO)'s Identified ESG Risks

ESG Risk Description	Associated MEI	Probability	Materiality
Gross margin headwinds due to greater focus on functional offerings, many of which operate under finished goods model (as opposed to concentrate).	E&S Impact of Products and Services	> 50%	< 10%
Environmental concerns force supply chain to pivot to more financially cumbersome packaging, for example, less PET and more aluminum, or expensive investments in deposit schemes.	E&S Impact of Products and Services	10% - 24%	10% - 24%
Precipitous and global decline in CSDs due to heightened societal awareness around health implications and social stigma, challenging top-line growth.	E&S Impact of Products and Services	< 10%	25% - 49%
Structural decline in brand equity, for example due to supply chain debacle or internal/external DEI failures.	Business Ethics	< 10%	25% - 49%

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## **Sustainalytics**

Sustainalytics is an environmental, social, and governance and corporate governance research, ratings, and analysis firm. Morningstar acquired Sustainalytics in 2020. Sustainalytics provides ESG scores on companies, which are evaluated within global industry peer groups, and tracks and categorizes ESG-related controversial incidents on companies. Morningstar uses Sustainalytics' company level ESG analytics to calculate ratings for managed products and indexes using Morningstar's portfolio holdings database.

## **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. The ESG Risk Ratings are based on a two-dimensional materiality framework that measures a company's exposure to industry-specific material risks and how well a company is managing those risks. ESG Risk Ratings are categorized across five risk levels: negligible, low, medium, high and severe. Ratings scale is from 0-100, with 100 being the most severe.

## **Economic Moat**

An economic moat is a structural feature that Morningstar believes positions a firm to sustain excess profits over a long period of time, with excess profits defined as returns on invested capital above our estimate of a firm's cost of capital. The economic moat rating is not an indicator of the investment performance of the investment highlighted in this report. Narrow moat companies are those Morningstar believes are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which Morningstar believes excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. Firms without a moat, including those that have a substantial threat of value destruction related risks related to ESG, industry disruption, financial health, or other idiosyncratic issues, are more susceptible to competition. Morningstar has identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

## **Uncertainty Rating**

Morningstar's Uncertainty Rating captures a range of likely potential intrinsic values for a company and uses it to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The Uncertainty Rating represents the analysts' ability to bound the estimated value of the shares in a company around the Fair Value Estimate, based on the characteristics of the business underlying the stock, including operating and financial leverage, sales sensitivity to the overall economy, product concentration, pricing power, exposure to material ESG risks, and other company-specific factors.

