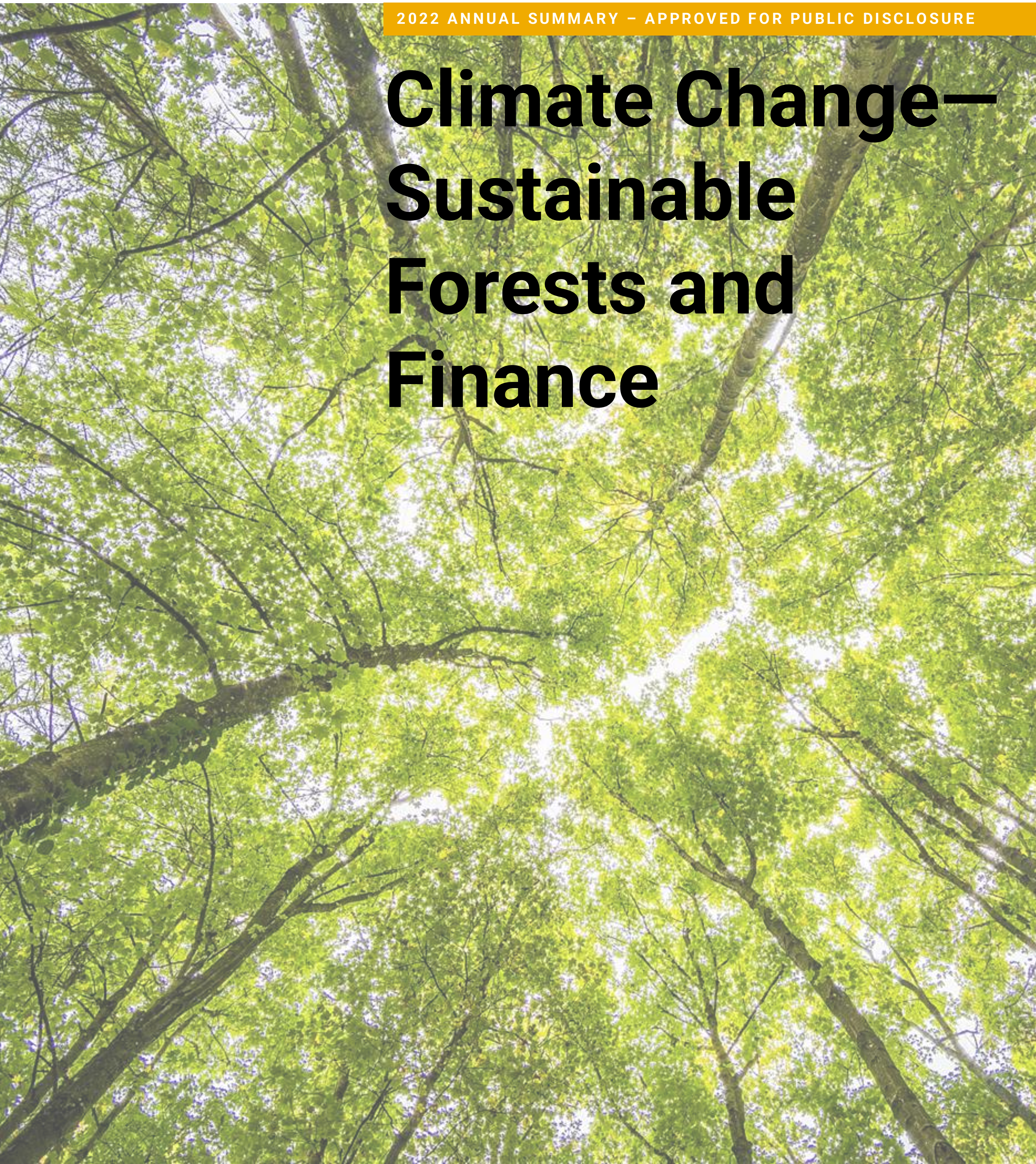
2022 ANNUAL SUMMARY – APPROVED FOR PUBLIC DISCLOSURE

Climate Change—Sustainable Forests and Finance



Climate Change—Sustainable Forests and Finance Thematic Engagement

2022 has proved to be a year of climate extremes[1], with the hottest summer ever recorded in Europe and extreme weather events happening across the globe. Extreme climate disasters have led to tremendous costs. For example, in 2022 in the US, 18 disasters cost more than USD 165 billion and 474 deaths[2]. The report from UN's Intergovernmental Panel on Climate Change (IPCC) also concluded with a striking warning of "Now or Never" to urge immediate action to limit global warming to 1.5 degrees. Meanwhile, there has been growing awareness of the nexus between climate and natural capital. Ending deforestation is essential to achieving net zero by 2050[3] and the EU has made its commitment to enforcement by banning deforestation-linked products to import into the EU[4]. Presumably, more regulatory requirements will follow across different jurisdictions on these topics.

Sustainalytics climate change – sustainable forests and finance thematic engagement targets companies across forestry-linked value chains, from the high-risk commodity sector to its major customers and financiers. Throughout the past year of engagement, the dialogues focus on companies' readiness to manage climate-related risks and natural resources management to ensure companies' practices are science-based and in line with investor expectations.

Developments in 2022

The April 2022 UN Land Report concluded that food systems account for 80% of deforestation and are also the leading contributor to biodiversity loss[5]. As the forestry and agriculture value chain is exacerbating climate change, companies involved in this sector are recognizing these risks and are increasingly implementing climate mitigation plans. The spectrum of climate change risk has also resulted in increased regulatory action. Most recently, the December 2022 EU deforestation-free regulation (EUDR) which prevents companies from selling high-risk commodities linked to deforestation into the EU market. The law will require companies to produce a due diligence statement to ensure zero deforestation in their supply chains, or they could face hefty fines.

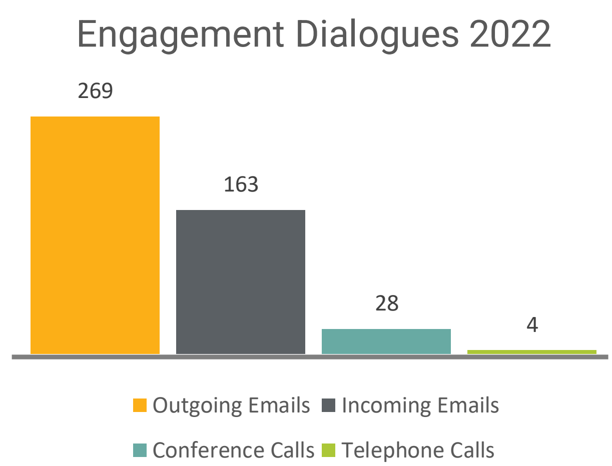
Yet, not all the developments have been positive; the June 2022 US Supreme Court decision on the Environmental Protection Agency's ability to consider carbon emissions as a pollutant, and the inclusion of gas and nuclear energy in the EU Taxonomy as sustainable business activities are both widely perceived as significant setbacks. Meanwhile, the growth of ESG continues to be challenged in the US. Despite these impediments, the new US climate bill, the Inflation Reduction Act of 2022, will help meet the ambitious goal of a 40% cut in emissions by 2030[6]. Furthermore, the US Securities and Exchange Commission (SEC) has proposed expansive new climate-related disclosures that could represent both a catalyst and an inflection point for businesses[7]. The International Sustainability

[1] https://climate.copernicus.eu/copernicus-2022-was-year-climate-extremes-record-high-temperatures-and-rising-concentrations
[2] https://www.ncei.noaa.gov/access/billions/overview
[3] https://climatechampions.unfccc.int/wp-content/uploads/2022/06/Why-net-zero-needs-zero-deforestation-now-June-2022.pdf
[4] https://ec.europa.eu/commission/presscorner/detail/en/ip_22_7444
[5] https://www.unccd.int/resources/global-land-outlook/overview
[6] https://www.science.org/content/article/surprise-climate-bill-will-meet-ambitious-goal-40-cut-us-emissions-energy-models
[7] https://www.responsible-investor.com/morningstar-calls-for-elimination-of-esg-integration-label-in-sec-consultation-response/

Standards Board (ISSB) has also delivered proposals that could create a comprehensive global baseline of sustainability disclosures and are based on the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD). Reporting on the TCFD has become mandatory by law in the UK, compelling over 1,300 UK companies to disclose information in alignment with the guidelines. Finally, the Taskforce on Nature-related Financial Disclosures (TNFD) has expanded its beta framework for nature risk management and disclosure with recommendations similar to TCFD, with a final version expected in September 2023.

Engagement Update

Throughout 2022, Sustainalytics' focus in this engagement progressed from building relationships and exploring the initial gaps into creating strong dialogues, addressing the major goals of the engagement theme, and outlining investor expectations. In this period, Sustainalytics conducted 28 engagement calls, 269 outgoing emails, 163 incoming emails, and 4 telephone calls with the companies in the three sectors (financiers, mid-value chain companies, and end-of-value chain companies). In addition, for the first time, we sent out investor letters to nine companies that had either insufficient responses or were unresponsive to our attempts at dialogue. Four companies agreed to enter the dialogue, and we escalated our engagement efforts with two low-response companies by issuing voting recommendations against specific related items on their annual general meeting agendas. The five remaining companies have been replaced taking into consideration both the geographic and value chain location, size, and business lines to be as close to the original list, as possible. A baseline assessment was conducted on five new companies which are all now in active dialogue at the end of 2022.



Company Performance

Throughout the engagement, Sustainalytics assesses the engaged companies on 5 key performance indicators (KPIs) that cover: Disclosure and Governance; Strategy; Forests and Mitigation; Physical risk; and Natural Resource Management. We have continued to observe some performance improvement across the board, largely driven by increased disclosure, but also by establishing strategies for reaching climate targets. Many companies are considering both increasing the ambition of their targets and engaging in third parties' validation of those targets in line with 1.5 degrees, something that will be helped by the recent release of the Science Based Targets initiative (SBTi) Forest, Land and Agriculture (FLAG) Guidance. Most companies believe a global effort is needed to tackle the climate crisis and have indicated a willingness to collaborate via different initiatives, something we have seen an increase in throughout agricultural supply chains. Regarding specific engagement with financiers, climate emissions accounting has continued at a steady pace. Several financiers have finalized their portfolio-based carbon emissions mapping for high emitters such as power, oil & gas, and automobile sectors according to international standards such as Partnership for Carbon Accounting Financials (PCAF). The financiers are also preparing for the next stage, accounting in less heavy emitting industries i.e., agriculture. Still, the most impactful change in financiers has been establishing strategies to decrease carbon emissions in their portfolios, ensuring they reach net zero by 2050 largely led through the Net-Zero Banking Alliance (NZBA). That said there is still a lack of third-party validation in targets and practical transparency regarding the detail of such strategies. On the other hand, commodity companies have gradually increased their scoring due to enhanced disclosure, including information on how they mitigate their deforestation risks and their approach to physical risks and nature. Companies have implemented some strategies to tackle climate and deforestation issues, such as monitoring land management using satellite technology and regenerative agriculture to increase climate resilience and biodiversity. The end-of-value chain companies have also begun to disclose strategies and measures to reach zero deforestation but little detail is provided and therefore large performance gaps remain. Hence the engagement dialogue has been focusing on not only company policy and commitments but also operationalizing commitments, supply chain due diligence and disclosure of indicators to track progress.

Case Study

Half of the companies we engage with are based in the US. We observe some interesting dynamics due to the country's polarized political climate and its impact on companies. This case study will analyze the current ESG landscape in the US market and its influence on engagement dialogue by breaking it down into three levels: federal level, state level, and private sector level.

- **Federal Level**: With the Republicans taking over Congress as the result of the US's 2022 midterm elections, Biden's aggressive climate-related federal legislations are not likely to be passed. The periodic power shift between parties has created enormous uncertainty in the regulatory landscape on sustainability topics. In return, companies are reluctant to further their sustainability-related commitments. In addition, the SEC's climate-related disclosure mandate excludes scope 3 emissions data as a mandatory requirement. This exclusion may send the wrong signal to the US market and has already resulted in some US companies stepping back on their scope 3 mapping and disclosure.
- **State Level**: Capital Monitor has mapped the polarization situation of ESG in the US, which highlights that sustainable investing is also embedded in the US' "cultural war"[8]. The dilemma also complicates the operating environment for companies, given that companies are required to comply with state level legislation as long as they are operating in the territory, regardless of their own will of operations. The politicization of ESG could increase risk in the long run and weaken companies' progress on ESG issues, including investors' decision-making toward increased focus on sustainable investing.
- **Private Sector Level**: We have experienced some pushback and delays on further disclosure on ESG topics in our engagement dialogue with US companies. Due to regulatory uncertainty, companies are more likely to be hesitant about ESG, even on the climate topic, which is a universal common goal for most stakeholders. With the rapidly changing legislation, companies tend to hold off on any human or capital resources investment in ESG reporting until the costs become compliance related. In addition, the US's litigious environment leaves companies hesitant to increase non-mandatory disclosure.

Despite the uncertain situation on the federal and state front, companies need to balance this with the expectations of the market. The earlier companies start to develop their ESG competence, the better their performance along the way. Overall ESG is a continuous journey and only by constantly monitoring the materiality of such issues can companies better pivot themselves to a more resilient business profile. Minimum safeguards in uncertainty might be a short-term solution, but robustly addressing ESG issues ensures business continuity in the longer term.

[8] https://capitalmonitor.ai/regions/america/mapped-the-polarisation-of-esg-in-the-us/

About Morningstar Sustainalytics

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 30 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 17 offices globally, Sustainalytics has more than 1,800 staff members, including more than 800 analysts with varied multidisciplinary expertise across more than 40 industry groups. For more information, visit www.sustainalytics.com.

Sustainalytics
info@sustainalytics.com
www.sustainalytics.com