MORNINGSTAR | SUSTAINALYTICS

Climate Change – Sustainable Forests and Finance

Thematic Engagement Biannual Executive Summary – August 2022
Approved for Public Disclosure

Climate risks and forest value chains

The Sixth Assessment **Report** by the UN's Intergovernmental Panel on Climate Change (IPCC) from April 2022 concluded with the starkest warning of '**now or never**' regarding limiting global warming to 1.5-degrees Celsius. News reports from around the world illuminate the climate breakdown with unprecedented flooding, megadroughts, and widespread wildfires. At the same time, the connections between carbon emissions, deforestation, and nature continue to be developed. The clearing of forests is driven by increased demand for food and resources. Further **research** has urged immediate action on deforestation, without which reaching net zero is impossible. The rising climate change risks have also resulted in increased regulatory action.

Still, the companies making up the forest value chain, with a significant number involved in the sourcing, trading, processing, and consumption of commodities result in a complex environment, one which is ultimately underpinned by financiers and remains difficult to change.

Update on our engagement efforts since February 2022

The second bi-annual report covers the period of engagement that took place between February and August 2022, following the publication of the first bi-annual report at the beginning of March 2022. Sustainalytics' focus moved from getting acquainted with the companies in the three sectors (financiers, mid-value chain companies, and end-of-value chain companies) and exploring the initial gaps into addressing the major goals of the engagement theme, creating a stronger dialogue, outlining investor expectations, and recognizing potential issues. In this period, Sustainalytics conducted 13 engagement calls, 116 outgoing emails, and 75 incoming emails. In addition, for the first time since the beginning of this program, we prepared and sent out an Investor Letter to nine companies that had either insufficient responses or were unresponsive to the invitation for dialogue. Four companies agreed to continue the dialogue, and we escalated our engagement efforts with two low-response companies by issuing voting recommendations against specific related items on their annual shareholder meeting agendas. The five remaining companies have been replaced with others while 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 has been conducted on the new companies.

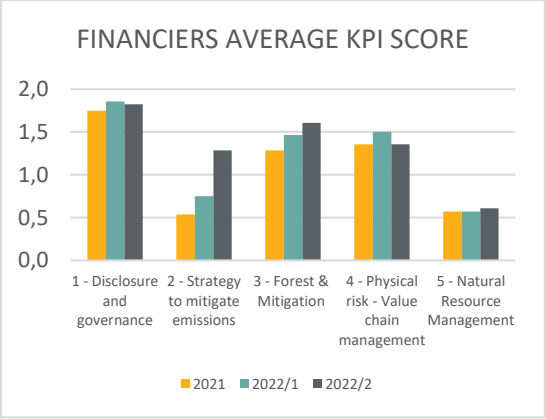

Figure 1: Graphs showing the average KPI score across the financiers in the value chain, the minimum score being 0, while the maximum score is 3.

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 improvement in scoring across the board, and as in the previous report it was largely driven by increased disclosure, but also by establishing strategies for reaching climate targets. Many companies are seriously considering increasing the ambition of their targets and having them validated by third parties in line with 1.5 degrees, something that will be helped with the expected September release of the SBTi FLAG methodology. Most companies believe that tackling this crisis needs to be a joint effort which indicates 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. These companies are also preparing for the next stage which would encompass less heavy emitting industries i.e. Agriculture. Still, the highest improvement has been in financiers establishing strategies on how to decrease the carbon emissions in their portfolios in the short and medium term, ensuring they could reach net zero largely led through the Net-Zero Banking Alliance. Commodity companies have gradually increased their scoring due to enhanced disclosure, but also by providing more information on how they mitigate their deforestation risks and their approach to physical risks and nature. The end-of-value chain companies have also begun to disclose their strategies and their measures to reach zero deforestation but there is still much to be done to bring further clarity.

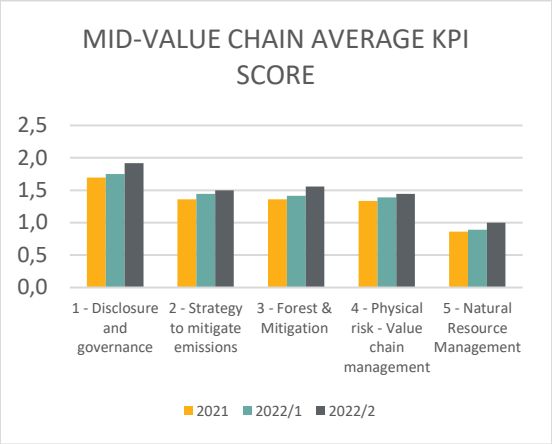

Figure 2: Graphs showing the average KPI score across the Commodity companies in the value chain, the minimum score being 0, while the maximum score is 3.

In terms of overall average scores, the financiers have seen a shift from 6.1 to 6.7 while mid-value chain commodities continue to score lowest with an average KPI score of 6.3, which is an improvement from 4.9, mostly due to the inclusion of the new companies. As with the other groups, the average score for the companies making up the end of the value chain group has shifted from 6.9 to 7.4 driven by publishing better climate change strategies. We have seen an increased focus on physical risks and efforts to understand how these companies can prevent deforestation. Nevertheless, the challenges in working with suppliers to map and reduce scope 3 emissions remain.

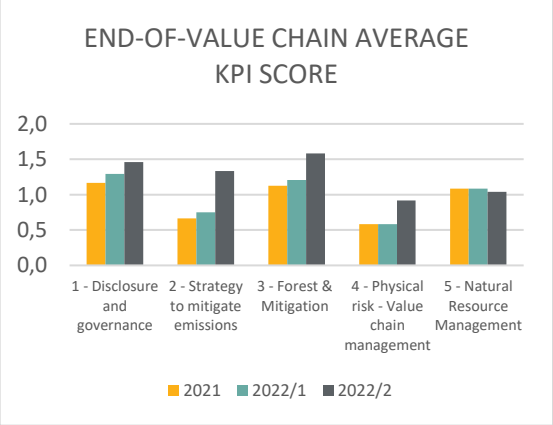

Figure 3: Graphs showing the average KPI score across the end of value chain companies, the minimum score being 0, while the maximum score is 3.0

Looking ahead

The next six months of the thematic engagement will focus on the third round of engagement sessions where the challenges of the companies will be examined further, particularly pertinent given the expected finalization around emissions account with the SBTi FLAG release, which we expect will provide momentum for science-based target verification of the next year or so of the engagement. At the same time, we will seek to deepen the dialogue with the five new replacement companies that we will establish engagement with and continue our discussions with stakeholders to stay ahead of the trends and be able to drive meaningful change with the theme.

About Morningstar Sustainalytics

Morningstar Sustainalytics 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, Morningstar 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. The firm 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, Morningstar Sustainalytics has more than 1,200 staff members, including more than 500 analysts with varied multidisciplinary expertise across more than 40 industry groups. For more information, visit www.sustainalytics.com.

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