ESG considerations in our corporate ratings

Qivalio

1. Introduction

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QIVALIO

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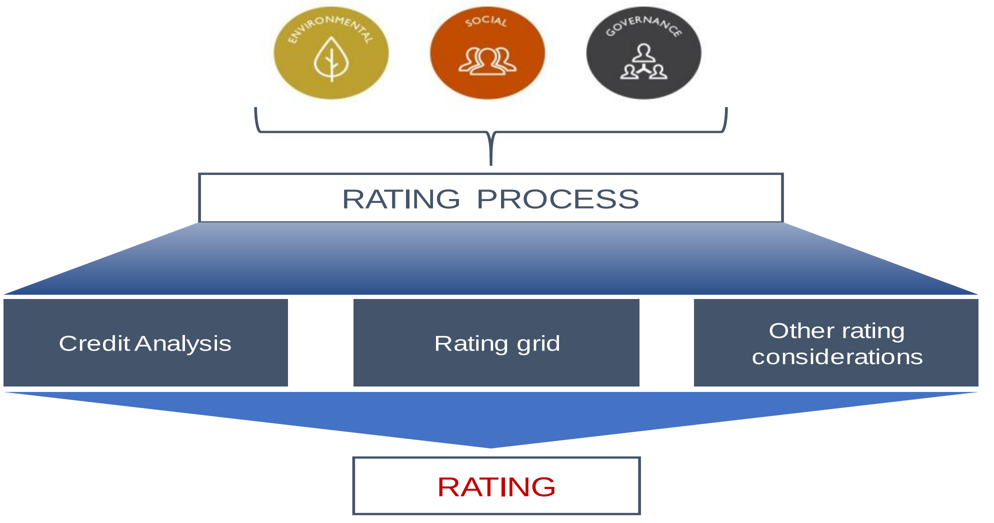
The level of attention paid to ESG risks has never been so high within the European credit market. While we believe the primary determinant of an issuer's credit quality remains its financial metrics and the sustainability of its business, Qivalio also believes that extra-financial risks linked to environment, social and governance (ESG) issues are an integral part of assessing the creditworthiness of an issuer.

Even though these risks were not previously explicitly detailed in Qivalio's main corporate rating methodology, the analysis of ESG risks has always been a major component of the analysis of the creditworthiness of an issuer and part of our rating process. In order to provide further transparency and to help investors and issuers to better understand the impact of ESG on our ratings, we have detailed in this section our approach to ESG risk analysis and its impact on our rating scorecard.

Before going into detail, it is important to understand that ESG assessment encompass a number of risks, some of which will have a detrimental impact on credit and others which will have very limited impact. It is also important to understand that this impact on credit could have different time horizons. For example, strikes at a company will have a detrimental impact which will be possible to assess with confidence while for instance the wider energy transition will be harder.

Where meaningful for an issuer's creditworthiness, Qivalio incorporates ESG risks in its rating analysis in two different ways:

- Direct impact on Qivalio's rating grid: Some ESG risks have quantitative or qualitative impacts which we will take into consideration in our rating grid. These could either be in the business and industry section (for example a company operating in the oil or airline sectors, which are industries with some of the most negative results for carbon dioxide issuance – though we note with differing impacts). They could also have an impact on our financial forecasts and thus on the company's credit metrics.
- Taken into account in our credit analysis: Although the risks cannot be directly measured in the scorecard, they will still have an impact on a rating. This is particularly true for governance risks.



Source: Qivalio

We present in the table below the likely impacts on our rating grid of the ESG risks identified during a review. This table is informative and should not be considered as strict rules or exhaustive.

Environment	Environmental risks are most likely to be taken into account through the industry section of the rating grid (i.e. for a company in the oil industry to reflect the expected long-term decrease of the oil consumption).
Social	Social risks are most likely to be taken into account through the financial forecast of the company (i.e. high social risks leading to higher cost of employees), and the industry section of the rating grid.
Governance	Governance risks are harder to assess and their impacts is not necessarily captured in our rating grid. Assessment of the risks will be down to the analyst's judgement with a potential denotching in case of serious risks. In the event of denotching this will be detailed in the rating report.

Source: Qivalio

As can be seen in the example given in this section, one could realize that ESG considerations will, in general, have only negative impacts on the rating of an issuer. This statement does not, however, undermine the positive impacts a good ESG policy can have on an issuer (not least in relative terms due to the absence of a negative impact on the rating) but the positive impact on credit quality and rating of this company will on the face of it be rather limited.

Finally, as we mentioned at the beginning of this section, this update to our methodology is provided in order to bring more transparency to our assessment of ESG risks. ESG risks have always been an integral part of our assessment of the creditworthiness of an issuer and as such there is no impact on our previously published ratings.

Qivalio has already started to describe these risks in a separate section within its rating reports. When an ESG risk is preponderant and has, on a standalone basis, a negative impact on the rating this is also clearly stated and further described in our rating reports.

In addition, Qivalio has developed a proprietary ESG methodology allowing our rating analysts to identify and focus on key ESG risks. This methodology allows us to attribute an environmental, social and governance score to each issuer in order to identify key areas of focus for investors and to benchmark different issuers.

2. How to analyze ESG risks

As we mentioned ESG risks are numerous with impacts and time horizons which differ widely. This is true in general but also within a category (for instance within the environmental category of a given company, it is easier to assess the economic impact of an increase of greenhouse gas issuance than the potential impact of new regulations).

Qivalio has leveraged its extensive knowledge on ESG in co-operation with EthiFinance, a leading sustainability research provider which joined the wider Qivalio group as its ESG division. Ethifinance has been operating for more than 15 years. With its 10+ senior analysts, the division covers more than 700 European corporates. Its services have been certified according to Arista standards, the leading ESG international certification body.

In our analysis of ESG risks we focus on identifiable, short/medium-term risks which could have an impact on credit. This is because we believe that long-term risks are first harder to apprehend in terms of impact but also because long-term risks fall in two categories: i) structural broad risks such as demographic changes; and ii) risks with low probability but severe impacts. The impacts of these risks will evolve over time (and generally in a negative way) and they will be taken into consideration when impacts are more concrete and quantifiable.

Whilst we do not deny these long-term risks, we believe they are secondary in the creditworthiness assessment of an issuer compared to risks with shorter term consequences, the impacts of which are more concrete and which can have a negative impact on the business profile of the company, the underlying demand for a company's products, and the financials of a company.

2.1 Environment

Environmental risks could have a significant impact on a number of issuers/sectors. We believe there are two different types of environmental risks: i) the consequences of new regulatory initiatives which could have detrimental impacts on some business models in order to limit some environmental trends; and ii) adverse effects of direct environmental trends.

As we mentioned before, environmental risks and impacts are not always easy to identify and quantify. In order to assess a company's exposure to environmental risks we have developed a proprietary grid which can be summarized in three different sections which include regulatory risks as well as quantitative and qualitative indicators,

We acknowledge that environmental disclosure differs from one company to another. Our indicators are designed in order not to penalize companies that have better reporting compared to others where information is more limited.

2.2 Social

Similarly, to environmental risks, we believe that social risks can be divided into two broad different categories: i) risks related to a specific company or sector (such as employee turnover, strikes); and ii) risks linked to evolution of the regulatory landscape. It is important to note that these types of risks can have detrimental quantifiable impacts on the company's financials but they could also have an impact on the longer term which is less quantifiable (such as boycott or shifts of consumer preferences). In order to assess the exposure of a company to social risk, Qivalio has developed a grid, which - similar to environmental risks - is divided into regulatory risks as well as quantitative and qualitative indicators.

As for the environmental section, the quality of disclosure will vary from one issuer to another and our indicators have been designed in order not to penalize companies that have a better reporting compared to others.

2.3 Governance

We see assessment of governance as key to having a better insight into a firm's management in order to avoid exposure to accounting fraud and other irregularities. In order to assess the governance of a company we have identified 15 indicators, which are in turn divided in 5 broader categories (shareholders, board considerations, executive leadership, auditors and other areas of focus).

Please note that this document is intended to provide a better understanding of our ESG considerations during our rating process. Should you need any further information regarding our indicators please feel free to contact us.

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