ESG in Danske Bank Credit Research

- *Beyond Green*

Louis Landeman
Senior Credit Analyst
+46 8 568 80524
llan@danskebank.com

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ESG research has become an integral part of our credit analysis

In 2019, we launched our new ESG research methodology. In 2020, we have continued to add ESG research on our coverage universe, using our internal framework, and have now applied it to some 40 issuers.

- **A thorough industry analysis is made, whereby we define the relevant ESG risk factors in the specific industry and what weightings should be applied for the various risk factors.**
  - In this analysis, we seek to evaluate both the direct (Scope 1 & 2) and indirect (Scope 3) impact that the industry has on the environment, as this could influence credit quality ahead.

- **For each issuer in the industry, we make a more detailed analysis, whereby we collect relevant data and seek to assess which strategic targets the issuer has set in order to reduce the ESG risks to which it is exposed.**
  - A clear mitigating strategy is crucial for issuers that face large ESG-related risks.

- **Having collected all relevant data, we then assess the three sub-components of the ESG risk as follows.**
  - We make an assessment of the Environmental risk as Low, Medium or High.
  - We make an assessment of the Social risk as Low, Medium or High.
  - We make an assessment of the Governance risk as Low, Medium or High.

- **The three sub-components are combined into one ESG risk indication that ranks as Low, Medium or High.**
  - Importantly, our ESG risk indication is *not* a formal rating or scoring. Rather it seeks to illustrate how we have factored the ESG risks into our overall investment recommendations.
  - In addition, our ESG risk indication is a relative rather than an absolute measure, as we seek primarily to illustrate to what extent various ESG-related factors could influence a company's performance in terms of credit quality and credit spreads.

Source: Danske Bank Credit Research

Why we focus more on ESG in our research work

- If we have a clear view on relevant environmental, social and governance (ESG) factors we can more easily asses whether they are appropriately factored in with regard to credit ratings and bond valuations. This should allow us to be more proactive in our investment recommendations.
- A structured inclusion of ESG risk assessment also enhances the quality of our credit analysis, as it forces us to dig deeper and make additional scenario analyses (including additional stress tests and financial forecasts).
- To encourage positive societal impact, many financial institutions and investors take a company's ESG profile into account when deciding on investments and loans to customers. Consequently, our clients expect us to have a view on ESG issues and are increasingly including ESG in their investment decisions.
- As many investors apply the recommendations from the Task Force on Climate-related Financial Disclosures (TCFD), this could further enhance the importance of ESG factors for investment decisions. This trend will likely be further supported by the EU taxonomy and other regulatory trends.
- In other words, a company's ESG profile can have a meaningful influence on both the funding cost and the refinancing risk of the issuer.

Source: Danske Bank Credit Research

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Examples of ESG issues for analysts to assess in research reports

- **What are the most relevant ESG factors that could potentially affect the company's future earnings and valuation (risks and opportunities)?**
    - We apply our fundamental deep knowledge of the Nordic companies under coverage to assess the materiality of all different ESG factors and decide which ones to focus on.
    - Various external sources can also be of help in identifying the risks, including Sustainalytics ESG Rating Report and SASB Materiality Map (https://materiality.sasb.org/).
    - Furthermore, we can use other types of risk indicators, such as investigating if a company has recently been involved in significant ESG-related controversies.

- **Does the company disclose a sustainability report that allows analysts to monitor and quantify relevant ESG factors?**
    - Is the company following the GRI Standards for sustainability reporting (best practice for reporting on a range of economic, environmental and social impacts)?
    - Ideally all material ESG data should be published by the company including relevant numbers, ratios and targets together with comments on developments and the company's relative position to closest peers.
    - Benchmarking of ESG reporting across an industry is an important tool for pushing companies to report according to best-practice. For this purpose we also assess and rank the quality of the company's ESG reporting (/'Average'/, /'Good'/,'Excellent'/).

- **How well is the company addressing its ESG risks/opportunities?**
    - Does the company integrate ESG risks/opportunities in its strategy and does it have clear policies to mitigate the risks or utilise the opportunities?
    - Has the company set clear and science based long term emission reduction targets?

Source: Danske Bank Credit Research

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Case study: ESG risk in the Swedish real estate sector

- The main ESG risk factors we have identified include direct physical climate-related risks, risk related to greenhouse gas emissions and rising energy costs, risks related to changes in society, risks facing the companies as employers, and credit-related governance and financial policy risks.

- With regards to CO2 emissions the Swedish real estate sector has been successful in reducing direct emissions from existing buildings thanks to a better energy mix and energy savings. However, the indirect emissions from new construction projects and renovations remain high and it will be a large challenge to reduce these emissions, meaning that current business models may have to be significantly revised.

- Swedish real estate companies have been active issuers of green bonds in recent years and the sector now constitute a major part of the Swedish green bond market. In total some 30 companies have established green bond frameworks. We regard this positively as it broadens the companies’ financing sources and increases the focus on their sustainability efforts.

- For the 14 companies included in the sector report published last year we assessed the ESG risk as ”Medium” for 11 companies, mainly as we have assessed both the Environmental and Governance risk as Medium, but with Low Social risk. For the remaining 3 companies with lower leverage and clear mitigating strategies we assess the ESG risk as ”Low”.

- With regard to ESG reporting, we see large scope for improvement. That said, the level of reporting is improving rapidly and most companies expect to improve their level of reporting going forward. We also see scope for improvement with regards to accounting transparency related to the treatment of maintenance costs, investments and reported market values.

Source: Danske Bank Credit Research

EU Taxonomy and green criteria for construction and real estate activities

EU Taxonomy

- The EU Taxonomy is part of the EU Action Plan on Sustainable Finance and aims to create a classification system or "green list" of sustainable economic activities that investors can use everywhere for climate-related investments and which will provide a basis for future regulation and standards – including the EU Green Bond Standard
- The final EU Taxonomy report was published in the beginning of March 2020 and includes a technical annex with screening criteria and thresholds for sectors considered to make a substantial contribution to climate change mitigation and adaptation
- From end of 2021, all financial market participants as well as companies subject to the Non-financial Reporting Directive (i.e. companies with over 500 employees) will have to make disclosures with reference to the taxonomy:
    - Companies will report on the share of their revenues, capex and opex that is Taxonomy-aligned
    - Investors will report on the percentage of their fund that is invested in Taxonomy-aligned activities

Climate change mitigation sectors

- Forestry
- Agriculture
- Manufacturing
- Electricity, gas, steam & air conditioning supply
- Water, sewerage, waste & remediation
- Transportation & storage
- Information & communications
- Construction & real estate activities

Each industry includes a range of activities and each activity has individual screening criteria as a basis for sustainable finance

EU criteria for "Construction, Real estate activities"

	Construction of new buildings	Acquisition and ownership	Buildings renovation	Individual energy saving measures
Threshold	• 20% lower energy use than required in the relevant Nearly Zero-Energy Buildings (NZEB) regulation (mandatory from 2021)	• Energy performance is in top 15% of similar stock (for buildings built before 2021) • Large non-residential buildings have to also have dedicated energy management systems	• Renovations that deliver 30% energy savings (only the renovation cost is eligible) • In the event the renovation reduces the building's energy use to the extent that it can be counted among the top 15%, the entire value of the building qualifies	• Direct costs for energy saving measures such as adding insulation, replacing windows or doors with new energy efficient ones, LED lighting, smart control systems, heat pumps etc.

Source: EU Commission, Danske Bank Credit Research