MSCI ESG Ratings methodology summary guide

MSCI ESG Research LLC

ESG Issuer Communications

June 2020

Contents

Introduction....................3
MSCI ESG Ratings overview....................3
Frequently asked questions....................3

INTRODUCTION

ESG Issuer Communications is the main point of contact for all companies in the MSCI ESG Research coverage universe. This guidance provides a summary overview of the ESG Ratings methodology used by MSCI ESG Research, and a list of frequently asked questions about this research. For questions pertaining to the either ESG Research reports and our company interaction process more generally, please refer to our General FAQ. This document will be updated periodically.

MSCI ESG RATINGS OVERVIEW

MSCI ESG Ratings are designed to help institutional investors identify Environmental, Social, and Governance (ESG) risks and opportunities. Companies are assessed and rated on a 'AAA' to 'CCC' scale according to their exposure to industry specific ESG risks and their ability to manage those risks relative to industry peers. We rate over 7,500 companies (13,500 issuers, including subsidiaries) and more than 650,000 equity and fixed income securities globally[1]. Below are the four key steps in providing an ESG rating.

Step 1: Evaluate corporate governance

MSCI ESG Ratings analyses begins with an examination across governance structures, director-level data, governance events et al. Corporate Governance is a universal key issue evaluated for every company in our coverage universe.

Step 2: Identify key issues by industry

The model adopts a quantitative approach to objectively identify economically relevant key issues (risks and opportunities) by industry. Once key issues are identified at the industry level, they are assigned to each company within the industry. MSCI ESG Ratings identify six to ten key ESG issues for companies in the industry that currently generate large environmental or social externalities; these are issues that may force some companies to absorb unanticipated costs associated with those externalities in the future.

Step 3: Score key issues (0-10)

We assess thousands of data points across 37 ESG Key Issues, focusing on the intersection between a company's core business and the industry issues that can

[1] As of October 2019, MSCI ESG Research LLC.

create significant risks and opportunities for the company. However, our model focuses on risk exposure and not just corporate disclosure. To understand whether a company is adequately managing a key ESG risk, it is essential to understand both what management strategies it has employed and how exposed it is to the relevant risk. The MSCI ESG Ratings model measures both: risk exposure and risk management. All 37 Key Issues are listed in the Appendix.

Step 4: Final ESG Rating (CCC-AAA)

To arrive at a final letter rating, the weighted averages of the Key Issue Scores are aggregated and companies' scores are normalized by their industries. After any overrides are factored in, each company's Final Industry-Adjusted Score corresponds to a rating between best (AAA) and worst (CCC). These assessments of company performance are not absolute but are explicitly intended to be relative to the standards and performance of a company's industry peers.

FREQUENTLY ASKED QUESTIONS

The most common questions that ESG Issuer Communications receive from global companies relate to the construction of our ESG Ratings. Below is a curated list of frequently asked methodology questions by issuers.

1. HOW ARE PEERS SETS CONSTRUCTED?

The Industry peer groups are typically standardized and determined by Global Industry Classification Standard (GICS®). In general, there is no analyst selection involved. Please note that the peers listed on page 4 or 5 in the ESG Ratings report are the five largest peers in the GICS® industry by market cap. It is only a subset of the peer set, not the full list.

2. HOW ARE KEY ISSUES DETERMINED?

ESG Key Issues are determined by a quantitative model based on intensity factors that allows different companies' core businesses to be comparable. All key issues and their relevance are reviewed by industry analysts annually and are discussed with clients as part of the client consultation process, where appropriate. The Environmental, Social and Corporate Behavior Key Issues vary between industries, but all companies in all industries are evaluated on the same Corporate Governance theme. ESG Key Issues are selected based on the extent to which the business activities of the companies in each industry generate large environmental, social or governance-related externalities.

3. HOW ARE KEY ISSUE WEIGHTS DETERMINED?

Once the key issues have been selected for a GICS® Sub-Industry, we set the weights that determine each key issue's contribution to the overall rating. Each key issue typically comprises 5 to 30% of the total ESG Rating. The weightings consider both the contribution of the industry, relative to all other industries, to the negative or positive impact on the environment or society; and the timeline within which we expect that risk or opportunity for companies in the industry to materialize, as illustrated conceptually below (excerpt from the full ESG Ratings Methodology).

Figure 1: Framework for Setting Key Issue Weights

		Expected Time frame for Risk/Opportunity to Materialize	
		Short-Term (<2 years)	Long-Term (5+ years)
Level of Contribution to Environmental or Social Impact	Industry is major contributor to impact	Highest Weight	
	Industry is minor contributor to impact		Lowest Weight

4. MY COMPANY HAS A VARIETY OF BUSINESSES/ MY COMPANY'S BUSINESS IS DIFFERENT FROM OUR PEERS. HOW DO YOU ACCOUNT FOR BUSINESS SPECIFICITIES AT A KEY ISSUE LEVEL?

In some cases, a company may face a unique set of environmental, social or governance Key Issues that is not shared by other companies in its industry. This can arise from several scenarios, ranging from companies with unique or diversified business models to subsets of companies within an industry that face a unique set of risks. In these cases, a Company-Specific Key Issue is added to the analysis and the weights on the remaining Key Issues are reduced proportionally.

5. HOW IS RISK EXPOSURE DETERMINED?

Most key issues, although not all, consist of two components: risk exposure and risk management. This dichotomy allows the model to adjust the strength of management systems required to achieve a given key issue score: companies facing higher risk exposure must have stronger management practices in place to mitigate their risks.

On the risk side, MSCI ESG Research has developed a proprietary risk exposure model. Our assessment of exposure is comprised of three different areas of analysis, depending on the key issue:

Business Segment Risk Exposure – analyzes the breakdown of a company's business segments in terms of revenues, assets, or operations

Geographic Segment Risk Exposure – analyzes the breakdown of a company's geographic segments in terms of revenues, assets, or operations

Company-Level Risk Exposure factors – such as number of employees, size, reliance on government contracts, or reliance on outsourced production

We utilize a variety of sources to determine the risk exposure level/scores for each of the areas.

For example, on Labor Management, Company X's risk exposure is determined to be high based on the type of business it is involved in (percent of operations in business segments with high labor intensity, as measured by average sales per employee), and the location of its operations (percent of operations in countries with high likelihood of labor unrest, based on historic precedent). The key issue also looks at additional factors, such as workforce size, recent restructuring, etc. The exposure side of this assessment does not consider Company X's track record in avoiding labor disputes or work stoppages. This would be a performance measure evaluated under the risk management side of the key issue assessment.

6. HOW IS THE WAKI SCORE CONVERTED TO IAS?

The Industry Adjusted Score (IAS) is defined by the Weighted Average Key Issue score (WAKI) and normalized based on score ranges set by the benchmark companies in the peer set.

The adjusted score of 10 is defined at the 97.5th percentile of the benchmark industry, and the adjusted score of 0 is defined at the 2.5th percentile of the benchmark industry, based on historically observed values. The score ranges are re-evaluated at the beginning of each calendar year. These assessments of company performance are not absolute but are explicitly intended to be relative to the standards and performance of a company's industry peers.

7. OUR COMPANY'S WEIGHTED AVERAGE KEY ISSUE SCORE (WAKI) HAS CHANGED BUT THE INDUSTRY ADJUSTED SCORE (IAS) REMAINS THE SAME. WHY?

The Weighted-Average Key Issue score is dynamic, reflecting changes in any underlying scores as of the Last Update date, while the Industry Adjusted (relative) Score is relatively static and corresponds to the Rating action date, and is updated when the overall rating changes. Score ranges for the Industry Adjusted score are re-evaluated at the beginning of each calendar year.

For more about score update timing, please refer to General FAQ Q 3.1.

8. WE DON'T REPORT CARBON EMISSIONS DATA. WHERE DID THE EMISSIONS DATA COME FROM?

Where companies do not report this information, we estimate based on MSCI ESG Research proprietary carbon estimation methodology. However, if the company does report carbon data publicly, please let us know, including the link to where this information can be found in the public domain. We will review and make the necessary updates, replacing the estimates where appropriate.

9. WHAT IS INCLUDED IN THE R&D EXPENSES FOR THE OPPORTUNITIES IN CLEAN TECH KEY ISSUE?

In general, we capture R&D expense data from the Consolidated Financial Statements disclosed by the company in its Annual Report. If the company reports a breakdown of its R&D expense that separates out Capitalized R&D from R&D expenses recognized as costs, we would exclude the capitalized amount and report the remaining figure. We do not consider R&D capitalized cost as part of the Research and Development expenses. Capitalized cost is considered to be an asset, and thus not included in R&D expense.

Furthermore, we report the figures disclosed by the company on its Annual Report for that specific fiscal year. If the company restated its expenses based on change in Accounting Principles, we would not restate historical figures since it would not accurately reflect the amount reported by the company in the previous years. Likewise, if the restatement was due to a corporate event (e.g., an acquisition, or spin-off), we would not restate historical figures, since it would not accurately reflect the amount of R&D expenses that the company had at the time.

We use USD as the main currency. If the company reports R&D expenses in local currency, this is converted to USD using the exchange rate date as of the fiscal year end date of the company. Discrepancy between the numbers might be caused by foreign exchange rate difference. We would not typically update minor discrepancies on an ad-hoc basis.

10. WHAT IS THE BEST PRACTICE FOR FREQUENCY IN EMPLOYEE ENGAGEMENT SURVEYS?

General best practice in terms of frequency of employee surveys is *annual*. Per our scoring, a company that conducts engagement surveys at any other regular frequency (e.g. every two years) will typically be assessed as "sporadically". While we are always looking to refine our indicators, this is currently the standardized scoring level.

11. OUR COMPANY BELIEVES THAT NOT HAVING A UNION IS AN INDICATION OF STRENGTH IN OUR LABOR MANAGEMENT. BUT MSCI APPEARS TO SCORE US NEGATIVELY FOR OUR LOW UNIONIZATION RATE. WHY IS THIS?

MSCI does not have an official position on merits of unionization. However, for our Labor Management key issue, we use unionization rate as a proxy for the presence of basic employee rights and benefits. Therefore, in this context, a higher unionization rate would score more positively for this indicator. Having said that, a company with low or no unionization rate could still receive a higher management score if it had strong performance on all other metrics

12. HOW IS THE SCORE FOR TAX TRANSPARENCY DETERMINED?

We evaluate the extent to which companies may face enhanced public and regulatory scrutiny as well as potential liabilities because of actual or perceived avoidance of corporate income taxes. Scores are based on the gap between the company's estimated effective tax rate and the estimated statutory tax rate if the company were paying taxes as per the statutory tax rates in the jurisdictions where it generated revenues. Scores are also adjusted based on the disclosure transparency around breakdown of revenues by country; whether a company is predominantly domestic; whether it is classified as a tax-favored structure such as REITs; and by involvement in controversies.

For more information, please see our issue brief: The Tax Gap – Regulatory responses and Implications for Investors. Please note that for *most companies*, this issue is 0% weighted and is considered an additional ESG issue, not impacting the overall ESG Rating assessment.

APPENDIX

MSCI ESG Key Issue Hierarchy

3 Pillars	10 Themes	37 ESG Key Issues	
Environment	**Climate Change**	Carbon Emissions Product Carbon Footprint	Financing Environmental Impact Climate Change Vulnerability
	Natural Resources	Water Stress Biodiversity & Land Use	Raw Material Sourcing
	Pollution & Waste	Toxic Emissions & Waste Packaging Material & Waste	Electronic Waste
	Environmental Opportunities	Opportunities in Clean Tech Opportunities in Green Building	Opportunities in Renewable Energy
Social	**Human Capital**	Labor Management Health & Safety	Human Capital Development Supply Chain Labor Standards
	Product Liability	Product Safety & Quality Chemical Safety Financial Product Safety	Privacy & Data Security Responsible Investment Health & Demographic Risk
	Stakeholder Opposition	Controversial Sourcing	
	Social Opportunities	Access to Communications Access to Finance	Access to Health Care Opportunities in Nutrition & Health
Governance	**Corporate Governance***	Board* Pay*	Ownership* Accounting*
	Corporate Behavior	Business Ethics Anti-Competitive Practices Tax Transparency	Corruption & Instability Financial System Instability

** Corporate Governance Theme carries weight in the ESG Rating model for all companies. In 2018, we introduced sub-scores for each of the four underlying issues: Board, Pay, Ownership and Accounting.*

Contact us

clientservice@msci.com

AMERICAS

Americas	1 888 588 4567 *
Atlanta	+ 1 404 551 3212
Boston	+ 1 617 532 0920
Chicago	+ 1 312 675 0545
Monterrey	+ 52 81 1253 4020
New York	+ 1 212 804 3901
San Francisco	+ 1 415 836 8800
São Paulo	+ 55 11 3706 1360
Toronto	+ 1 416 628 1007

EUROPE, MIDDLE EAST & AFRICA

Cape Town	+ 27 21 673 0100
Frankfurt	+ 49 69 133 859 00
Geneva	+ 41 22 817 9777
London	+ 44 20 7618 2222
Milan	+ 39 02 5849 0415
Paris	0800 91 59 17 *

ASIA PACIFIC

China North	10800 852 1032 *
China South	10800 152 1032 *
Hong Kong	+ 852 2844 9333
Mumbai	+ 91 22 6784 9160
Seoul	00798 8521 3392 *
Singapore	800 852 3749 *
Sydney	+ 61 2 9033 9333
Taipei	008 0112 7513 *
Thailand	0018 0015 6207 7181 *
Tokyo	+ 81 3 5290 1555

ABOUT MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 45 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process.

About MSCI ESG Research Products and Services

* = toll free

MSCI ESG Research products and services are provided by MSCI ESG Research LLC, and are designed to provide in-depth research, ratings and analysis of environmental, social and governance-related business practices to companies worldwide. ESG ratings, data and analysis from MSCI ESG Research LLC. are also used in the construction of the MSCI ESG Indexes. MSCI ESG Research LLC is a Registered Investment Adviser under the Investment Advisers Act of 1940 and a subsidiary of MSCI Inc.

To learn more, please visit www.msci.com.

Notice and disclaimer