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Opportunities and Challenges of ESG Ratings: a Case Study on the Fashion Industry

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Introduction

Nowadays ESG Ratings are one of the main trends in financial markets.

They assess the commitments and performance of companies in relation to sustainable goals.

The three Environmental, Social and Governance dimensions have become a measure of risk of firms and they are progressively included in corporate evaluation methods.

Nonetheless, we still do not have a clear and unique definition of sustainable performance and rating agencies provide their own assessment of corporate conducts, without following a common procedure.

Therefore, even though we see a correlation between ESG ratings and sustainable business practices, evaluations are heterogenous and not always clear to the investors.

The aim of this paper is to investigate the opportunities, challenges and divergence of the ratings.

In the first chapter, we will investigate the theoretical framework behind the discrepancies among the ratings, their impact on stock returns and the greenwashing practices in financial markets.

We will mention the Sustainable Finance Disclosure Regulation (SFDR), as a relevant step in the definition of sustainable financial products.

The second chapter will be devoted to the analysis and comparison of ESG rating methodologies used by MSCI and Standard & Poor's (S&P).

MSCI is the world leader agency in measurement of “financially relevant ESG risks and opportunities”¹.

S&P is one of the three largest rating agencies, together with Moody's Investor Services and Fitch Ratings.

I have chosen to compare the methods implemented by those two agencies because of the diversity of their approach.

MSCI grounds the entire company valuation on mathematical formulations and on publicly available data.

¹<https://www.msci.com/our-solutions/esg-investing/esg-ratings>

²https://en.wikipedia.org/wiki/S%26P_Global_Ratings

S&P adopts a subjective and less numerical way of analysing, employing published information and survey submitted to firms.

The third chapter is a case study about the sustainable performance in Fashion Industry.

We will take into consideration the ESG assessment that MSCI and S&P have done about two players of the sector.

The investigation concerns the business practices of Moncler S.p.A. and Kering S.A.

Moncler is an Italian group that has been added to the S&P Global Gold Class, but classified as an average performer by MSCI.

Kering is a French world-leader group in Luxury industry, rated as ESG leader by MSCI and positively by S&P.

After having compared the estimations about the companies we will detect any impact of ESG score on stock prices in the last six months.

1. ESG Ratings and Assessment of Corporate Sustainability

1.1 ESG ratings and correlation with sustainable business practices

ESG ratings are measures of exposure and commitment of firms to environmental, social, and governance risks. They evaluate practices aimed at integrating sustainability considerations into business and investment portfolios.

The acronym refers to three fundamental factors in the evaluation of sustainable investments.

The environmental component is related to the company's impact on the ecosystem and includes parameters such as pollution, emissions, waste, and efficient use of resources.

The social dimension concerns the effect of the company's activity on society, workers, and customers, from the point of view of safety, fair employment conditions, and attention to the needs of local communities.

The governance aspect considers the structure of governing bodies, the management, and policies that guarantee equity, respect, and avoid illegal practices. It also contemplates rules and procedures that ensure diversity and inclusivity.

The idea of integrating those factors into the daily activity and management of the company is often referred to as Corporate Social Responsibility (CSR).

The popularity of CSR and companies' engagement in safeguarding the environment and human beings reveal a change in "the theory of the firm, especially regarding a firm's objective function¹".

In the past the company's purpose was exclusively to maximise profit for shareholders, even sacrificing social and environmental interests.

Today, the firm is conceived as an entity involved in the surrounding community and it is accountable for the externalities it produces.

Nonetheless, CSR is viewed not only as a not-to-profit attitude towards society and the ecosystem but also from a strategic point of view.

Indeed, it enhances the reputation, the competitive advantage, and the perception of the quality of products and builds trust and social capital.

¹Corporate Social Responsibility and Sustainable Finance: A Review of the Literature - Hao Liang, Luc Renneboog

Capital providers perceive firms showing commitment to CSR and having a high ESG score as less risky². Investors accept lower expected returns and higher prices to provide capital to ESG-compliant companies.

A firm that acts responsibly towards the environment creating value for all stakeholders will minimize risks.

The evidence is shown using one of the most common corporate valuation methods, the Discounted Cash Flows.

$$DCF = \sum_{n=1}^t \frac{CF_n}{(1 + WACC)^n}$$

The ESG parameters affect the cash flows estimation at the numerator, the discount factor at the denominator, and - as a result - the overall market assessment.

In particular, the lower risk affected by the superior ESG performance will produce better cash flows, since the company will use resources more efficiently, and sustainable investments – even if expensive in the short term – will improve the overall productivity of the company.

The denominator will be lower because the assessment of ESG practices allows incorporating another form of risk in our model, making our estimation more precise.

A remarkable ESG score is therefore associated with a lower risk premium.

Moreover, the incorporation of another measure of risk will benefit the capital market, enhancing its resilience and efficiency³.

As a result, the measurement of sustainability-related parameters affects the idiosyncratic risk of the firm – which will be measured properly - and the systematic risk of the market – developing more conscious and updated evaluations of corporate behaviour.

Nonetheless, if corporate finance literature agrees on the contribution of ESG and sustainable performance to the generation of value – the relation with asset pricing is more complex.

As we will further investigate, the ESG ratings create several opportunities for firms to improve business practices, but they also pose significant challenges.

Scholars have recognized the lack of a clear and unique definition of ESG ratings, they examined discrepancies among the results provided by the agencies, and they have detected noise in the measurement of sustainable attributes.

²⁻³DCF METRICS AND THE COST OF CAPITAL: ESG DRIVERS AND SUSTAINABILITY PATTERNS Roberto Moro Visconti – Università Cattolica del Sacro Cuore, Milan, Italy

1.2 Discrepancies among ESG Ratings

As sustainable investment practices gain popularity, the discrepancies among ESG ratings and their scarce correlation become relevant.

These differences make the evaluation of sustainable performance difficult; they do not incentivize firms to improve it, and eventually, they do not contribute to implementing policies in favour of the planet.

Furthermore, the diversity and discrepancy of information about sustainability make it difficult for investors “to synthesize into strategic and operational decisions”⁴.

Indeed, we do not have a clear and unique definition of sustainable performance and each rating agency provides its own interpretation of the issue. While credit ratings are based on the probability of default, we do not even have a reporting standard for ESG.

As a result, we can observe a pronounced discrepancy among ratings issued by the agencies that compute their results by gathering information from multiple sources and with dissimilar standards.

According to Berg, Koelbel, and Rigobon 2019, we can distinguish three forms of divergence that cause the “Aggregate Confusion”⁵ about ESG ratings.

The scope divergence concerns the different attributes included in the ratings and used to evaluate the performance. As a matter of fact, the four key entity-specific factors used by S&P Global to evaluate the Governance Profile are structure and oversight, code and values, transparency and reporting, and financial and operational risk⁶. On the contrary, in MSCI ESG Ratings Methodology, the themes used to examine the Governance aspect are corporate governance and corporate behaviour⁷.

The measurement divergence relates to the use of different indicators to measure the same attribute. Indeed, the above-mentioned rating agencies measure the Waste and Pollution attribute in distinct ways. For S&P Global, the key indicators are the proportion of waste recycled and the current level of recycling⁸; whereas MSCI ESG Rating focuses on toxic emissions and waste, packaging material and waste, and electronic waste⁹. The weights divergence refers to the relevance that the ratings give to the attributes and

⁴ Why sustainable business needs better ESG ratings; MIT Management Sloan School

⁵ Aggregate Confusion: The Divergence of ESG Ratings; Florian Berg, Julian F. Koelbel, Roberto Rigobon

⁶⁻⁸⁻¹⁰ Environmental, Social, And Governance Evaluation Analytical Approach; Analytical Approach; S&P Global

⁷⁻⁹⁻¹¹ MSCI ESG Ratings Methodology - Executive Summary; MSCI ESG Research LLC

indicators. S&P Global analyses the sector and region to be compared with the performance of the entity, assessed using the four key-entity-specific factors. Each factor weights equally¹⁰. Conversely - in MSCI ESG Rating - each Environmental and Social Key Issue contributes to 5%-30% of the total rating of the entity. The weight reflects the contribution of each key issue to the social and environmental externality and the length of time in which the risk or opportunity will take form¹¹.

The study of Berg, Koelbel, and Rigobon has given relevant results in the field, proving that the main driver of the discrepancy is the measurement divergence contributing to 56% of the total, followed by the scope divergence yielding 38% and the weight divergence that causes only 6%¹².

To perform a complete analysis, they have created an approximated taxonomy grouping all the indicators related to the same attribute in a specific category. The results show that the 709 indicators identified comparing six ratings are grouped into 64 categories. A difference in broadness has been identified among the categories created and there are many unclassified indicators. Thus, the taxonomy suggests that there are general aspects that are examined in different manners by each agency and there are several others that are not even considered by more than one issuer. These two aspects are the main contributors to the scope divergence.

Then, they exploited the taxonomy to evaluate the measurement divergence. They have assessed the scores given by each rating agency for each ESG category, showing that a substantial difference exists in how the competitors choose to measure, rather than what they measure¹³.

From the comparison of the scores, they have understood that the correlation among them differs for each category, showing different levels of agreement among the rating agencies.

Furthermore, correlation among the scores increases when data about specific and narrow categories are grouped in more general and broad classification. This is mainly due to the scarce data quality, which gives more homogenous results only through gathering. As a result, the correlation among the scores of three dimensions of ESG ratings will be higher than the one among the scores of the single categories.

They have also detected a bias called the “rater effect” or “halo effect”¹⁴, related to the measurement divergence. This effect implies that if the rating agency gives a positive

¹²⁻¹³⁻¹⁴ Aggregate Confusion: The Divergence of ESG Ratings - Florian Berg, Julian F. Koelbel, Roberto Rigobon

evaluation to the company about an indicator, it will be likely that also the evaluation for the other aspects will be favourable.

To investigate the weight divergence, they performed a non-negative least square regression, to detect whether the linear model of their taxonomy can truthfully represent the ratings. A non-negative least square regression excludes any negative coefficients and the function representing the relationship- minimizes the difference between the sum of the square of the residuals. The model has shown high R^2 values for each rating agency.

Nonetheless, they have observed differences in the weights attributed to each indicator. Notably, the three most relevant categories are different for each rating agency, implying different views about the most influential aspects in assessing the sustainable performance of the company.

The study carried out by Berg, Koelbel, and Rigobon explains and decomposes the differences among the ESG ratings and methodologies used by the agencies.

It calls for greater transparency from rating agencies in disclosing the methods used, the categories and indicators, their weights, and, above all, their definition of ESG performance.

At the same time, regulators should impose standards for measurement and assessment of companies' actions, to face the issue and improve the quality and accessibility of data.

Such Aggregate Confusion poses challenges, especially for investors that use data produced by a single provider or should struggle to minimize the measurement divergence and make a meaningful and careful comparison of the ratings.

Also, companies are impacted in establishing the ESG targets for the period and subsequent compensation of top management. Indeed, it is difficult for companies to set targets and goals that would permit an enhancement in ESG scores in all ratings.

Therefore, reducing the ESG divergence and setting standards for the evaluation of ESG performance would bring relevant advantages to different actors in financial markets.

First, it would reduce competition among the rating agencies, currently struggling to set their own methodology and definition as a standard for the market.

It would reduce uncertainty and bring clarity in financial markets about sustainable performance, improving the effectiveness of goals established by companies for the safeguard of companies.

Finally, it would facilitate the practices of sustainable investing, since homogenous ratings would be interchangeable and easily comparable by investors.

1.3 Impact of ESG performance on stock return

In the last years, financial markets have seen a huge increase in demand for sustainable assets. Events like the Covid-19 Pandemic and the ongoing Climate Crisis have raised concern among investors, wishing to align their portfolios to more sustainable investment practices.

As a rule, an increase in demand would boost prices and lower the expected return of the asset. Nonetheless, the empirical evidence about prices and performance of sustainable products is conflicting, as Berg, Koelbel, Pavlova, and Rigobon suggest.

The relation between ESG attributes and stock returns is heavily impacted by the available measures of ESG performance. Indeed, “the noisier the measurement of ESG performance, the lower the sensitivity of stocks return to ESG performance”¹⁵.

As mentioned before, the low availability of standardized data impacts the differences in ESG assessments¹⁶.

The rating agencies gather data from distinct sources, including regulatory documentation, corporate social responsibility reports, media, modelled data, and questionnaires.

Data models are internally produced by the agencies to organize pieces of data and relate them when corporate reports are missing.

The confusion in ESG ratings is also related to noise in weights. The ESG score is a weighted average of several indicators¹⁷. The weights that the rating providers attribute to each indicator should reflect the relevance that investors give to the various aspects of sustainable performance. Since investors’ views are unknown, each agency applies weights attempting to interpret them, contributing to the noise. Moreover, weights are usually industry-specific, intensifying the discrepancies.

Notwithstanding the issue of noise, Berg, Koelbel, Pavlova, Rigobon identify two forms of influence of ESG ratings on stock returns¹⁸.

ESG-conscious investors are interested in characteristics of a Company’s activity not related to cash flows.

¹⁵⁻¹⁶ ESG Confusion and Stock Returns: Tackling the Problem of Noise – Florian Berg, Julian F. Koelbel, Anna Pavlova, and Roberto Rigobon

¹⁷ The environmental, social, and governance (ESG) dimension of firms in which social responsible investment (SRI) and conventional pension funds invest: The mainstream SRI and the ESG inclusion - Mercedes Alda

¹⁸ Aggregate Confusion: The Divergence of ESG Ratings - Florian Berg, Julian F. Koelbel, Roberto Rigobon

A superior ESG performance will result in a higher bid price, lowering the cost of capital of the firm.

A higher ESG score entails a lower risk related to environmental, social, and governance issues and therefore the rate of return will be lower. The price will be impacted positively since the investors will be willing to pay more for ESG-compliant security.

The relation between price and return is illustrated also by the Gordon Growth Model:

$$P_0 = \frac{D_1}{r - g}$$

Assuming constant growth in dividends, the price of a stock is computed as the present value of dividends, discounted for the rate of return minus the growth rate.

The lower risk represented by the high ESG score implies a lower cost of capital for the firm. The cost of capital is the opportunity cost for capital providers of investing the same money in other financial instruments having similar risk and characteristics. It consists of the cost of debt and the cost of equity. In particular, the cost of equity is the return required to purchase shares of the firm. It can be estimated by employing the Capital Asset Pricing Model (CAPM). The CAPM is a mathematical model that relates the return of a security to its risk. In a simplified scenario without transaction costs and taxes, the model distinguishes an idiosyncratic and a systematic risk, and measures the expected return as follows:

$$E(R_p) = R_f + \beta_p(E(R_m) - R_f)$$

where R_f is the risk-free rate and R_m is the rate dominant in the market. β_p is a measure of the correlation between the security and its reference market:

$$\beta_i = \frac{Cov_{ij}}{\sigma_j^2}$$

Where i is the security and j is the reference market.

As pointed out by the CAPM, a lower risk – given by sustainable corporate practices – will lower the cost of equity and therefore the overall cost of capital for the firm.

The second effect detected by the authors is opposite to the first one. It is represented by higher returns on stocks with superior ESG performance during periods of high inflows of new investors into those securities. This effect would eventually reverse once the inflows would stabilize.

After having identified the two main opposite effects of ESG scores on stock return, the authors have built a key equation describing the relation:

$$E(\Delta S_{t+1}) = a_0 + c_{impact} \times Y_t + c_x \times X_t + \dot{\eta}_t$$

Where a_0 is the stock average return, Y_t is the ESG performance multiplied by its impact on return, X_t is a vector of firm's characteristics related to cash flows and lastly, $\dot{\eta}_t$ is the signal in the market about the cash flows.

Nonetheless, in the market, we do not observe the true ESG performance but noisy measures. The score $s_{i,t}$ given by the rating agency is, therefore, a heterogenous estimate and its relationship with the real ESG performance is illustrated as follows:

$$s_{i,t} = Y_t + \epsilon_{Y_{i,t}}$$

Where we have an error term $\epsilon_{Y_{i,t}}$ that is added to the real ESG performance and is independent of Y .

The model constructed by Berg, Koelbel, Pavlova, Rigobon is relevant because it is a mathematical formulation of the noise that affects ESG scores. It allows distinguishing the various effects that contribute to the expected return of a stock and it considers also the impact of errors in the measurement of ESG performance.

The impact of the error differs among the ratings produced by the various agencies, and it enables to recognize the noisier ratings.

Despite that, the authors precise that even if confusing, all ratings are informative and should be compared by the investors.

As a matter of fact, they report heterogeneous results that - jointly examined - enable to have a more exhaustive view of the sustainable performance of the firm.

1.4 Greenwashing practices in financial markets

Greenwashing was coined during the 1980s by Jay Westerveld, referring to “any dishonest practices used by business to represent themselves as more sustainable either by giving a false impression or providing misleading information as to the sustainability of a product/service”¹⁸.

Nowadays, the term is widely used to denounce and criticize corporate behaviour in all industries, and it can be applied also in financial markets.

¹⁸ESG: Addressing greenwashing in financial services - KPMG United Kingdom

Indeed, the increase in demand for sustainable financial instruments and the pressure made by regulators push firms to undertake measures to become, or at least, appear more sustainable.

Sustainability is a trend and both consumers and investors actively seek sustainable products and investments.

The risk of greenwashing is incumbent also due to the heterogeneity and confusion that characterize the ESG ratings.

As we will analyse in the following chapters, evaluations made by the agencies on the same company differ substantially. In a similar scenario - where we do not have a clear definition of an ESG-compliant attitude – greenwashing practices spread easily.

Also the birth of ESG ratings is controversial. The first agency to publish sustainability-related ratings has been MSCI in 2019. The data produced by MSCI were described by the chief executive officer Henry Fernandez as a “mean to an end”¹⁹.

Today, MSCI still dominates an unregulated business, rating companies according to its own definition of sustainable performance.

However, the purpose of MSCI ratings is not to evaluate the commitment of firms to safeguard of the environment.

Indeed, the rating measures the potential impact of the world on the company and on shareholders²⁰.

It takes into considerations the environmental, social and governance issues that could harm the company and it evaluates the solidity of the company with respect to those risks.

Therefore, the whole concept and scope of ESG ratings has never been implemented.

Bloomberg Businessweek analysed 155 upgraded companies during 2020 and 2021, proving that their score had been enhanced due to one, two or three significant factors.

Among the upgrades, we have different examples that show the weakness of MSCI ratings.

Atmos Energy has been updated to A on March 2021, according to an enhancement in the parameter Biodiversity. Bloomberg explained that the measurement of safeguarding of biodiversity had been modified according to company location.

Similarly, Baxter has been upgraded to BB for having eliminated toxic substances from his

¹⁹⁻²⁰ What is ESG Investing - MSCI Ratings Focus on Corporate Bottom Line - Cam Simpson, Akshat Rath, and Saijel Kishan–Bloomberg

products.

Also, the approach to relevant issues such as the efficient use of water is impressive. Indeed, MSCI does not whether the company is stressing the local water supply, but it verifies whether the communities have access to the resource or not.

The lack of clarity about ESG ratings, their definition, and the widespread practices of greenwashing highlight the need for policies about sustainable performance.

As already state, standards and policies would enhance the activity of the company, the investment practices and financial markets.

Eventually, they will also enhance trust among consumers and investors that would have at their disposal a set of clear, homogenous and easily comparable data about sustainable performance of companies.

1.5 Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy

The greenwashing practices and divergences in sustainability disclosure have been recently addressed by the European Commission in the Sustainable Finance Action Plan.

The Sustainable Finance Action Plan is a policy objective that aims to promote sustainable development in financial markets.

One of the fundamental pillars is the Sustainable Finance Disclosure Regulation (SFDR) which imposes new standards for ESG disclosure for entities and financial products.

The SFDR has been published in 2019 and came into force in 2021.

As stated in Article 1, “this Regulation lays down harmonised rules for financial market participants and financial advisers on transparency with regard to the integration of sustainability risks”.

The SFDR distinguishes different categories of investment products and classifies them according to their approach to sustainability.

According to Article 6, all investment products and all financial entities have to disclose how the ESG risks and Principal Adverse Impacts (PAIs) are integrated in the risk policies of the financial instrument.

The PAIs have been conceived within the framework of the regulation to refer to the negative

²¹REGULATION (EU) 2019/2088 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 27 November 2019 on sustainability-related disclosures in the financial services sector

effects that investment decisions can have on sustainability issues.

Article 8 and Article 9 provide a categorization of financial products.

Article 8 mentions the financial products that promote some social and environmental principles.

Article 9 focuses on financial products whose objective is a sustainable investment.

They require disclosure about the sustainable aspect of the product and about the reference benchmark used.

Moreover, SFDR enforces also an entity-level disclosure of sustainability risk policies and policies to address the adverse impacts.

Within the Sustainable Finance Action Plan, the European Commission has also created the EU Taxonomy, which classifies economic activities according to sustainability.

The Taxonomy has identified six environmental objectives within which the sustainable activities would fall, namely the climate change mitigation, the climate change adaptation, the sustainable use and protection of water and marine resources, the transition to a circular economy, waste prevention and recycling, the pollution and prevention control and the protection of healthy ecosystems.

The process established by the EU Taxonomy identifies the portion of Capex, Operation expenditure or revenues of the company that is associated with the sustainable economic activity recognized in the framework.

Then it verifies whether the activity gives a “substantial contribution” in terms of sustainability, whether the activity is in contrast with the other environmental objectives, and finally whether labour conditions are fair.

Even if they do not directly address the ESG rating divergences, the SFDR and the EU Taxonomy represent a cornerstone in the fight against greenwashing.

The two regulations are relevant steps to achieve high and reliable sustainability standards in the financial markets and they reveal a strong concern by institutions about ESG performance and practices.

²² REGULATION (EU) 2020/852 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088

2.ESG Ratings Methodologies

2.1 MSCI ESG Rating Methodology

MSCI publishes an executive summary about its ESG Rating Methodologies every two months.

The purpose of their rating is to measure the resilience of the firms to the long-term sustainability risks. In particular, they aim at assessing whether the negative externalities created by the company could turn into costs in the medium and long term. Similarly, they detect whether the sustainability issues that characterize the industry could represent an economic opportunity for the firm in the medium and long-term¹.

The analysis performed by answering these two questions - is translated into a letter rating, like the default ratings.

The MSCI ESG letter rating entails two ESG score types; namely the weighted average key issue score and the industry-adjusted score.

The weighted average key issue score is an absolute measure, and it gives a total idea of the firm risk.

The industry-adjusted score is useful to perform peer-to-peer comparisons within the same industry or GICS sector.

The Global Industry Classification Standards (GICS) have been developed by MSCI and S&P to categorize companies according to their business and make financial research comparable all over the world².

In the executive summary of the ESG rating methodologies, the data processing and measurement are described.

The raw data to appraise the risk exposure of the firm are microdata at the segment or geographic level; corporate reports and Government databases³.

Their process of data gathering and review is “standardized and systematic”⁴. They do not collect information via surveys and they do not use any evidence that is not publicly available.

As a result, the score proves to be reliable and easily contestable.

¹⁻³⁻⁴⁻⁵ MSCI ESG Ratings Methodology - Executive Summary - MSCI ESG Research LLC - April 2022

² The Global Industry Classification Standard (GICS®) - <https://www.msci.com/our-solutions/indexes/gics>

After having gathered the data, the rating agency proceeds with the assessment of the environmental, social, and governance pillar score.

The environmental and social pillar score is computed as the weighted average of the key issues scores.

MSCI has elaborated 35 key issues that identify material risks and opportunities for companies across different industries.

For each GICS sub-industry, the agency selects the most relevant and useful Key Issues to reveal the risks that can translate into costs for the firm and the opportunities that can be capitalized⁵.

Each environmental and social Key Issue has a weight from 5% to 30% of the total score. The criteria used to determine the weight are the level of contribution of the company to the externality and the expected time frame in which the circumstance will materialise.

The impact can be judged as “high”, “medium” or “low”, while the expected time horizon is short-term, medium-term, or long-term.

The short-term timeframe refers to a period of fewer than two years and the long-term is used for events that will occur in more than 5 years.

As stated in the executive summary, a key issue defined as “high-impact” and “short-term” would be weighted three times higher than a Key Issue defined as “Low-impact” and “Long-term”.

After having chosen the pertinent Key Issues for the industry and their weights in the overall valuation, the score for the company is computed.

The score of each key issue is determined based on the risk exposure and the risk management of the company.

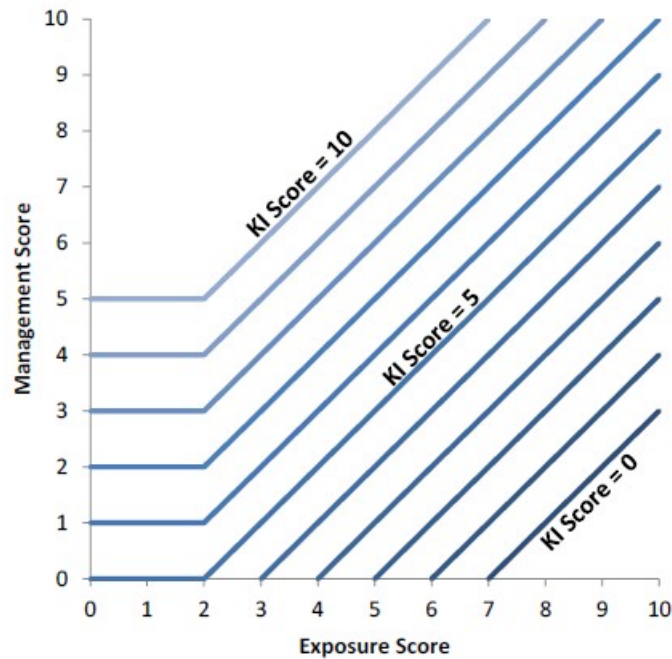
The management must be strong when we have high exposure to the risk – in order to have a high score.

The exposure to the risk is influenced by the location, the outsourcing of production, and the peculiarities of the core business of the firm.

For example, a company located in an area affected by deforestation – using wood as primary raw material in their operation – is exposed to a high location risk.

Similarly, the outsourcing of production in countries with poor labour conditions entails a high exposure to risk.

Risk management refers to those policies, and strategies to face properly the risk exposure. Both risk exposure and risk management are scored on a 0-10 scale and the measures are combined as shown in the graph below.



Source: MSCI ESG Ratings Methodology - Executive Summary - MSCI ESG Research LLC - April 2022 - Exhibit 4: Combining Exposure and Management – ‘Risk’ Key Issues

As we can observe, the relation between the exposure score and the management score is not always a linear one.

On the one hand, for a risk exposure score between 0 and 2, we have the same management score, which increases to reach a level of Key Issues score among 5 and 10.

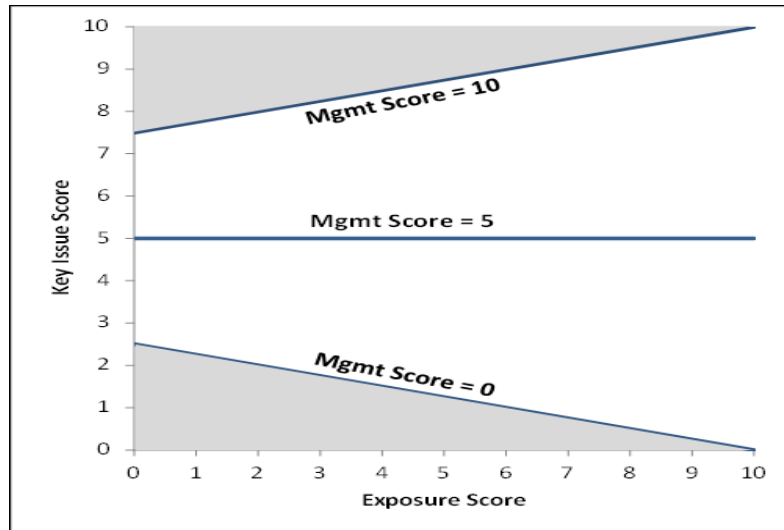
On the other hand, as the risk exposure grows the management score increases linearly to obtain a high Key Issue score.

The relation is explained by the following formula:

$$Key\ Issue\ Score = 7 - (MAX(exposure, 2) - management)^6$$

⁶ MSCI ESG Ratings Methodology - Executive Summary - MSCI ESG Research LLC - April 2022

Also for the opportunity, the rating agency measures the exposure score and the management score.



Source: MSCI ESG Ratings Methodology - Executive Summary - MSCI ESG Research LLC - April 2022 - Exhibit 5:
Combining Exposure and Management – ‘Opportunities’ Key Issues

The graph shows that the Key Issue Score falls in the middle of the 0-10 range, for a low exposure score. With a high exposure score, it can be either very high or very low according to the management score. Indeed, the model evaluates the ability of firms to take advantage of opportunities.

Contrary to the environmental and social pillar scores, the governance pillar scores entail a different assessment, and its contribution is at least 33% of the overall score.

It is estimated following a deductive approach to investigate about two main themes and six key issues, which can be applied to each GICS category.

The first theme is Corporate Governance, below which four Key issues fall, namely Ownership and Control, Structure of the Board, Payrolls and Salaries, Accounting principles and Methodologies.

The second theme is Corporate Behaviour, comprising Business Ethics and Tax Transparency.

Once the Environmental, Social, and Governance Pillars scores are assigned on a range from 0 to 10, the Weighted Average Key Issue Score (WAKIS) is computed.

The WAKIS is the weighted average of the underlying pillars, and it is the basis for the computation of the Final Industry Adjusted Score (IAS).

Also the IAS ranges from 0 to 10 and it is adjusted to the industry peers.

The scores obtained by the various companies operating in the same GICS or industry are normalized, setting the top company score among the 95th and the 100th percentile and the worst one among the 0th and the 5th percentile.

Finally, the IAS is translated into the well-known letter rating, as stated in the table below

Letter Rating	Leader/Laggard	Final Industry-Adjusted Company Score
AAA	Leader	8.571* - 10.0
AA	Leader	7.143 – 8.571
A	Average	5.714 – 7.143
BBB	Average	4.286 – 5.714
BB	Average	2.857 – 4.286
B	Laggard	1.429 – 2.857
CCC	Laggard	0.0 – 1.429

Source: MSCI ESG Ratings Methodology - Executive Summary - MSCI ESG Research LLC - April 2022 - Exhibit 8:
Mapping the Industry Adjusted Company Score to Letter Ratings

The WAKIS and the IAS allow different evaluations of sustainable performance.

The IAS is used to do a peer-to-peer comparison and to identify the best performer in the industry, while the WAKIS highlights the company’s idiosyncratic risk.

Indeed, the WAKIS is an absolute measure of risk, capturing not only the aspects that distinguish the company from its peers but also the industry-related ones.

The WAKIS evaluates the strength of the management effort with respect to the overall risk exposure of the company. On the contrary, the IAS is suitable to determine the competitiveness of the firm⁷.

Giese et al (2019) identified three channels of economic transmission of the ESG score.

They are the cash flow channel, the idiosyncratic risk channel, and the valuation channel⁸

⁷Comparing Risk and Performance for Absolute and Relative ESG Scores: An Empirical Analysis Using MSCI ESG Scores, Ankit Sayani, Bentley Kaplan

⁸Giese, G., L.-E. Lee, D. Melas, Z. Nagy and L. Nishikawa. 2019. “Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk and Performance.” Journal of Portfolio Management

Savani, Kaplan (2020) showed the correlation of these three channels with the WAKIS and the IAS.

Economic transmission through the cash flow channel occurs when companies with high ESGs cores have higher profits, higher dividend yields, and stable earnings. The higher profitability is due to better management practices, implementation of “green” innovation, and better customer satisfaction - with respect to competitors. The cash flow channel showed a higher correlation with the IAS, which captures competitiveness.

The idiosyncratic risk channel, which entails a lower risk exposure for firms with higher ESG scores, is better represented by the WAKIS. The aggregate measure summarizes the overall risk involved in investing in the company, considering the industry characteristics and the firm-specific aspects.

The valuation channel refers to the resilience of companies with superior ESG performances to economic downturns. This last effect is represented by the two scores. On the one hand, the WAKIS gives a comprehensive view of the risk exposure and management strength and resilience. On the other hand, the IAS is helpful because it compares the company to its competitors.

2.2 S&P Global Rating ESG Evaluation

S&P Environmental, Social, and Governance Evaluation is characterized by an analytical approach.

For S&P, “the ESG factors typically incorporate the entity’s impact on the natural and social environment and the quality of its governance”⁹.

The analysis aims to capture those risks and opportunities that are more qualitative and to assess the contribution of the environmental, social, and governance profile to the ESG evaluation, expressed on a 100-point scale.

Any event or issue that impacts the company’s cash flows, operations, reputation, and relationships with stakeholders is considered material and is included in the ESG evaluation.

The ESG Evaluation is composed of the ESG profile and Preparedness.

The ESG Profile measures the exposure of the company to the current risks and its capacity to lessen their impact on operations. Similarly, it examines the opportunities and the ability of the company to extract value from them.

The Preparedness is focused on the long-term attitude of the company to disruptions. It considers the adaptability of the firm to emerging trends in the environmental, social, technological, and regulatory domains.

Therefore, the ESG Evaluation assesses not only the current view of the company but also its readiness to change.

Both the ESG Profile and Preparedness are combinations of different factors and elements.

To describe the ESG Profile, the rating agency examines the company’s Environmental, Social, and Governance profiles and it measures the twelve ESG factors.

The twelve ESG Factors - or Building Blocks - are connected to the three dimensions of sustainable performance and they represent material risks and opportunities for the company.

The Environmental Profile is appraised considering the Greenhouse Gas Emissions, Waste and Pollution, Water Use, and Land Use.

The Social Profile is related to Workforce and Diversity, Safety Management, Customer Engagement, and Communities.

⁹ S&P Global Ratings – Environmental, Social and Governance Evaluation: Analytical Approach – Dec. 15, 2020

The Governance profile is described by the Structure and Oversight, the Code and Values, the Transparency and Reporting, and the Financial and Operational Risk.

Each Building Block entails a risk or an opportunity for the company, depending on the approach and the attitude that the entity implements.

For instance, the impact of the company's operations on local communities can be a reputational threat if the entity does not show any commitment. Conversely, it can be a source of differentiation and competitive advantage if the firm engages properly.

The assessment of the comprehensive ESG profile using the twelve Building Blocks always starts from the Environmental Dimension.

The rating agency develops the company's "E Profile" which describes the "relative sustainability of an entity based on its environmental risks and opportunities compared to its sector and industry"¹⁰.

Indeed, the company's exposure is compared to the sector and region conditions, which are assessed with a numerical score.

Then the two scores are combined into a "blended sector-region score", weighted according to the company's exposure to particular regional or industry-specific risks and its business mix.

The business mix is the range of activities, products, or services that the firm has and, as such, is used as a proxy for its exposure to environmental issues.

The blended sector-region score is compared to the entity-specific assessments, performed using the four building blocks.

For each building block, the performance of the entity is compared against the data of the sector, employing specific indicators.

When the industry data are not available or not comparable, the rating agency will perform some adjustments to the measurement – to address the shortcoming. Among the possible adjustments, the rating agency could replace the numerical information about the firm with a qualitative analysis of its performance.

For the GHG Emission factor, the indicators of the exposure to risk and opportunities could be the "intensity of Scope 1 and Scope 2 emissions" of the company, to be measured against those of other entities operating in the industry.

¹⁰ S&P Global Ratings – Environmental, Social and Governance Evaluation: Analytical Approach – Dec. 15, 2020

The GHG Scope 1 emissions are direct emissions produced by sources owned and controlled by the entity.

Scope 2 emissions are indirect emissions, and they are generated by electricity and heat that the company buys from third parties to perform daily operations.

For the waste and pollution factor, they consider the policies and mitigation strategies undertaken by the firm and indicators such as the proportion of waste recycled and measures of water, air, and land pollution.

The third building block is Water Use, whose indicators could be the proportion of water recycled or the amount of water used.

Lastly, Land Use and Biodiversity are examined through the policies and mitigation strategies, since no relevant data is available.

Like the Environmental Profile, the Social Profile is developed starting from the sector and regional analysis.

Subsequently, the blended sector-region score adjusted for the entity business mix is combined with the entity-specific analysis.

The entity-specific analysis is determined by the four factors with related indicators.

The key indicators for the Workforce and Diversity are training hours per employee, diversity and inclusion, and employee retention.

Safety Management is measured by the frequency and severity of incidents and Customer Engagement with trends in customer satisfaction, retention, and complaints.

The last factor is related to the impact on local communities, evaluated with a qualitative assessment of the policies in favour of human rights and the social standards along the supply chain.

The last profile to be included in the general ESG profile is the Governance one.

The first step in the development of the Governance Profile is the jurisdiction-based score, evaluating the governance standards of the country where the head office is located.

The jurisdiction-based score is then compared with the entity-specific analysis, built on the four factors and their key features.

The first factor is Structure and Oversight which describes some key features like the composition, diversity, and independence of the governing body.

The Code and Values examine the policy framework, the ethics, values, and the code of conduct.

Transparency and Reporting include the level of disclosure about ESG and taxation, whereas Financial and Operational Risk is related to topics like cybersecurity, internal controls and audit, disaster recovery, and supply chain management.

Once the ESG Profile is examined, the rating agency considers the Long-term Preparedness of the company.

Long-term Preparedness is a qualitative investigation of the ability to anticipate and adapt to disruption and emerging trends.

It is composed of the three Capabilities – Awareness, Assessment, Action Plan – and Embeddedness – including Decision-Making and Culture.

Awareness is the most important factor, and it is related to the effectiveness of recognizing potential strategic risks and opportunities.

To investigate Awareness and ability to recognize the emerging trend, the Board of Directors and the management are interviewed.

The Assessment captures how the company measures the impact of the trends on its business, strategy, and operations.

The Action Plan concerns the actions the company undertakes to manage, exploit or mitigate the effects of the trends.

Embeddedness judges the adaptability and agile working methodologies.

The effectiveness and integration of the culture in the organization and among the employees show cohesion and adaptability.

Likewise, the impact of the strategic objectives and corporate culture on the daily decision-making demonstrate flexibility and changeability in the organization.

The qualitative analysis of the Preparedness and the ESG Profile are integrated to form the comprehensive ESG Evaluation, expressed in numerical form.

The result can be further enhanced by adding the evaluation of Climate-Related Financial Disclosure, at the entity's request.

This last parameter investigates the quality of a company's disclosure about climate change issues.

2.3 Comparison

The analysis of methodologies implemented by two rating agencies gives practical evidence of the divergence in ESG measurement.

MSCI and S&P methods show distinctiveness in their general approach to measurement, in the data selection and processing, and – eventually – in results.

The aim pursued by the two providers is the same. They both focus on assessing the impact of environmental, social, and governance risks and opportunities on the company's cash flows and reputation. They both ground their evaluation on material risks, and they measure the resilience of firms to those events.

Both S&P and MSCI follow the market tendency of considering how the company could be damaged by the surroundings, neglecting the duty of the entity to act responsibly and consciously towards the environment and all stakeholders.

Except for the purpose, the ratings take different paths in measurement.

Concerning the data quality and selection, MSCI employs only publicly available data, and their method is “systematic and standardized”. They do not rely on surveys or interviews with the company management, to provide an objective and faithful assessment.

S&P defines his approach as analytical and focused on detecting the more qualitative risks. They use industry data, and they openly state they incur in shortcomings. To address those, they replace the numerical information with qualitative analysis. Moreover, they interview the management to assess the company's preparedness and reactivity to emerging trends and they evaluate Climate-Related Financial Disclosure, only at the entity's request. These practices jeopardize the impartiality and objectivity of the appraisal.

Also the scores are expressed differently. MSCI elaborates a letter rating that is obtained from two numerical scores. The WAKIS is the weighted average of the underlying Key Issue scores and it is the basis for the computation of the IAS. Then, from the IAS, a certain letter is assigned according to the range of numbers in which the score falls.

S&P ESG rating is based on a 100-point scale score, but no disclosure is done about how the indicators and the result are linked. They distinguish the short-term risks from the long-term ones since the overall ESG evaluation is composed of the ESG Profile and the Preparedness. The starting point for the appraisal of the ESG Profile is a sector-region analysis that is adjusted for the business mix of the company. Then, the entity-specific assessment is performed. On the

other hand, Preparedness is evaluated focusing exclusively on the entity and its code, values, strategy, and operations.

Regarding the parameters used to evaluate the Environmental and Social dimensions, MSCI picks them among the 35 key issues. It selects the Key Issues that better fit the industry and the company's operations. It also explains how the weight of each Key Issue is determined, according to the urgency and impact of the event described. To each key issue, two scores are assigned, evaluating the exposure and the management. These two parameters are tied by a mathematical relation that explains how the overall Key Issue score is produced.

MSCI appraises the quality of Governance following a more deductive approach, suitable for the analysis of qualitative information.

On the contrary, S&P applies to all entities examined in the same twelve Building Blocks. They are general factors related to the three dimensions of ESG performance and they are analysed using indicators. The agency does not disclose how those indicators are chosen. They probably vary from time to time, according to the data shortcomings. The weights of the Building Blocks and their indicators are not revealed and no mathematical or analytical relation is mentioned.

The divergence in methodology is reflected in a different assessment of the performance of the industries and companies, as we will further investigate analysing the scores obtained by two players in the Fashion Industry.

3. Case study on the Fashion Industry

3.1 MSCI about the Apparel, Accessories, and Luxury Goods Sector

The MSCI ESG Industry Materiality Map is a tool created to investigate the main risks and opportunities that affect a particular GICS or sector.

It is a publicly available search tool that identifies the Key Issues to evaluate the performance of a specific industry according to the Environmental, Social, and Governance dimensions.

The map lists the Key Issues that will be the basis for the company-specific measurement, and it specifies the average weight that will be attributed.

As previously mentioned, the percentages are established according to the contribution of the business to the total externality and the time frame within which the event will occur.

Nonetheless, the macro analysis may not be reflected in all specific firms' evaluations, due to divergences in businesses, production processes, and corporate practices.

MSCI analyses the performance of the Fashion Industry in the Apparel, Accessories, and Luxury Goods sector, in the consumer discretionary category.

The consumer-discretionary section includes all non-essential goods and services.

The two main key issues chosen to estimate the environmental performance are Raw Material Sourcing and Product Carbon Footprint.

The rating agency employs Raw Material Sourcing Key Issue to examine the theme of Natural Capital and it judges the environmental impact of the firms' supplies, and the traceability along the supply chain.

The Average weight of Raw Material Sourcing is 13%.

The Product Carbon Footprint is related to the Climate Change theme and it appraises the emissions of carbon dioxide released during production and usage of the good and it represents the 10% of the whole score.

The Social Pillar is described by Labour Management, Chemical Safety, Supply Chain Labour Standards, Controversial Sourcing, Privacy & Data Security, and Consumer Financial Protection.

Labour Management proves to be relevant, with a weight of 17.1%, taking into consideration the strength of worker protection mechanisms, the employee engagement practices, and the relationship between the management and the workforce.

Chemical Safety is also crucial and it detects the presence of harmful chemical substances in the product and the R&D progress of the company to find sustainable alternatives.

The average weight is 13.3%.

Supply Chain Labour Standards consider the transparency of the supply chain and compliance with the legal working standards, constituting only 8.8% of the total.

Controversial Sourcing has an average percentage of 2% and it is not applied to all companies in the industry, since it regards the provisioning of raw materials from conflict-affected areas.

Privacy and Data Security and Consumer Financial Protection are company-specific measures, respectively accounting for 0.5% and 0.2% of the whole score.

Privacy and Data Security concerns the gathering and protection of consumers' data and compliance with privacy regulations.

Consumer Financial Protection is related to the reputational issues and the unethical practices in which companies may be involved.

The Governance dimension cannot account for less than 33% of the whole score.

Indeed, it represents 35.1% of the whole score in the Apparel, Accessories and Luxury Goods.

The MSCI Rating Methodology explains that every company is judged according to Ownership & Control, Board, Pay, Accounting, Business Ethics, and Tax Transparency.

After having referred to the Materiality Map, the investor employs the ESG Ratings & Climate Search Tool, which synthetize the main ESG concerns for each company.

For every corporation, MSCI creates a data sheet, that comprises a climate-related evaluation and the actual ESG score.

To examine the climate topic, it provides the Implied Temperature Rise, indicating how the firm is aligning to global climate targets.

In particular, the rating agency analyses whether the company is acting in line with the Paris Agreement.

¹Implied Temperature Rise Methodology – MSCI ESG Research – September 2021

The Paris Agreement is an international treaty on climate change that has been adopted by 196 countries on December 12th 2015.

The goal of the covenant is to limit Global Warming below 2, preferably to 1.5 degrees Celsius, implying an economic and social transformation².

To compute the Implied Temperature Rise, MSCI has introduced the concept of Carbon Budget, which represents how much the world can emit and the emissions allowed for the firm.

The first step in the computation the Implied Temperature Rise, is the allocation of a portion of the Global Carbon Budget to the firm, according to the sector, the country, and the production activities carried out.

Then, the rating agency will consider the future emissions of the enterprise, projecting time series until 2070 for Scope 1, 2, and 3 emissions.

The projections are based on the reduction targets declared by the corporation.

The carbon budget and the projected carbon emissions are compared to determine whether the company is overshooting or undershooting its limit.

Finally, the overshoot or undershoot is converted into degrees of temperature rise using the Transient Climate Response to Cumulative Emissions (TCRE).

TCRE is a mathematical formulation related to the global averaged surface temperature change per unit of carbon dioxide emitted³.

The Implied Temperature Rise is therefore an estimation of the global temperature rise that would occur if the whole economy emitted the same quantity of carbon dioxide as the company under analysis.

MSCI mentions also the decarbonization target of the firm, its ambition and comprehensiveness of the footprint entailed by the target.

After the climate related analysis, the datasheet shows the ESG Rating, expressed in a letter format that corresponds to the leader, average or laggard position in the industry.

The letter rating is justified by the evaluation that the agency provides about the industry material key issues.

²<https://unfccc.int/process-and-meetings/the-paris-agreement/the-paris-agreement>

³ https://en.wikipedia.org/wiki/Transient_climate_response_to_cumulative_carbon_emissions

3.2 MSCI on Moncler

Moncler S.p.A. is classified as an average ESG performer in the Apparel, Accessories and Luxury Goods sector.

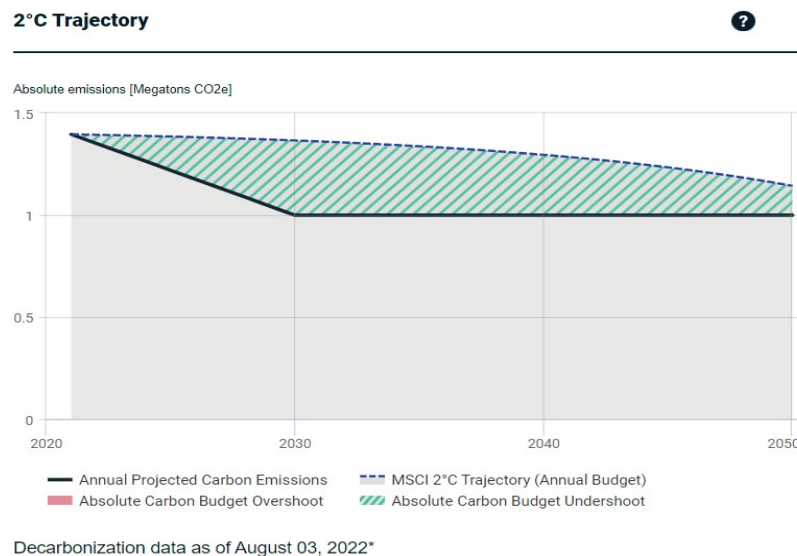
Regarding the climate issue, the group is in line with the Paris Agreement, but it does not have a proactive approach.

Indeed, it has an Implied Temperature Rise of 2° degrees Celsius.

The projections plotted in the graph shows that Moncler is undershooting his carbon budget.

From 2020 to 2030, the annual projected carbon emissions decline from 1.5 to 1, to stabilize until 2050.

The MSCI trajectory of the annual budget is higher than the projected emissions, explaining the undershoot.



Source: ESG Rating & Climate Search Tool – Moncler S.p.A.

MSCI specifies that the firm has a decarbonisation target, which has been included in the measurement of the Implied Temperature Rise.

As depicted in the graph, the target year for the achievement of the target is 2030, with a projected reduction of -2.97% per annum.

The objective encompasses 100% of the group footprint.

Concerning the ESG performance, MSCI assigns to Moncler an A score, that corresponds to a medium high performance.

Moncler has been upgraded in December 2021, from a BBB score to an A score.

Focusing on the material Key Issues for the industry, Moncler is an ESG Laggard in Product Carbon Footprint, compromising its results in the environmental dimension.

The social pillar is affected by an average performance in Corporate Behaviour, Labour Management, Raw Material Sourcing and Chemical Safety.

As a matter of fact, the 2020-2025 Sustainability Plan published presents discreet results.

The firm plans to use low-environmental impact materials for a 50% of the total raw materials by 2025.

Similarly, the traceability systems of raw materials and suppliers are still in trial phase and they will be fully implemented in 2025.

The promotion of a fair and safe workplace has given good results in 2021.

They have adopted methodologies to assess wage practices among suppliers and it has also performed 180 ethical and social audits.

Moncler is an ESG Leader in Corporate Governance, with a positive impact of the group ownership, board and compensation practices on investors.

3.3 MSCI on Kering

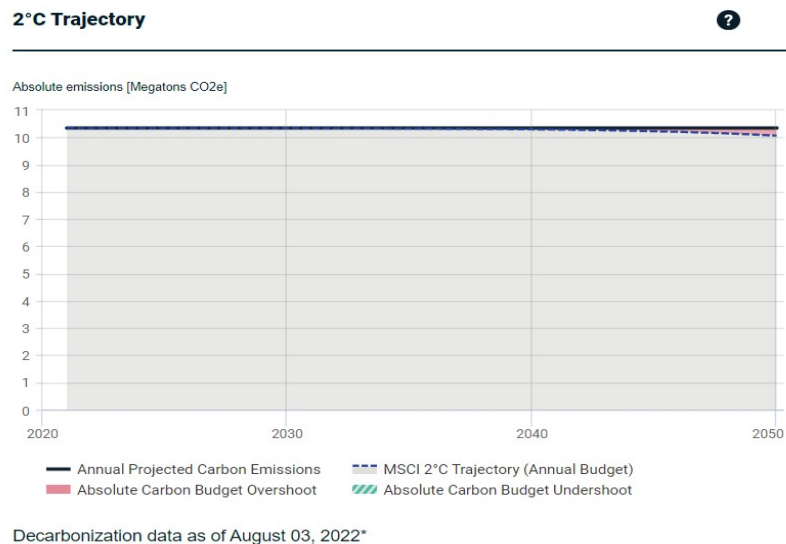
According to MSCI evaluation, Kering S.A. is an ESG Leader in the industry.

However, the group is misaligned with the global climate goals, showing a “business as usual approach”.

We can assume the Kering is reluctant to any reduction in their carbon emissions.

MSCI has assigned a 2.1° degree Celsius and the projections of the carbon emissions trajectory illustrates an overshoot in the long-term activity of the firm.

The annual projected carbon emissions coincides with the budget until 2040, when the projected emissions continue to be stable, while the limit imposed by MSCI declines.



Source: ESG Rating & Climate Search Tool – Moncler S.p.A

The group has a decarbonisation target, that has been integrated in the computation of the Implied Temperature Rise and it will be achieved in 2025.

The objective includes the 100% of the footprint and the projective reduction per annum amounts to 0%, as illustrated in the graph.

The ESG performance of Kering is outstanding, with a AAA score.

The ESG sector leader has been upgraded from AA to AAA in August.

Being an ESG Leader, the group does not prove to be an ESG Laggard in any of the Key Issues considered material for the industry.

It is an average performer in corporate behaviour and labour management.

On the other hand, the group demonstrates great commitment and remarkable results in Corporate Governance, Raw Material Sourcing, Chemical Safety and Product Carbon Footprint.

In the Sustainability Progress Report, Kering declares to have attained 100% responsible gold purchase and 88% traceability of their key raw materials, with a target to reach 100% by 2025.

In 2019, they have established the first animal welfare standard for luxury and fashion industry.

To ensure a safe management of chemical substances, Kering has developed a Chemical Management Policy that serves as a standard for all productive processes.

The Policy deals with all substances that could be harmful for the environment and for the human beings.

It also includes chemicals that have not been regulated yet, revealing a proactive corporate behaviour.

To measure their carbon footprint and ensure transparency along the value chain, Kering has introduced the Environmental Profit and Loss (EP&L) account.

EP&L account is a tool used to gather real time data about footprint of the group activities and products, monitoring the process of the sustainable strategy.

From 2019, the EP&L is also a publicly available platform, where the customers can trace the footprint of Kering's products.

3.4 S&P on the Textile, Apparel & Luxury Goods Sector

Every year S&P publishes the Sustainability Yearbook, in which the insights from S&P Global's research are reported.

The report explores the main trends and takeaways about sustainability and it provides the investor with Industry Profiles.

The Industry Profiles are brief reviews about a sector, its driving forces, criteria to evaluate it and statistics.

About the Textile, Apparel & Luxury Goods sector, S&P highlights a strong need for transparency along the supply chain.

S&P mentions the enquiry about labour, human rights and wage issues - especially during COVID-19 crisis.

In an industry characterized by brand recognition, firms have to preserve their reputation, dealing with attention to sustainability by customers.

Moreover, with the rise of Fast Fashion and expansion of online shopping, fashion brands must focus always more on customer engagement.

Sustainability concerns can boost clients' commitment, if applied coherently throughout all tiers of company's operations.

The industry's sustainability leaders integrate sustainability issues throughout the entire lifecycle of the product, from raw materials sourcing to good's recycling and disposal.

Also the package can be a source of differentiation, if the company proposes alternatives to plastics.

Moreover, agreement and monitoring of suppliers is crucial to support the brand reputation and sustainability consciousness.

In the Industry Profile, S&P discloses the highlighted criteria and the dimension weights, useful to evaluate the ESG performance of the firms operating in the sector.

In the Textile, Apparel & Luxury Goods appraisal, the environmental dimension has a 22% weights and it is estimated on the basis of Climate Strategy, Operational Eco-Efficiency and Product Stewardship.

The Social Dimension accounts for the 37% of the overall score, with emphasis on Human Rights, Labour Practices Indicators and Occupational Health and Safety.

The Governance and Economic Dimension represents the 41% of the result, evaluated according to Customer Relationship Management, Risk & Crisis Management and Supply Chain Management.

As mentioned in the Industry Statistics, S&P has assessed 85 companies, with a market capitalization of 1728.9 billion of USD dollars.

Ten of those eighty-five firms have remarkable performance and have been inserted in the Yearbook, with a market capitalization of 609.9.

The Industry Profile mentions the members of the sectors that have been awarded in 2022.

In particular, Moncler S.p.A. has been included in the S&P Global Gold Class with an ESG Score of 89/100⁴.

Kering S.A. is in the S&P Global Silver Class, scoring 85/100 points.

At company-specific level, the rating agency creates a data sheet, where it provides the overall ESG Score and the specific results for the three dimensions.

For each dimension, the industry average and industry best score are reported, to facilitate comparisons among peer companies.

The score history describes the evaluation of the firm during the last five years.

Then, the rating agency provides an assessment of the Corporate disclosure.

All companies evaluated by S&P are Corporate Sustainability Assessment (CSA) survey responded and the score is grounded on publicly available data.

S&P distinguishes the participating companies and the non-participating companies.

The participating companies are evaluated according to the information they provide with the questionnaire.

The non-participating companies are assessed only via publicly available data.

The data sheet provided for each company includes an assessment of the ESG score contribution.

The ESG Score Contribution section describes how much the required public disclosure and the additional one contribute to the overall S&P Global ESG Score.

⁴The Sustainability Yearbook 2022 – S&P Global

The rating agency expresses the actual score based on the disclosure, in points from 0 to 100.

The sum of the scores based on public and additional disclosure gives the overall S&P Global ESG Score.

The Corporate Sustainability Assessment is the procedure used by S&P to evaluate companies and benchmark their performances, employing a variety of key indicators suitable for the industry.

Finally, the data sheet presents a spider chart that gathers the key indicators for the industry with the relative average performance, the best achievements in the sector and the one of the company under investigation.

3.5 S&P on Moncler

Moncler S.p.A. has an ESG Score of 89/100, with an Environmental Score of 95, a Social score of 91 and a Governance and Economic score of 85.

The group is an outperformer relative to the industry mean in the three dimensions but it does not reach the best result in the sector.

It has been recently upgraded from 87 to 89 and the data availability is classified as very high.

The ESG score contribution of the Required Public Disclosure is 30, with a disclosure rate of 95% and a very high data availability.

Regarding the additional disclosure, the disclosure rate is 100% and the score contribution amounts to 59.

Therefore, Moncler is a participating score with a high availability of data, that meet the requirements of the Corporate Sustainability Assessment.

As shown by the graph below, the 89 ESG score is justified by Moncler's performance against industry peers, following the mentioned criteria.



SOURCE: Highcharts.com

The high score in Operational Eco-Efficiency and Climate Strategy could be justified by the reduction of CO₂ emissions by 35% and the mapping of energy sources used by the Group's suppliers.

Great results in Product Stewardship are given by use of lower impact fabrics and definition of guidelines on sustainable materials; and by the launch of programs for recycling of nylon and cotton.

Similarly, the Supply Chain Management has been enhanced by increasing traceability of raw material sourcing.

Nonetheless, Moncler lacks Human Rights policies, as shown by the low score.

Indeed, they have only performed “pilot audits to test human rights on a sample of about 40 down suppliers”⁵.

Labour Practice Indicators and Occupational Health & Safety has reached the same level of the industry best competitors.

Those results are related to projects carried out to promote a fair and safe workplace.

The group has performed 180 ethical and social audits and all outwear manufacturers have been audited during the last three years.

Moreover the 80% of strategic suppliers have been aligned to the Moncler social compliance standards⁵.

⁵2020-2025 Strategic Sustainability Plan . Moncler S.p.A.

3.6 S&P on Kering

Kering S.A. has an ESG score of 84/100, with an Environmental score of 93, a Social score of 75 and a Governance and Economic score of 88.

As Moncler, Kering is an outperformer with respect to the industry mean in the three dimensions but it does not reach the results of the industry best competitor.

The group has been downgraded from 85 to 84 in 2021.

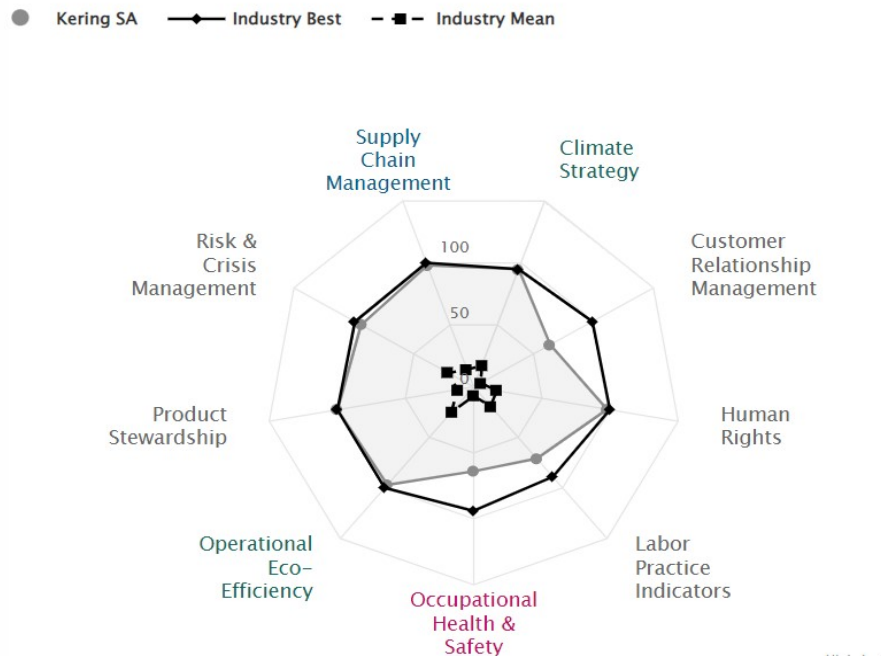
The data availability is high, with an ESG Score Contribution of Required Public Disclosure of 31.

The actual score based on disclosure is then added to the Additional Disclosure, with 53 points.

The additional disclosure rate is 99% and the score is just below the maximum industry score.

As a result, Kering is a participating score, whose data are compliant with the requirements for Corporate Sustainability Assessment of S&P.

The graph illustrates the evaluation of Kering's activity, according to the different indicators. As we can observe, the assessment is much more heterogeneous than Moncler's one.



SOURCE: Highcharts.com

The group has an excellent performance in Supply Chain Management, Climate Strategy, Risk & Crisis Management, Operational Eco-Efficiency and Product Stewardship.

Those results are mainly due to progress in measurement and reduction of footprint, and in raw material and manufacturing.

As mentioned above, Kering has implemented a meticulous assessment of the impact of activities and products, through the Environmental Profit and Loss account.

The EP&L account has clearly affected the evaluation of the group, related to the five indicators.

Indeed, it allows the group to identify the hotspots and the risks throughout raw material sourcing, manufacturing and usage of the product.

The estimates about Labour Practices Indicators, Occupational Health & Safety and Human Rights are much more controversial.

The Sustainability Progress Report 2017 – 2020 mentions the work-life balance benefits that are ensured to all employees.

If on the one hand, the group receives a remarkable assessment on Human Rights, it is lacking on the other aspects.

The Report reveals the group commitment to ensure fair living wages throughout the supply chain, but it does not refer to any measure for health & safety.

3.7 Comparison

The comparison between two ESG ratings shows the difficulty that investors have comparing scores issued by different agencies.

The differences in structures of the data sheet stands out.

MSCI reports data about climate change separately from the ESG scores, it applies a mathematical formulation to the Implied Temperature Rise, to predict the impact of the company.

In the second section of the data sheet, MSCI explains the ESG scores, showing the indicators in which the company is laggard, average and leader.

S&P creates two sections of the data sheet, for the ESG score and data disclosure.

Contrary to MSCI, S&P is more focused on industry peers comparison, providing data about the performance of industry best player and average competitors.

They emphasize the commitment of the company in supplying data compliant with their Assessment Policy, differentiating the participating from non-participating companies.

The three dimensions have different weights in the two ratings.

In particular, the Governance dimension accounts for the 41% in the S&P ESG rating, whereas the other two dimensions have lower weights.

In MSCI's rating, the weights are more balanced since the Governance represents the 35% of the total score.

Also the key issues or indicators employed to evaluate the performance of the industry and companies are various.

MSCI identifies only two Key Issues for the evaluation of the environmental dimension and several more for the social dimension.

The Governance aspect is estimated following a standard set of aspects that does not vary across the industries.

S&P has nine key indicators, three for each dimension, applied to the sector and to the corporations.

If on one hand, the S&P's approach seems more systematic due to the application of the three indicators for each ESG dimension, on the other hand the MSCI analysis is more detailed.

In the Industry Materiality Map, MSCI gives a brief explanation of the key issue chosen and it reveals the percentages.

On the contrary, the S&P summary of the industry and the firms' data sheets lack of clarity since no definition of the indicators is provided to the reader.

Although more precise and based on mathematical formulations, the MSCI presents some flaws and inaccuracies.

The illustration of the issues in which the company is leader or inadequate should be more detailed.

They do not disclose neither the score nor an evaluation about the company according to the key indicators, but they simply classify it as laggard, average or leader.

Furthermore, the Climate Change and ESG sections should be integrated.

Indeed, it seems that the appraisal done in the Climate Change section does not influence at all the ESG score.

As we can observe from the datasheet, Kering is an ESG industry leader, but still it has an Implied Temperature Rise of 2 °C.

It is inconsistent that the ESG pioneer of the sector adopts a business-as-usual approach to one of the core themes of sustainability.

In S&P rating the two aspects are well integrated, since the Climate Change is a key indicator of the overall results

In the next paragraph we will assess the impact of the ESG ratings on stock prices and movements of the investors.

3.8 Impact on stock prices

The ESG ratings should have an impact on movements of investors and on stock prices of the rated companies.

As explained in the first chapter, capital providers perceive companies with high ESG scores as less risky and they are willing to buy stocks with higher prices and lower expected return.

By observing the price changes and trends in the stock market, we detect the positive correlation between the stock prices and ESG scores.

As stated in the MSCI ESG Methodology report, the rating agency updates every quarter its measurement and assessment of firms.

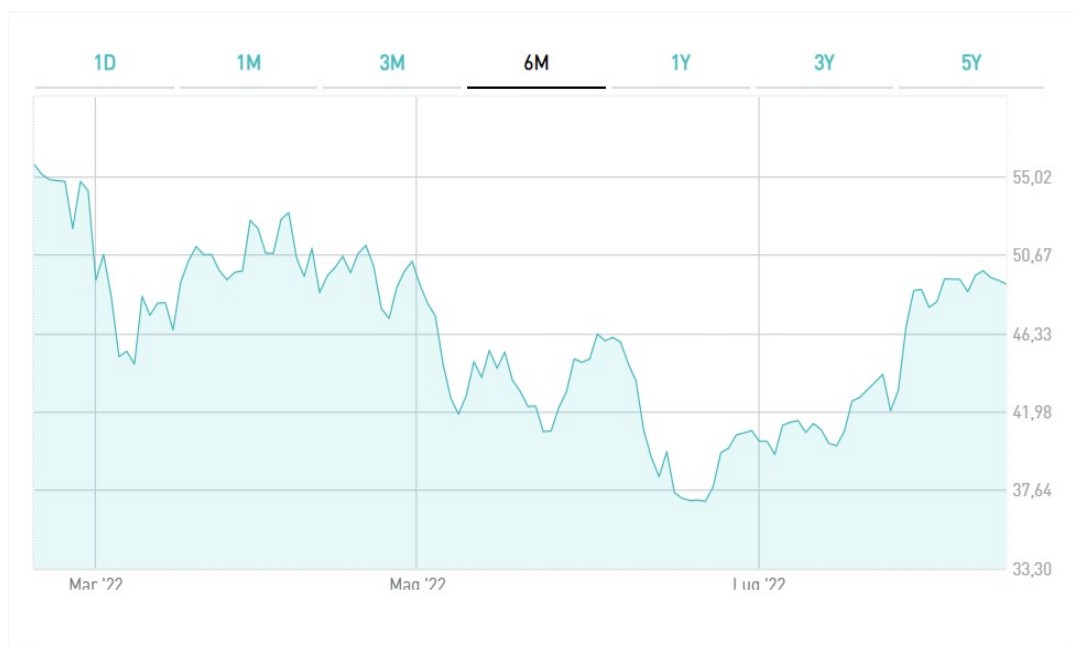
The last update of MSCI ESG scores have been published in July 2022.

S&P revise the evaluation every year, or more frequently in case of major developments.

The most recent changes go back to January 2022.

We will perform the analysis for Moncler and Kering, exploring the effect of both ratings on stock market movements, in the last six months.

In the last month, Moncler's performance has grown by 22.5%, but the six-months trend has been negative, with a growth of -12.12%.



Source: Borse Italiana – Stock search – Moncler S.p.A. - Summary

The graph plots the stock prices of Moncler of the last six months.

It shows a positive peak at the beginning of the period, in February, when the stock price was around 55.64, against the current price of 49.

The increase in price of mid-February could correspond to the January update of the ESG score by S&P.

In March and May, performance declined and then increased again, until end of June when price diminished to 37.

In July, we can observe a slower but durable recovery, that coincides with the update of ESG performance by MSCI.

The update by MSCI classified Moncler as an average ESG performer.

Anyway, it could be related to the positive impact on the stock price growth.

Nonetheless, the highest trades volumes have been registered in March 2022, with 179.577 trades, as shown by the graph below.

The peak in trade volumes of March 2022 could be still connected to the S&P Global Corporate Sustainability Assessment.



Source: Borse Italiana – Stock search – Moncler S.p.A. – Intraday

Kering performance has been growing 14.40% in the last month, but as Moncler it had a negative growth in the last six months, with a -10.35% decrease.



Source: Borse Italiana – Stock search – Kering S.A. - Summary

The group had a positive peak in mid-February, but then it declined until mid-March.

In mid-February the price reached 666.800 against the current 566,700.

This was probably due to the positive assessment published by S&P in January.

Even if the company was rated at the levels of Moncler, it was positively scored with 84 points.

Kering shows a trend similar to Moncler’s, with some positive and negative peaks in stock price during the second quarter.

It had a durable and more stable growth from July, coinciding with the positive assessment as ESG leader updated by MSCI.

As illustrated by the graph, we do have any particular peaks in trade volumes in the last six months, but only a declining trend from January on.



Source: Borse Italiana – Stock search – Kering S.A. - Intraday

Conclusion

The evaluation of sustainable performance and the inclusion of such measures in the risk assessment are crucial.

ESG Ratings and sustainable performance entail relevant opportunities for companies, investors and financial markets as a whole.

An high ESG score enhances the reputation of the company, reducing risk and uncertainty related to Environmental, Social and Governance issues.

Capital providers perceive those companies involved in Corporate Social Responsibility as more solid and they are more inclined to finance them.

Therefore, ESG ratings are creating new forms of investments and evaluation of companies, reshaping the layout of financial markets.

Nonetheless, they imply challenges, related to divergences among the various ratings and their implications on stocks returns.

Although the ESG Ratings are correlated with more sustainable business practices, we can observe the Aggregate Confusion described by Berg, Kolbel, and Rigobon.

The differences in scope, measurement and weights have controversial effects on the stocks prices and returns and they lead to the spread of Greenwashing practices.

Although they do not affect the ESG rating methodologies, the SFDR and EU Taxonomy represent a first valuable attempt to bring clarity in capital markets.

The regulations (EU) 2019/2088 and 2020/852 impose a certain degree of “sustainability related financial disclosure” and they establish a framework to classify sustainable investments.

In the second and third chapter, we have demonstrated that the divergence of ESG ratings is well reflected in practical examples.

The differences in methodologies used by MSCI and S&P prove that there is a need for a clear and unique method of evaluation of sustainable performance.

Furthermore, the results and appraisal of companies like Moncler and Kering issued by the rating agencies are sometimes contradictory, and their effect on stock prices is easily detected.

Once again, we recall the advantages that the establishment of common standards would entail for all the actors in financial markets.

There would be a reduction in competition among the rating issues and all ratings would be interchangeable.

This would bring uniformity about the definition of sustainable performance for investors and corporations.

Firms would be able to do more targeted investments to reduce their environmental and social impacts.

Capital providers would compare sustainable financial products effortlessly and they would be more conscious about their investments.

Therefore, even though the trend of ESG Ratings reflects an evolution towards a more sustainable, ethical and conscious finance, changes are ongoing and legislation is still incomplete.

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