ARTICLE
For professional investors
October 2018

The hows and whys of linking SDGs to credit portfolios

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- SDG linked investment strategy requires a consistent approach
- Broad range of issues means SDGs can have conflicting effects
- Weaker SDG sectors still contain issuers with positive impact

After years of preparation, the United Nations released its Sustainable Development Goals (SDGs) in 2015. The 17 SDGs, and the 169 sub-goals, target a broad range of topics such as the availability of water and sanitation for all, food security, achieving gender equality, and access to affordable and sustainable energy.

The UN Commission on Trade and Development (UNCTAD) estimates that between USD 5-7 trillion per year will be needed to achieve the goals by 2030. As it is unlikely that governments alone will be able to find such huge sums of money, the UN has explicitly asked the private sector to contribute as well.

Investors too are becoming increasingly interested in investments that contribute to the realization of these goals and at the same time offer attractive returns. It is not difficult to imagine that some businesses have a more positive impact on the goals than others. A solar energy company is more likely to contribute positively than an oil firm. However, for other companies it is more complicated. In constructing a targeted SDG strategy, the challenge for asset managers is to assess and quantify the contribution that all companies in an investment universe make to achieving these SDGs.

'USD 5-7 trillion per year will be needed to achieve the SDGs by 2030'

Figure 1 | The UN Sustainable Development Goals

Source: United Nations, www.un.org/sustainabledevelopment/sustainable-development-goals/

Relevance of an SDG linked investment strategy

There are many – often quite intuitive - reasons why it is essential to incorporate SDG considerations into investment strategies. In a global economy increasingly based upon renewable energy, it is easy to foresee that the business models of companies such as coal miners, oil producers, and fossil fuel-based electricity generators will come under severe pressure. Although less obvious it is also relevant, for example, for car manufacturers that do not adapt quickly enough to a world of electric vehicles.

Furthermore, the financial consequences – in the form of fines, compensation, and potential license withdrawals – can be very material for companies that fail to act in accordance with the SDGs. Environmental spills, bribery, money laundering and miss-selling are a few examples. In its report 'The SDG Investment Case' the UN PRI summarizes this very clearly (p.16): *"The way that past economic growth had been achieved cannot be maintained: it has been responsible for an expanding list of environmental and social burdens. With many of the catalysts of past growth (i.e. use of fossil fuels and rapid urbanization) no longer sustainable in their current form, future growth is likely to be much slower and more erratic over the next 30 years…"*. This means that ignoring the SDGs could ultimately affect every investor and it clearly demonstrates the relevance of SDG linked investment strategies. So those firms that offer solutions to accomplish the SDGs may well become the winners of the future and attractive investment candidates at the same time.

SDG measurement framework

Any credible SDG linked investment strategy requires an objective and a consistently applied measurement framework. This is quite a challenge with 17 main SDGs and 169 sub targets, addressing a very broad range of issues, some of which have conflicting impacts on each other. The agrochemical industry is a good case in point. On the one hand, crop-protection products improve agricultural yields significantly, which is very beneficial for SDG 2 (zero hunger). But pesticides are increasingly criticized for contaminating the environment and so also have a negative association when it comes to other SDGs. Another example is a firm manufacturing plastic food packaging that increases the shelf life of products – again beneficial for SDG 2 (zero hunger). But plastic packaging is also waste that to a large extent ends up in the environment.

The list goes on. For example, how should we deal with firms that engage in heavily polluting activities (extracting oil, shale gas) but take issues like gender equality (SDG 5) and health and safety (one of the sub goals of SDG 8) extremely seriously? Or companies that have fully streamlined their operations to meet the SDGs, but are suddenly hit by a major bribery or fraud scandal? Steps to shut down or wind up coal mines or nuclear power generators are very beneficial for SDG 7 (affordable and clean energy) but cause unemployment, something that can have a material negative impact on SDG 1 (no poverty), especially in developing economies.

A comprehensive SDG measurement framework with clear, objective and consistent guidelines is required to deal with all these questions and considerations. RobecoSAM's proprietary SDG framework, shown in Figure 2 below consists of a three-step approach.

Figure 2 | A three-step SDG framework

Step 1:	Step 2:	Step 3:
What do companies produce? > Do products or services contribute positively or negatively to SDGs?	**How do companies produce?** > Does the company's business conduct contribute to SDGs?	**Check on controversies** > Has the company been involved in controversies?
Positive contribution examples: > Medicine, water, healthcare **Negative contribution examples:** > Shale gas, fast food, gambling	**Assess a company's:** > Governance factors > Pattern of questionable conduct? > Differentiate between firms with highest SDG impact	**Examples of controversies** > Spills > Bribery and fraud > Mis-selling

Three-step approach

Step 1: What does the company produce?

Step 1 links the products and services offered by companies to the SDGs and assesses to what extent they make a positive or negative contribution. An extensive set of rules and Key Performance Indicators (KPIs) are used to do this and these are summarized in a guidebook, which links each sector and industry to specific SDGs that correspond to the products and services of a specific issuer. The guidebook also states whether the SDG contribution of these products/services is positive, neutral or negative.

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Figure 3 | Snapshot from the guidebook

		Starting point		KPI - 1				KPI - 2		- - -
Sector	SDGs	Contribution	Impact	Measure	Threshold	Contribution	Impact	Measure	Threshold	- - -
Banks	1, 8, 9	Positive	Low	%SME loans/ total loans	>25%	Positive for SDG 1, 8, 9	Medium	%EM loans/total loans	<25%	- - -
									>25%	- - -
									>50%	- - -
Energy (E&P)	7, 13	Neutral		%natural gas	>65%	Positive for SDG 7, 13	Low	%Fracking+oil sands	>80%	- - -
					45-65%	Neutral			50-80%	- - -
					30-45%	Negative for SDG 7, 13	Low		20-50%	- - -
					<30%	Negative for SDG 7, 13	Medium		<20%	- - -
Telecoms, cable	1, 8, 9	Positive	Low	%EM sales	<10%	No pass SDG 1, positive for SDG 8, 9	Low	%Radio/TV content of sales	>50%	- - -
					>25%	Positive for SDG 1, 8, 9	Medium			- - -
					>50%	Positive for SDG 1, 8, 9	High			- - -
- - -										

Source: Robeco, RobecoSAM.

For telecom, for example, the starting point in terms of contribution is positive. Telecommunication is an essential part of the infrastructure needed to maintain a safe, secure and connected society. Industrialization and increased productivity are highly dependent on effective telecommunications and contribute to making cities smarter and more sustainable. They help improve the quality of life. Farmers can use mobile phones to check market prices before selling to intermediaries, and market traders can accept mobile payments. This means that the telecom sector can contribute to a proper infrastructure (SDG 9), economic growth (SDG 8) and ultimately to the reduction of poverty (SDG 1).

We then determine the extent of the contribution, which in the case of telecom is deemed to be low. Having established the starting point of the sector's contribution and impact, we then dig deeper to look at the individual companies within this sector. To this end, we define a set of KPIs, on which the individual companies are assessed. If, for example, more than 25% of the telecom company's sales take place in emerging markets (which have most to gain from a good telecom network), we upgrade the impact from positive-low to positive-medium or, if this figure is 50%, to positive-high.

Step 2: How does the company operate?

SDGs are also about how individual companies operate. Do they cause pollution, respect labor rights, refrain from corruption and have a diversified management? In Step 2, credit analysts check whether the way the firm operates is compatible with the SDGs. They do this by examining a company's environmental policies, conduct track record, governance framework, etc. On the basis of their findings, the SDG ratings can be adjusted if necessary.

Adjustments made in Step 2 often relate to inadequate governance practices. A poorly designed framework with few checks and balances can result in a company being downgraded by several notches on the basis of its governance. Low RobecoSAM governance scores act as a warning signal, although the company's management must already have a poor track record when it comes to fairly balancing the interests of all stakeholders before poor governance affects the overall SDG score.

Other adjustments can also relate to the type of clients to whom products are sold. For example, a firm's products can be assessed favorably under Step 1 but if a significant proportion of sales are to the military sector or aircraft manufacturers, for example, these firms can be assigned a high negative classification for SDG 16 at the Step 2 stage.

The finance sector has been plagued by numerous high-profile conduct issues in the last decade, often resulting in large fines and expensive settlements. As a result, many banks have strengthened their internal controls, adapted fee structures, made changes to employee incentive programs and so on. So for the majority, conduct issues are now merely a legacy from the pre-Global Financial Crisis era. However, there are still some banks that are downgraded in Step 2 as a result of more recent business ethics related controversies. Examples of other Step 2 adjustments can be the result of issues such as aggressive selling techniques, abnormal price increases in the pharmaceutical sector, and predatory lending issues.

Occasionally firms are also upgraded. The strong and very conservative risk cultures of two Scandinavian banks ensured them a one-notch upgrade, while some insurance companies are upgraded as a result of a high degree of ESG integration in their investment portfolios.

Step 3: Are controversies known?

The final step is to check whether the company concerned has been involved in any controversies. A company can make the right products, operate in the right manner, meeting the Step 1 and 2 criteria, but still be caught up in controversies, such as oil spills, fraud or bribery. The analyst then makes the final decision. In this context, it is important to know if the controversy is structural or just a one-off, and if management has taken sufficient precautions to prevent recurrence in the foreseeable future. The credit analyst can therefore propose to give a negative ranking while awaiting a management response and corrective measures. Firms that commit serious and structural breaches of the UN Global Compact can even be excluded.

SDG scores

The results of this three-step analysis are quantified in a proprietary SDG score. All companies are given a score based on their contribution to the SDGs (positive, neutral or negative) and the impact of this contribution (high, medium or low). This is shown in Figure 4.

Figure 4 | Outcome three-step process quantified in SDG rating framework

Assessment	Impact	SDG Score
Positive	High	+3
	Medium	+2
	Low	+1
Neutral		0
Negative	Low	-1
	Medium	-2
	High	-3

Source: Robeco, RobecoSAM.

It is important to note that the three steps must be looked at sequentially. So if the outcome of Step 1 is negative a company cannot be upgraded to positive in Steps 2 and 3. Take, for example, the products of a beer manufacturer. According to the SDG measurement framework, having over 5% of your revenues linked to alcohol already reduces your SDG score to -1 (for SDGs 2 and 3). So even if the beer manufacturer implements water saving measures and takes further steps to minimize its environmental impact – also very beneficial from an SDG perspective (SDG 12, responsible consumption and production) – its product (beer) is still negative from an SDG perspective. And as such, its final SDG score remains negative.

A sector approach to SDGs?

Although there are a few sectors that clearly make an outright negative contribution to the SDGs (tobacco, gaming, aerospace/defense), in most cases, it is unfortunately not so clear cut. Take the utility sector as an example. Benchmark sector definitions don't look at how the electricity is generated. Electric utilities contain both coal fired generators and electricity producers that rely heavily on renewables. Firms falling into the latter category receive high SDG rankings, while utilities relying more heavily on fossil fuels and nuclear power are assigned negative SDG scores. So we cannot strictly link sectors to SDGs – if we do, does that make the utility sector positive or negative? Such a system is not realistic. This approach would also mean that, by taking a sector approach, any Step 2 or 3 considerations relating to how a company handles its environmental impact, labor relations, supply chain considerations and so on, are overlooked.

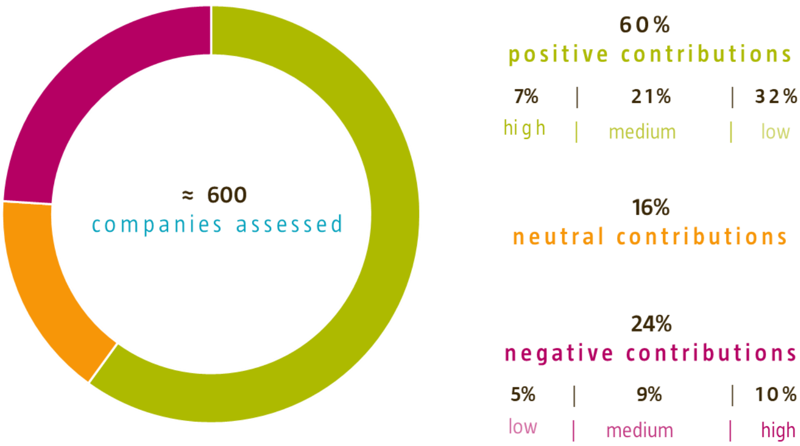
The automotive sector is another good example. Most car manufacturers still have a negative-medium impact SDG ranking because they have not yet attained the electric vehicle/hybrid production thresholds. However, there are some that have. If you take a sector approach, labeling the entire sector as negative, those car makers that are performing well in SDG terms fail to receive the recognition they deserve. Furthermore, according to the

Bloomberg Barclays index definition, this sector also includes trucks. In our SDG framework, the starting point for trucks is neutral as they are essential for distributing food and other materials. And depending on the products (i.e. efficiency enhancing, safety supporting) car parts suppliers can actually contribute positively to the SDGs. For example, a sub-goal of SDG 3 (good health & well-being) targets a 50% reduction in traffic-related deaths and injuries globally in 2020. Once again, this demonstrates that taking a sector approach to SDGs is not effective.

Applying the SDG measurement framework to a credit universe

Robeco's credit analysts together with RobecoSAM's SI specialists have applied the SDG measurement framework to a credit universe of almost 600 names. This universe is diversified in terms of sectors and consists of investment grade, high yield, and emerging issuers. The overall outcome was that 60% of the companies have been assessed as making a positive contribution. 24% of the companies analyzed received a negative SDG score, and 16% received a neutral ranking. In 10% of the cases, scores were adjusted in Step 2 and 3.

Figure 5 | Results SDG screening process



Source: Robeco, RobecoSAM. Data September 2018

As highlighted above it is difficult to approach SDGs purely through sectors. Nevertheless, a few general conclusions can be drawn from our mapping exercise. First of all, in the food and beverage sector. Intuitively one would think the entire food and beverage sector would contribute very positively to SDG 2 (zero hunger). Unfortunately, the opposite turns out to be the case. Both SDG 2 and SDG 3 (good health and well-being), require healthy and nutritious food. And this is precisely the issue. Most food and beverage producers add too much sugar and/or fat to their products. The result is unhealthy food with far too many calories that contribute very significantly to rising global obesity levels. Firms are increasingly adapting their product palette to address this, but the proportion of healthy food they produce is generally still far below the thresholds defined in our SDG framework.

Another challenging industry from an SDG perspective is the energy sector. In our SDG framework both the E&P sector (exploration & production) and the oil field services and refiners receive a negative SDG ranking. We currently categorize natural gas as an 'intermediate' energy source and believe it could facilitate the transition to a global economy based entirely on renewable sources of energy. Those E&P firms where over 65% of the production consists of natural gas actually receive a positive-low impact SDG score, while those with 45% receive a neutral impact score. An additional requirement is that firms should not apply fracking techniques. Unfortunately, there are very few companies that are able to achieve these thresholds.

Other sectors that generally do not come out of the SDG assessment very positively are car manufacturers, aerospace/defense, tobacco, and gaming. Sectors that have a more positive impact from an SDG perspective include telecoms, banks, grid operators, and healthcare/pharmaceutical companies.

Conclusion

Assessing a company's contribution to the SDGs is a challenge. However, our three-step approach offers the solution. It links a company's products and services to the SDGs in order to determine their contribution and impact, analyzing the company's operations, and checking for controversies. Results of our analysis indicate that sectors with a weaker SDG profile include the energy, car manufacturers and food & beverage sectors. However, we have also found that there are more than enough issuers within these sectors to create a well-diversified global credit portfolio with a positive impact on the SDGs.

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Version Q1/18