Engagement 360

2024 Q1 Report



Stewardship is where insights become action. Engagement 360 supports a holistic approach to mitigating ESG risks and capitalizing opportunities.

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Stewardship Approach

Engagement 360 is a holistic stewardship offering that promotes and protects the world's leading asset owners' and managers' long-term shareholder values through consistent engagement outcomes. Engagement 360 addresses ESG risks and strives to create positive social and environmental outcomes.

ESG STRATEGY AND RISK promotes and protects long-term value by flagging high- and severe- risk companies to proactively engage unmanaged and financially material ESG issues. The focus is on companies with unmanaged ESG risk greater than 30 as identified by Morningstar Sustainalytics' ESG Risk Ratings.

INCIDENT engagements address companies that severely or systematically violate international standards, such as the UN Global Compact and OECD Guidelines for Multinationals to ensure that investors are managing associated reputation risk. This engagement aims to not only to verify how a company addresses the incident but also to effectuate change in the company's policies and/or processes to ensure proper policies and programmes are in place to avoid future reoccurrences and improve its ESG disclosure. Companies flagged as 'Watchlist' or 'Non-Compliant' as identified by Morningstar Sustainalytics' Global Standards Screening research are targeted for this engagement.

THEMES are SDG-aligned proactive engagements that enable investors to align their interests in addressing specific systemic issues across the ESG spectrum. Thematic engagement's philosophy centers around systematic change, collaboration, root causes and best practice sharing at its core. The purpose of this engagement is to influence companies to proactively manage specific ESG risks and capitalize on opportunities.

Morningstar Sustainalytics' ESG Voting Policy Overlay provides vote recommendations that align to widely accepted ESG principles, sustainability objectives, ongoing corporate engagements and ESG issues most important to investors.

Executive Summary

Palle Ellemann
Director/Product Manager,
Stewardship
Engagement 360
Morningstar Sustainalytics

We are delighted to report on the activities and results of the Morningstar Sustainalytics Engagement 360 for Q1 2024. The quarterly report provides an overview of the activities and insight to the results of the stewardship work in the quarter.

Highlights of the Quarter

The positive trend from 2023 has continued as we have successfully resolved 12 engagements in the first quarter. Most of the resolved engagements are driven by companies improving their ESG risk management practices and moving from the high to the medium risk category of the ESG Risk Rating. The quarter has also seen a relatively high number of archived engagements, due to the retirement of several legacy Thematic Engagement Programmes. These are now replaced with the new Thematic Stewardship Programmes, where we in the coming quarters will continue opening up new engagements around the six programmes: Biodiversity and Natural Capital, Human Capital Management, Net Zero Transition, Scaling Circular Economies, Sustainability and Good Governance, and Human Rights Accelerator (to be launched in 2025). During Q1, the Stewardship Team has:

- Conducted 159 meetings, including 13 meetings in-person in Saudi Arabia, Türkiye, Malaysia, Singapore and Taiwan. The engagement trips to these countries also included five site visits.
- Exchanged 2,105 emails and phone calls.
- Delivered 102 voting recommendations on resolutions voted at 77 shareholder meetings plus 51 engagement company Meeting Commentaries.
- Achieved 48 Milestones.

Looking Ahead

In Q2, we anticipate our engagement activities will continue to expand as we roll out the Thematic Stewardship Programme (TSP) and add more companies to these programmes. Q2 is also a good time to engage with companies as many of them are releasing new annual ESG disclosures, and we can verify Positive Developments implemented and update our Suggested Actions for what we see as opportunities for improvement.

We will also be able to announce plans for engagement trips later in the year. We use these trips to build relationships with the companies that we engage and in-person meetings can be essential for establishing dialogue with some companies. It will also deepen our understanding of the corporate context and facilitate site visits, where engagement managers obtain very detailed insight to the ESG challenges that the companies are facing and how they mitigate these risks and incidents.

For general questions or feedback regarding Engagement 360, please email E360@sustainalytics.com or your client team.

Stewardship Overview

796
active engagements during Q1 2024

4
new engagements

102
vote recommendations have been delivered to clients

Food Producers
is the most engaged industry

Highest number
of engagements in a single market is the United States

Net Zero/ Decarbonization
is the most engaged topic

SDG 12 Responsible Consumption & Production
(56%) linked to engagement objective

Engagement Status

When we open an engagement, the status is Engage. We will then pursue engagement until we change status to:

Resolved The company has achieved the engagement objective.

Archived Engagement is concluded, the engagement objective has not been achieved.

Disengage Engagement is deemed unlikely to succeed.

792 engagements as of 01 January 2024

4 new Engage

12 Resolved

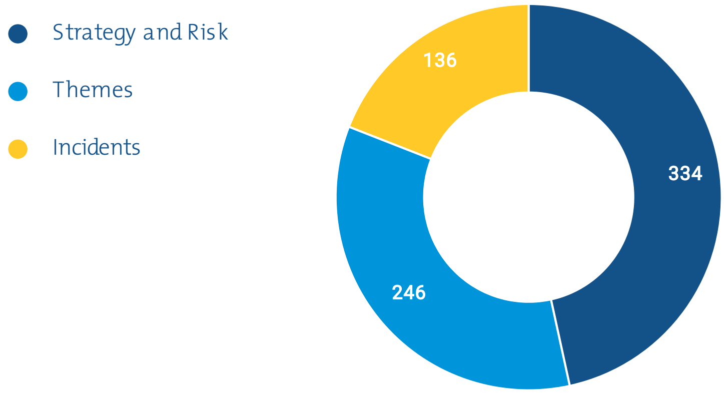
98 Archived

3 Disengaged

696 engagements as of 31 March 2024

796 engagements during Q1 2024

Engagement Type



- Strategy and Risk engages on unmanaged risk as determined by Sustainalytics ESG Risk Rating.
- Themes engages on systemic ESG issues and leverage multiple Sustainalytics research.
- Incidents engages on major incidents identified by the Sustainalytics Global Standards Screening.

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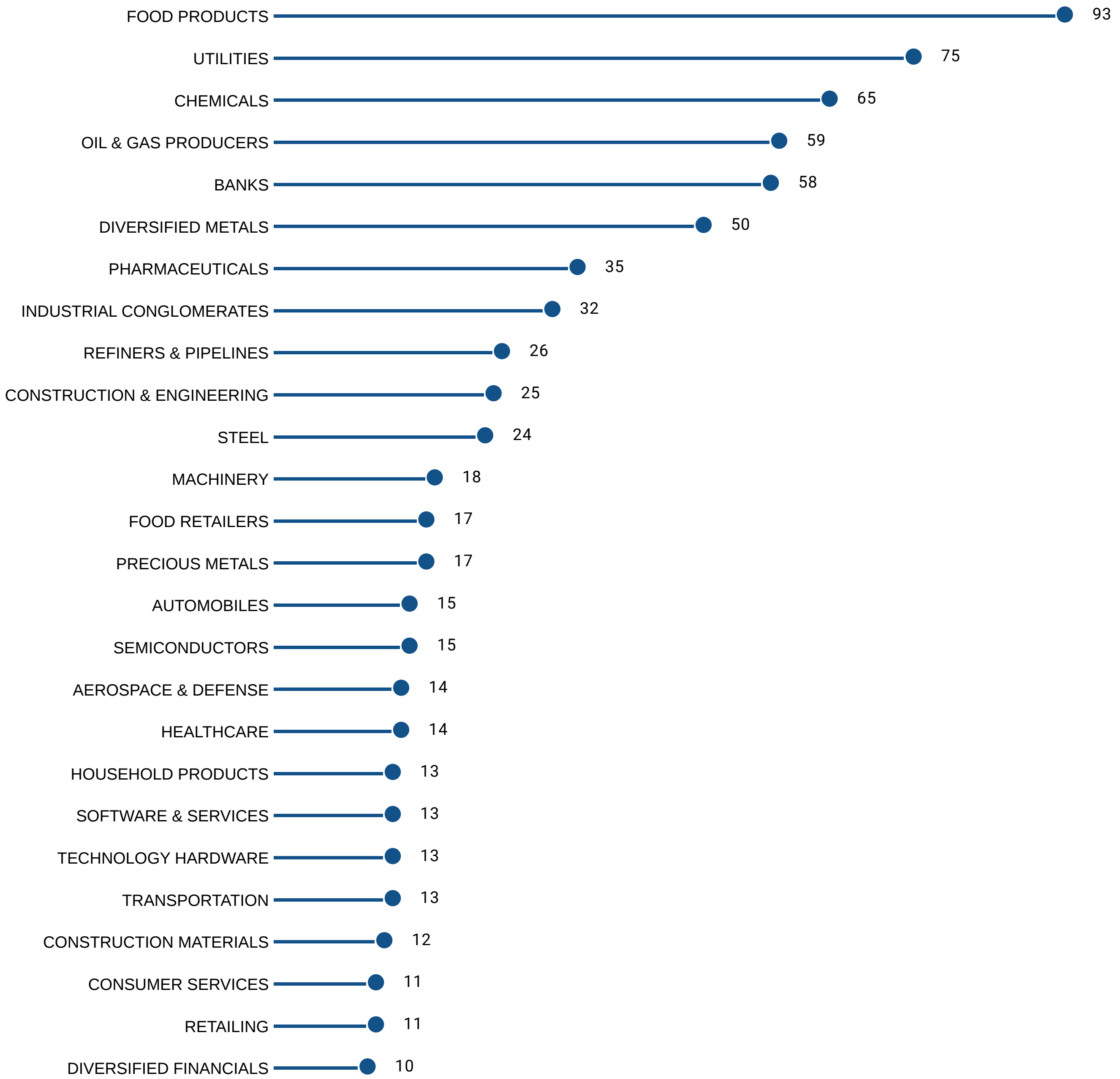
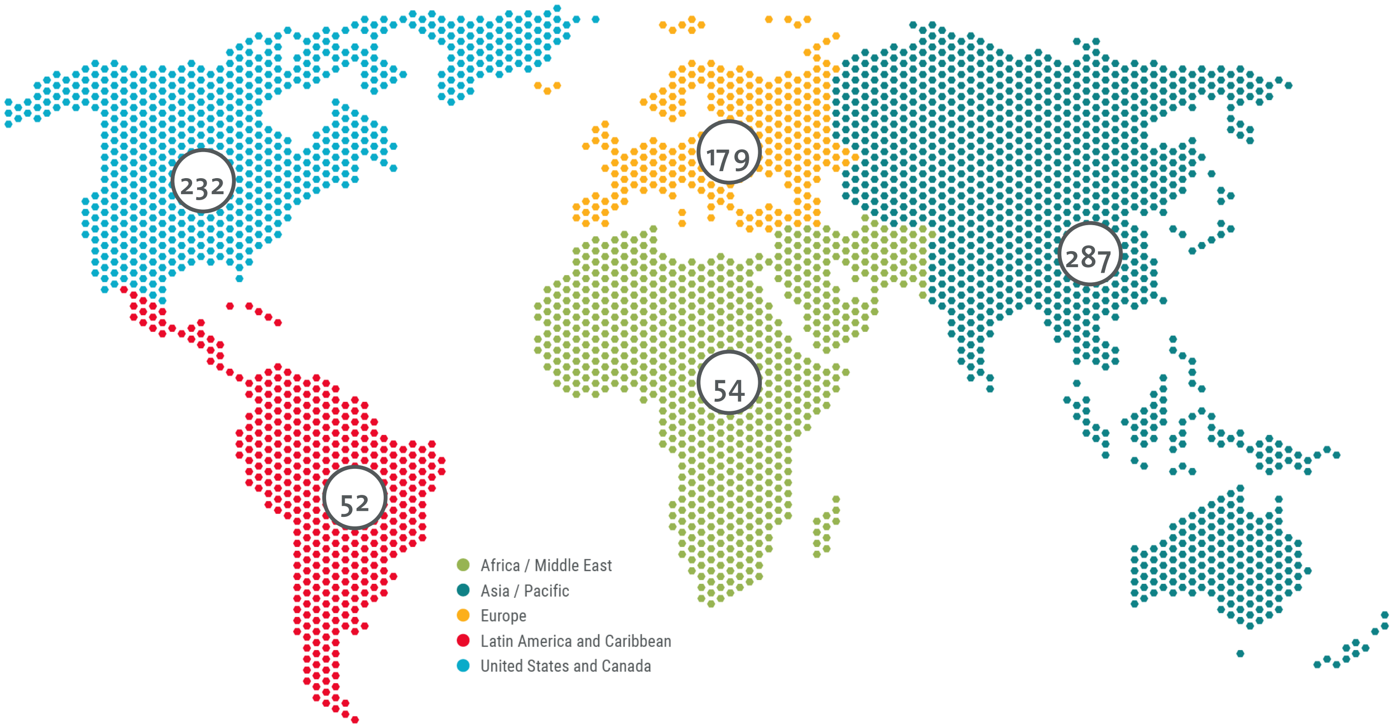
Industry Distribution

(Industries included with a minimum of 10 engagements)



Engagements by Headquarter Location



Environmental, Social and Governance Overview

E, S and G Overview

Note: Stewardship can cover one or more issues and objectives reflected in overlapping issue statistics.

Engagement Topics

At the end of the reporting period, our engagements addressed a number of topics across the environmental, social and governance pillars.

ENGAGEMENT TOPICS	ENGAGEMENTS
Net Zero Decarbonization	228
Disclosure	206
Climate Change	201
Water Security	148
ESG Governance	143
Human Rights	102
Deforestation	101
Biodiversity	98
Water Quality	96
Community Relations	90
Land Pollution and Spills	85
Product Quality and Safety	79
Labour Rights	73

ENGAGEMENT TOPICS	ENGAGEMENTS
Business Ethics, Bribery and Corruption	70
Board Composition	68
Human Capital	57
Occupational Health and Safety	47
Waste Management	46
Child Labour	45
Indigenous People	41
Accounting and Taxation	36
Diversity, Equity and Inclusion (DEI)	32
Shareholders Rights	30
Natural Resource Use	29
Forced Labour	28
Circular Economy	19
Data Privacy and Security	18
Just Transition	12
Air Pollutant Emissions	9
Marketing Practices	8
High-Risk Territories	5
Weapons	4
Sanctions	1

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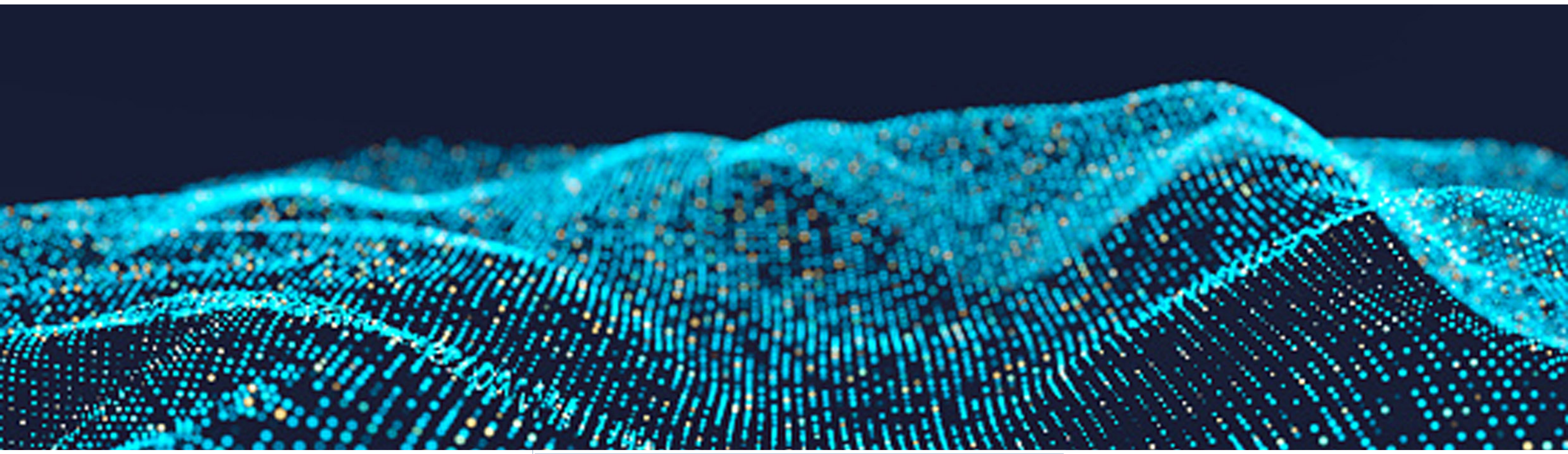
Sustainable Development Goals — Mapping Engagements

All engagements are mapped to the 17 UN Sustainable Development Goals (SDGs). The mapping is done by Morningstar Sustainalytics and refers to the focus and objective(s) of the engagement.

1 No Poverty	5%
2 Zero Hunger	11%
3 Good Health and Well-Being	25%
4 Quality Education	0%
5 Gender Equality	6%
6 Clean Water and Sanitation	13%
7 Affordable and Clean Energy	23%
8 Decent Work and Economic Growth	25%
9 Industry, Innovation and Infrastructure	24%
10 Reduced Inequality	11%
11 Sustainable Cities and Communities	10%
12 Responsible Consumption and Production	56%
13 Climate Action	55%
14 Life Below Water	11%
15 Life on Land	17%
16 Peace and Justice, Strong Institutions	41%
17 Partnerships to Achieve the Goal	5%

Engagement Results



159
meetings, including 13 in-person meetings

2,105
emails and phone calls exchanged

12
engagements have been Resolved

48
Milestones achieved in Q1 2024

58%
of engagements remain in early-stage dialogue (Milestones 1 & 2)

41%
of the engagements show Good or Excellent Response

29%
of the engagements show Good or Excellent Progress

Engagement Progress

Progress reflects the pace and scope of changes towards the engagement objective that the company is making, assessed on a five-point scale.

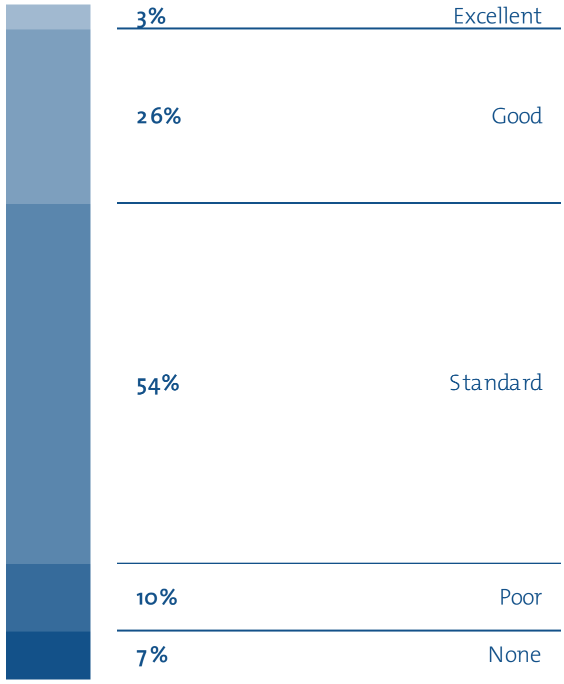
Excellent The company has adopted a proactive approach and addressed the issues related to the change objective.

Good The company has taken sufficient measures to address the issues related to the change objective.

Standard The company has undertaken a number of measures to address the issues related to the change objective.

Poor The company has indicated willingness to addressing the issues related to the change objective, but no measures have been taken yet.

None The company has not made any progress against the engagement objective.



Engagement Response

Response reflects the company's willingness to engagement dialogue with investors, assessed on a five-point scale.

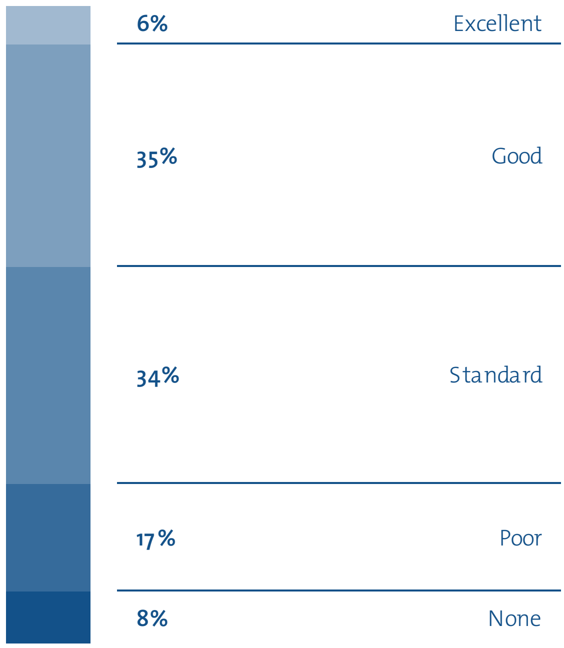
Excellent The company is proactive in communicating around the issues related to the change objective.

Good The company addresses all the issues related to the change objective.

Standard The company provides responses to some of the issues related to the change objective.

Poor The company has initially responded but not properly addressed the issues related to the change objective and is unwilling to engage further with us.

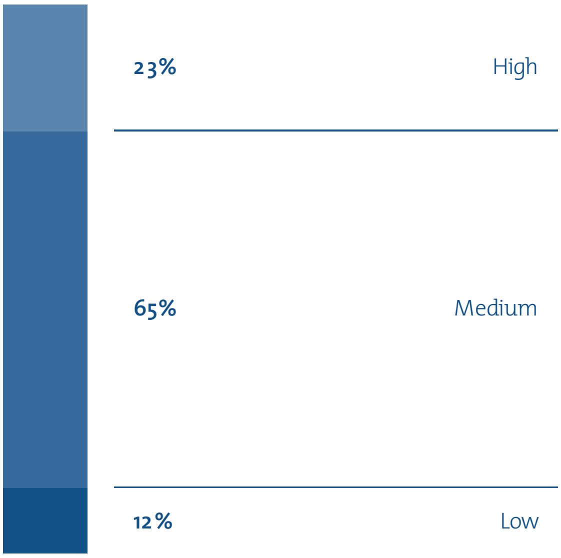
None The company has not responded to the inquiries.



Engagement Performance

Performance describes the combined company Progress and Response.

High	Good or Excellent Progress in combination with Good or Excellent Response.
Medium	Standard Level of Progress and Response.
Poor	Poor or None Progress in combination with Poor or None Response.



Engagement Milestones

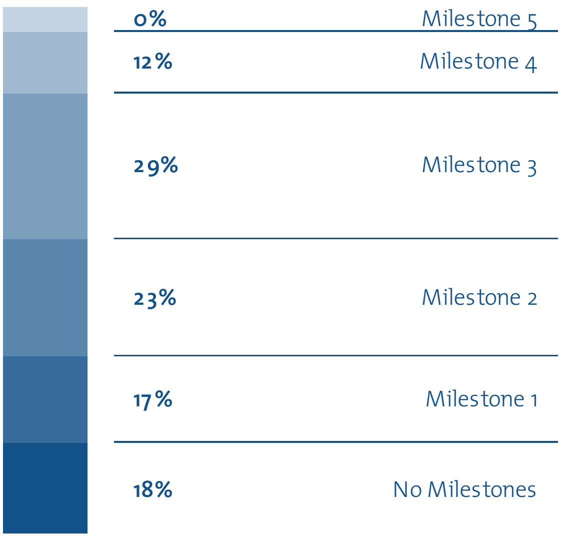
Milestones are our five-stage tracking of Progress in achieving the engagement objective.

48
Milestones achieved in Q1 2024

Milestone Framework Structure

Milestone 5	Change objective is considered fulfilled.
Milestone 4	Implementation of strategy has advanced meaningfully, and related issuer disclosure maturing.
Milestone 3	Strategy is well formed and has moved into early stages of implementation.
Milestone 2	ESG risk management and strategy established.
Milestone 1	Acknowledge of issue(s) and commitment to mitigation.

Engagements by Highest Milestone Achieved



Engagements Resolved

COMPANY	COUNTRY	INDUSTRY	ISSUE	RELATED COMPANY
Banco de Credito e Inversiones SA	Chile	Banks	Focus on ESG Integration Financials	
BRF SA	Brazil	Food Products	Focus on E&S Impact of Products and Services and Land Use and Biodiversity	
China Construction Bank Corp.	China	Banks	Focus on ESG Integration Financials	
Hitachi Ltd.	Japan	Industrial Conglomerates	Focus on Product Governance	
Kumho Petrochemical Co., Ltd.	South Korea	Chemicals	Focus on Carbon Own Operations	
Mahindra & Mahindra Ltd.	India	Automobiles	Focus on Risk Assessment and ESG Disclosure	
Metropolitan Bank & Trust Co.	Philippines	Banks	Focus on ESG Integration Financials	
NovoCure Ltd.	United Kingdom	Healthcare	Focus on Risk Assessment and ESG Disclosure	
Stryker Corp.	United States of America	Healthcare	Focus on Product Governance	
Syngenta AG	Switzerland	Chemicals	Quality and Safety	China National Chemical Corp., Ltd.; Sinochem Group Co., Ltd.; Sinochem Holdings Corp. Ltd.
Teva Pharmaceutical Industries Ltd.	Israel	Pharmaceuticals	Focus on Business Ethics	
Top Glove Corp. Bhd.	Malaysia	Healthcare	Labour Rights - Operations	

Materiality Considerations for Evolving Responsible Investment Strategies

Marta Mancheva
Manager, Stewardship
Material Risk Engagement/Strategy and Risk
Morningstar Sustainalytics

Shane Tiley
Manager, Stewardship
Material Risk Engagement/Strategy and Risk
Morningstar Sustainalytics

Introduction

As responsible investment strategies move beyond ESG integration to impact investing, it's important to consider how newly standardized ESG reporting requirements align with investor preferences. At the core of all ESG reporting frameworks is the materiality assessment. This article focuses on the key distinctions between financial, impact, and double materiality concepts and the related implications for issuers and investors.

Materiality, in the view of ESG reporting, is a concept which provides criteria for determination of whether a sustainability topic or information should be included in an ESG disclosure. The debate on global alignment of sustainability disclosure rules revolves around the concept of materiality.

The inaugural International Sustainability Standards Board (ISSB) disclosure standards and the U.S. Securities and Exchange Commission (SEC) climate disclosure rules both define materiality based on an assessment of the financial risks and impacts that a sustainability issue poses to cash flow and enterprise value. In contrast, the recently enforced EU Corporate Sustainability Reporting Directive (CSRD) and the EU Sustainable Finance Disclosure Regulation (SFDR) adopt a double materiality approach, which includes both financial and impact materiality.

Doubling Down on Materiality

In financial reporting, companies typically assess materiality with a focus on the information needs of potential and existing investors and lenders as the primary users of financial statements. According to the International Financial Reporting Standards (IFRS), information is financially material if omitting, obscuring, or misstating it could be reasonably expected to influence investor decisions.[1] The use of financial materiality is rooted in several core legal principles, starting with fiduciary duty. However, as investors begin to shift focus from ESG integration to impact investment strategies, issuers who limit sustainability and climate disclosures to align only with financially material ESG topics may also be limiting opportunities to demonstrate their performance in line with external impact.

According to guidance issued by the European Financial Reporting Advisory Group (EFRAG), a sustainability topic or information is material from an impact perspective if the undertaking is connected to actual or potential significant impacts on people or the environment and is related to the sustainability topic over the short, medium, or long term. Double materiality is the combination of impact materiality and financial materiality. A sustainability topic or information meets the criteria of double materiality if it is material from the impact perspective or from the financial perspective, or from both perspectives.[2] SFDR, which mandates the disclosure of sustainability information by financial services firms, also requires that firms disclose how they manage ESG risks that impact the financial performance, as well as how investment decisions impact on sustainability factors.

Getting to Impact

Fiduciary duty, as the primary responsibility of investors, is subject to interpretation across different regulatory environments. Traditionally, fiduciary duty prioritizes investment factors with direct financial impacts, while the progressive model applies a broader lens that balances long-term financial liabilities with ESG factors that could impact value over long time horizons.

As the concept of fiduciary duty evolves globally, there is a parallel emergent investment trend towards a greater emphasis on sustainability outcomes and impact, reflecting a broader interpretation of value beyond immediate financial returns. Double materiality assessments are key to adopt an impact perspective. This method not only uncovers potential risks and opportunities that may be missed by taking a financial focus only, but also contributes to evaluating investments' impacts.

The European sustainable debt market, valued at EUR 1.7 trillion in 2022,[3] grew 130% over 2021 and 2022 signaling a broader global shift toward sustainable finance, which is projected to reach USD 30.9 trillion by 2032.[4] Such growth, driven by steady demand for sustainable finance products like green bonds and sustainability-linked loans, underscores the increasing interest in impact-oriented investments. The rising appetite for sustainable investment products highlights the need for issuer double materiality assessments, and issuers across the globe are taking note.

In 2024, large financial institutions and listed companies in the EU will conduct their materiality assessments under the CSRD's double materiality standard and begin to collect data for reporting in 2025. As part of the double materiality exercise, European issuers need to engage meaningfully with stakeholders and understand material sustainability risks, impacts and opportunities in their value chains. Driven by regulatory push in the EU, the first wave of CSRD reporting will provide valuable learnings on the double materiality approach for issuers globally.

In Canada, an October 2023 ESG disclosure study of 227 S&P/TSX Composite Index constituents showed that 19% of materiality assessments undertaken by Canadian issuers are currently applying a double materiality approach.[5] And in February 2024, an ESG Sentiment Study of Canadian Institutional Investors[6] showed that 43% of asset managers interviewed were planning to launch impact-oriented products that year. However, the Canadian Sustainability Standards Board (CSSB) announced on 14 March the release of new proposed standards for companies to report sustainability and climate-related information based on the ISSB disclosure standards, which only focuses on financial materiality. Following the release of the proposed CSSB standards, the Canadian Securities Administrators (CSA) said that it would consider the final CSSB standards, with potential capital markets-focused modifications, for incorporation into a CSA rule.[7]

China has also issued draft guidelines for a mandatory climate disclosure regime including a double materiality approach, requiring its biggest listed companies to report on a broad range of sustainability-related risks and impacts from 2025. The Shanghai, Shenzhen, and Beijing exchanges are requiring issuers to report on the impact of their activities on the environment as well as the risks and impact of environmental factors on their businesses.[8]

Promoting Long-Term Value

There is mounting evidence[9] that financially immaterial sustainability issues may become financially material over time. For instance, investors increasingly factor in climate-related risks and impacts, previously considered immaterial, to mitigate exposure to climate-related financial risks in portfolios. The concept of dynamic materiality[10] argues that sustainability issues, which are only material from an impact perspective, will eventually become financially-material. As a result, investors might not be sufficiently informed about potential and emerging financial risks if issuers' ESG disclosures are limited to financially-material information. A forward-looking approach to integrating dynamic ESG issues in portfolio construction and security selection may enable investors to better anticipate and respond to future material issues.

Integrating real-world impact into investment strategies further offers an opportunity to address systemic ESG issues, thereby promoting long-term value. By considering impact, investors can assess and respond to risks and opportunities associated with systemic environmental and social issues before they become apparent to the broader market. This proactive approach allows for the early identification of potential issues, enabling investors to make better-informed decisions that mitigate risks and capture emerging opportunities. Ultimately, considering impact in investment decision-making helps investors proactively manage systemic risks that could materially affect investment returns at the portfolio level.

Responsible Mining Companies Should Have an Unwavering Commitment to Safety

Nigel Rossouw
Associate Director, Stewardship
Global Standards
Engagement/Incidents
Morningstar Sustainalytics

What is Safety in Responsible Mining?

The World Bank[11] and the Global Investor Commission on Mining 2030[12] (a collaborative investor-led initiative) acknowledges that a low-carbon future is only possible with the mining of minerals and metals. Growth in renewable/clean energy technologies (wind, solar, electric vehicles, battery storage, electrolyzers and fuel cells) is required for the transition to a low carbon economy. Minerals and metals are a vital enabler for clean energy transitions,[13] and yet the great paradox is that the world needs mining to increase substantially, to mitigate climate change. However, for the energy transition to be just, mining companies have a vital role in ensuring that human rights are safeguarded.

Having safe and healthy conditions of work is a globally recognized human right. In 2022, the International Labour Convention adopted a resolution to include a safe working environment as the fifth of the International Labour Organization's (ILO)[14] fundamental principles and rights at work. Workers in the mining sector face numerous safety hazards due to the nature of the work they perform. Because of the many hazards inherent in mining that can lead to injuries, illnesses, and death, a strong focus on safety must be present at responsible mines.[15] The International Council on Mining and Metals[16] defines responsible mining companies as those that have a staunch commitment to the safety of workers and their families, local communities and wider society. Responsible mining companies have a safety management system in place which promotes practices that prevent loss of life, minimise injuries, and have a goal of zero harm.

Engagement Questions for Testing Safety Management Basics

Morningstar Sustainalytics' experience in engaging with mining companies is that complying with international conventions (such as the 1995 ILO Safety and Health in Mines Convention),[17] adhering to safety regulations, having a safety policy and a commitment to zero harm are not enough to prevent loss of life or injury among mineworkers. As part of information gathering and ESG performance evaluation for engagements focused on the issue of occupational health and safety with mining companies (such as **ArcelorMittal SA**, **Harmony Gold Mining Co. Ltd.**, **Ntpc Ltd.** and **Sibanye Stillwater Ltd.**), Morningstar Sustainalytics tests whether the building blocks of an effective safety management system are in place by reviewing the organizational approach to safety including aspects such as safety governance, safety leadership, safety risk management, emergency response planning, training, contractor safety management and learning from incidents.

What is Required for a Step Change in Safety Performance?

In our Global Standards/Incidents engagements with mining companies, some of the areas where we have seen gaps and that would trigger significant positive developments (in improvement of safety performance) include:

- Safety governance: board members and the executive leadership make personal commitments to safety and visibly demonstrates duty of care and culture of care for workers' welfare.
- Visible-felt safety leadership: the top management's visible actions in participating in safety initiatives and where workers can "feel" their leaders' safety expectations.

- Digitization to focus on risk prediction and proactive measures: invest in real-time monitoring and predictive analytics (using artificial intelligence, machine learning and internet of things) for early warning detection of hazards to initiate preventive or emergency action.
- Implementing a gender-based approach in safety practices: ensure that safety policies and programmes contain a well-defined and transparent gender dimension, for example developing detailed guidance explaining menopause and its impacts in the workplace.
- Safety culture: develop a dedicated culture transformation programme to improve employees' safety mindset to empower employees at all levels to take personal accountability for safety and to develop a culture of caring for one another.

Some of the key ongoing safety challenges that still remain in the mining sector include: fatality prevention, safety leadership, ensuring consistent safety performance across regions, empowering workers and implementing cultural shifts. On the other hand, some of the key areas where Morningstar Sustainalytics has seen mining companies making significant strides and having a positive impact on safety performance, include: increasing gender diversity (there are numerous anecdotes that point to the positive influence that women have on enhancing safety initiatives), acknowledging mental health and applying digitization to optimize safety initiatives.

Towards Transparency: Exploring the Rise of Nature Disclosure

Gayaneh Shahbazian
Manager, Stewardship
Biodiversity and Natural Capital
Morningstar Sustainalytics

Nature-related disclosure is quickly becoming a reality, evidenced by 320 organizations signalling their intent to align with the Taskforce on Nature-related Financial Disclosures (TNFD) Recommendations in their corporate reporting. Among the 50 companies engaged in the Biodiversity and Natural Capital Stewardship Programme, approximately one-fifth are on this list, with five companies intending to disclose by the financial year 2024 or earlier and four by 2025.

COMPANY	INDUSTRY GROUP	TNFD-ALIGNED DISCLOSURE(S) BY FINANCIAL YEAR
Bank of America Corp.	Banks	2025
Bunge Ltd.	Food Products	2024 (or earlier)
Carrefour SA	Food Retailers	2024 (or earlier)
Crédit Agricole SA	Banks	2025
Mowi ASA	Food Products	2024 (or earlier)
Nissui Corp.	Food Products	2025
Olam International Ltd.	Food Products	2025
Sumitomo Mitsui Financial Group (SMFG) Inc	Banks	2024 (or earlier)
UBS Group AG	Diversified Financials	2024 (or earlier)

Figure 1. *Organizations within our engagement programme who have signaled their intent to start adopting the TNFD Recommendations.*[18]

Although most engaged companies on the list belong to the Foods Products group, these also constitute the majority of our current engagement. Banks stand out as an industry group, with three out of the eight in our programme indicating their intention to disclose against the TNFD.

The Europe and Asia Pacific regions lead the way towards TNFD-aligned disclosure. Conversely, none of the companies we engage with from Latin America or Africa and the Middle East have signalled their intent to disclose in alignment with the TNFD. However, these regions also represent a smaller percentage of our current engagements (12% and 4% respectively). Despite companies from the United States comprising the largest portion of our engagement cases (36%), only 2 out of 17 companies from the United States are on the list. Meanwhile, 21% of companies from Asia Pacific and 40% of European companies are represented. These regional disparities are reflected across all 320 organizations, with 85% being European or from Asia and the Pacific.[19]

Global Biodiversity Framework: Target 15

Target 15 of the Global Biodiversity Framework will require countries to take legal, administrative, or policy measures to regularly monitor, assess, and transparently disclose their risks, dependencies, and impacts on biodiversity along value chains and portfolios.[20] With countries realigning their National Biodiversity Strategies and Action Plans with the Framework ahead of COP16, the TNFD will be an important element in implementing this target.

Nature Disclosure in EU Regulation

Some companies will soon be required to start nature-related disclosure through the Corporate Sustainability Reporting Directive (CSRD). Companies within the regulation's scope and for which biodiversity and ecosystems are material topics will report against the European Sustainability Reporting Standards (ESRS) E4 on "Biodiversity and Ecosystems". The phased approach began in January 2024, with the first reports due in 2025.[21] To enhance corporate disclosure on biodiversity, the ESRS disclosures and the TNFD Recommendations have been designed with a high level of alignment and interoperability.[22]

Engagement Focus for the Year Ahead

Nature-related disclosure is a key part of our Programme's Outcome Assessment under the Transparency Pillar (see ***Figure 2***). Advancing companies from Marker 1 to Marker 2, where "TNFD reporting is in place but with significant omissions", will be an area of focus for our engagements this year. We anticipate leading companies to progress to Marker 2 by the end of the year. For companies yet to commit to TNFD reporting, we will encourage progression to Marker 1, fostering commitment to nature-related disclosure. There will be a second opportunity for companies to join the list of TNFD Early Adopters at the Biodiversity Conference in October this year, COP16.

Challenges to Committing to TNFD-Aligned Disclosure

From our recent engagement, we have identified the top three reasons why companies have yet to commit to TNFD-aligned reporting:

- They are currently assessing the TNFD's relationship to other nature-related frameworks and standards such as the ESRS.
- They are prioritizing mandatory reporting first.
- They aim to enhance readiness on data quality and availability before committing to disclosure.

While the above motives have been consistently cited across our engagement companies, one company has said that they prefer to ensure the topic is material to its business before committing to disclosure and another company is openly skeptical of the added value or relevance of the TNFD.

Conclusion

Challenges in reporting nature-related impacts, dependencies, risks, and opportunities across the value chain are valid. However, organizations possess significant relevant data to leverage, such as waste, water, climate, and pollution. As organizations step forward, this year's disclosure will demonstrate the feasibility of reporting on this data.

Collating and disclosing such data will provide organizations with a better understanding of the nature-related challenges and clearer oversight to apply better management responses. Transparent and comparable nature data are essential to comprehend our current status and the necessary actions to halt and reverse nature loss by 2030.

Transparency and Accountability

Best practice definition: The company discloses on biodiversity in line with best practice, following international standards and frameworks, including the Taskforce for Nature-related Financial Disclosures (TNFD). The company's annual report includes biodiversity-related targets and progress towards these.

0	The company has not made significant progress towards the outcome.
1	The company has committed to report in accordance with the TNFD or participated in a TNFD pilot study.
2	TNFD reporting is in place but with significant omissions.
3	TNFD reporting is in place with no significant omissions.
4	TNFD reporting considers relevant reporting standards.
5	The company has met expectations on the outcome.

Figure 2. *The outcome scorecard for the Transparency and Accountability pillar defines a five-level hierarchy outlining the trajectory towards best practice.*

What Obstacles do Businesses Encounter in Substantiating Their Scope 3 Science-Based Net Zero Targets?

Amar Causevic
Manager, Stewardship
Net Zero Transition
Morningstar Sustainalytics

In early March 2024, the Science Based Targets initiative (SBTi) altered the status of 239 companies within its tracking dashboard, shifting them to "committment removed," emblematic of the intricate challenge corporations face in formulating strategies to achieve net zero objectives.[23] Significant entities, such as Microsoft, Proctor & Gamble, Unilever and Walmart are now categorized as "committment removed" for net zero by SBTi, collectively representing a market capitalization exceeding $4 trillion.

This adjustment arises from an SBTi policy implemented in 2023, granting companies a 24-month window to submit science-based targets for validation following a committment. The entities affected by the status modification had until 31 January 2024 to fulfill this requirement concerning previously declared net zero committments.[24]

One of the primary hurdles encountered by companies pertains to reducing their Scope 3 emissions in alignment with SBTi's objectives. This challenge was underscored by an unrelated decision from the United States Securities and Exchange Commission, which exempted corporations from reporting Scope 3 emissions in its recent climate disclosure rule.[25] Under this proposed mandate, public companies must disclose solely Scope 1 and Scope 2 emissions.

The Net Zero Transition Thematic Stewardship Programme's approach involves assessing engaged companies' current positions regarding Scope 3 emissions and exploring strategies to drive progress despite regulatory delays. Recognizing that companies are at different stages regarding Scope 3 reduction efforts is essential. The programme focuses on engagin with companies to understand their strategies and progress. We are committed to working collaboratively with companies to drive progress on Scope 3 emissions reduction, recognizing the importance of transparency and alignment with sustainability goals.

Committing to carbon reduction within one's value chain proves challenging due to the distant deadline of 2050, extending beyond typical corporate planning cycles of three to five years. This complexity arises from the independence of suppliers, who may not have aligned themselves with net zero initiatives.[26]

Furthermore, SBTi validates near-term initiatives aimed at halving emissions by 2030 with 60% of the companies labeled with "committment removed" retaining such near-term targets, as the organization states.[27]

Elevating Human Capital Management: A Data-Driven and Technology-Enhanced Transformation

Enrique Figallo
Manager, Stewardship
Human Capital Management
Morningstar Sustainalytics

In engaging companies on human capital management (HCM), our focus is underpinned by two critical insights: the transformative power of people analytics and the undeniable potential of technological innovations in developing, implementing, and measuring the effectiveness of HCM initiatives.[28] As we navigate the intricacies of workforce management, we believe that HCM strategies and programmes need to be forward-thinking and focused on data-driven and technology-enhanced insights. Progress is measurable, outcomes are tangible, and strategies are adaptable, based on empirical evidence and cutting-edge technological tools.[29]

Effective Board Oversight of Human Capital Management

Effective board oversight of human capital management is instrumental in guiding organizational strategy and fostering a culture of accountability and transparency. Boards play a pivotal role in ensuring alignment between human capital initiatives and business objectives. By actively engaging with management on human capital issues, boards can mitigate risks, drive performance, and enhance stakeholder value.[30] This involves ensuring that decisions around workforce management are backed by robust data insights and leveraged through technological advancement, transforming governance into a catalyst for informed decision-making, strategic foresight, and enhanced operational efficiency.

Strategic Workforce Planning: Leveraging Analytics for Future Readiness and Technological Agility

In dialogues around strategic workforce planning, we aim to understand how companies are leveraging the utilization of advanced analytics and predictive modeling, along with the strategic deployment of digital tools and platforms. We advocate for a planning process that harnesses data to anticipate future trends, identify skill gaps, and formulate strategies to navigate the evolving business landscape, all while incorporating technological solutions to enhance flexibility and innovation. This approach enables companies to move from reactive workforce adjustments to strategic positioning that proactively addresses emerging business needs through both data insight and technological adaptability.[31]

Skills-based Approach: Analytics and Technology at the Core of Talent Development

Our engagement emphasizes the critical role of data and technology in transitioning towards a skills-based talent management approach. By adopting people analytics, companies can gain deeper insights into the existing skills landscape and employee potential. Furthermore, the use of artificial intelligence, machine learning, and digital platforms can personalize learning and development efforts, ensuring they are aligned with both individual growth and strategic business needs. This empowers organizations to not only tailor reskilling and upskilling programs more effectively but also to measure the impact of these initiatives through data, thereby ensuring continuous improvement and alignment with business objectives.[32]

Assessing Diversity, Equity and Inclusion (DEI) Initiatives: The Imperative for Outcome-Based Metrics

In our engagements on DEI, we will place a strong emphasis on the need for data-driven assessment frameworks, augmented by technological tools that facilitate deeper insights and broader inclusivity. While many companies report on DEI activities, the shift towards a results-oriented approach necessitates the adoption of quantifiable metrics, benchmarks, and technology-enabled practices.[33] This not only enables the tracking of progress over time but also helps in identifying areas for improvement, scaling successful practices, and ensuring that DE&I efforts are inclusive and impactful across all levels of the organization.

Technological Innovation in HCM: A Paradigm Shift

At the forefront of our engagement strategy is the recognition of technological innovations as key drivers of HCM excellence. The integration of AI and emerging technologies represents a paradigm shift in how companies approach talent management and throughout the entire employee life cycle.[34] These technologies offer new avenues for enhancing the efficacy of HCM practices, ensuring a more engaged, agile, and future-ready workforce. By championing these technological advancements, companies can optimize their human capital potential while navigating the complexities of the modern workplace with greater agility and innovation.

Conclusion: A Call for Data-Driven and Technology-Enhanced Transformation

As we advise investor clients and engage with companies on enhancing their HCM strategies, our call-to-action centres on the adoption of a data-driven and technology-enhanced mindset. The integration of people analytics and technological innovations into all facets of human capital management represents a comprehensive approach—a move towards evidence-based decision-making that ensures accountability, measures progress, and drives continuous improvement, all while leveraging technological advancements to optimize operations and enhance employee experiences. In this data-oriented and technologically-enabled era, the ability to articulate, measure, and report on the tangible outcomes of HCM initiatives becomes a key differentiator for companies, aligning them more closely with the expectations of ESG-focused investors and positioning them for sustainable success in an increasingly complex and competitive environment.[35]

Towards a Circular Economy in the Global Automotive Value Chain

Joris Laseur
Associate Director, Stewardship
Scaling Circular Economies
Morningstar Sustainalytics

Before reaching out to the first batch of companies, Morningstar Sustainalytics studied the public reporting of these companies, identifying highlights of their current efforts. Most of the targeted companies are already demonstrating awareness of and commitment to circular economy principles. It is likely that these companies already satisfy some markers in our outcome assessment framework for this Scaling Circular Economies Stewardship Programme, but we would like to use the first round of engagement calls to confirm our analysis of the reporting before granting any markers.

In pursuit of a transition toward a circular economy, along with general environmental aspirations such 'net-zero' carbon emissions, 'water positive', 'nature positive', green logistics and packaging and site-level environment management systems, investors can help identify and promote the most promising industry-specific efforts. The examples presented below offer a first impression of innovative measures already being taken in the automotive industry specifically. These offer excellent entry points for our engagement dialogues on the Scaling Circular Economies Stewardship Programme.

- **BMW** and **Tesla** stand out positively in terms of reporting environmental performance metrics per vehicle sold.
- **Kia** has started to report the combined weight of recycled plastic or bio-based materials per vehicle.
- **Ford** has notably specific and quantified targets for increasing the use of recycled and renewable plastics.
- **LG Energy Solution** has set an ambitious renewable energy target ('RE100') not just for its own sites but also for its direct suppliers.
- With its own charging infrastructure, Tesla contributes to making EV charging with renewable energy possible.
- **Tata Motors** is developing a stationary energy storage system powered by second-life EV batteries.
- **Michelin** reports tire and road wear particle (TRWP) emissions and claims to outperform its main peers.
- **Volvo** quantifies average vehicle utilization and reports percentages of recycled content with regard to plastics, steel and aluminium and bio-based materials.
- Ford, LG Energy Solution, Tesla and **Volkswagen** have been piloting 'battery passport' reporting. Tesla and Volvo have published particularly detailed life cycle analysis results on the carbon footprint of specific models.
- BMW and LG Energy Solution engage in venture capital investing to search for promising innovations with circular economy benefits. **Bridgestone** has teamed up with specialized business partners to recover materials from end-of-life tires. Tata Motors has initiated several recycling projects in India and the UK. Volvo has been collaborating with suppliers to increase the supply of low-carbon and high recycled content materials, and Tesla reports that it invests in battery reverse logistics and recycling and it 'in-sourced' an upstream activity with the purpose of demonstrating that acid-free lithium refining is possible.

- To improve resource efficiency, there are opportunities to improve the utilization of cars. Volkswagen acquired **Europcar** to diversify into car rental; Ford sponsors local community-led mobility improvement programmes in the US; **Renault** and Volvo have each launched a car-sharing service. Tesla has been developing a 'Robotaxi' supported by autonomous driving technology.
- Companies can try to accelerate their circular innovation by participating in a collaboration platform, such as Ford and Renault in the Ellen MacArthur Foundation, BMW in UnternehmerTUM's Circular Republic, and Volvo in the World Economic Forum's 'Circular Transformation of Industries'.

It has become common among companies to make circular economy progress in terms of relative decoupling, i.e. reducing the ecological intensity per unit of economic output. It is often possible to establish a strong business case for resource and energy efficiency improvements. However, there has been a persistent lack of evidence of the feasibility of absolute decoupling from intensive resource use. The pursuit of economic growth still continues to deplete natural resources, compromise nature and surpass many so-called planetary boundaries[36] within which humanity can continue to develop and thrive for generations to come.

In the automotive industry, circular economy aspirations easily conflict with targets to sell ever more cars. The Scaling Circular Economies Stewardship Programme encourages companies to prioritize alternative 'value pools' (sources of revenue) that are less resource intensive. Examples involve maintenance, reuse and mobility-as-a-service offerings. Growing markets for recycled and renewable materials will also help, but for the transition to a circular economy to reach scale, companies will need to find ways to end their reliance on linear economy, 'take-make-waste' business models. Circular solutions need to become standard as opposed to serving only a niche market that is willing to pay a green premium. Considering how large and well-capitalized the targeted companies are, institutional investors expect them to be ambitious and accountable. The Scaling Circular Economies Stewardship Programme seeks to leverage what companies do best, e.g. raising capital, innovating, producing, marketing, selling and lobbying.

Sustainability and Good Governance: An Aspiring Journey

Simone Altoe
Manager, Stewardship
Sustainability and Good Governance
Morningstar Sustainalytics

In today's business landscape, corporate governance and sustainability are intertwined in shaping companies and investment strategies. Corporate governance ensures transparency and accountability, while sustainability principles guide responsible practices and investment. Understanding this connection is vital for fostering long-term value creation and resilience in companies.[37] Engaging with enterprises to address corporate governance issues is important because it ensures that the rules and structures governing their operations are aligned with their sustainability strategy. When the corporate governance framework is well-defined, investors can better understand how companies make decisions and can hold them accountable. This clarity is essential for investors, as it facilitates a deeper understanding of resource allocation and the pursuit of long-term sustainability objectives within businesses.[38]

A company with a robust governance strategy is also better able to address material risks and succeed.[39] Based on the outcomes of Morningstar Sustainalytics' corporate governance thematic engagements concluded in 2023,[40] we have pinpointed four challenges companies are facing to fine-tune their corporate governance strategies which we will address in the Sustainability and Good Governance Stewardship Programme. By anchoring the companies' response to these four challenges within our Core Pillars of Corporate Governance, they will be able to navigate complexities and drive meaningful progress towards sustainability and responsible business practices.

Corporates need to better define and communicate their purpose. In 2023, it became evident that investors and key stakeholders wanted to know business strategies beyond profit maximization and understand the reason an organization existed.[41] According to Principles for Responsible Investment (PRI),[42] clearer purpose enhances transparency, fosters trust, and aligns corporate goals with investors' expectations, driving long-term value creation. Furthermore, it enhances the ability of investors to align with companies that are well positioned to deliver sustainable financial returns while also making positive contributions to society and the environment.

Corporates need to clearly communicate their sustainability vision to stakeholders.[43] Companies need to define their long-term sustainability goals and create quantifiable ESG targets to achieve those. This information should be precise and reliable to avoid greenwashing risks,[44] and board members should be well-versed in the data delivered.[45] When disclosing data and sharing information, corporates should engage with all relevant stakeholders, stimulating them to embrace their sustainability vision and embark on their shared ESG journey.

Corporates need to be more transparent regarding ESG performance metrics in executive pay. According to recent disclosures, 76% of the largest publicly traded companies were embedding some type of ESG metric into their leadership compensation policies in 2023.[46] However, they were failing to disclose the awards linked to the ESG performance and the steps the company was taking to achieve their long-term sustainability goals. Investors and stakeholders wanted to better understand what executives were expected to achieve and how they would be awarded for that.

There is a need for consensus around a standardized set of ESG indicators. There is a promise of standardization coming from the EU Corporate Sustainability Reporting Directive (CSRD)[47] and the International Sustainability Standards Board (ISSB)[48] framework. Sustainable companies are also using the UN Sustainable Development Goals (SDGs) as a guideline; however, there is no standardized way to measure the impact of business on the SDGs yet. We expect the trend towards unification of ESG reporting to continue in 2024.

This programme encompasses these topics as its outcome assessment scrutinizes the companies' governance, risk management, strategy, targets and performance, accountability, and transparency. By addressing these challenges during the programme, companies will not only foster trust and credibility but also align their governance strategies with evolving investor expectations—paving the way for sustainable growth and long-term value creation. As corporates navigate these issues, embracing transparency and accountability will be integral to their future resilience and competitiveness in an increasingly conscious marketplace.

Engagement Events and Industry Initiatives

Engagement Trip to Türkiye and Saudi Arabia

In January 2024, Associate Director Matthew Gray conducted an engagement trip to Türkiye and Saudi Arabia for Material Risk Engagement. On this trip he met with eight companies and toured two sites, including Aramco's headquarters. These companies were selected because they are amongst the most at risk per Sustainalytics' ESG Risk Ratings and among the largest and most influential companies in the countries. The meetings gave deep insight into the ESG focus and trends of the country due to the companies' influence and dependence with the government's regulations, and because these companies are the main clients of the medium-sized companies through the value chains.

With this trip, our team aimed to build trust and expand our network so we can have wider and deeper engagements with these companies and more engagements with other companies. We also wanted to provide investors with a more contextually driven understanding of the challenges facing these companies. At an in-person meeting, it is also much easier to have the full attention of stakeholders and this adds to collaboration and offers an opportunity to contribute where you might not have been able to virtually. When you meet someone once, the next time you meet them they have a stronger reference point for the relationship. You can also develop more of an offline relationship in a less formal setting which can allow you to breach more challenging topics in the future, and in that region it's very important.

Most of the companies we visited don't have decarbonization pathways for 2050 and 2060. It is clear that they are depending on new technology to achieve carbon neutrality. In the short-medium term, they are dependent on green ammonia / green steel to be imported and the viability of carbon capture and storage.

Today, Saudi Arabia and Türkiye both reflect the emerging markets' ESG momentum towards increased government buy-in, as well as corporate action. Both countries are now committed to making ESG disclosures mandatory for large cap public and private companies, with both using International Sustainability Standards Board (ISSB) standards as the primary disclosure requirements, yet with their own local adjustments. Türkiye's reporting requirements will take effect in 2025, while Saudi Arabia is targeting 2027 or sooner.

Face to Face Meeting with Wilmar International Ltd. in Malaysia

In March 2024, we met with palm oil producer **Wilmar International Ltd.**, at its offices in Kuala Lumpur in order to further explore the commitments and content made in their sustainability report, specifically as it relates to human rights and community engagement. The company gave a presentation providing an overview of its approach to sustainability and highlighting itself as a leader in the sector.

Handbook on Social Impact Assessment & Management

Morningstar Sustainalytics' Stewardship Services Associate Director, Nigel Rossouw, co-authored chapter 37 of this newly published *Handbook on Social Impact Assessment & Management*.[49] The book showcases 50 authors that examine the "S" in ESG including how to monitor impacts, how to remediate harm; how to respect rights; how to share benefits; and how to build trust with communities, and more. Nigel's chapter is called Monitoring for the *Adaptive Management of Social Impacts* and was co-authored with Liza van der Merwe. Nigel engages with over 22 companies in Global Standards Engagement Services overseeing issues from community relations-Indigenous peoples to consumer interests and money laundering.

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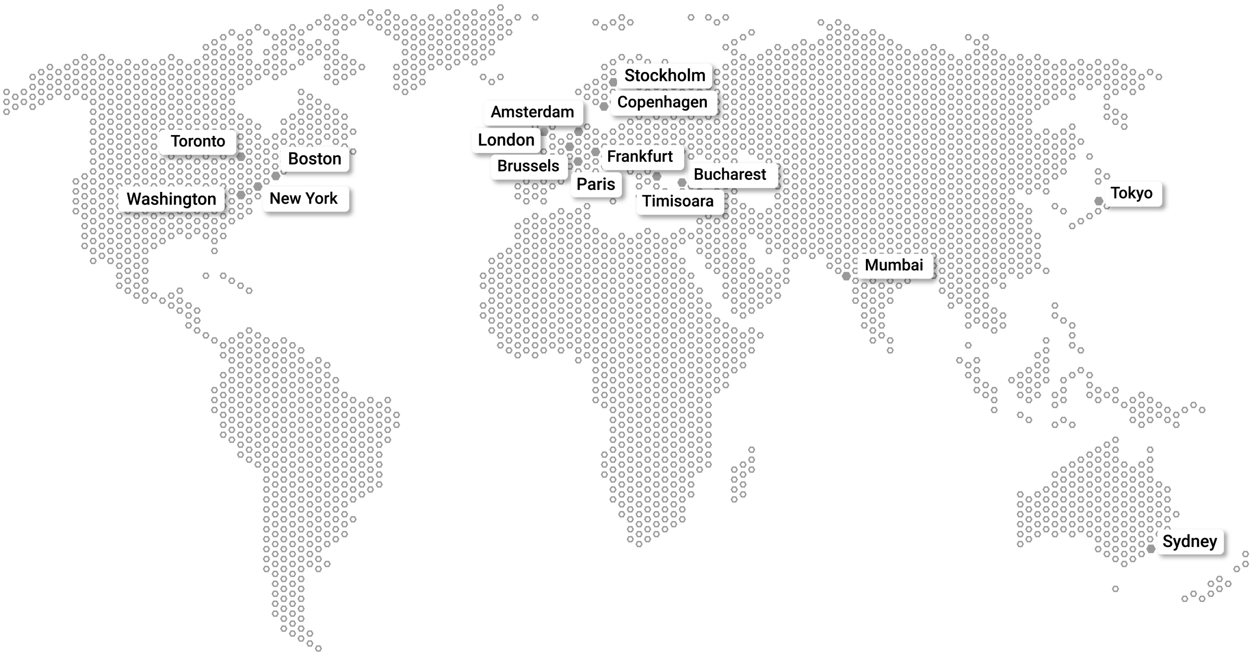

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Paris (+33) 1 184880642
Stockholm (+46) 8 505 323 33

Americas:
Boston (+1) 617 603 3321
New York (+1) 212 500 6468
Toronto (+1) 416 861 0403

Asia Pacific:
Sydney (+61) 2 8320 9436
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