Scope
Scope Ratings

ESG considerations for credit ratings of consumer goods companies

Environmental, governance and social (ESG) factors are particularly relevant for credit quality in the consumer goods industry. Vertical integration and local raw material sourcing and production have important roles to play in the transition to a more circular economy. The EU Green Deal will aim for more sustainable consumer good production and packaging. Staff, customers and investors increasingly expect safer products, production methods and working conditions.

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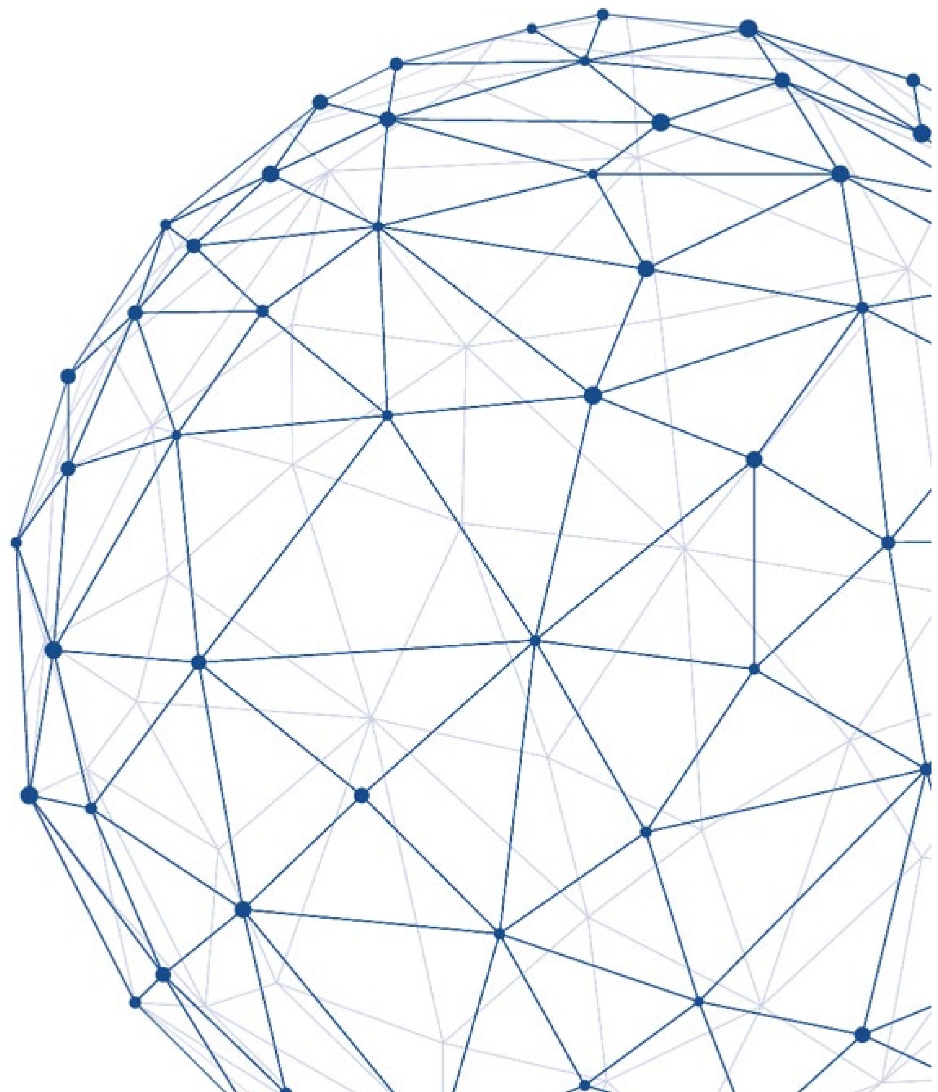

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1. General ESG framework at Scope

Our ESG framework evaluates the extent to which ESG factors are credit-relevant for different industries. We also provide an overview of how ESG factors are integrated into our credit analysis. Our evaluations are not mutually exclusive or collectively exhaustive as these factors overlap and evolve. Reporting standards for these non-financial key performance indicators are undergoing major changes, shedding more light on stakeholders' understanding and expectations of ESG. We therefore aim to update the framework on a regular basis.

Our corporate credit rating analysis remains focused on credit quality and credit assessment drivers. We only consider an ESG factor relevant to our credit rating process if it has a ubiquitously discernible and material impact on the rated entity's cash flow profile and, by extension, its overall credit quality. Contrary to ESG ratings, which are largely based on quantitative scores for different rating dimensions, credit-relevant ESG drivers are mostly of a qualitative nature. Hence, identified ESG rating factors are based on an opinion in a relative context.

The importance/relevance of certain ESG factors is specific to each rated entity, industry and region, except for the dimension of governance, which is universally applicable across all industries. For example, the risk of pollution and environmental damage is important in the utilities, chemicals and natural resources industries but less relevant to the retail sector, where governance and social factors are more relevant. The same applies to an assessment of ESG-related factors that might have a significant impact on a company located in western Europe but no effect on an eastern Europe corporate with a similar business model. A good example is the impact of regulatory risks, which may be significantly greater in some jurisdictions.

Governance is an indication of how well a corporation is controlled and directed and the extent to which the interests of different stakeholders are safeguarded, including the payment of all due amounts on time and in full. Governance is thus relevant to all rated entities. In contrast, environmental and social variables capture risks and opportunities that are often specific to the activities of a company and the industry in which it operates. All such factors may have a direct or indirect impact on a rated entity's market position and its financial performance.

ESG-related factors can directly or indirectly affect all the rating elements which make up our assessment of an issuer's business risk profile, financial risk profile and supplementary rating drivers. We provide a list of ESG factors that we normally consider for a given industry, although only some of the factors listed are likely to apply and be relevant to any given company.

ESG rating drivers are part of the rating framework that is outlined in our general rating approach in addition to our specific approach to the sector: see our see our rating methodology for Consumer Products corporates.

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2. Important ESG themes in the consumer goods industry

The products we buy and use daily are inevitably at the centre of attempts to create more sustainable economies and improve human wellbeing.

Climate change and environmental degradation are significant threats which have risen fast to the top of the policy-making agenda in Europe. EU member countries have agreed on the European Green Deal which aims to transform the EU into a modern, resource-efficient and competitive economy, with some primary goals:

- reducing net greenhouse gas emissions by at least 55% by 2030
- achieving no net emissions of greenhouse gases by 2050
- decoupling economic growth from resource use
- ensuring no person and no place is left behind in a just and fair transition towards carbon neutrality.

"Achieving these emission reductions in the next decade is crucial if Europe is to become the world's first climate-neutral continent by 2050 - and for making the European Green Deal a reality. One third of the EUR 1.8trn investments in the NextGeneration EU Recovery Plan and the EU's seven-year budget will be devoted to the European Green Deal," according to the European Commission.

Consumer goods companies are, as a result, under growing regulatory and legislative pressure to disclose ESG-related performance. That, in turn, is vital if they want to benefit from green financing initiatives, such as green debt instruments co-financed by development banks or central banks, or sustainability-related state subsidies. Most of the subsidised green-debt financing programmes are aiming to ease funding for small and mid-sized corporates. Large players have in general good access to financing and issue green instruments for reputational; purposes and because coupons can be lower given increasing demand for green debt instruments from investors. Regulators sometimes incentivise banks by requiring less equity in financing green projects.

Large consumer goods companies are under pressure to examine their whole value chain when assessing ESG factors. Take the case of social factors. The safety of staff is a priority not just at the company's own sites but increasingly through the supply chain in addition, of course, to the safety of a company's products and services for consumers. Ignoring safety inevitably poses significant risk of scandal, damage to brand value and corporate reputation quite apart from the risk of regulatory sanctions as past incidents involving food poisoning and overheating electronic devices have shown.

For non-durable consumer goods suppliers, protecting their own suppliers and reducing waste are also priorities, for example, by providing support for farmers and supporting food banks. For durable goods suppliers, making sure that disposal of hazardous waste and recycling involving third parties meet high ESG standards can minimise financial and reputational risk.

Most elements related to ESG are relevant to the credit quality in the consumer products industry, but some themes are particularly important for durable and non-durable consumer goods companies:

1. **Recycling and product support**: encouraging use of recycled materials in new products and packaging, selling reusable or multi-use/multi-purpose products, favouring product compatibility and providing customer support, guarantees and repair services.
2. **Brand value which integrates sustainability:** associating brands with the circular economy by addressing climate change, improving sustainability, and adapting to regulatory shifts and new taxonomies favouring sustainable consumption and economic growth.
3. **Safety and labels:** using safe and environmental-friendly production processes and technology to protect all stakeholders, aided by transparent product labelling. Giving back to the society also labels a company (such as sponsorships for local communities, food bank, education / R&D support with mutual benefit)

Consumer products companies can improve sustainability across the whole value chain - from sourcing of raw materials to product use by end consumers – particularly by working more closely with natural resource producers such as farmers and mining companies.

For a discussion of the ESG considerations for retailing companies please see our 4 November report here.

2.1. Recycling and product support

Regulators, investors, customers and staff increasingly expect consumer-products companies to favour use of recycled materials in new products and packaging, to offer reusable or multi-use/multipurpose products. Ensuring product compatibility and providing customer support, guarantees and repair services are other priorities.

We detect the onus on consumer goods companies is shifting to leading the way on sustainability rather than simply complying with environmental and safety regulation which tends to be the norm today.

Non-durable consumer goods (food and drink, tobacco and personal care products) are under great scrutiny by consumers for taste, nutritional value, quality, price and other factors such as how the product was developed and tested and whether if fits a sustainable lifestyle. Recycled, sustainable or zero packaging and low emission footprints are becoming priorities as countries adopt ambitious climate goals.

Policymakers are eager to guide consumers toward healthier nutrition by taxing products which contain too much sugar, salt or fat, and increasing levies on tobacco and alcohol. They are also requiring more detailed mandatory labelling on nutritional facts and risks. Deposits are making a comeback to encourage recyclable packaging.

A company which recycles its own output - such as PET bottles, aluminium cans and other packaging – can significantly reduce its carbon footprint. In contrast, a company which buys recycled material from locations far from its production sites and does not collect its own output looks vulnerable to criticism of greenwashing. The energy needed for recycling and transportation may have a worse environmental impact than using new packaging material without any reduction in local pollution. Credible transition goals and pathways don't count offsets as stated in the Paris Agreement[1], putting pressure on companies to focus on recycling to reduce environmental impacts.

For consumer goods companies, recycling increasingly is a way to protect if not improve sales, profitability and brand value in the short to medium term by escaping regulatory-driven taxes which can make a non-recyclable product significantly more expensive (double digit %). Take non-alcoholic drinks. Owners of strong brands could pass on environmental levies on packaging to consumers through higher prices, but it could be harder for sellers without market leading brands and or less brand-sensitive drinks - such as bottled water which is often sold under local brands - to do so without losing market share and sacrificing profitability.

Plastic use is increasingly in the spotlight for the sector. The world's largest consumer goods companies are trying to reduce plastic packaging. However, results are mixed. There is huge potential to reduce plastic use, especially through more widespread use of reusable containers, smarter retailing methods, encouraging bulk-food buying, plus initiatives that promote the reuse of packaging, for example, for fresh food and ready-to-deliver meals. Producers, retailers, consumers and policymakers will all likely have a role to play.

Regulators and retailers will also have to work together in terms of reducing waste through local collection and recycling of packaging. In many cases, centralised collection makes the most sense, with costs borne by companies and consumers. For example, non-recycled rubbish is taxed by volume in Switzerland, for example, with a levy on garbage bags, or in Germany, by deposits paid by consumers for PET bottles, aluminium cans and glass bottles.

Durable consumer goods differ from non-durable goods not just by their longer product life but in the way they are sold. Think of the advertising money spent on convincing consumers to buy the latest fashion or products they did not know they needed. Marketing and building brand value are increasingly considers sustainability amid

[1] The Paris Agreement sets out a global framework to avoid dangerous climate change by limiting global warming to well below 2°C and pursuing efforts to limit it to 1.5°C. It also aims to strengthen countries' ability to deal with the impacts of climate change and support them in their efforts

shifting consumer preferences for clothing and wearables, household products (incl. electronics), sport & leisure equipment.

- **Fast fashion** might be starting to give way to worries about over consumption. The impact of the Covid-19 pandemic and new technology has made fitness a more important part of our daily life.
- Regulators are looked more closely at the **electronics** sector to reduce built-in obsolescence and lack of equipment standards. The aim is to guide companies to develop compatible products and accessories (such as chargers, cables, protective covers) and provide support.
- Pressuring companies to **recycle, repair and provide guarantees** for an extended period is also on the regulatory agenda. Often companies offer repair locally with reduced economies of scale compared with original production. Spare parts tend to be made in low volumes since products change over time, leading to higher repair costs than the original purchase price. France is one country where labelling is now mandatory on the reparability of products. Other EU countries have introduced measures such as minimum guarantees and repairs linked to the purchase price: minimum one-year guarantee for products priced up to EUR 300, increasing to three years for products above EUR 700.

Emphasising product reuse, repair, and recycling to enhance sustainability presents challenges to consumer products companies as it can come at the cost of sales of new products.

Relevance to our rating approach:

When assessing how a consumer goods company addresses risk related to recycling and product support, we focus on:

i) additional costs in providing longer product support (software updates, guarantees, repair etc) and hence lower future sales of latest-generation models,

ii) additional capital expenditure to reduce plastic use and enhance recycling,

iii) tougher regulatory expectations, more fees and fines, new rules for recycling and packaging.

2.2. Putting the circular economy as the centre of building brand value

Branding is at the heart of the consumer products sector. We expect companies to keep brand equity in focus as they address climate change, improve sustainability, and adapt to changes in consumer demand, regulatory shifts and new environmental and social taxonomies.

This applies to some degree to durable and non-durable consumer goods as consumers pay closer attention to nutritional quality and health risks associated with food and drink. Companies reliant on sales of blockbuster products will have to make sure they protect the brand value, while adapting and adjusting their product line-ups to match shifting consumer perceptions and regulatory concerns.

Still, the magnitude of these trends depends on the countries and markets in question. Levels of economic development and individual wealth are important as are the geographical setting (city vs rural), demographics, culture and other social trends.

What consumer products companies have in common is the risk that inattention to sustainability in terms of meeting, if not surpassing, regulatory requirements and changing customer preferences will erode brand value and ultimately revenues and profit. Avoiding this trap will require upfront spending in terms of capital spending required to adapt existing products, create new ones and reshuffle product portfolios. This will require expenditure on modern, energy efficient, low emission manufacturing equipment and logistics and possibly greater vertical integration. Helping companies make the change will be the government subsidies available in Europe.

Creating a circular economy also means more local sourcing of raw materials to lower transportation costs and emissions with the goal of more sustainable production with a diminished impact on the local environment.

Durable consumer goods producers are under great scrutiny by consumers for the materials they use, electricity usage, durability, guarantee, product features, product support – all vital components of brand value.

Building brand value for durable consumer goods takes time. Product lifecycles are measured in years. However, commercial reputations can be ruined overnight by bad press or regulatory breaches, eroding consumer confidence, sales and profitability.

Relevance to our rating approach:

When assessing how a consumer goods company addresses risk related to brand value and circular economy, we focus on:

i) the product-portfolio sustainability of the company and its impact brand strength (goodwill)

ii) policies to address loss of market shares due to change in consumer demand or opportunities to grow in new segments through M&A to reshuffle product portfolios, often under umbrella branding

iii) capital expenditure needed to keep up with regulatory expectations and new taxonomies, noting that delayed implementation to match regulatory deadlines can temporarily improve metrics

iv) changes in EBITDA margins due to sustainability-related changes in the sales mix and/or costs related to changes in the product portfolio: investment in new products, discontinued lines of obsolete goods.

2.3. Safety and labelling take on greater significance

Consumer goods companies are increasingly being scrutinised for safe and environmentally friendly production processes and technology as well as the quality of their relationships not just with staff and investors but also suppliers and other stakeholders.

We identify two main challenges related to the environmental, governance and social impacts and risks for the consumer goods industry at large and any assessment of a consumer products company in particular:

- Responsible product development for healthier living
- Responsible and fair raw material supply/trade for protection of the environment and people working in the manufacturing process

Safe production of **non-durable consumer goods** is tightly regulated in Europe and in most of the world: strict hygiene measures imposed by both regulators and retailers; regular audits and adherence to HACCP principles; pharmaceutical-grade products are regulated by the Good Manufacturing Practice (GMP).

We have seen rapid growth in the variety of product labelling: bio, vegan, vegetarian, fair trade, farmed responsibly, dolphin safe, MSC blue fish, “free” labels – lactose-free, gluten-free - and “non/without” labels such as non-GMO crops, artificial ingredients or taste enhancers. Labels guide consumers towards certain products, even if these labels can have inherent conflicts of interest: The revenue of such labels is often linked to product sales. The common goal is to guide shoppers toward sustainable, safe and nutritious food and drink where customers drive change instead of the regulators.

More detailed product labelling dovetails with growth in the market for organic food in Europe where consumers spend around EUR 56 on organic food per person annually (European Union: EUR 84). Per capita, consumer spending on organic food has doubled in the past decade.

In 2019, Danish and Swiss consumers spent the most money on organic food (EUR 44 and EUR 338 per capita, respectively).

Nevertheless, the annual expenditure per capita is still relatively low for organic food. We expect big brands to focus on labels and content behind them which could boost sales and margins as well, as consumer behaviour is clearly changing in favour of organic food.

Regulation and company self-interest should ensure that **durable consumer goods** are safe to use and with a long product life as they are comparatively expensive to buy compared with non-durables though there are clearly exceptions. Regulators are imposing longer guarantees, repair and support services on manufacturers and retailers, particularly to tackle the problem of electronic waste.

For manufacturers, keeping up with or getting ahead of regulatory requirements requires upfront investment to keep up with latest digitalisation, automation and improvements in energy and water consumption for household goods.

Relevance to our rating approach:

When assessing how a consumer goods company addresses risk related to safety, we focus on:

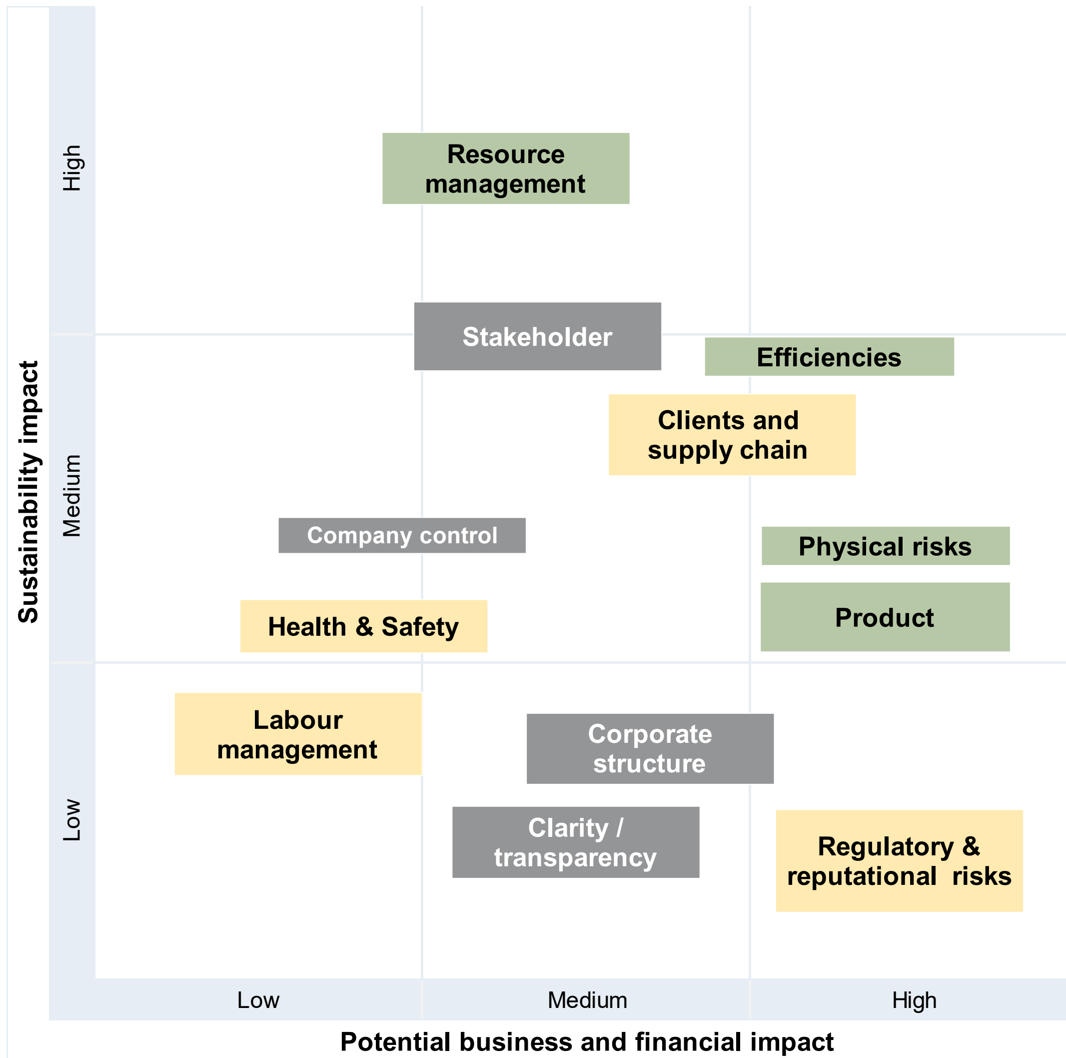
i) corporate governance

ii) investments into more efficient / greener / organic / sustainable product portfolio

iii) exposure to changing regulatory expectations, new taxonomies; vulnerability to regulatory fees and fines

3. Materiality of the ESG factors on the consumer goods industry

Our ESG framework includes various broader categories related to environmental, social and governance factors. We differentiate between the impact these factors have on sustainability and on a company's credit profile (business and financial risk). Not all ESG factors influence an issuer's creditworthiness to the same extent.



4. Typical ESG factors in consumer goods sector

Governance is generic and applies to all industries. How it is measured is therefore particularly important. The environmental and social factors listed here provide a realistic reflection of the risks and opportunities that a consumer goods company might face. The list below is non-exhaustive and expected to evolve over time.

Environment			
	Sub-Indicator	**Measurement/Indicator**	**Credit impact**
Resource management	Circular economy	• Use of recycled, renewable and eco-label material in all stages of manufacturing • Waste production (such as share of waste recycled, amount/treatment of hazardous waste) • Proportion of water that is reused/recycled • Proportion of water that is reused/recycled • Use of by-products	• Use of recycled, renewable materials could help lower production costs, thus increasing return on capital invested and/or higher operational cash flow. • Reduction of waste contributes directly to lower costs for materials, processing and disposal. • Use of by-products tends to increase profit versus cost of disposing them.
Efficiencies	Energy management	• Saving on energy and water consumption • CO2-emission reduction	• Lower energy and water cost • Lower waste-water cost • Lower CO2-emission cost
Product innovation	New products with healthier ingredients	• GMO-free, vegan, lactose-free, gluten-free products	• Higher margin compared to similar products with additives or non-diet products
Physical risk	Force majeure risks	• Assets that can be negatively affected by extreme weather/natural disasters such as storms, wildfires, flooding, and earthquakes • Assets located in regions suffering from extreme poverty, violence, and weak rule of law	• A high exposure to regions that suffer from extreme weather events or natural disasters leads to higher insurance premiums, a greater likelihood of asset non-performance and increased capex • Risk of stranded assets/asset impairments

Social			
	Sub-Indicator	**Measurement/Indicator**	**Credit impact**
Labour management		• Employee satisfaction, employee retention and turnover • Gender diversity • Gender pay ratio	• The greater the employees' satisfaction, the greater an employer's ability to attract and retain skilled staff, reduce turnover, control staff costs, and enhance productivity (less downtime, lower restructuring and litigation costs). • Staff-diversity reporting beyond the mandatory minimum can limit the risk of future penalties. • Increasing transparency over gender pay ratios can satisfy legislative scrutiny and mandatory reporting covering pay differences, such as those being rolled out across the EU.
Health & safety	Production safety	HACCP measures for hygiene and safety Good manufacturing practice	No positive impact - but protection against adverse impacts
	Taxation	So called "vice taxes," "fat taxes"	No added tax to products
Clients and supply chain	Local economic development	Share of local suppliers and contractors, inclusion of local retailers in the sales channels	High proportions of local suppliers, contractors can benefit a brand's reputation in the local market.
		Spending on social projects in local communities where the company operates	Can improve customer loyalty
Regulatory & reputational risk	Regulation	Adherence to and reporting on local regulations Adherence to and reporting on EU/US/other regulations	• Customer-friendly product content produced in a fair and sustainable manner enables regulatory compliance and contributes to a low-tax-rate product portfolio. • Avoidance of regulatory fines • Avoidance of potential costs to remedy production failures including potential impairments
	Reputation	Long-term goals	A focus on sustainable targets, instead of maximising short-term profit, helps establish the company's standing as a reliable long-term partner for all stakeholders.
		Consumer surveys / Consumption behaviour	Avoidance of reputational scandals, which, especially in the food industry, may have a long-term financial impact and large, short-term demand swings due to boycotts by consumers.

Governance	Sub-Indicator	Measurement/Indicator	Credit impact
Company control	Board structure and effectiveness	• Board independence • Competence and diversity of board members • Effectiveness of oversight, risk management and internal control mechanisms • Sustainability targets at board and executive management levels	• Ineffective board or lack of controls can result in poor decision-making and failure to achieve strategic goals. • Tight controls are vital to minimise fraud, theft and the misuse of company resources.
	Risk management	• Risk management framework and culture • Risk-adjusted return/performance measures	• Risk awareness at all levels of an organisation is crucial for effective strategic, operational and financial risk mitigation.
	Bribery and corruption	• Frequency and magnitude of bribery and corruption incidents.	• Adverse reputational consequences can lead to regulatory reprimands, fines, the loss of assets and/or the loss of operating licences.
Clarity/ transparency	Financial disclosure	• Timeliness and quality (GAAP) of disclosures. • Comprehensiveness of disclosure (e.g. on terms of loan agreements, contingent liabilities, related-party transactions, ownership structure) • Consistency in reporting formats	• Rapid and comprehensive financial reporting instils confidence and signals strong and effective internal controls. • Conversely: slow and incomplete reporting may signal weak controls, incompetence or attempts at concealment ('creative accounting').
	Transparency of communication	• Earnings calls and investor presentations that help stakeholders understand the company's performance drivers and strategic direction • Risk factor (including ESG-related risks) and sensitivity analysis	• Transparency is often associated with strong governance. • Understanding and openness about risk factors allows a company to hedge against risks and prepare mitigation strategies.

Governance			
	Sub-Indicator	**Measurement/Indicator**	**Credit impact**
Corporate structure	Complexity	• Complex and transparent ownership structure (nominee holdings hiding true owners) • Complex group structure • Complex debt structure • Significant related-party transactions • Aggressive tax optimisation strategies • History of frequent legal or regulatory infractions	• Opaque company ownership, cross holdings, and significant minority interests may hide conflicts of interest. • Complex debt structures can result in unexpected events of default and cross-acceleration. • Related-party transactions can disguise inappropriate diversion of company assets. • Aggressive tax strategies can backfire and result in unexpected tax penalties, negative publicity, and reputational damage.
Stakeholder management	Stakeholder relations	• Respect and balance of interests of all stakeholders	• Stakeholder disputes may have negative reputational and financial consequences.
	Shareholder distributions	• Financial policy clarity, consistency, credibility and track record • Board level endorsement of financial policy	• A clear and credible financial policy helps management meet strategic targets and manage stakeholder expectations.

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