

MODEL INSIGHT

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How Sustainable is Your Supply Chain?

Supply chains can often undermine business success, as we have seen prominently during recent years. There are clear incentives for identifying and managing ESG risks across the entire supply network. Insufficient assessments of suppliers' ESG risks and business practices may impact operations, leaving orders unfilled, causing reputational damage to both suppliers and clients, as well as impacting sales and firm security.

How can we evaluate ESG risk consistently and quickly across highly complex networks with global and multi-sector operations and the supplier network? How can companies screen the entire network to identify and mitigate ESG risks and achieve responsible sourcing?

- » While a corporation may manage overall ESG risk well, insufficient evaluation of supplier ESG-related risks can seriously impact operations, disrupting its entire supply chain.
- » The complexity of supplier networks makes it difficult for companies to know everything that happens in their supply chain and even more difficult to assess and monitor supplier ESG practices.
- » Moody's ESG Score Predictor estimates ESG scores consistently and quickly for all direct and indirect suppliers. It generates predicted ESG scores on any company, regardless of private/public status, using basic firm-level information such as industry, size, and location.
- » These predictive ESG scores enable corporates to detect potential weaknesses in the supplier network, profile vendors to scope assessments, and improve the sustainability and resiliency of the supply chain.

Moody's ESG Score Predictor provides real-time ESG assessments and climate metrics for SMEs and unlisted assets based on location, industry, and size.

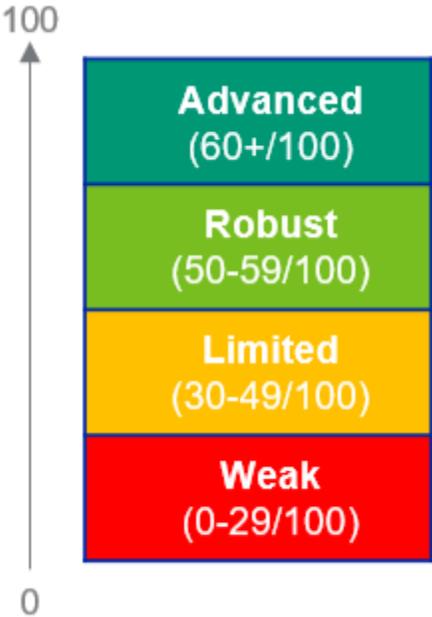
[Moody's ESG Score Predictor.](#)

We demonstrate ESG Score Predictor's ability to help improve supply chains by analyzing the ESG risk profiles of two European corporates and their suppliers. We evaluate individual ESG scores and compare these against peers to gain insights into supplier performance. We also categorize vendors to prioritize and plan the in-depth ESG risk assessment and mitigation strategy. Results show that, while corporate firms may have robust ESG risk management, their suppliers can show very poor ESG performance, leading to potential business disruptions as well as operational and reputational risk for corporate customers. Using ESG Score Predictor, we can easily identify ESG risk for an entire supply network and target due diligence areas, further evaluating the most relevant suppliers.

Company A produces luxury and fashionable leather goods, perfumes, and cosmetics company. Company B is a large fashion distributor. Both companies should be responsible for ensuring that decent social conditions are granted to suppliers' employees and sourcing responsibly. Company A should also guarantee the traceability of key raw materials and how various suppliers are managing the environmental impacts of production.

We begin by evaluating individual company performance using ESG assessment scales derived from Moody's ESG Solutions methodology (Figure 1). Scores range from 0 to 100, with zero indicating the weakest performance and 100 the most advanced management of ESG risks and opportunities. We also compare companies against peers to evaluate performance within the context of their operating environment and business models and identify leaders and laggards within selected groups. We construct representative peer groups based on companies' size, NACE Level 2 sector, and region using the Orbis database.

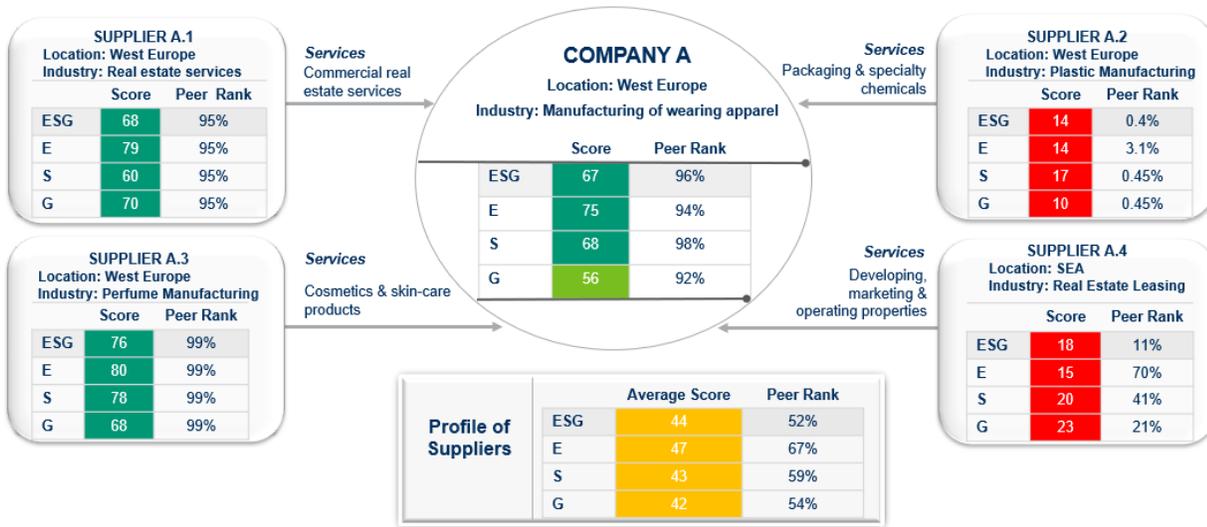
FIGURE 1. ESG Assessment Scale



Source: Moody's ESG Solutions

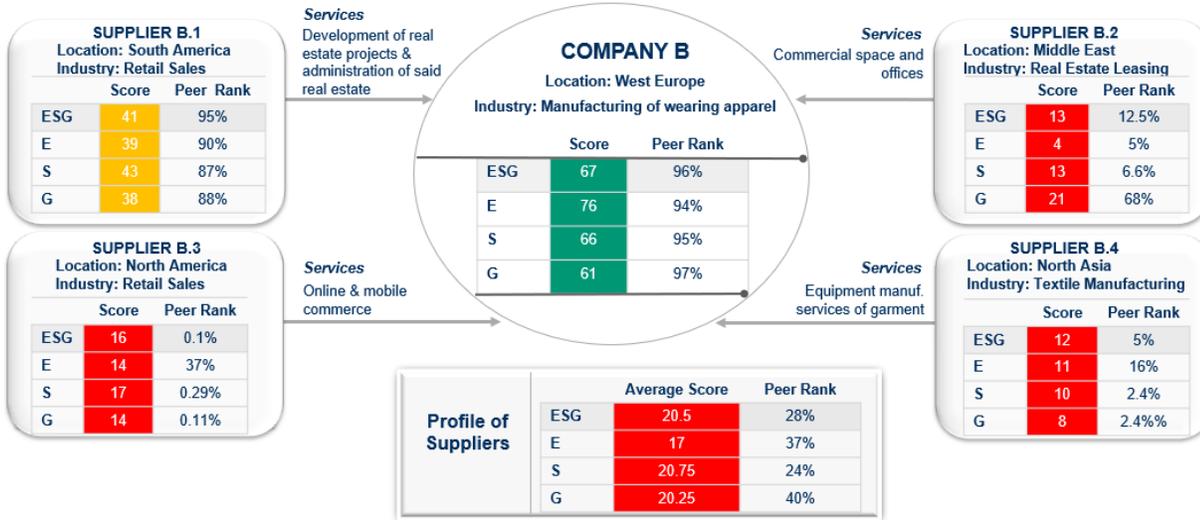
Figure 2 and Figure 3 show evaluation results.

FIGURE 2. Estimated ESG scores for Company A and selected suppliers



Source: Moody's ESG Score Predictor, Orbis, and Supply Chain Catalyst

FIGURE 3. Estimated ESG scores for Company B and selected suppliers



Source: Moody's ESG Score Predictor, Orbis, and Supply Chain Catalyst

Both companies show similar advanced performance in overall ESG, Environment, and Social scores. The Governance score ranks lowest among the ESG pillars, displaying robust performance for Company A and advanced performance for Company B, mostly explained by the limited performance that companies in the sector display on executive remuneration and anti-competitive practices. From a relative perspective, both companies outperform more than 90% of their peers in all aspects based on peer ranking. We consider Company A and B as leaders in terms of ESG efforts and practices.

The figures also include results of selected suppliers of Company A and B, as well as the average scores of the supplier network. Although they show the same company-level ESG score, the analysis indicates that Company A uses better sustainable sourcing than Company B, due to its suppliers' ESG outperformance. From both an absolute score and relative ranking perspective, the results suggest that Company A's supplier network has an average overall ESG score of 44 and performance above their respective peers. Company A may consider further engaging with its supplier producing plastic packages for cosmetics and perfumes, to establish a certain code of conduct or action plan to help improve the company's ESG performance and disclosures. As a plastics manufacturer, this supplier shows noticeable weaknesses in product safety, atmospheric emissions, and the health and safety of the labor force, among others. And Company A may be negatively affected by potential regulatory action or scandal. Company A may also consider looking for an alternative supplier if this one does not align with its overall ESG goals or mandates.

In contrast, Company B's suppliers show weak performance managing ESG issues and a relative performance below 70% of their respective peers. Within Company B's supplier network some suppliers show noticeable weaknesses in managing ESG issues, such as leasing and operating shopping centers. Due to limited resources and a less stringent regulatory environment, it is harder for firms to achieve the same level of sustainability, for example, a garment manufacturer in emerging markets in this particular case. As a result, Company B has higher exposure to potential disruptions in its supply chain suppliers are subject to legal actions or reputational costs due to ESG controversies or they may suffer from higher costs to improve their ESG ranking.

Using estimated ESG scores to screen suppliers allows corporates to identify potential poor performers and potential weaknesses in the network, helping boost the sustainability and resiliency of the supply chain.

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