All Angles Podcast
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Natural Capital

Practical Ways to Assess Financial Materiality for Companies

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Focus on portfolio exposure to sectors and companies with financially material risks

Investors seeking to analyze natural capital risks in their investment strategy can start from a broad portfolio perspective before narrowing in. We start by evaluating our position sizes so we can understand where we have the greatest exposure and then consider where natural capital risk is the most material within those sectors. For example, the food supply chain has a very high dependency on natural resources and also a great impact on them. At the issuer level, we consider how financially material natural capital is by understanding the dependence on natural resources for operations, goods and services and figuring out the hotspots within those supply chains. This involves identifying where the supply chains are located, whether they could disrupt operations for companies we own, investigating if companies are taking proactive measures to mitigate risks to their business and also seeing how exposed they are to risks further down the supply chain.

Following this assessment, our approach at this stage is to craft an engagement strategy with companies based on due diligence rather than advising them on specific actions:

- Are senior management even thinking about natural capital risks and opportunities?
- Have they identified and stress tested weak links in their supply chain?
- Are they investing capital and R&D to fix potential issues?
- And are they seeking to do this at scale?

Be aware of challenges to integrating natural capital analysis into investment theses

From our experience, three major challenges arise when developing investment theses to incorporate natural capital risks and opportunities. First, there may be a complex supply or value chain for impacted sectors. Our research into the food sector helped us to understand that brands are heavily reliant on grain trading companies to purchase raw materials, meaning brands have little visibility at the farmer level. This creates a challenge as brands have more ambitious targets to end deforestation across their supply chains than grain trading companies who don't see it as their responsibility to influence change; however, brands have little visibility into what is happening upstream at the farmer level.

Second, regulations are different across the globe. This means companies set their own policies based on the regulations of geographies in which they or their supply chains operate. Meeting zero deforestation or nature positive targets requires companies to act in place of governments by holding themselves to much higher standards than regulators do, which is a hard ask for companies when management teams are still incentivized on three- to five-year horizons. Understanding and following regulations is a critical part of the integration process as it helps to size and time the risks as well as provides context with which to engage with companies.

The third challenge is understanding the financial implications of the companies investing to solve natural capital crises before they hit the bottom line. It can be difficult for companies to provide guidance on the capex or R&D needed as they may not know what those figures are. It's complex but linking it back to financial materiality for an individual company is key because we are looking at major systemic issues for many companies and countries.

Partner with organizations and access existing resources to build knowledge

There are a number of different frameworks available to understand nature-related issues. The Taskforce on Nature-related Financial Disclosures (TNFD) is a good option for investors looking to engage with companies on improving disclosure. It provides guidance for financial institutions as well as sector guidance. The framework is already widely adopted from a climate perspective, so companies already know how to work it into their strategy. Organizations like Ceres and Asia Investor Group on Climate Change (AIGCC) are useful for issues around deforestation and change of land use. Each organization has its own niche, so it's important to consider which firm best aligns with the investment mandate.

The Carbon Disclosure Project (CDP) is a resource we find very helpful but is underused. CDP conducts forestry, water and climate surveys which are financially oriented with companies. For example, the surveys ask companies to size the percentage of their revenues that are dependent on different commodities at risk from deforestation, the proportion of their operations in water-stressed areas and the financial impact over three-, five- and ten-year horizons if the risks are not mitigated. These figures may not be available in companies' annual reports, but the CDP survey forces them to put numbers to these risks. While the numbers may be theoretical, they do require companies to carefully consider their responses and map the risks across their organization. This data is standardized and provides helpful context to have a conversation with companies.

We welcome the opportunity to discuss key sustainability themes with you. Please contact allangles@mfs.com and we will be happy to help.

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