

Commentary

Climate Change Impact and the Retail Sector: Focus on Large Retailers to Lead the Transformation

Morningstar DBRS

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Key Highlights

- Retail sector accounts for roughly 25% of the global emissions and 40% of the plastic usage globally.
- Regulatory mandates, changing consumer purchasing behaviour, and investor sentiment are causing retailers to redirect their capital investments and strategic planning efforts toward sustainable and responsible growth.
- No near-to-medium term credit implications for retailers but companies that lag materially or fail to achieve net carbon neutrality may see a negative impact on their credit risk profile in the long run.

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Near-to Medium-Term Impact of Climate Change Is Modest

The retail sector, including all activities along the full supply chain spectrum, is among the top 10 most carbon-intensive industries globally. The sector accounts for roughly 25% of the global greenhouse gas (GHG) emissions¹ and 40% of the plastic usage globally. In the UK, the British Retail Consortium (BRC) has acknowledged that the sector's annual GHG emissions are 80% higher than those of all road traffic in the country. The majority of the emissions in the retail sector are not generated through merchandisers' direct operations. Rather, they occur in the extensive supply chain, which includes the upstream emissions caused by manufacturing facilities and logistics activities to get merchandise to consumers, as well as downstream emissions related to product use and end-of-product-life treatment.

Despite not being directly responsible for the generation of most emissions along the broad retail supply chain, large merchandisers have faced mounting pressure from consumers, regulators, and investors to play a pivotal role in mitigating GHG emission risks and facilitating the entire sector's transition to a low-carbon footprint. In response, globally, these large retailers are committing to carbon neutrality targets by 2040–50. For example, industry association EuroCommerce² is targeting a sector-wide 50% reduction in GHG emissions by 2030 and aims to achieve net-zero by 2050. Although retailers across the world have made significant progress over the years to address both their direct and indirect emission responsibilities, there is still a considerable gap between the GHG emission targets and the results achieved to date.

While, in the near to medium term, we believe these climate change risks are unlikely to have a material impact on these retailers' credit risk profile, companies that lag materially or fail to achieve their GHG emission targets may see a negative impact on their credit risk profile over time. Additionally, we believe that the cost and efforts related to implementation of a net-zero emission target are important considerations for a retailer's operating margins, market competitiveness, and return on invested capital and could also lead to weakening of the credit profile and possibly negative credit rating actions over time.

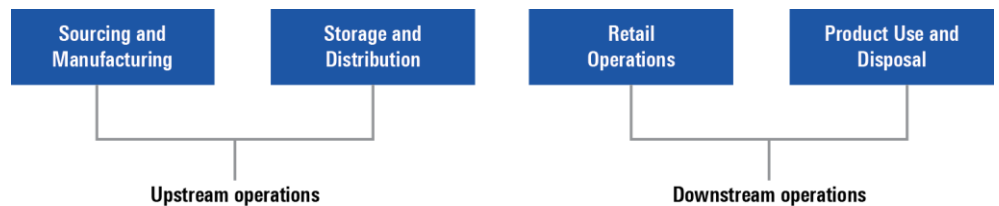
1. Source: Boston Consulting Group and Ascential's World Retail Congress

2. Members include 27 European nations; <https://www.eurocommerce.eu/members/>

Climate Change Affects All Stages of Retail Life Cycle

One of the biggest challenges for retailers in their climate change initiatives is the GHG emissions from upstream and downstream business activities such as procurement, transportation, and distribution; product use; and end-of-life processing (classified as scope 3 emissions under the GHG protocol). In various ways, large merchandisers are being held responsible for much of this exposure. Exhibit 1 (below) and the following text summarizes the main stages of the retail life cycle, their impact on carbon emissions, and retailers' possible initiatives to mitigate the climate risks at each of these stages.

Exhibit 1 Retailer Supply Chain and Emission Contributors



Source: Morningstar DBRS

Sourcing and Manufacturing: Retailers procure goods from their suppliers, consumer product companies, as well as contract manufacturers. Raw material sourcing by suppliers and manufacturers is a leading contributor to GHG emissions, especially for products that use agricultural-based, fossil fuel-based, or mined materials. Similarly, product manufacturing processes are another source of GHG emissions, especially for more capital-intensive goods, and we note that for private label products, large merchandisers are considered more directly responsible for any production process carbon footprints. For retailers, tracking GHG emission levels at sourcing or product manufacturing level can be extremely challenging. At the same time, this stage is extremely relevant as retailers are increasingly being expected to require their suppliers and manufacturers to provide/use lower-impact sustainable and environmentally friendly materials with relatively green end-of-life disposals, as well as include decarbonization considerations in all of their procurement and supplier arrangements.

Storage and Distribution: Retailers as well as wholesalers and distributors rely on storage and distribution facilities to ensure product availability and supplies. Product packaging materials used, miles covered, and the mode of transportation for these storage and distribution facilities are critical factors from a climate change perspective. For context, in case of an online order with priority shipping, last mile deliveries could have a larger impact as it increases the likelihood of air transport or deliveries via trucks that are only partially stocked, contributing to overall energy inefficiencies. To contribute to the reduction of carbon emissions, retailers can adopt energy efficient solutions, electric fleets, and recyclable packaging materials. Localization or near-sourcing are also emerging as much more efficient methods for retailers especially given the supply chain challenges witnessed during the post-pandemic era.

Retail Operations: The direct operations of retailers include activities and processes associated with the sale of the finished product to a consumer, and can occur through multiple channels. Generally, GHG emissions related to the sale of finished product to consumers through brick and mortar stores, ecommerce, or omnichannel facilities are typically much smaller compared to retailers' supply chain operations. For example, GHG emissions at a retail store primarily relate to energy use associated with lighting, heating, cooling, and refrigeration requirements, etc. Retailers' emission reduction efforts at this stage are pursued through store efficiencies and by using renewable sources of energy for power needs.

Product Use and Disposal: The product use phase is also a major source of emissions especially for electronics products, household appliances, and for some food items. Product disposal is another significant factor and a shift to recyclable or biodegradable materials is likely to materially reduce waste disposal requirements. For context, some fashion retailers are allowing consumers to donate, rent, or resell their clothes instead of discarding them, while hardline retailers have launched secondhand outlets or have committed to using recycled materials in their products. Consumer preferences for more energy-efficient products and increased awareness over time are also influencing retailers' selection of products for sale as well as their marketing strategies.

Allocation of Costs and Responsibilities Across the Value Chain

As is clear from the stages discussed above, retailers may have limited control over the scope 3 (or indirect) emissions defined earlier, other than supplier and product selection, but are required to calculate and provide regulatory disclosures on these GHG emissions all the same. Also, while the direct costs of abating these GHG emissions would primarily fall on suppliers or product manufacturers, retailers would have to evaluate the broader impact of the decarbonization efforts in their supply chains to understand trade-offs and interdependencies. As a result, retailers could see increases of at least 10% to 15% in their annual capital budgets and up to 8% jump in cost of goods sold in select categories,³ which we believe is significant.

Consumers and Regulators Demand It

Regulatory mandates, evolving consumer purchasing behaviour, and changing investor sentiment are all pushing retailers to redirect their capital investments and strategic planning efforts toward more sustainable and responsible growth. Our recent commentary on [The Body Shop's bankruptcy filing](#) highlights how today, these sustainability concerns are perceived as necessities by modern day consumers, rather than a differentiating factor. Many retailers are focusing on improving the sustainability credentials of their products—as well as their overall brands—as a core part of their business strategies to address stakeholder concerns. Retailers that lag materially or fail to achieve the transition to net carbon neutrality may also be penalized by regulators or in the capital markets and/or may fall out of favour with consumers.

3. 2022 report from McKinsey & Company

Capital Markets Crave It

Equity investors and lenders are increasingly considering climate change-related risks as they make decisions to invest in retailers, and also they have become increasingly conscious of how their own reputations are affected by the retailers they support. Although still relatively small, the market for sustainable bonds has grown exponentially in recent years and lower yields on green bonds are encouraging retailers to tap attractive financing for their decarbonization efforts. In 2021, Couche-Tard was the first convenience and fuel retailer to issue a green bond, raising \$350 million to support initiatives in clean transportation, renewable energy, pollution control, wastewater management, and green buildings. One of the UK's largest retailers, Tesco plc's first sustainability linked bond in 2021 was six times oversubscribed, reflecting strong investor demand for such initiatives. Fashion retailers including Chanel and Burberry, H&M Group, and VF Corp (owner of Timberland brand, \$500 million in 2023) have also issued green or sustainability-linked bonds to help achieve their environmental targets.

Climate Change in Our Approach to ESG Factors in Credit Ratings

Exhibit 2 Morningstar DBRS ESG Factors That Consider Climate Change

Environmental	Social	Governance
<ul style="list-style-type: none"> Emissions, Effluents, and Waste (G/F/C/S) 	<ul style="list-style-type: none"> Social Impact of Products and Services (F/C/S) 	<ul style="list-style-type: none"> Bribery, Corruption, and Political Risks (G/F/C)
<ul style="list-style-type: none"> Carbon and Greenhouse Gas (GHG) Costs (G/F/C/S) 	<ul style="list-style-type: none"> Human Capital and Human Rights (G/F/C/S) 	<ul style="list-style-type: none"> Business Ethics (F/C)
<ul style="list-style-type: none"> Resource and Energy Management (G/C) 	<ul style="list-style-type: none"> Product Governance (F/C/S) 	<ul style="list-style-type: none"> Corporate/Transaction Governance (F/C/S)
<ul style="list-style-type: none"> Land Impact and Biodiversity (G/C) 	<ul style="list-style-type: none"> Data Privacy and Security (F/C/S) 	<ul style="list-style-type: none"> Institutional Strength, Governance, and Transparency (G)
<ul style="list-style-type: none"> Climate and Weather Risks (G/F/C/S) 	<ul style="list-style-type: none"> Occupational Health and Safety (C) 	<ul style="list-style-type: none"> Peace and Security (G)
	<ul style="list-style-type: none"> Community Relations (F/C) 	
	<ul style="list-style-type: none"> Access to Basic Services (G/F/C) 	

G = Governments, F = Financial Institutions, C = Corporate Finance, S = Structured Finance: These denote the applicability of each factor to particular rating groups.
Source: Morningstar DBRS.

Within the *Morningstar DBRS Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings* (the ESG Criteria), climate and climate change considerations are included in several of our ESG risk factors. We apply the ESG Criteria to every Morningstar DBRS credit rating.

The consequences of climate change could generally result in an increase in an issuer's risk of default and/or a reduction in its asset valuation(s). The ESG factors associated with climate change that could affect a company's ratings are highlighted in the above table with bold lettering in Exhibit 2. See our commentary titled, *ESG: Climate Risk and Credit* for further details on our approach to the effects of climate risk on the credit analysis.

The retail sector finds itself confronting both physical and transition risks, as both these climate change risks have substantial implications for the sector. Since climate-related physical and transition risks vary from one region to another, retail companies, especially those with a global presence and extensive product portfolio, are focused on developing a business model that is resilient amid climate change uncertainty.

Physical Risk

Physical risks arise from the direct impacts of climate change, such as floods or cyclones, which can affect store locations or disrupt supply chains. While such events can cause widespread social, economic, and financial disruption, thus far these effects have largely proven to be temporary in nature as well as manageable. This, however, could change in the future should adverse weather events become more frequent or sustained as a result of climate change. Physical risks such as rising temperatures or changing rainfall patterns can negatively impact agricultural commodity supplies, affect energy requirements for retail operations, degrade infrastructure, as well as negatively affect consumers and/or employee health in a region. We note that severe outcomes have typically been concentrated in specific regions and/or geographies and can be partly mitigated through geographical diversification (for large retailers) and/or insurance coverage, although with regard to the latter, costs are rising and availability is declining.

Transitional Risk

For the retail industry, transitional risk, which arises from moving towards a lower-carbon economy, substantially refers to (1) regulatory mandates focusing on reducing GHG emissions, (2) shifts in consumer behavior and/or investor sentiment, and (3) legal implications. In our commentary, *ESG: Climate Risk and Credit*, we put forward the view that transition costs toward a less carbon intensive society were more imminent than the physical costs of climate change. Retailers face the challenge of transition risk, such as increased capital spending and operating expenses to comply with carbon neutrality mandates. For example, installation of solar panels at stores and distribution facilities or facility renovations to improve energy efficiencies, investing in electric fleets for transportation or sustainable products and packaging, can all result in some financial stress for retailers.

While these risk factors are not currently material enough to affect our issuer's credit ratings under our Merchandising methodology, and therefore are not considered to be relevant⁴ or significant⁵ for grocers or other retailers, we anticipate that the financial impact of transition risks could increase materially over time.

4. Relevant factor means that the impact of the applicable ESG risk factor has not changed the rating or rating trend on the issuer.

5. Significant factor means that the impact of the applicable ESG risk factor has changed the rating or trend on the issuer.

Credit Ratings Impact

In the near to medium term, we expect only modest effects of these climate-related physical and transition risks on the credit profile of our rated universe of well diversified retail issuers. However, the credit quality of these issuers could deteriorate as a result of the transition risks, if issuers incur significant reputation issues affecting brand strength and loyalty, operating or capital expenditures to comply with mandatory compliance norms and/or shifting consumer preferences and/or legal issues, without any immediate financial returns. Furthermore, there could be operational execution challenges if compliance-related product or process changes result in volumes or margin declines for a retailer. Therefore, some of these risk factors under our ESG criteria could become material in our credit ratings assessments over time under the Merchandising methodology and affect issuers that have not adequately invested in the transition to net zero and/or higher costs related to this transition has resulted in credit weakening for these retailers. These measures will also remain crucial to their credit quality in the long term because failure to comply with decarbonization efforts could affect a retailer's brand strength and loyalty base.

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