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ESG Engagement in Practice

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Many investors fear that applying Environmental, Social and Governance (ESG) criteria to their investments will reduce returns. We've found that needn't be the case.

Engaging with an issuer on ESG matters can help investors better understand the issuer's business risks better and track its progress in addressing them, which will help investors price its bonds better.

Investor engagement can also spur companies to reduce business risk, which can improve investor return. This paper explains our approach.

What Is Investor Engagement?

Investor engagement with corporations varies widely. At one end of the spectrum are investors that simply wait to receive annual corporate updates. At the other end are shareholder activists that demand representation on the board of directors so they can drive major changes in corporate strategy, and fixed-income investors who buy up debt of companies in crisis so they can negotiate the terms of a bankruptcy reorganization. We take a mid-spectrum approach: ongoing dialogue with management about ESG concerns in order to influence business decisions.

Make no mistake: ESG engagement meetings are quite different from traditional company meetings with investors, at which company managers "disclose" financial data that is already publically available. ESG engagement meetings are dialogues, in which investors express our ESG concerns and the disclosures we need to track progress, and the companies explain their ESG efforts. Not all meetings are productive, of course. Sometimes, one or both sides do not prepare properly. But at best, ESG engagement can be a virtuous circle that helps investors and companies to understand the company's risks and rewards better. Investors get the information they need to size up risks and assess whether market prices reflect the risks appropriately, while issuers can learn about emerging threats to their businesses that investors see. The company may also benefit from a lower cost of funding on future issues, if investors see the company better managing its risks or building a more durable business.

Integrating ESG into Credit Research

Credit research analysts of the Global Fixed Income (GFI) Team engage directly with issuers on important ESG issues as part of the 35-factor screening process we apply to all debt instruments. Analysts present engagement summaries as part of their reports to the GFI Team's Credit Committee.

ESG investing is still relatively new in terms of broad adoption, and both sides are still learning. We've learned it helps to focus on a few key ESG issues at meetings with companies, while some companies have learned to appreciate our questions about ESG issues and are becoming more proactive on disclosing relevant information.

We are now building a more nuanced analytical framework for our ESG analysis, and are creating ESG data sets that include key performance indicators that track a company's progress. Our tools also enable comparison across companies and industries. Focusing on these key indicators and asking for better data disclosures help us to capture changes occurring at companies that the backward-looking, third-party ESG scores miss.

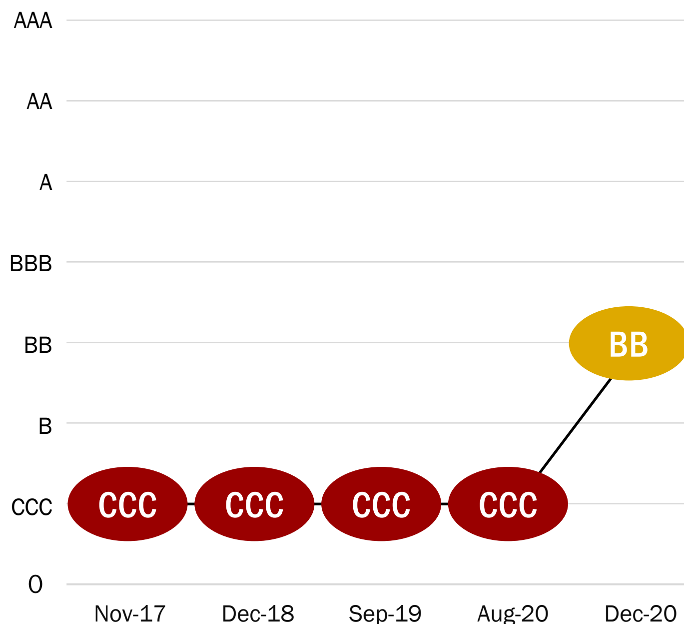
Taking a Forward-Looking Approach

For example, due to news that broke in 2016 about staff at a US bank opening fake customer accounts to meet productivity benchmarks, several third-party ESG score providers have

scored the bank toward the lower end of the ESG rating spectrum. Clearly, the bank had serious governance weaknesses that harmed its customers, its reputation and its growth prospects. The Federal Reserve punished the bank by limiting its balance sheet.

We have seen positive change at the bank since a new CEO took over in October 2019. The bank has adopted a simpler business model with reduced operating risk, and we expect outstanding regulatory matters to be resolved. Our credit analyst's engagement with the bank led us to see these improvements underway in Q4 2019, well before a third-party ESG data provider raised its ESG rating on the bank in December 2020.

FIGURE 1: MSCI ESG RATING HISTORY OF A US BANK



Source: MSCI ESG Research LLC

A Multi-Pronged Approach

We take a multi-pronged approach to engagement that we believe gives us a fuller picture of the investment opportunity and enhances our ability to influence the outcome.

For particular investments, the process typically starts before a new bond is issued and may continue until it is paid off. Typically, we meet with company management during investor roadshows for new issues to learn all we can. We also interact with the lead underwriters seeking to structure the debt. By expressing interest in being an anchor investor in a new issue, we gain an opportunity to encourage issuers to improve their ESG policies and perhaps include specific disclosures we can use to monitor progress in addressing them. We follow up with the company on specific areas of focus. In company visits, investor updates and investor conferences, we assess how much progress companies are making in achieving ESG goals and push for change. The ongoing communication allows us to track progress and build out our proprietary databases.

For example, we are tracking the US banks' lending exposures to the energy sectors to determine the risk these banks have if left financing stranded assets, like old technology carbon intensive energy sources, that have declining value.

More broadly, we meet with regulators and rating agencies to understand how they are trying to integrate ESG analysis into their own company analyses. For example, bank regulators recently announced they want to include some environmental factors into stress tests. We plan to watch carefully which factors they incorporate and how they measure progress. We also participate in investment industry groups to promote ESG principles and encourage their implementation.

We believe the cumulative impact of these efforts bends corporate outcomes in our favor, improving the risk-reward trade-off of investing in corporate debt.

New Areas of Engagement

Many companies are reluctant to declare themselves wholehearted adopters of ESG policy. We encourage these companies to look at ways to issue bonds with key performance indicators, such as meeting certain environmental targets. Reducing water use, for example, could significantly lower operating costs and liability for a paper company. Companies do not need to change their business radically to issue a green bond, but they must take an important step towards adopting ESG business practices.

Longer term, we'd like to encourage the industry to define what constitutes a green bond and eligible green assets. Ambiguity about whether a project is green creates reputational risk for the issuer and investment risk for investors.

Focusing on Material Concerns

We seek to engage with companies on ESG matters that are relevant to the investment, and where we can influence the

outcomes. While increasing recycling may have a material impact on the financial results and environment impact of a car manufacturer, it's likely to be far less material for a financial firm. Last year, a US auto manufacturer declared that by 2030 it wants to achieve at least 50 percent sustainable material content in its vehicles. For a financial firm, by contrast, increased recycling is less likely to be material. Even several relatively small such changes may not be worth monitoring. We've found that focusing on a few specific areas can create a better pay off.

Here is another example: in mid-2020 we looked at a large US real estate investment trust (REIT) with exposure to the hotel and travel sectors. Low occupancy rates across its hotel portfolio, related to the COVID-19 pandemic, was putting a growing strain on liquidity. The REIT wanted to refinance its bank line with term debt to alleviate near-term liquidity pressure.

Two key ESG considerations were relevant to the REIT's credit profile.

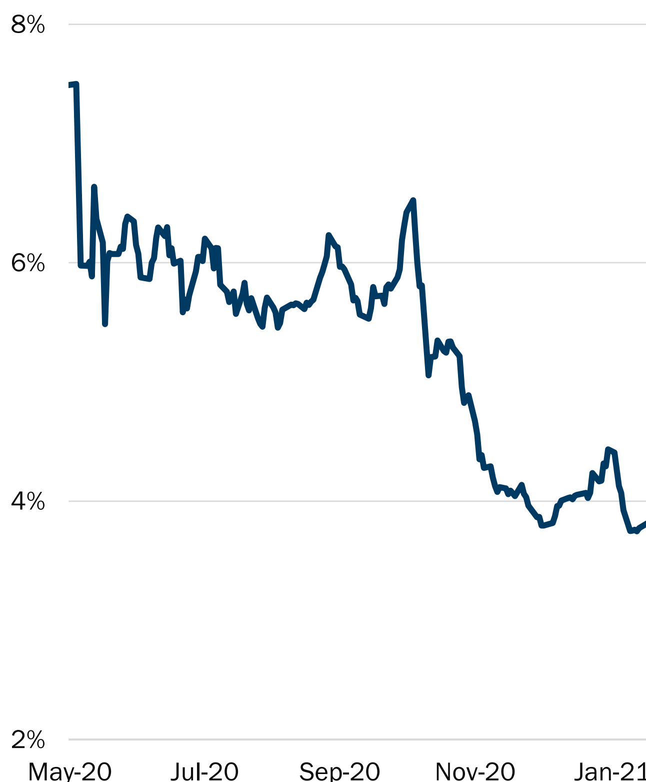
1. Governance: the REIT is externally managed, and the external manager's incentives were not necessarily aligned with shareholder and bondholder interests. As an example, the manager could look to increase leverage to grow the REIT's assets to bolster earnings.
2. Social: during the pandemic, a careless hotel operator could endanger public health and safety. This REIT provided accommodations to healthcare first responders, a contribution to public health that could offer public relations benefits if handled well.

We saw the REIT as an opportunity to participate in the US travel sector's potential recovery when the COVID-19 crisis subsides through a company with a large asset base. Traditional REIT bond covenants would give us some asset protection. The company also had some financial flexibility to weather the COVID 19-induced slowdown on its business.

We partnered with a large broker-dealer to approach the company about refinancing its bank line with an unsecured bond issue. During the due diligence process, we met with management and discussed our concerns that the external manager's interests might be misaligned with our own.

To protect our investment and address these governance issues, we worked with the company and broker-dealer to structure a bond with a full, unconditional guarantee on the REIT's US assets. The bond also has the first claim on the REIT's unencumbered assets. We anticipate these additional bond covenants will provide us with added credit protection if the economic recovery is slower than anticipated. Investors recognized the company's increased liquidity resources following the bond issuance and ability to manage through the COVID-19 crisis. These factors helped narrow credit spreads.

FIGURE 2: YIELD TO MATURITY OF REIT INVESTMENT: POWER OF ENGAGEMENT CREATES OPPORTUNITY



Source: Bloomberg

Next Up: Senior Debt of Banking Holding Companies

US financial regulators have made significant progress in requiring large, systemically important banks to issue senior holding company debt that shields taxpayers from the risk of having to bail out troubled financial firms again, as they did in 2008 and 2009. If a bank weakens to the point it might fail, existing shareholders are wiped out and the senior unsecured holding company debt holders become the new shareholders.

However, bond covenants provide few details about how bondholders would exert control if we become shareholders. Could we replace senior management with a new team we select? The GFI team plans to start talking to banks and regulators about inserting control provisions into future issues of senior bank holding company debt. Control features are essential to such a process, as well as to making the investments attractive to us and our clients.

Portfolio Implications and Asset Allocation

We have learned that our engagement efforts have a direct effect on reducing uncompensated risk within our portfolios. For example, we avoided investing in a certain global pharmaceutical company that was involved with aggressive acquisitions and pricing tactics that ultimately resulted in a management change. The strengthening of issuer selection across our credit portfolios in recent years is a testament to achieving long-term value for our clients. Ultimately, we believe the incorporation of ESG factors into corporate fixed income investment analysis augmented by active corporate engagement creates more durable investment portfolios, and these have a place in helping build out more sustainable multi-strategy portfolios.

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