The Rise of ESG Investing and Its Implications for Leveraged Finance Markets

- In this note, we briefly summarise the regulatory and political framework driving the market's focus on ESG and examine the quantitative link between ESG factors and returns.
- We also solicit leveraged finance investors' perspectives on their approach to ESG analysis.
- We intend to follow Part I of this report with the results of the survey, current obstacles to effective ESG analysis and recommendations for ensuring that leveraged borrowers do not fall behind both public equity and investment grade credit markets in their provision of relevant ESG-related disclosure.
- It is ELFA's view that further progress in this area will be required in order to enable high yield and leveraged loan issuers and investors to benefit from the growth of ESG investment mandates. We will continue to work with bond and loan market participants to ensure that efficient and effective ESG analysis is achievable.
- Our development of these resources falls within our mission to promote better disclosure and greater transparency in reporting so that investors can readily access material information necessary to their investment analysis.
- It is our objective to serve the buyside and work toward a healthy, growing debt capital market for the benefit of all.

Market and regulatory momentum mean that ESG is here to stay

The integration of environmental, social and governance (ESG) factors into mainstream investment mandates is on the rise as reflected in the growing number of fiduciaries who have pledged to adhere to the UN's Principles for Responsible Investment (the PRI). At the end of 2018, over 2,000 asset owners and investment managers accounting for just under $90tn of AUM had signed the PRI.

> The latest UNI PRI annual report highlights that 39% of the approximately $90tn AUM is represented by fixed income signatories

Indeed, growth in the number of funds with explicit ESG mandates is accelerating. 168 new sustainable funds launched in the first half of 2019, compared to 305 for the whole of 2018. Such funds' assets under management reached a record level of €595 billion at the end of June 2019, reflecting a 20.5% growth in six months. [1]

By integrating ESG principles into their investment processes, fiduciaries are not only responding to the demands of their clients, they also are acknowledging that the assessment of ESG factors alongside more traditional operating and financial metrics can enhance investment analysis and investor outcomes.

To date most of the growth in ESG oriented fixed income products has been in the investment grade mandates. This might well be a reflection of where investor demand lies, but it is worth noting that investment grade corporates have a distinct advantage over high yield when it comes to ESG investing, namely, the prevalence of MSCI-rated entities. Much of this advantage is attributable to the overlap of ESG-rated investment grade issuers with large-cap listed equities where MSCI has focused its efforts to date.

Given the higher proportion of privately owned and small-cap issuers in leveraged finance, the pressure to disclose ESG metrics has been slower to build. However, the tide has already started to turn. As ESG focused high yield and leveraged loan mandates grow in popularity and as high yield and leveraged loan assets are incorporated into ESG oriented multi-asset strategies.

[1] *According to Morningstar's European Sustainable Funds Landscape report published in August.*

Leveraged issuers will need to comply with the same demands placed on other asset classes. Leveraged borrowers who choose to adhere to the status quo of limited ESG-related disclosure will need to consider the implications for their access to the primary market and the cost of capital.

"[T]he business case for ESG investing is empirically very well founded...in general, increasing exposure to ESG rarely underperforms the market, and often outperforms the market, especially during the last few years".
- Axioma [4]

The impact of ESG risks on financial materiality – ESG impact on the bottom line

A clear link has been established between ESG factors and credit quality, and therefore investment returns. This has been confirmed by myriad sources, including a comprehensive study carried out in 2015.[2]

The study found a positive correlation between ESG and corporate financial performance, and concluded that "the business case for ESG investing is empirically very well founded". In addition, a study from Axioma showed that "in general, increasing exposure to ESG rarely underperforms the market, and often outperforms the market, especially during the last few years".[3]

Fund performance further supports this thesis. For example, the J.P. Morgan ESG Global High Yield Corporate Index has outperformed the conventional baseline index by 36bp since inception, with similar volatility, similar duration and a higher Sharpe Ratio. This has been achieved despite a modestly lower yield for the ESG index.

Indeed, private equity sponsors recognise the relationship between ESG and returns, and have aligned their own investment analysis with ESG factors, resulting in a greater volume of ESG-relevant disclosures produced in their investment process.

That ESG risks can cause significant losses for investors has been clearly demonstrated by a number of recent high-profile examples, such as the governance issues that were apparent in Carillion and Steinhoff, the numerous ESG related problems that have plagued Bayer's acquisition of Monsanto, and the rising investor aversion to financing the coal industry that has contributed to the bankruptcy filings of four major coal companies.

These instances have served to highlight that there are risks that often go beyond the business as it is conventionally depicted through the lens of financial statements, offering memoranda and investor meetings.

While it might be unrealistic for an issuer to admit that its corporate controls are weak and that its board is ineffectual or conflicted, we believe that a greater investor focus on such risks is warranted. This focus will expand the range of questions put to issuers and require an enhanced level of non-financial disclosures.

While enhanced ESG transparency will not in all cases spare investors the pain of the next Steinhoff, inadequate efforts to address investors' ESG-related inquiries could in itself provide enough of a red flag to drive active investors away. The threat of imparting a higher cost of capital on issuers that either disclose poor ESG practices or fail to disclose anything along these lines should be a compelling incentive for management to create better, more robust businesses.

Sources and quality of information about ESG risk currently available in leveraged finance

Investors in leveraged finance currently gather information on ESG risk from several different sources, and the quality and availability of the information varies greatly from company to company.

Morningstar reported in its European Sustainable Funds Landscape report that the one-year returns of 63% of sustainable funds finished in the top half of their respective categories, with 34.1% in the top quartile.[5]

2 *ESG and financial performance: aggregated evidence from more than 2000 empirical studies by Gunnar Friede, Timo Busch & Alexander Bassen*
3 *Thompson J. (2018) 'Companies with strong ESG scores outperform, study finds' Financial Times, 12 August [Online] Available at: https://www.ft.com/content/f99b0399-ee67-3497-98ff-eed4b04cfde5 [Accessed: 17 September 2019].*
4 *ESG's Evolving Performance: First, Do No Harm by Anthony A. Renshaw*
5 *According to Morningstar's European Sustainable Funds Landscape report published in August.*

Resources for management disclosure of ESG risk

- The Sustainable Accounting Standards Board (SASB) Engagement Guide for Asset Owners and Asset Managers available here
- The Task Force on Climate-Related Disclosures (TCFD) guide available here

Credit rating agencies are deepening their approach to ESG analysis. The traditional credit rating agencies, Fitch, Moody's, and S&P[6], are all becoming more explicit about their recognition of ESG factors in their research, including by way of dedicated scoring systems, improved transparency and disclosure, and more formal inclusion in the ratings processes.

At the same time, ESG assessment services, including MSCI, Sustainalytics, Trucost, and VigeoEiris, have introduced greater coverage and depth of analysis on these factors, increasing the influence and reach of ESG ratings and raw data. Most of the information used by ESG ratings agencies comes from publicly disclosed metrics, usually through comprehensively developed documents like annual reports.

This is resulting in more pressure on private companies to disclose more ESG metrics as they align themselves to either best-in-class or at least industry norm. For example, in the mining industry almost all presentations now start with the Lost Time Incident Rate in response to pressure from investors wanting to understand worker safety and possible labour disruption.

Given the increasing pressure on companies to provide more fulsome ESG disclosures, services have been launched to provide guidance to management on how to disclose and classify ESG risks, highlighted in the above sidebar. These resources can be helpful as they provide a common framework for disclosure that companies can rely on to measure, report, and track ESG factors over time.

Further, there has been an increase in norms-based screening tools, like activity screens from ISS Ethix, allowing for greater granularity and stewardship of how funds are deployed. As a result, participation in certain activities can lead to exclusion and these can be either any involvement or involvement up to a certain threshold (e.g. x% of revenues), and the failure to provide sufficient disclosure on more sensitive activities could cause companies to be excluded from portfolios. Despite the availability of these resources, however, inefficiencies in the production of ESG disclosure by leveraged finance companies have already started emerge. For example, many investment firms have developed bespoke ESG investment questionnaires that deal teams must work with management to complete individually, diverting significant resources as a result.

ELFA believes that it is essential for the informational needs of leveraged finance investors to be communicated directly to borrowers so that disclosure and reporting can be tailored in an efficient and effective way, and this report, along with the accompanying ESG survey, is our first step in contributing to this process.

The importance of establishing a coordinated approach to ESG disclosure and analysis – a call for comment

Given the increased level of information on ESG risk available to the market, ELFA believes that a coordinated approach to disclosure and analysis will facilitate an efficient flow of information to market participants and more effective engagement by investors with management.

Volumes of ESG relevant information is available from public companies, but investors must analyse the same factors for private companies, and often with far less information. Consistent presentation of information is essential to effective investment analysis. To the extent consistent metrics can be generated for specific industries, ESG analysis can become accretive to broader credit analysis whilst also being incorporated seamlessly into the offering process and in reporting.

[6] *Nauman B. (2019) 'Credit Rating Agencies Join Battle for ESG Supremacy' Financial Times, 17 September [Online] Available at: https://www.ft.com/content/59f60306-d671-11e9-8367-807ebd53ab77 [Accessed 17 September 2019].*

The alternative – varying questions from different institutions and divergent reporting from different companies – could stymie the financial markets by burying management and investors in red tape.

To support the development of resources for leveraged finance companies and investors, we have developed a survey for investors to complete that is designed to elicit their views on ESG disclosure, risk, and analysis.

In the second part of this report, we will make the results of the survey available to the public, and intend to use the information gathered from investors to create resources for the market to use as a basis for more efficient ESG disclosure and analysis.

ELFA's aim is to increase awareness of the importance of ESG analyses and create tools to support borrowers in their disclosures of these increasingly important metrics to the market.

-- The European Leveraged Finance Association
September 2019

Click here to take the ESG investor survey

About The European Leveraged Finance Association

Our Mission Statement:

ELFA seeks to create a more transparent, efficient, and resilient leveraged finance market while acting as the voice of its investor community. To that end, our diverse forum of investors engage with other industry professionals in order to educate and to promote best practices and transparency.

The Benefits of Being an ELFA Member:

- Quarterly educational seminars for member firms with leading industry professionals
- A forum to share ideas for improving the leveraged finance market, which can be reflected in the initiatives that emerge from ELFA
- Participation as a thought-leader to develop industry guidelines and standards to promote transparency and establish industry best practice
- Educational initiatives to assist member firms in discovering risk in documentary provisions
- Dedicated working groups for both bond and loan investors working to achieve both thei shared and unique goals

Upcoming Events:

7-9 October: Fixed Income Leaders Summit (FILS)
The Fixed Income Leaders Summit continues to position itself as the leading voice in the fixed income industry with 2019 set to be the largest gathering of fixed income professionals in Europe including the biggest buy side attendance yet. ELFA will host the high yield stream.

15-17 October: Debtwire Week 2019
Featuring a range of viewpoints on the themes that will dictate yields in the year to come. More than 100 speakers take part from the most prolific credit funds, leading banks and advisors. Members of our ESG committee will share their views on the topic during the third day of the event.

20 November: Restructuring Seminar with Houlihan Lokey
Join us in the evening on 20 November for a deep dive discussion on recent restructuring trends with Houlihan Lokey. Experts will discuss stressed scenarios, reviewing case studies and lessons learned. As we near the cycle's end, this seminar will give you the tools you need to navigate stressed and distressed scenarios effectively. to RSVP, contact sfox@elfainvestors.com.

Find Out More at: www.elfainvestors.com