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

Part II: ELFA's ESG Investor Survey Results and ESG Disclosure Roundtable

Executive Summary:

- In the first volume of our ELFA Insights series on environmental, social and governance (ESG), The Rise of ESG Investing and its Implications for the Leveraged Finance Markets, we described the growing trend of ESG analysis in European leveraged finance against a backdrop of increased regulatory and political influences driving investors to incorporate these factors into their investment analyses.

- We launched an ESG investor survey to determine the extent to which investors were already integrating ESG factors into their investment decisions, to understand their motivations for doing so, and to identify opportunities and challenges facing the market.

- In this note, we present the key findings from our November 2019 ESG Investor Survey, which received 100 credit investor responses.

- The results reveal that 70% of respondents already address ESG considerations as part of their investment process on at least half of their fixed income assets. Often however, there is insufficient data available on ESG metrics for high-yield issuers and leveraged loan borrowers, in particular for small-cap and privately-owned companies not covered by external data vendors. This presents a major challenge for conducting a comprehensive ESG investment analysis in the leveraged finance market.

- The finding that credit investors are increasingly including ESG as part of their credit analysis suggests that an increasing number of them consider information about ESG topics to be relevant and material to their investment decisions. Respondents also indicated that they believe improved corporate data disclosure could accelerate ESG integration amongst credit investors.

- The survey showed that investors see a role for ELFA in promoting more issuer ESG data disclosure, as there is an increasing need to establish a co-ordinated approach. Informed by these results, ELFA is initiating an engagement programme for 2020 with key stakeholders to develop a standard set of material ESG disclosure topics on which issuers and borrowers can be expected to report publicly.

- ELFA is liaising with issuers, private equity sponsors, deal arrangers, the UN-supported Principles for Responsible Investment (PRI) – as part of the PRI's initiative of ESG in credit risk and ratings – as well as other stakeholders, as we believe that a collaborative approach generates practicable outcomes benefitting all parties.

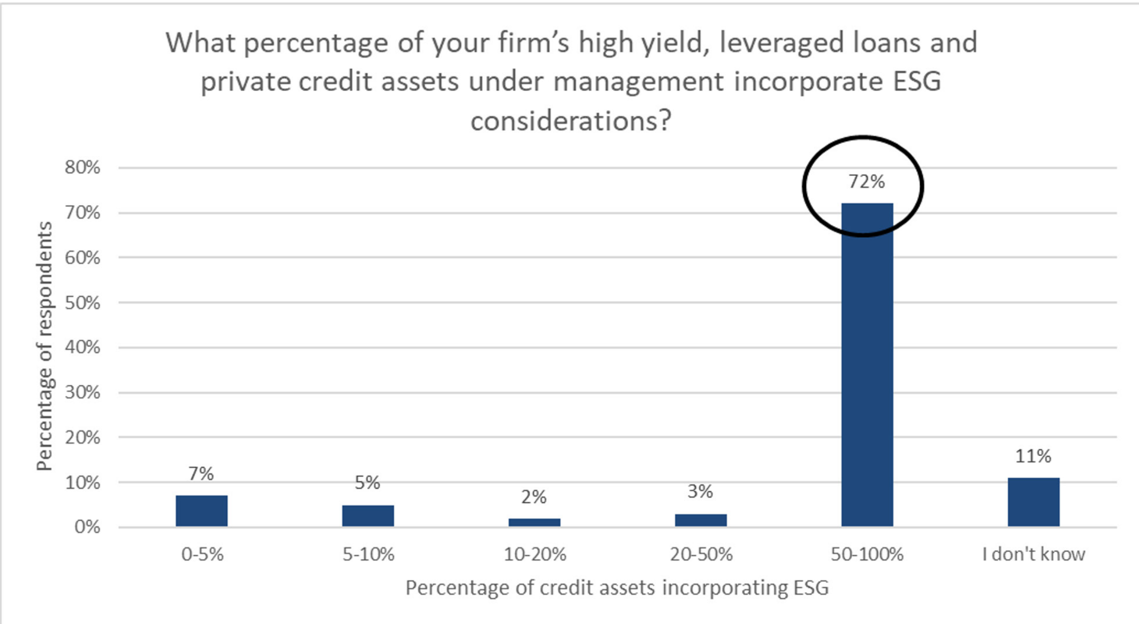
- We are joined in this initiative by the Loan Market Association (LMA), and our first event will be a roundtable with selected credit analysts and leveraged finance issuers organised with the PRI in London, with a follow-up session that will include credit rating agencies later this year. More details on this event will be announced in due course.

- We invite you to contact us if you would like to be part of this initiative.

Survey Background:
The ESG Investor Survey, which ran in November 2019, was developed by ELFA to gain insights on investors' views and practices on ESG investing. The online survey – comprised of 14 questions - was open to all investors, including non-ELFA members. In total, 100 investors from over 55 organisations participated, with approximately 90% representing firms managing high yield bonds and/or syndicated leveraged loans.

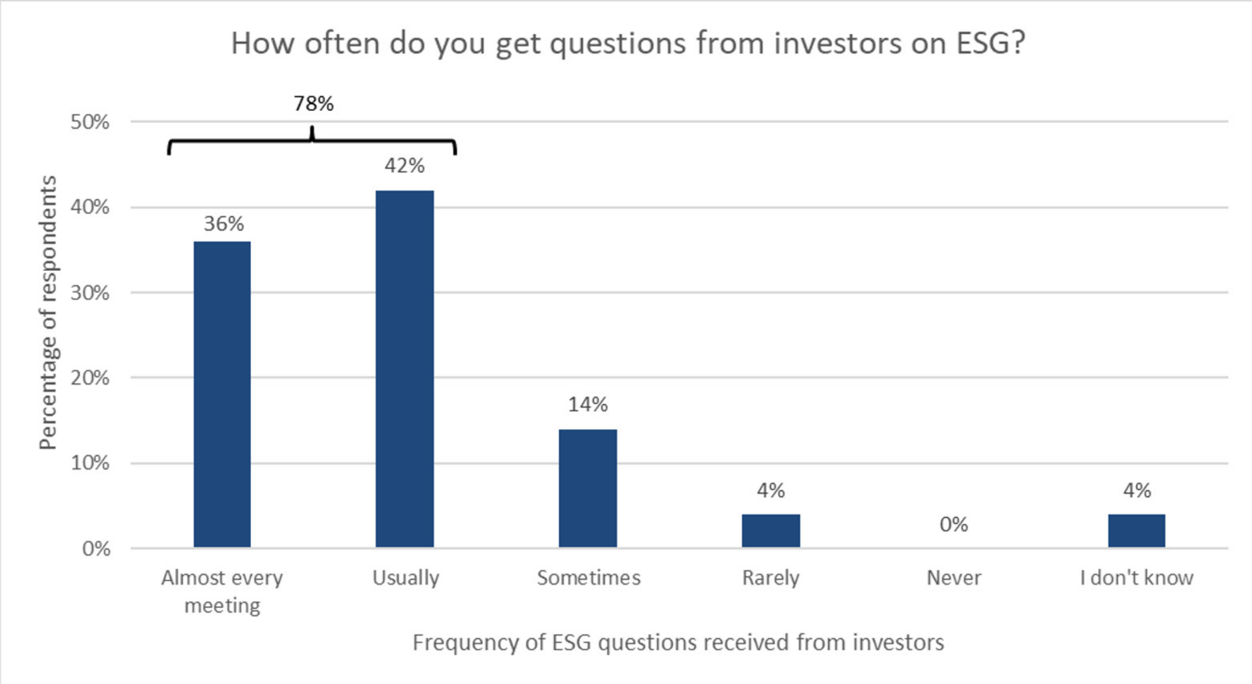
Credit investors are catching up on ESG

Of our survey respondents, over two-thirds (72%) already address ESG considerations as part of their investment process on at least half of their fixed income assets. Whilst arguably there may be some selection bias here, this is quite a remarkable statistic as there is generally the perception that credit investors are lagging behind their equity counterparts in integrating ESG considerations into their investment processes. It now appears that the gap may be closing. This is likely driven by (i) a growing recognition that ESG issues are relevant and can pose material risk to credit investments, and (ii) the fact that credit managers are more frequently asked to demonstrate their knowledge on ESG issues by their investors.



Source: ELFA, November 2019. No. of respondents: 100

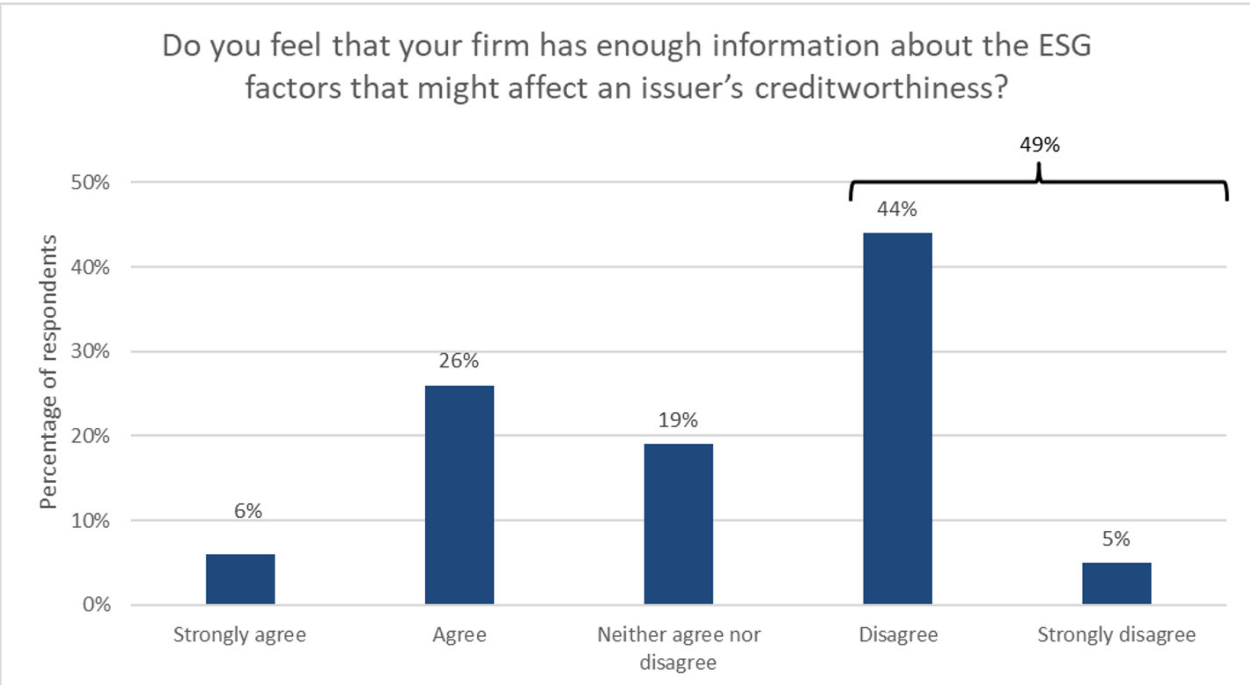
In response to why investors are considering ESG in their investment decisions, respondents cited a combination of 'push' factors (which are forcing investors to act) and 'pull' factors (which are encouraging them to act proactively). Of the 'pull' factors, respondents cited that integrating ESG enabled a more holistic credit research process (86% stated this was extremely/very important). As to the 'push' factors, over three-quarters of respondents revealed they usually get ESG questions from their investor base, with over one-third even stating that ESG factors are mentioned in nearly every investor meeting. Many also reported that they need to meet end-investor requirements for industry/company exclusions based on ESG concerns (58% of respondents).



Source: ELFA, November 2019. No. of respondents: 100

Investors believe corporate ESG data is particularly lacking in the leveraged finance markets

Most investors (approximately 70% of respondents) purchase ESG research on issuers and borrowers from external vendors. However, the survey results showed that investors believe that these sources lack meaningful coverage of high yield/leverage loan issuers, with nearly half of respondents (49%) stating they do not believe they have adequate information on material ESG issues that are relevant for credit investments. Such a finding is not necessarily surprising as the



Source: ELFA, November 2019. No. of respondents: 100 leveraged finance market includes a high proportion of privately owned and small-cap issuers with very limited public information per se, let alone data on ESG-related matters.

To fill the gap, investors seek other ways of gathering ESG information on these issuers. Most respondents conduct their own proprietary research (85%) and/or compile bespoke company ESG questionnaires (41%). No doubt, this adds substantial work for both investors and issuers as borrowers are faced with numerous – and different – lists of ESG questions coming from a range of investors, which creates inefficiencies for all parties.

Need for increased issuer ESG data to faciltate ESG integration

When asked what is required to enable more credit investors to incorporate ESG into their investments, investors agreed that improved issuer data disclosure is the most critical need.

Apart from better ESG data disclosure from issuers, 'push' factors that were mentioned included:

(i) increased research and evidence to make the business case for ESG;
(ii) the establishment of benchmark ESG indices;
(iii) an expanded ESG investment universe;
(iv) alignment in and incentives from central bank policies;
(v) increased awareness of and education on ESG issues;
(vi) expanded coverage of third-party ESG scores; and
(vii) a standardisation in ESG definitions and approaches taken by asset owners, credit managers and ESG data vendors.

'Pull' factors that were mentioned included:

(i) an increased demand from more asset owners, further incentivising credit managers to adopt an ESG approach, if they have not already, or market more ESG specific products; and
(ii) regulatory requirements on issuers, asset managers and asset owners.

Investors provided guidance on the most investment-relevant and material ESG metrics

Our survey asked investors to indicate the level of importance on a range of ESG measures. The highest priority (of importance) was assigned to the following metrics:

- **Environmental factors:**
  - Details on off-balance sheet environmental liabilities
  - GHG emissions/emissions intensity data
  - Environmental certifications
  - Waste management
  - Presence or quality of environmental management systems

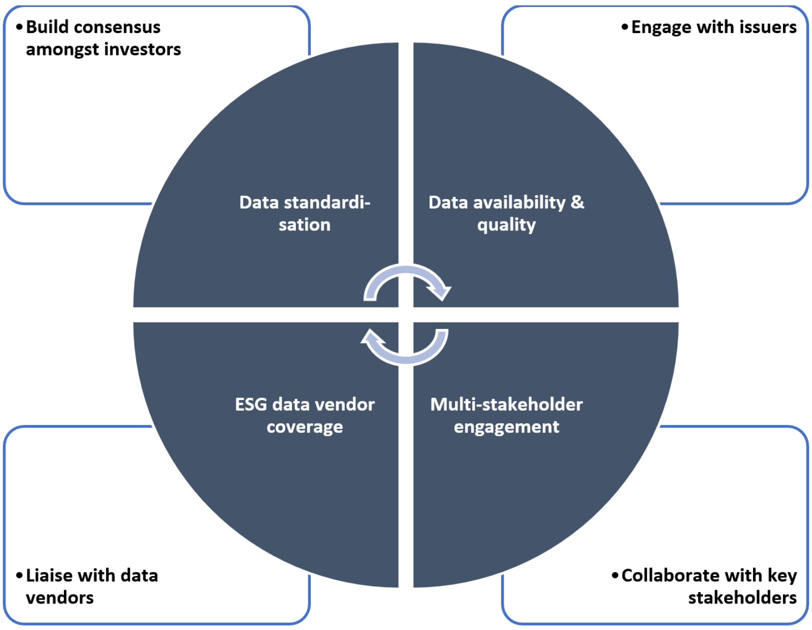
- **Social factors:**
  - Compliance with labour and human rights standards
  - Health and safety records and policies
  - Supply chain information (to evaluate labour risk profile)
  - Cybersecurity risk

- **Governance factors:**
  - Bribery and corruption policy
  - Board composition including diversity and independence
  - Management compensation structure
  - Independent auditor and turnover
  - Inclusion of sustainability objectives in management performance goals and alignment of pay

Investors see a role for ELFA in promoting issuer ESG data disclosure

Our survey asked an open-ended question, seeking investors' thoughts on how ELFA could support their ESG investing efforts. Across responses, ESG data was the overriding theme. Specifically, investors indicated that ELFA could assist in the following areas:

- **Data standardisation:** working with the investor community to build consensus around a single set of issuer/borrower ESG metrics, thereby facilitating some level of standardisation in the industry. This could include the promotion of existing frameworks (e.g. GRI, SASB).
- **Data availability & quality:** acting on behalf of investors to encourage issuers to disclose credit relevant ESG information.
- **Multi-stakeholder engagement:** collaborating with a range of key stakeholders, including issuers, private equity sponsors, deal arrangers, the PRI, industry trade associations and credit rating agencies, in order to promote ESG disclosure in the industry.
- **ESG data vendor coverage:** engaging with ESG data vendors to increase coverage of leveraged finance issuers including small-cap and privately-owned companies.



With a commitment to support its investor members and informed by these results, ELFA's Board has prioritised the promotion of ESG data disclosure as one of the goals for our 2020 membership year. We initiated efforts in late 2019 to engage with key stakeholders including issuers, private equity sponsors, deal arrangers, credit rating agencies and others in order to develop a standard set of the most relevant disclosures for the purpose of making informed ESG-related investment decisions.

We are joined in this initiative by the Loan Market Association (LMA), and our first event will be a roundtable with selected credit analysts and leveraged finance issuers organised with the Principles for Responsible Investment (PRI) in London, with a follow-up session that will include credit rating agencies later this year. More details on this event will be announced in due course.

We believe it is time for all market participants to recognise that ESG investing is here to stay and that a collaborative approach would yield benefits for investors and issuers alike.

If we have not already done so, please reach out to us if you would like to be part of this initiative. Contact our Executive Advisor, Sabrina Fox, at sfox@elfainvestors.com

About the European Leveraged Finance Association:

ELFA (the European Leveraged Finance Association) is a trade association comprised of European leveraged finance investors from over 30 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit the ELFA website: www.elfainvestors.com.