Principles for Responsible Investment

European Leveraged Finance Association

ESG IN CREDIT RISK AND RATINGS: BRINGING ANALYSTS AND ISSUERS TOGETHER

Sub-investment Grade Borrower Workshop - Part 3

The ESG in Credit Risk and Ratings Initiative is funded by the Gordon and Betty Moore Foundation through the Finance Hub, which was created to advance sustainable finance.

NOTES FROM THE WORKSHOP

The PRI's [ESG in credit risk and ratings initiative] is, for the first time, bringing voices from the corporate side into the conversation on how to better integrate environmental, social and governance (ESG) factors into credit risk analysis. This article summarises the key points from a workshop held with sub-investment grade (IG) borrowers, bringing together buy-side and sell-side credit analysts, representatives of credit rating agencies (CRAs), corporate finance and investor relations teams. This workshop, held in collaboration with the European Leveraged Finance Association (ELFA), is the ninth of the series [Bringing credit analysts and issuers together], as part of the ESG in credit risk and ratings initiative, which promotes a transparent and systematic consideration of ESG factors in credit risk assessment.[1]

The 19 May 2021 workshop was hosted in collaboration with the ELFA, reflecting synergies between the PRI's ESG in credit risk and ratings initiative and the ELFA's ESG disclosure initiative.[2]
The event was the third organised with the ELFA with sub-IG corporate borrowers and attracted over 50 market participants, including representatives from seven corporates from the transport sector and three sub-sectors of the healthcare industry: hospitals & care homes, medical devices and pharmaceuticals. Five CRAs and 30 investors from 19 organisations were also in attendance (see Appendix for the full list of participating organisations).

The discussions were held under the Chatham House Rule and were structured around a set of guidelines that were circulated to participants prior to the event and tailored by sector.[3] After the 2020 workshops, the PRI and the ELFA have published sector-specific ESG Fact Sheets and will add to the list over the coming months. These are designed to support borrowers in preparing ESG disclosure, and to facilitate engagement between investors and corporate borrowers on important ESG topics.

This report contains highlights from discussions held during the breakout sessions with companies in the healthcare (hospital & care homes, medical devices and pharmaceuticals) and transport sectors. Some observations were common or were covered in other articles of the series. In this report we address only new or sector-specific themes, and report on emerging solutions that participants have begun to consider.

Key findings of these discussions are grouped into four main areas, as follows:

1. Data: The main area of focus
2. Social risk: Measurement challenges
3. Transparency: Improving disclosure
4. Targets and pricing: Planning ahead

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[1] The workshops series follows a string of 21 roundtables organised for institutional investors' credit analysts and CRA representatives between 2017 and 2019. The discussions are documented in the trilogy, Shifting perceptions: ESG, credit risk and ratings.
[2] The ELFA is joined in this initiative by the Loan Market Association (LMA).
[3] The PRI initially published these guidelines after the Paris workshop, the first of the series. They will be refined as the workshops continue.

1. DATA: THE MAIN AREA OF FOCUS

Access to meaningful, standardised data and key performance indicators (KPIs) about internal operations and supply chains remained a frequent topic of discussion among corporate borrowers[4] and investors during the breakout sessions. Investors face difficulty comparing ESG metrics across borrowers due to the lack of homogeneity in reporting and data standards, often exacerbated by poor visibility into supply chains. The challenge of collecting data on multiple companies results in heavy reliance on third-party ESG ratings providers.

> "We tend to rely much more on discussions with management on how they behave and how they executed in the past. We find ourselves needing to explain how we come to the relevant scores because there is no one KPI, but rather it is more of a judgement call." – Credit rating analyst

Borrowers cite multiple reasons for the lack of homogenous evaluation standards, including different regulations by sector and region. A participant with operations in more than 10 countries said the reliability and quality of emissions reporting varies widely, creating concerns regarding its veracity. Another said availability of ESG data is weak in India, where it sources active pharmaceutical ingredients. Gathering and auditing ESG data and monitoring suppliers on related KPIs is particularly difficult for mid-sized companies.

> "We rely on third-party estimators for emissions projections. When factual disclosure has come along after we make our assumptions, the difference can be massive." – Corporate borrower

One medical device company said it looks closely at ESG issues and it may expand the use of audits to check on suppliers' ESG performance. Such audits are currently focussed more on issues such as labour rights than environmental issues. The participants agreed that the Sustainability Accounting Standards Board (SASB) Materiality Map was a key resource for identifying the KPIs relevant to a particular sector, including the medical devices sector.

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[4] Including debt issuers beyond loan instruments, such as bonds.

"The whole way we approach audit is changing and will change dramatically – the scope is increasing to cover ESG factors, and there are more questions about carbon impact in supply chains, which is currently hard to track." – Corporate borrower

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A transportation company has set science-based emissions targets to 2030, with individuals across business units responsible for implementation. One borrower cited a desire to participate in a sectoral pathway but wants to be confident that the roadmap is feasible before announcing goals it cannot meet. Supplier contract renewals were noted as an opportunity for ESG standard setting. One investor said it would tolerate margin compression if borrowers use suppliers with better disclosure.

2. SOCIAL RISK: MEASUREMENT CHALLENGES

Recruiting and retaining employees is the primary challenge described by health care participants. For investors, the lack of a common set of easily translatable disclosures across the industry is the main barrier to measuring social factors in ESG.

A participating company observed that, despite a recent 10-15% increase in pay in the hospital & care home sector in France, employee turnover did not decline. Beyond pay, a barrier to improving retention is the lack of career paths in a heavily regulated sector, where, for example, many care givers would need a nursing degree to advance. Retention can improve with good management and clear communication with employees. Labour shortages can impact balance sheets if there is an over-reliance on agency workers as this can be expensive, one credit rating analyst noted.

"Working with elderly people with certain physical needs and health issues such as dementia is not easy and requires specific skills." – Corporate borrower

Participants described a high dependence on patient and employee surveys assessing patient welfare, cost of care, staff satisfaction, patient experience and health care outcomes. While this is aimed at insurance companies, it also serves patients well and boosts employee engagement.

"The regular online surveys are becoming much more standardised, before they were more what the companies picked, so the benchmarks are getting better. If any investor would ask for the data, I would be happy to share it as this is our daily work." – Corporate borrower

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Employee surveys and Net Promoter Scores (NPS) are used heavily as a gauge of employee satisfaction. One corporate participant conducts employee surveys twice a year, leading to a specific action plan; directors have targets and bonuses tied to NPS scores.

3. TRANSPARENCY: IMPROVING DISCLOSURE

Investors want to understand where risks may arise; as such, they seek greater transparency within energy usage, supply chain footprint and reliability, cybersecurity (private data security), employee satisfaction, and the ESG consequences resulting from M&A transactions. Not disclosing a metric that is perceived to be readily available could raise a red flag unless borrowers proactively explain why it is not available.

One investor highlighted as good practice the weekly reports sent during the COVID crisis by one of its portfolio companies covering death rates, patient conditions, feedback from employees and how the company was managing the crisis.

"Having this kind of disclosure from companies was very helpful when having to deal with reputational damages from the headlines. If you are not willing to disclose the data to us when you say that you are doing the surveys, it can be a bit of a red flag." – Investor

Credit rating agencies, lenders, investors, and customers can all drive ESG disclosure and standardisation of data by asking relevant questions. To this end, the ELFA-PRI ESG Fact Sheets can help to reduce multiple duplicative questionnaires, but borrowers should consider being proactive in providing this information. In addition, the frequency of disclosures is important – these should be made not only during roadshows, but also as a part of regular periodic reporting.

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A pharma participant said that disclosure is driven by the regulatory framework, noting that the UK framework is the most advanced and is helping to raise the bar. Borrowers that improve ESG transparency may be rewarded with an increased sense of purpose and better performance on employee recruitment and retainment.

4. TARGETS AND PRICING: PLANNING AHEAD

Investors look to corporates to set targets to track the company's progress over time. Some targets are set too far in the future; investors would like to see shorter-term accountability and transparency on how the company is progressing.

One borrower developed a strategy around three pillars, with 24 concrete actions to deliver by the end of 2022, including energy and water consumption targets. A third-party vendor monitors the borrower's scope 1-3 emissions. The strategy includes implementation guidelines and monitoring, and management bonuses are tied to the targets.

"The monitoring is on a monthly basis and is done country by country and facility by facility, therefore covering the global operation of the group." – Corporate borrower

Investors also sought greater insight into M&A strategy, where disclosure can be limited. Investors seek disclosure on M&A rationales and on policies for integrating ESG factors into due diligence processes.

"We have a very clear process of integration when we have M&As, as that is common for us. . . I think we need to work on a specific program to deploy and integrate ESG practices and policies. It should be something like a 100-day integration program to be able to get the ESG policy standardised for the targets." – Corporate borrower

Pricing was a final area attracting discussion among health care stakeholders. Investors and credit rating agency participants expressed a need for greater transparency on how health care companies control pricing. Concerns include access to healthcare products and finding the right balance between the cost to society and the financial good of the company. It is difficult to measure the degree of opportunistic pricing behaviour, which is seen as threatening the social viability of the business.

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Target setting coupled with management incentives and disclosure will help investors assess progress on an interim basis. Greater insight into M&A strategy also reassures investors. On pricing, investors advised borrowers to increase disclosure about pricing committees, how they work, and any data related to the price-setting process, for instance, the frequency of increases.

5. SECTOR-SPECIFIC CONSIDERATIONS

The discussions highlighted several other considerations specific, but not unique, to the industries of the companies represented. The following are examples of areas where investors may request more information for ESG analysis, and where borrowers may seek to improve disclosure.

HOSPITALS AND CARE HOMES	PHARMACEUTICALS
■ Emissions related to distribution and warehouse operations ■ Sustainable packaging, food waste, recycling ■ Staff turnover, use of agency workers ■ Potential for regulatory intervention on staffing levels ■ Employee COVID vaccination levels ■ Sharing of value-based studies ■ Board level responsibility for cyber security ■ Workforce cyber security training ■ M&A disclosure below reporting threshold	■ Waste and water management, emissions, environmental liabilities ■ Patient safety, opioid exposure ■ Auditing of supply chain and frequency ■ Treatment of employees ■ Sourcing of Active Pharmaceutical Ingredients ■ Governance, quality and safety, business ethics ■ Access to healthcare products (affordability) ■ Increased disclosure re. pricing committees ■ Fines and cases related to regulation or lawsuits
MEDICAL DEVICES	**TRANSPORT**
■ Access to health care products, opportunistic pricing ■ Transparency on governance ■ Planning for ESG risks including: demographic changes, pricing issues, climate change, and ESG-related litigation ■ SASB Materiality Map as a key resource for identifying KPIs in this sector	■ Scope 1-3 emissions, energy consumption levels, initiatives in recyclability of on-board materials ■ Gender pay gaps, women in the workforce and in management ■ Incident rates and other health/safety metrics ■ Executive remuneration linked to ESG targets/criteria ■ Spending to influence policy ■ Data protection and security ■ Days lost to strikes ■ Tax payments ■ Legal/litigation costs

Keep up-to-date with the PRI's ESG in credit risk and ratings initiative and ELFA's ESG disclosure initiative

APPENDIX

Table 1: Participating organisations

Sector	Companies
Hospitals and care homes	Colisée, Mediq
Medical devices	Sivantos/WS Audiology
Pharmaceuticals	Atnahs, Ethypharm, Zentiva
Transport	Air France KLM

Investment institutions		
Alcentra	Colchester Global Investors	Oakhill Advisors
APG Asset Management	Janus Henderson Investors	Oaktree Capital
Bain Capital	JP Morgan	PGIM
Barclays	M&G	Rothschild & Co
Barings	Man Group	ZAIS Group
Capital Four	Morgan Stanley IM	
Cairn Capital	Muzinich & Co.	

CRAs	
DBRS Morningstar	Moody’s Investors Service
Fitch Ratings	S&P Global Ratings
Kroll Bond Rating Agency	

Other industry associations
Loan Market Association