INSIGHTS

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# ESG Workshop Briefing Paper: Autos, Building Materials, and Services

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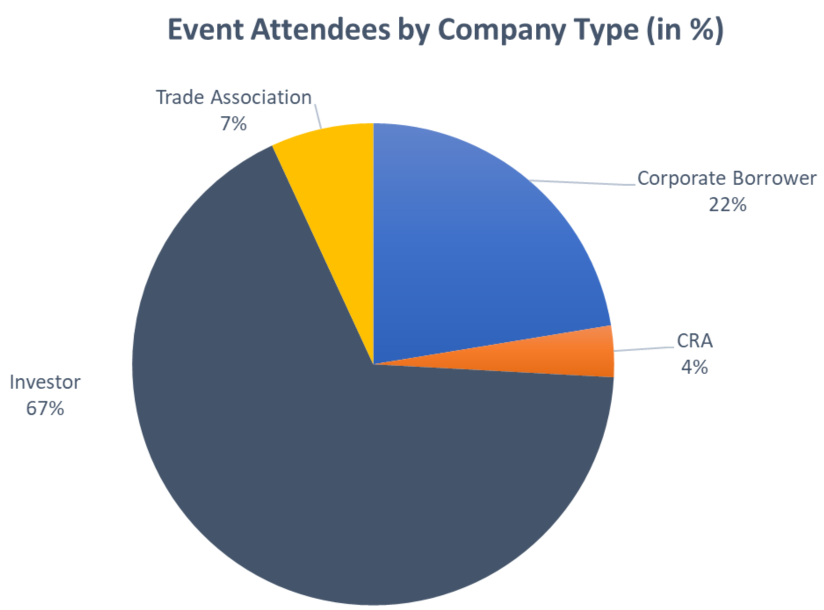
## Introduction

The European Leveraged Finance Association (ELFA) recently brought together sub-investment grade corporate borrowers, investors and credit rating agencies (CRAs) to discuss environmental, social and governance (ESG) topics relevant to the autos, building materials, business and consumer services sectors (see Table 1 for attendees). The events attracted over 70 market participants, including 18 representatives from 13 sub-investment grade corporate borrowers and 39 credit investors.

## Table 1: Participating sub-investment grade borrowers

| Sector | Corporate borrowers |
|---|---|
| Autos | Grupo Antolin, Faurecia Group |
| Building materials | Boels Rental, Loxam, Altadia Group, STARK Group, Xella |
| Services | House of HR, IQ-EQ, Empark, Verisure, VFS Global |

This was the fourth ESG Workshop presented as part of our ESG Disclosure Initiative, designed to increase ESG disclosure and deepen engagement between corporate borrowers and lenders in the European leveraged finance market. ELFA will use feedback gained from the workshops to develop ESG Fact Sheets for those sectors, which will be published in the coming months. ELFA's ESG Fact Sheets support borrowers in preparing ESG disclosure and facilitate engagement between investors and the companies to which they lend on important ESG topics.




The recent event follows those held in September 2020, January 2021 and May 2021. Each of these led to the publication of sector-specific ESG Fact Sheets and a sector-agnostic General ESG Fact Sheet. These ESG resources, and a Guide for Company Advisers to ESG Disclosure in Leveraged Finance Transactions, are available for download here.

We plan to host additional events for sub-investment grade corporate borrowers and credit analysts to incorporate additional sectors not currently covered by the existing ESG Fact Sheets. If you are a corporate borrower or a credit analyst and would like to propose a sector for inclusion in the ESG Disclosure Initiative, please contact Sabrina Fox, CEO of the ELFA, at sfox@elfainvestors.com.

## Our key findings from the workshop discussions are grouped into three main areas:

1. Positive progress achieved by companies in ESG data disclosure.
2. KPIs and standardisation within ESG reporting sought by investors; and
3. Governance and transparency remain essential focus areas for investors.

| Sector | Key ESG Considerations |
|---|---|
| Building materials | ▪ Carbon footprint of operations, energy management and water usage<br>▪ Insulation importance for net zero targets<br>▪ Raw materials handling and waste disposal<br>▪ Significant lawsuits relating to materials (note Grenfell issues)<br>▪ Circular economy<br>▪ Governance and transparency |
| Services | ▪ Health and safety of employees<br>▪ Employee satisfaction, engagement, training and churn<br>▪ Data security<br>▪ Consumer satisfaction<br>▪ Governance and transparency |
| Autos | ▪ Carbon footprint and transition of engine technologies<br>▪ Circular economy<br>▪ Product safety and quality<br>▪ Employee and customer satisfaction<br>▪ Governance and transparency |

## 1. Positive progress achieved by companies in ESG data disclosure

Since the start of ELFA's ESG Disclosure Initiative, borrowers have made good progress on their ESG journeys. Compared to September 2020, when we hosted our first ESG Disclosure Workshop in collaboration with the Principles for Responsible Investment, the conversation with borrowers has evolved from the foundational question 'why is ESG important to investors?' to the more nuanced 'what quantitative metrics do investors want to see disclosed from borrowers?'. This more substantive dialogue on ESG topics has emerged between borrowers and investors is a positive development in itself.

Regulation has been a critical driver of this acceleration in ESG awareness amongst borrowers across sectors, but especially in sectors such as autos which must undergo a transformation to be aligned with the EU's Green Deal.

Another key driver has been fast-evolving investor requirements, partly resulting from the increase in regulation and partly due to the increasing granularity of investor queries they receive. One investor participant mentioned that they are more focused on the principles of a circular economy in addition to topics such as climate change and governance, which is appearing more frequently in their conversations with borrowers.

**"Watch this space – we will be committing to targets soon."**
**– Corporate borrower**

## 2. KPIs and standardisation within ESG reporting sought by investors

Investors noted during the workshop a need for more disclosure from borrowers on KPIs, which should be consistent between companies within a sector, and for key metrics such as carbon emission, across the leveraged finance market.

**"We are conscious that stakeholders want to see more KPIs and data from us."**
**– Corporate borrower**

One investor recommended that when companies consider setting KPIs that these are:

1. material,
2. fair and balanced,
3. comprehensive, and
4. strategic and forward-looking.

These factors broadly align with our guidance on ESG provisions in term loans, published jointly with the Loan Market Association, available here.

Specifically, investors are looking for more quantitative metrics in addition to the qualitative disclosure that is currently widely used in reporting. More quantitative and standardised data would enable investors to compare a borrower's ESG performance versus peers. However, borrowers face significant challenges in deciding which KPIs to monitor as they need to be aligned with what is most important for that company and sector.

Collecting standardised data across different jurisdictions is also a challenge in need of a solution before consistent reporting can be the norm. One borrower noted in addition to jurisdictional requirements the mounting challenge of balancing the various KPI requests from different stakeholder groups.

There was a strong focus on GHG emissions data and energy consumption during the discussions. Several borrowers are planning to set formal targets internally on environmental performance, which is encouraging. With respect to social metrics, quantitative health and safety KPIs should be the easiest to track, collect and report, for example, the number of health and safety-related accidents or employee injury rates.

There are some challenges with collecting diversity and inclusion statistics, including local law restrictions on collecting certain data. However, some borrowers discussed the ease of tracking gender pay gap, and gender and age distribution. Ratios such as male-to-female representation in the workforce or on the board of directors is also easily tracked.

Human capital management is an essential focus across sectors and investors typically seek data on training, talent retention, employee turnover and satisfaction levels. Some borrowers also frequently track customer satisfaction levels, which data could be made part of corporate reporting. The lack of standardisation and therefore the comparability of social data between borrowers can be low even in the same sector. Data availability is compounded by hesitancy on the part of some companies to disclose this information.

Borrowers raised the challenges in setting KPIs for IT security and data protection, with some borrowers suggesting alternative disclosure like data on certifications, external audits, penetration testing, number of data breaches and number of hours of training.

**"We are seeing an increasing level of questions from LPs, who request data as per the EU taxonomy – but this data is not yet always available."**
**– Investor**

## 3. Governance and transparency remain essential focus areas for investors

Investors aim to assess several areas within the governance umbrella. One topic that was frequently discussed was whether executive/board remuneration is linked to meeting ESG performance targets to better align incentives.

However, investors are aware that this could also encourage a narrow focus on merely hitting these targets, rather than putting in place a holistic, sustainable business strategy more broadly.

Investors regularly seek disclosure on the composition of the board and board diversity, level of independence in control committees, and ownership control, amongst others.

**"Board diversity has been a key theme across all industry groups, we feel that issuers are still lagging with limited disclosure".**
**– Investor**

Investors are also seeking more transparency on covenant-related metrics to analyse the company's ability, for example, to pay dividends or acquire assets. Investors wish to understand on an ongoing basis how covenants are calculated, if there is any headroom, how EBITDA is adjusted, and how adjustments are verified.

Indeed, in our 2021 ESG Investor Survey, 75% of respondents said that disclosure of covenant capacity, and 67% said disclosure on levels of key covenant definitions (like EBITDA and net debt), are key indicators of strong transparency.[1]

Investors are focused on reporting on underlying trends in the business together with covenant calculated leverage and EBITDA. Investor participants noted that due to the multitude of adjustments permitted under the covenants, unless management provides this information it can be very difficult to estimate covenant capacity.

**"Every quarter, we report the covenant EBITDA for covenant calculations and we explain it. When you are new to the market, like us, you need to adhere to the highest standards." – Corporate borrower**

One investor said that he seeks to understand how the size of the financial control function changes as the borrower grows. Another investor said transparency in disclosure is essential, especially as acquisitions are frequent in the leveraged finance space, which can be hard to accurately model and forecast for a credit analyst unless the reporting is clear and easy to follow.

[1]Results from 65 respondents as of 22nd November 2021.



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