European Leveraged Finance Association

INSIGHTS

18 January 2022

ESG Integration in Leveraged Finance – Continued Focus Amidst Persistent Data Gaps: ELFA's 2021 ESG Investor Survey Results

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Executive Summary

- The ELFA ESG Disclosure Initiative was launched in June 2019 with a goal to increase ESG disclosure by borrowers and reduce the reliance by investors on individual ESG questionnaires. We subsequently launched our ESG Investor Survey in 2019 to gather investors' views about what could be done to address the challenges facing the market at the time. Those survey results have helped guide our approach to increasing ESG information over the last two years.
- The growth of ESG in the market over the time since that first survey has been stratospheric, so last year we conducted our second ESG Investor Survey to determine how best to continue our support of ESG in the leveraged finance market.
- In this Insights report, we present the key findings from the second ESG Investor Survey, which collated views from 66 investors representing 37 organisations.
- The results reveal a continued focus on ESG analyses across portfolios, driven in large part by end-investor requests for ESG data. Further, ESG continues to drive investment decisions, with 98% of respondents having passed on, reduced or sold out of investments due to ESG issues in the last 12 months.
- Availability of ESG data continued to stymie investors' ability to assess financially material ESG factors in 2021.
- Regulation presents additional challenges, with a significant percentage of investors unsure of whether they will report in line with the new EU Sustainability Finance Disclosure Regulation (SFDR), and more than half reporting that they would likely disclose (partially or fully) in alignment with the new rules.
- Credit investors appear to be moving away from negative screening compared to 2019, suggesting an increase in the use of ESG integration, likely demonstrating that European credit investors' approach to ESG analysis is evolving closer to that of investors in public equities markets.
- The survey also highlights the prominence of climate change risk assessment, and the role transparency plays in governance factors.
- Informed by these results, ELFA has initiated an engagement programme for 2022 with key stakeholders with a view to increasing the availability of quality ESG data.

Introduction

This report highlights key findings from ELFA's latest ESG Investor Survey of investors in high yield bonds and leveraged loans..

The ELFA ESG Investor Survey 2021 follows up on themes explored in our inaugural ESG Investor Survey conducted in November 2019. The latest survey provides insights into evolving ESG investing practices in the leveraged finance market. We will revisit these topics in an investor survey periodically, not only to track developments but also to inform the initiatives of ELFA's ESG Committee.

The ESG Investor Survey 2021 was again open to all investors (not just ELFA members) managing funds investing in high yield bonds and/or leveraged loans. In total, 66 investors from 37 organisations participated.

In this Insights report, we explore the following key findings from the ELFA ESG Investor Survey 2021:

1. ESG integration is impactful and drives investment decisions. Nearly all respondents noted that they have passed on credits, reduced or sold out of investments due to ESG issues in the last 12 months.
2. Further engagement with market participants is needed, including borrowers, arranging banks, private equity owners and others, as

there remain gaps in knowledge of ESG topics amongst key players in the leveraged finance market.

3. Consideration of climate change risk has increased in prominence since our last survey.
4. Under the EU Sustainable Finance Disclosure Regulations (SFDR), investment managers are more likely to launch Article 8 funds than Article 9 funds. Nearly a fifth of respondents reported that at least half of their high yield bond or leveraged loan AUM has been categorised as Article 8 or will be in the next three months.
5. Despite some respondents not being in scope of the SFDR, more than half of those investors plan to partially or fully disclose in alignment with the new rules.
6. Stakeholder reporting on ESG metrics is becoming more prevalent, increasing the need for borrowers to disclose metrics that funds' end investors are asking about.

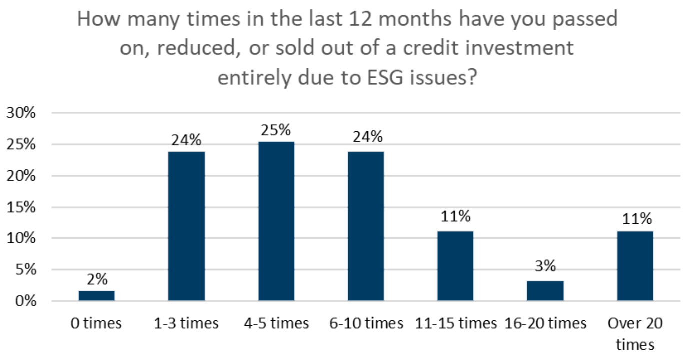
ESG investing in the high yield bond and leveraged loan market has evolved, but data availability remains a challenge

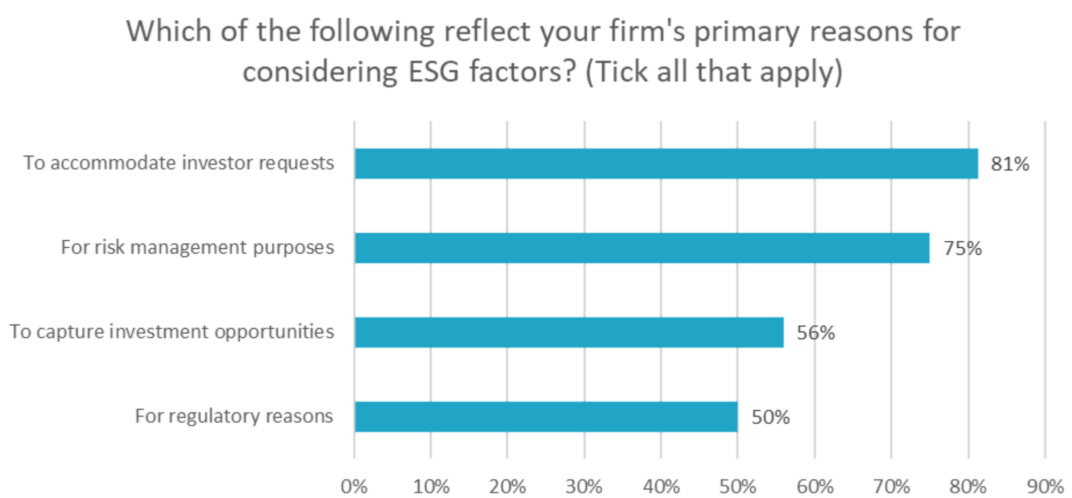
ESG analyses continue to be an integral part of European fund managers' investment processes. Seventy-seven per cent of respondents reported considering ESG factors for over half of their firm's high yield and leveraged loans AUM, with the vast majority (65%) incorporating ESG considerations for between 75% and 100% of this AUM.

The reasons for incorporating ESG factors into the investment process continue to be primarily driven by risk management and accommodation of end-investors requirements. The most common approach to ESG analysis taken by respondents is ESG integration, whereby ESG factors are systematically and explicitly included in the investment process (86% of respondents).

Regarding negative screening, in the 2019 survey 34% of respondents selected exclusions as one of the primary ESG approaches for their firm, whilst in the 2021 survey just over 6% chose negative screening as their primary approach to ESG investing. This suggests a likelihood that investors are using ESG integration more than previously and that the approach of European credit investors is evolving closer to that of investors in public equities markets.

The survey results indicate that ESG integration is impactful and drives investment decisions. It is clear from the survey results that ESG data matters, as 98% of respondents have passed on, reduced or sold out of investments due to ESG issues in the last 12 months.



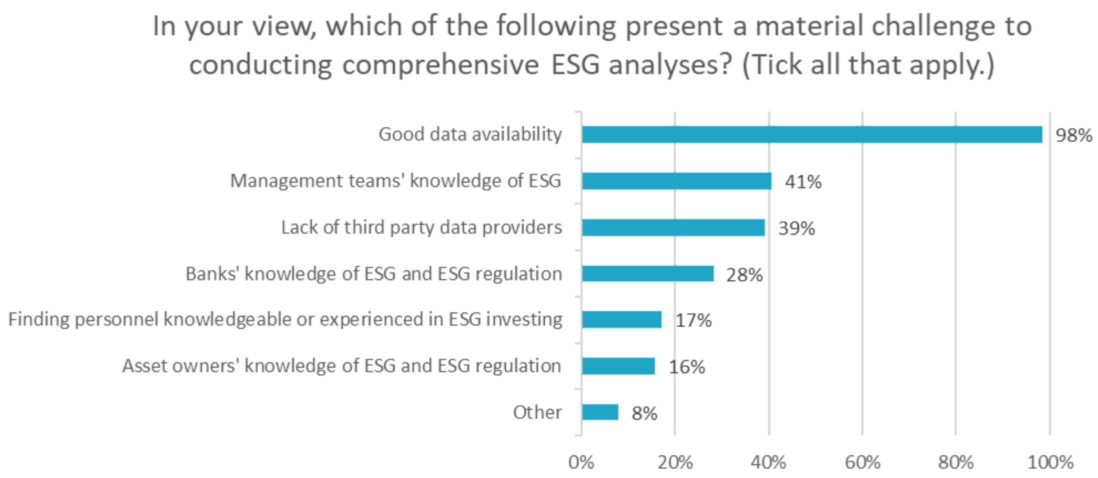


Challenges remain, however, and the availability of good ESG data continues to be the greatest obstacle to comprehensive ESG analyses, with ninety-eight per cent of respondents flagging this as an issue. Other challenges include gaps in knowledge of ESG and related regulations amongst management teams and other stakeholders, and limited coverage of the European leveraged finance universe by ESG data vendors. These are both topics that ELFA will focus on during 2022, as we acknowledge that ESG is evolving quickly, so it is understandable that management teams and other stakeholders struggle to stay on top of the most recent developments.

6. For sustainability-linked issuance, KPIs and ratchets need to become more challenging to meet for the issuers to drive substantial changes rather than often more business as usual targets.

SFDR leaves investors with many questions still to answer

Challenges presented to investors by the SFDR was among the prominent topics in 2021 that we expect to continue into 2022.[1] Seventy-one per cent of survey respondents reported being in scope for the regulation. Of those respondents not in scope, 53% said they would likely still disclose (partially or fully)



When asked what, in their view, could increase the growth of ESG investing in the high yield bond and leveraged loan market, respondents suggested the following:

1. Publication of research that demonstrates ESG adds value to investment decisions and positively impact returns in the leveraged finance sector.
2. Improvement in the availability of ESG data, including metrics, and standardisation in disclosure.
3. Third-party verification of ESG metrics/KPIs.
4. Raise awareness amongst market participants of the regulatory framework in the asset management industry, especially with banks and borrowers.
5. Increase industry-wide engagement with sponsors.

in alignment with the new rules, with 20% reporting that disclosures at the firm level will be aligned and 33% reporting that both the firm-level and product-level disclosures would be aligned.

Almost a fifth of respondents reported that at least half of their high yield bond or leveraged loan AUM has already been categorised as Article 8 under the SFDR or will be in the next three months. Significantly fewer respondents reported having classified or having plans to classify their high yield bond or leveraged loan funds as Article 9. This is likely because Article 9 fund categorisation is far more narrowly defined and more challenging to achieve for mainstream investors. This likely will result in fewer managers choosing to launch an Article 9 fund and, as a result, fewer Article 9 funds overall.

However, these results come with significant uncertainty from survey respondents about the new regulations – over 20% of respondents were

[1]Download ELFA's Insights Series report, SFDR's Disclosure Challenges – How credit investors and corporate borrowers can prepare, published in 2021 with our partners at Hogan Lovells

unaware whether their firm was in scope for SFDR, and of those not in scope, 45% did not know whether their firm would nonetheless report in line with the regulation's requirements.

Forty-one per cent of respondents reported finding the collection of the principal adverse indicators (PAIs) under SFDR level 2 text to be the most challenging aspect of compliance with the regulation. Of the PAIs, 84% of respondents reported that emissions data has the most focus from end-investors.

Investment managers are often questioned by their end-investors about SFDR classifications and reporting requirements, with 60% of respondents reporting being asked about SFDR usually or sometimes and an additional 10% of respondents reporting being asked always or almost at every meeting.

ELFA asked survey respondents for ideas on how to solve the data challenges posed by the SFDR – some of the suggestions we received are below, and ELFA will look to action these through our ESG Committee efforts:

1. Co-ordinated industry efforts to signal investors' need to disclose ESG data in line with requirements under the SFDR and Taxonomy to raise awareness amongst borrowers;
2. Standardisation of ESG data, especially from borrowers that do not have an external ESG score;
3. Engagement with ESG data providers to increase coverage of the European leveraged finance sector; and
4. More engagement with private equity sponsors, sell-side banks and borrowers to increase awareness of the implications of ongoing regulatory changes.

Climate change risk assessments increase in prominence

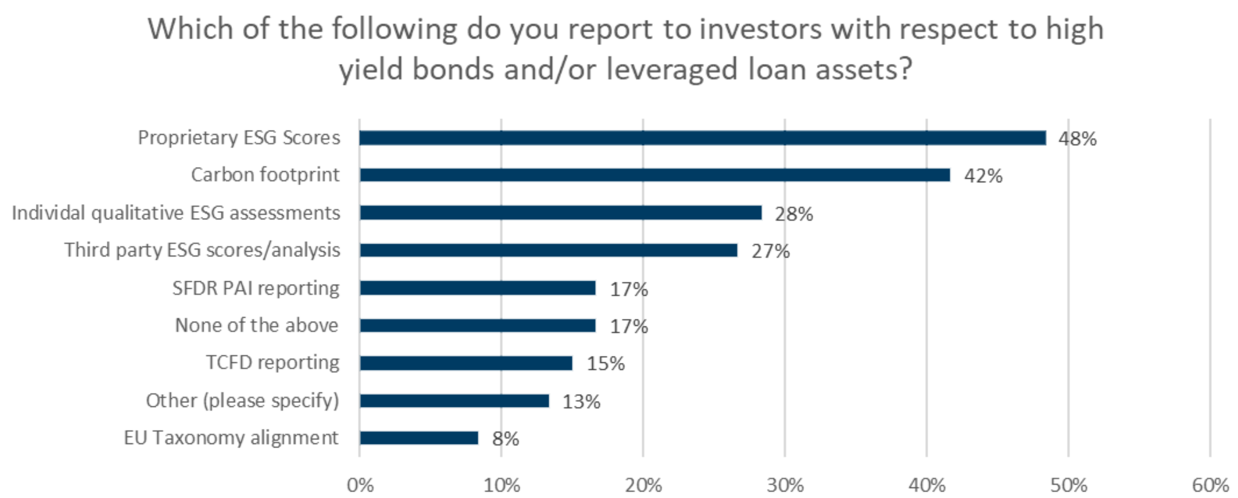
After the increased focus on climate change in 2021, partly driven by COP26 and partly due to the ever-increasing severe weather-related headlines across the globe, we included a section of climate-related questions in the survey.

Fifty-seven per cent of respondents reported that climate change risk is extremely or very important to their credit analyses, bringing into focus a significant data gap as most leverage finance borrowers do not disclose carbon data. Respondents reported using data derived from their internal research or received after sending bespoke questionnaires/ELFA ESG Fact Sheets to borrowers or from external data providers.

LPs demand increased and nuanced ESG reporting from managers

The increased focus on climate data is in part driven by end-investor demands – 73% of respondents reported an increase in questions relating to portfolio-level climate change risk data by end-investors over the past 12-24 months, including with respect to carbon emissions data and to what extent portfolios are net zero-aligned, with 40% reporting receiving questions usually or at almost every meeting.

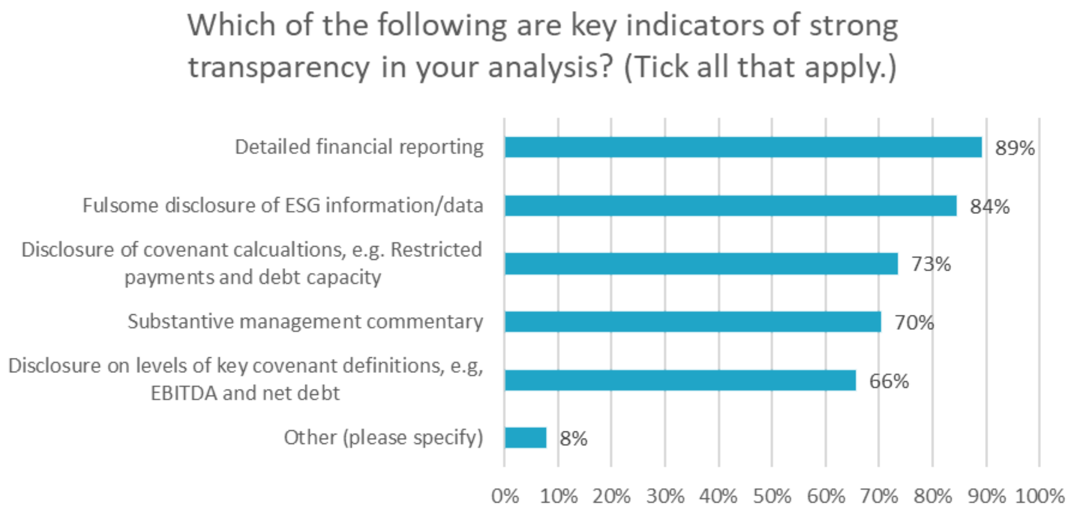
External reporting from GPs to LPs on ESG metrics is becoming more prevalent. Forty-eight per cent of respondents report their proprietary ESG scores to investors and 42% report the carbon footprint of their high yield bond and leveraged loan assets



Transparency in focus as a key “G” factor

Transparency in governance is to be of paramount importance to investors, with nearly half of respondents reporting that transparency is extremely important and almost 44% of respondents reporting that it is very important. We asked respondents which of the following are key indicators of strong transparency, with the responses below:

Respondents also noted that the level of detail provided on management calls and access to management and their level of responsiveness are key indicators of strong transparency.



Putting our survey results into action – how ELFA plans to implement solutions to support the growth of ESG in the leveraged finance market

Nearly 60% of respondents reported using completed ELFA ESG Fact Sheets in their ESG assessment of a borrower, and we are encouraged by these results. There is still some progress to be made with embedding ESG information as part of ongoing corporate reporting and reaching a level of standardisation in the data and KPIs being reported. Some of our plans for 2022 are set out below.

ESG Workshop for Advisers – 25th January from 3.30pm: We will continue to engage with a range of market participants, including private equity sponsors and arranging banks. During this workshop, we will consider updates to the Guide for Company Advisers on ESG Disclosure in Leveraged Finance Transactions so that it remains up-to-date with recent developments. If you are interested in attending the workshop, please send an email to ELFA’s CEO, Sabrina Fox, at sfox@elfainvestors.com.

ESG Data Providers Working Group: This year we are also leading a working group focussing on ESG data providers with a view to increasing leverage finance coverage and facilitating engagement on climate and carbon data reporting. To join this working group, send an email to Sneha Nayak, Research Analyst for ELFA, at snayak@elfainvestors.com.

Transparency in Covenants: The ESG Committee will work with the Disclosure & Transparency Committee to highlight the need for more transparency on covenants as this is increasingly an essential part of investors’ ESG analyses. For more information about this initiative, contact Sneha.

ESG Fact Sheets: We plan to further improve the ESG Fact Sheets by incorporating additional sectors and also by making it easier for borrowers to discern when investors want quantitative versus qualitative disclosures. If you have suggestions for additional sectors we should seek to cover, or on the ESG Fact Sheets themselves, send them to Sneha.

About ELFA:
ELFA is a professional trade association comprised of European leveraged finance investors from over 50 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. The 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's website: www.elfainvestors.com.

European Leveraged Finance Association
35 Ballards Lane, London N3 1XW
T +44 (0)7921 384457
E support@elfainvestors.com