European Leveraged Finance Association

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Engagement with Leveraged Finance Borrowers on ESG Topics: Perspectives from Investors at ELFA's Engagement Workshop

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Executive Summary

- Engagement is a dialogue between lenders and borrowers that is focused on positively influencing corporate behaviour.
- A credit investor's objective for engagement could be to drive impact, improve a borrower's ESG profile, or mitigate investment risk using ESG data.
- There are differences in how investors approach engagement depending on the asset class and region in which they operate.
- Engagement can be carried out with various market participants, including for example with borrowers, private equity sponsors and arranging banks.
- At ELFA's recent ESG Engagement Workshop, credit investors across the high yield bond, leveraged loan and private debt asset classes discussed the challenges and opportunities they face within ESG engagement.
- Investors noted that it is essential to raise awareness of why investors need ESG data and how they use it in their investment decision-making process.
- Investors also highlighted the need to educate counterparties about the various regulatory demands that asset managers are currently facing.
- Investors find that engagement on ESG topics is most challenging post-issuance.
- In some instances, investors prefer seeking collaborative engagement, for example, in situations when the borrower's management is unresponsive to their engagement efforts, slow to rectify ESG failings, or simply because joining like-minded peers carries additional weight and can accelerate change.
- There is strong LP interest in engagement on topics such as carbon footprint, energy transitions and net-zero commitments.

Introduction

As part of our continued efforts to support the growth of ESG investing and integration in the European leveraged finance market, ELFA recently held an ESG Engagement Workshop for member firms. During the workshop, participants discussed the steps that firms are taking to engage with market participants, including borrowers, private equity sponsors, and arranging banks.

This report contains highlights from discussions held during the event, split between high yield bonds and broadly syndicated leveraged loans (BSL) (discussed as part of a single group) and private credit.

Engagement and its Objectives

Engagement is a dialogue between lenders and borrowers that is focused on positively influencing corporate behaviour. Investor objectives for engagement could be any of the following: to drive impact in the real world, encourage borrowers to perform better by improving their ESG profile or mitigate investment risk by making a better-informed investment decision using ESG data. It could also be to support the borrower in making the transition to a greener economy and motivate borrowers to make a net-zero commitment. All these goals requires as a first step reliable and up-to-date ESG disclosures by borrowers.

Investors in private credit highlighted the differences in their engagement approach compared to large, syndicated deals. If you are the sole or lead lender, are lending to a family-owned business or have control positions in a distressed asset, engagement is usually more direct and relatively more straightforward.

Investors in the high yield bond and BSL asset classes noted differences across regions, for example, between the US and Europe, affecting how investors engage and the focus of their engagements. They mentioned that this is typically driven by the different levels of pressure from LPs across regions to measure the progress in and the impact of engagement activities, and the presence of mounting ESG regulations within Europe.

"Engagement could be a process of making a business (more) financially attractive"
– Private debt investor.

"It's about making a real impact."
– Private debt investor.

Investors noted that not only do they engage with individual borrowers but also with private equity sponsors and banks as, in their view, these parties all play a crucial part in driving change in the leveraged finance market. Investors particularly highlighted the need to educate market participants about the various regulatory changes that asset managers are currently facing.

Surprisingly, given their importance in the market, no investor mentioned engaging directly with law firms. This is a role that ELFA has been taking on, on behalf of its members, engaging with lawyers on how ESG language can be embedded in deal documentation.

"Engagement is educating issuers about what is changing in the asset management industry"
– HY bond and BSL investor.

What is the most effective form of engagement?

Engagement can take various forms, such as written correspondence, telephone conversations or face-to-face meetings. Workshop participants agreed that it is easier to engage with borrowers when they are marketing a new transaction. Although there often still remains a lack of detailed ESG disclosures at the time of new issuance, especially for high yield bonds where the content of the OM remains behind the times compared to what investors in these deals now expect.

In some cases, investors prefer seeking collaborative engagement, for example, in situations when management is unresponsive to their engagement efforts, slow to rectify ESG failings, or simply, because joining like-minded peers carries additional weight and can accelerate change.

In private credit, investors noted they must educate and engage with borrowers more patiently on ESG and sustainability topics. Their engagement approach is likely to take longer than engaging with companies operating in more liquid markets where investors may have voting rights or can more easily divest. Although some investors noted that engaging in private debt transactions has sometimes been more successful as they may have a greater stake in such investments and can, in those instances, more easily justify a dialogue with management on ESG topics.

What are the challenges to engagement for private credit?

It will come as no surprise that a lack of ESG data availability is the main challenge for investors in private credit, which hampers their engagement activities. In the first instance, engagement then focuses on improving ESG data disclosure by borrowers.

Investors discussed that in some cases borrowers do not respond to their engagement attempts or even if they do, their actions are at times not satisfactory.

One investor mentioned that it is essential to raise awareness of why investors need ESG data and how they use it in their investment decision-making process. Educating borrowers along the way is part of the journey. Another workshop participant mentioned that they provide borrowers with a list of ESG resources that borrowers can use to help them get up to speed on how sustainability can be helpful and potentially value-additive to their businesses. One investor noted explaining to borrowers that when companies get sold, investors providing buyout financing will likely want to discuss their ESG profile, so it is beneficial for borrowers to be on top of their ESG data.

Investor participants agreed that being on top of your ESG profile and being able to engage well on ESG topics with lenders is a good proxy of how well the management team is managing their business.

"When we did our carbon foot printing of one of our largest private equity funds, when we started, a high percentage of borrowers did not know what carbon foot printing was."
– Private credit investor

"When a borrower and sponsor are just not engaging, then you need to think about what this tells you about them and their management team."
– Private credit investor

What are the challenges to engagement in the syndicated leverage finance market?

In the high yield and BSL break-out session, investors noted that it is likely to be more challenging to engage on ESG topics post-issuance. Although another viewpoint is that compared to investment grade businesses, access to high yield and leveraged loan borrowers is at times much better, as investors often have more direct access to management.

Investors discussed how they are keen to discover new tools and resources, ideally sector-specific, to support their engagement activities. One investor mentioned that Chemscore was helpful to them, which ranks the world's top 50 chemical producers on their work to reduce their chemical footprint, albeit focusing on the largest companies.

Finding a method to prioritise an investor's engagement activities can also be a challenge and investor participants shared how they addressed this within their own organisation. One investor said they are prioritising engagement topics by materiality; in addition, if a company is not disclosing sufficient ESG data, this triggers engagement with the company. Some investors set a timeframe during which they expect to see improvements on the borrower side. Another investor mentioned assigning two sector-specific engagement criteria to each borrower, which are both measurable and deliverable.

What are the most popular engagement topics?

In the private credit session, investors mentioned the strong LP interest in topics such as carbon footprint data, energy transitions and net-zero commitments. LPs often look for anecdotal examples of how fund managers engage with underlying borrowers.

In the high yield market, similar engagement themes arise, and investors noted that disclosure of a company's carbon footprint is relatively good in this space, especially for large-sized companies. Smaller companies may be willing to provide this data but may struggle with a lack of resources. One investor mentioned that, for some of their smaller issuers, even SASB reporting standards are too ambitious. This is where the sector-specific ELFA ESG Fact Sheets can be very useful as a resource for borrowers that fills an important gap in the leveraged finance market.

Investors, however, highlighted that very few companies have come up with an actual plan to be net-zero by 2050 in either the high yield or BSL markets.

How are engagement activities tracked and reported?

Most investors reported that their engagement activities are tracked through internal systems. End-investors may request engagement activity data, for example, the number of companies engaged and the number of engagement topics. There is also a strong interest in sharing engagement case studies.

Some investors hold a quarterly meeting where progress towards engagement targets is checked.

Workshop participants noted that quality control of information captured in this process is essential to ensure consistency in what qualifies as an engagement activity across asset classes.

Who carries out engagement within an asset manager's organisation?

Most investors reported that credit analysts or PMs engage with borrowers, sometimes with support from an ESG team – the latter could be a firm-wide ESG Committee or a specific ESG stewardship team. For example, one investor mentioned they have an ESG engagement team that handles all the firm's engagement activities across asset classes.

How ELFA can support investors' engagement activities

While the discussions at our ESG Engagement Workshop provided significant value to participants through the exchange of experience and knowledge amongst ELFA members, many investor challenges remain in carrying out ESG engagement effectively. ELFA is however encouraged by these discussions, which demonstrate how the industry has progressed in the last 12 months.

ELFA can support its members by working closely with all market participants, for example, by:

- raising awareness with borrowers of investor needs in the context of new ESG regulations that investors face; and
- working closely with company advisers such as banks and lawyers to ensure ESG information is captured in the initial stages of the due diligence process and forms part of deal documentation.

We plan to continue these engagements with various counterparties across our industry. ELFA is also exploring new ways to support engagement post-issuance and we will continue to facilitate collaborative engagement according to our members' needs.

About ELFA:
ELFA is a professional trade association comprised of European leveraged finance investors from over 55 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.

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