ESG DUE DILIGENCE OF SPONSOR AND CORPORATE IN THE LEVERAGED LOAN MARKET

SIGNATORY TYPE
Investment Manager

OPERATING MARKET
UK

ASSETS UNDER MANAGEMENT
£286* billion**

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M&G allocates long-term capital to responsibly-managed businesses, financing impactful investments since the 1930s. As a long-term, active investor, governance has always played an important role in M&G's investment analysis, due diligence and engagement processes. Increasingly, it is incorporating environmental and social issues, where they have a meaningful impact on risk and return.

Leveraged loans are floating-rate debt issued – on a secured basis – by sub-investment grade companies, typically to finance mergers and acquisitions (M&A) often as leveraged buyouts by private equity (PE) sponsors. The majority (around 70 percent) of leveraged loans issued in Europe derive from PE buyout activity, often following large mergers where listed, public companies divest non-core divisions.

Leveraged finance is therefore well adapted to engagement as the direct, contractual nature of the loan creates more frequent interaction between the parties, permitting engagement and lobbying to a greater extent than between a bondholder and issuer.

Investors are currently giving greater prominence to ESG matters. This poses certain challenges for the private European leveraged loan market, with portfolio companies typically unlisted and therefore less exposed to the expectations of the exchange-traded equity and debt worlds in terms of corporate governance disclosure, transparency rules and annual reporting requirements. However, given the relationship nature of the market, we believe that those challenges can be overcome. As lenders, our objective is to engage with private companies and their PE owners.

STRONG DRIVERS FOR INTEGRATING ESG ISSUES

Limited Partners (LPs) are interested in the ESG activities of PE firms, and sponsors are showing increasing appetite to integrate ESG throughout the deal cycle – from screening targets, risk mitigation in ownership and capturing value on exit. Industry players are at different stages of ESG incorporation, but those that are more advanced understand that a responsible and active engagement approach can, and should, be an important driver of value creation.

*Rounded to the nearest £ billion
**As at 30 June 2018

FINANCE UNEP INITIATIVE | United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

HOW LENDERS CAN MANAGE ESG RISKS

Unlike company owners (and their LPs), lenders tend to have very limited influence over the design, management and implementation of portfolio companies' ESG policies. One of the advantages of being private-side, is that lenders often receive private information from issuers throughout the life of the investment, creating scope for financial and non-financial disclosures to be made outside of the regular reporting cycle. This can help to highlight any emerging ESG issues and identify how to reduce risks and improve performance.

Before we decide to invest in a new loan issue, we determine with the relevant PE sponsor what ESG due diligence was performed prior to company purchase, and whether any red flags were reported. Anything unearthed will be discussed and evaluated. We primarily seek assurance that there are no serious issues or that there can be no reoccurrence of previous issues. During our lending life with a company, we demand on the occurrence of an event deemed to have material ESG significance: full details of the event, as well as an explanation for it and advice on remedial and preventative action. We also regularly ask for an update on the most material potential ESG risks or previous areas of concern.

ESG IN PRACTICE – UNILEVER'S GLOBAL SPREADS DIVISION: ASSESSING THE COMMITMENT TO SUSTAINABLE SOURCING UNDER PE OWNERSHIP

In December 2017, KKR acquired Unilever's global spreads business, Flora Food Group, for €6.825 billion. We had the opportunity to invest in the loans issued by the new standalone company.

Before deciding whether to invest, we undertook extensive credit analysis and due diligence to evaluate the transaction and the quality of the business.

When a new buyer becomes owner of a company, we seek to understand the work performed during the bidding process, its rationale for arriving at the purchase price and its aspirations for the target. We also consider its attitude to ESG to mitigate risk and ensure that our interests are aligned with the sponsor.

Our ESG-focused diligence is carried out as part of the credit approval process and typically includes a Q&A, in-person discussions with the sponsor and management team, and in-depth analysis to determine the materiality of possible ESG issues to understand and evaluate their potential impact on a company's worth.

ASSESSING THE MATERIALITY OF ESG FACTORS

Flora Food Group (now Upfield) produces, distributes and markets food products for baking and cooking, with margarine, spreads and mélanges categories representing the largest proportion of its sales. The company operates in 69 countries and is the market leader in the global margarine and spreads category.

Margarine is made from a combination of plant-based oils, including palm oil. The issue of palm oil sourcing was flagged as important during the early stages of considering this transaction. There are some specific concerns around the sustainability of palm oil generally, with some of its production potentially linked to deforestation and human rights violations.

For Upfield, palm oil accounts for an important part of its raw material purchases. Any negative publicity around palm oil sourcing could damage the brands and affect the performance and value of the company. This can cause secondary market volatility in our loans and, more seriously, cause valuation multiples to contract and impair our investment. As for every investment, scenario analysis and consideration of what could go wrong was modelled. Particular attention was paid to the size of the cost base accounted for by raw materials, with cash flows being stressed for a consequent rise in input prices and a contraction in margins.

UNILEVER – DRIVING SUSTAINABILITY STANDARDS IN THE GLOBAL PALM OIL INDUSTRY

Unilever has strong commitments to ESG, with relevant reports and progress made against those goals in the public domain. It has been one of the largest buyers of palm oil in the world, and as part of the Unilever Sustainable Palm Oil Sourcing Policy (launched in 2013), the multinational consumer goods giant publicly set out its commitment to sourcing 100 percent of palm oil sustainably by the end of 2019.

HANDING OVER THE BATON OF RESPONSIBILITY TO THE NEW OWNER

Unilever had a strong legacy in sustainability, so it was important that responsible sourcing continued to be a priority at Upfield under PE ownership.

Unilever gave us comfort by asserting that KKR was very open about its approach to ESG and viewed it as a key part of its equity story on this transaction. KKR's equity story is centred around building a premier plant-based food company with sustainably-sourced ingredients. Replacing animal-based with plant-based foods in diets is clearly part of the solution, from a health and wellness as well as environmental perspective. In many places, nutritional guidelines are being introduced which express both dimensions in dietary recommendations, including in comparison with meat and dairy. On top of this wider societal benefit, KKR committed to 100 percent sustainably-sourced palm oil. This is aligned with our own expectations as lenders.

KKR'S RESPONSIBLE SOURCING INITIATIVE

KKR's Responsible Sourcing Initiative provides portfolio companies with guidance and resources focused on the continuous improvement of their management of human rights and environmental issues in global supply chains.

Find out more

Additional reassurance came from the fact that KKR is a PRI signatory (since 2009) and is listed in the US, so is subject to disclosure laws and regulations enforced by the US Securities and Exchange Commission. In 2013, KKR formalised its global PE ESG policy.

When it came to our appraisal and evaluation of KKR's ESG approach, as well as the information required in this transaction, we were encouraged by the historical accessibility and contact with the firm, including with those responsible for ESG, over the years. We also used this insight to test how KKR's ESG approach compared to other sponsors, including across asset classes.

POST-INVESTMENT MONITORING

Post commitment, we continue to regularly monitor ESG risks and work closely with the management team and key shareholders to identify any weak links from an ESG perspective that can be strengthened. When dealing with a transgression or failing in any investment, which in this case could be around the issue of palm oil sourcing, our actions would typically include: 1) interviewing relevant management and deal partners; 2) seeking demonstration of actions taken; and 3) heightened monitoring of an issuer/owner.