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Investment insight

What can loan managers do to manage ESG risks?

M&G INVESTMENTS

June 2018

Far more attention is being paid by investors to ESG matters. For the private European loan market, this raises certain challenges given that companies are typically unlisted and so are less exposed to the expectations of the exchange-traded equity and debt worlds. However, **Fiona Hagdrup**, leveraged loans fund manager, finds that lenders are not without influence – particularly those that remain 'private-side'.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested.

The role of private equity – shifting attitudes towards ESG integration

The European loan market is dominated by private equity-owned (PE) borrowers and corporate deal-making (M&A) is the single biggest driver of the market. According to Standard & Poor's (S&P), the pile of uninvested cash held by PE sponsors is 'bigger than at any point in the past decade' and data provider Preqin put it at US$1 trillion at the end of 2017 (of which c.$630 billion is reserved for buyouts).

Many believe the size of the PE industry, and the characteristics of its business model (the PE average global buyout holding period was five and a half years in 2017 (year of exit))[1], mean that it has a clear role to play in influencing the attitudes of portfolio companies towards the effective management of environmental, social and governance (ESG) issues. This is particularly pertinent when considering that many companies, currently under sponsor ownership, will one day become publicly-listed entities, given that an Initial Public Offering (IPO) is the typical private equity owner's exit objective.

Our objective is to remind private companies – and their owners – that it is incumbent on all stakeholders to lobby for disclosure and sensible terms, and that the integrity of management is judged by its actions. Indeed, inactivity in engagement may result in being 'named and shamed' by the Principles for Responsible Investment (PRI), as the United Nations-supported organisation recently announced it intended to do for its signatories that have been supine and silent.

ESG integration may be in its infancy for some companies and sponsors, but not all. Furthermore, it is a topic that is evolving for the industry. Nearly all (96%) the PE houses surveyed by PwC for its "Global PE Responsible Investment Survey 2016[2]" have – or will have – a responsible investment policy, while the survey also highlighted growing interest from the PE industry in integrating ESG management throughout the deal cycle – from screening targets through to capturing value on exit. Many sponsors are also UNPRI signatories.

Prior to acquisition, PE firms are typically looking out for 'red flag' events; i.e. any potential or actual problems within a portfolio company, that have the potential to create additional costs, fines or reputational damage further down the line, according to PwC. However, following purchase, the focus then typically switches to implementation or improvement of ESG policies and processes with reporting – at least to limited partners – being made on progress, as changes and improvements are made.

Why disclosure and governance are key to responsible lending

Unlike company owners (and their backing fund investors), lenders tend to have very limited influence over the (design, management and implementation of) ESG policies of portfolio companies. In our experience, however, there are certain advantages afforded by both being private-side and by appropriate use of the necessarily-iterative relationship between lender and borrower. In other words, the direct, contractual nature of a loan creates more frequent contact between the parties, permitting engagement and lobbying to a greater extent than is the case between bondholder and issuer.

Before we decide to invest in a new loan issue, we determine, with the relevant PE sponsor (whether or not they are a signatory to the UNPRI), what ESG due diligence was performed, prior to company purchase, and whether any red flags were reported. Anything unearthed will be discussed and evaluated. In the main, we look to be assured that there can be no reoccurrence of any issues. Thereafter, we monitor the development and implementation of the company's ESG policies and measures, and assess their resilience (see ESG in action example 1 on page 2).

We also use our frequent interaction with our portfolio companies and their owners, during the life of our investment, for instance, to attest to their governance models, their environmental and social operating policies and guidelines and to lobby for greater disclosure of ESG issues, where appropriate. We shall demand, on the occurrence of an event, deemed to have material ESG significance, for full details, explanation and advice of remedial and preventative action.

[1] Source: Preqin Private Equity Online

[2] Source: PWC, report published in 2016

Leveraged finance and ESG in action example 1 : Pushing for better information disclosure

We decided to engage with one of our portfolio companies and owner to improve the transparency and level of reporting relating to their environmental procedures. The company in question is involved in the production of chemicals and we required greater information on its safety-reporting processes, following a spill, to fully evaluate the materiality of this specific environmental risk posed by the business as well as seek fuller information on safety monitoring and reporting to permit fuller credit assessment.

We raised the issue with the portfolio company and its owner and our disclosure requirements were successfully met.

Leveraged finance and ESG in action example 2 : Assessing the potential risks of poor governance

We recently declined to invest in a loan owing to governance concerns, relating to the target company and its reliance on one key contract, which represented a large proportion of revenues. We felt that any risk of poor conduct or governance, that may threaten a company so dependent on one contract, was a valid and significant credit concern, exacerbated by the fact that one of the company's subsidiaries was subject to an ongoing investigation by the US Department of Justice.

The ownership and operation of its main contract added further opacity to an already-questionable opportunity, resulting in our decision to decline the transaction.

In Europe, leveraged loans occupy the space between liquid public bonds and illiquid private debt. Lenders receive private information from issuers through the life of the investment, creating scope for both financial and non-financial disclosures to be made outside the regular reporting cycle. This can help highlight any emerging ESG issues and identify remedial action to reduce risks and improve performance, where possible.

There has been a considerable improvement in the number of companies providing ESG data and the quality of information – having depth and breadth can allow a manager to assess the materiality of various ESG factors.

Typical reasons for declining transactions on ESG grounds pertain to any ownership and / or governance opacity. When a new buyer becomes owner of a company, we would seek to understand its own structure, history, aspirations for the target as well as its attitude to ESG. We also like to meet its key personnel as well as company management. Any past ESG issues must be disclosed to us, including their rectification measures (one of the key benefits of being private-side is access to full due diligence of a company). Given the asymmetry of returns that define the loan asset-class, any significant ESG uncertainty would result in our declining to lend – a poor approach to ESG being symptomatic of an unwillingness more generally to embrace transparency, in our view.

It may require a stretch of the term, but we count overly-aggressive documentation as a governance issue. Too many 'loopholes', for example, placed in the legal terms and irrelevant to the stated aims of management – including those that potentially threaten the future seniority or secured status of the debtholder – raise concerns about integrity and the potential for future action, adverse to the interests of some stakeholders (see ESG in action example 2).

Helping to develop 'green' lending standards

The Loan Market Association (LMA), the body that establishes guidelines for the EMEA syndicated loan market, together with the Asia Pacific Loan Market Association (APLMA), published Green Loan Principles (GLP) in March 2018 – seen as the first step in establishing widely accepted principles in green lending. As a member of the LMA's Green Lending working party, we took an active role in drafting the principles.

Green loans, as defined by the LMA[3], are any type of loan instrument made available to finance or refinance, in whole or in part, new and / or existing eligible Green Projects – eligible projects should provide clear environmental benefits, which will be assessed, and where feasible, quantified, measured and reported by the borrower. Green loans must align with the four core components of the GLP:

1. **Use of Proceeds**
2. **Process for Project Evaluation and Selection**
3. **Management of Proceeds**
4. **Reporting**

M&G were also part of the PRI's Bondholder Engagement Working Group, which recently launched the report, "ESG engagement for fixed income investors: managing risks, enhancing returns", aimed at providing further asset class specific guidance on responsible investment practices.

[3] Source: Green Loan Principles, published on 21 March 2018

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JUN 2018 / IM-1810_UK