ESG IN CREDIT RISK AND RATINGS: BRINGING ANALYSTS AND ISSUERS TOGETHER

French sub-investment grade issuer workshop

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NOTES FROM THE WORKSHOP

The PRI's [ESG in credit risk and ratings initiative] is, for the first time, bringing voices from the corporate side into the conversation on how to better integrate environmental, social and governance (EGS) factors into credit risk analysis. This article summarises the key points from a workshop held with sub-investment grade (IG) French borrowers, bringing together buy-side and sell-side credit analysts, representatives of credit rating agencies (CRAs), corporate finance and investor relations teams. The workshop, held in collaboration with the French Financial Analyst Association (SFAF), is the fourth of the series Bringing credit analysts and issuers together, as part of the ESG in credit risk and ratings initiative, which promotes a transparent and systematic consideration of ESG factors in credit risk assessment.[1]

During the French sub-IG workshop there were five discussion groups, each with one company (Atalian, Casino, CMA-CGM, iQera and Loxam), representatives from six CRAs and 34 investor or investment bank analysts from nearly 20 institutions, as well as members of SFAF's ESG and credit commissions (see Appendix for the full list of participating organisations). The discussions were held on 25 November 2020 under the Chatham House rule. They were structured around a set of guidelines that were circulated to participants prior to the event and tailored by sector.[2]

Several observations in this workshop echoed themes highlighted elsewhere in the series, whilst remaining focused on credit-relevant ESG issues (i.e. which factors can impact a company's cash flow, what is the cost of transitioning to a more sustainable business). In this article, we only highlight new or sector-specific themes, and report on emerging solutions that participants have started considering.

Overall, excluding the shipping sector, discussions concentrated more on social, rather than environmental or governance, factors – reflecting the fact that the participating borrowers were service companies, whose operations tend to be more labour-intensive than some of the contributors involved in previous workshops (e.g. manufacturing or oil and gas firms). Some social factors were common across participants (e.g. resource management), others were sector specific and are listed at the end of this note. Furthermore, discussions touched on additional themes such as the European regulation. Finally, participating CRA representatives explained how they continue to incorporate ESG factors in their methodologies for credit ratings (which are regulated activities) and how they have improved the signposting of these factors in their credit rating assessments.[3]

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[1] The workshops series follows a string of 21 roundtables organised for institutional investors' credit analysts and CRA representatives between 2017 and 2019. The discussions are documented in the trilogy, Shifting perceptions: ESG, credit risk and ratings.
[2] The PRI initially published these guidelines after the Paris workshop, the first of the series. They will be refined as the workshops continue.
[3] This is in keeping with their commitment to increased transparency, as promoted by the ESG in credit risk and ratings initiative which they support, as well as in response to new guidance on disclosure requirements by the European Securities and Market Authority.

1. COMPANY STRUCTURE RELEVANT FOR ESG ASSESSMENT

Company structure (size and ownership: family-owned, private equity-owned or listed) significantly impacts how analysts incorporate ESG factors in their evaluation of high-yield (HY)[4] companies, compared to IG borrowers.

These dimensions determine the resources that a company allocates to its ESG communication and how accessible that information is to market participants. Smaller companies, which are prevalent among sub-IG borrowers, have fewer resources to collect and disclose ESG data, while private companies are not subject to the same disclosure requirements as public companies. Finally, smaller companies are often positioned in niche markets. This complicates peer comparison, as it is difficult to identify suitable benchmarks.

A company's ownership structure can impact its transparency, the time-horizon of its business strategy, its internal culture as well as the use of leverage and remuneration policies – factors that are important when assessing governance.

> "The credit market is not limited to listed companies; regulation will have to be imposed on non-listed companies as well. But this requires standardisation of data and the creation of frameworks suitable for smaller issuers."

Credit analysts regularly use information such as a company's board composition to assess its complexity. Family-owned companies tend to be more flexible and faster in making decisions. They can also be more open to taking medium- and long-term risks, in contrast to the short-term share price dynamics that impact listed companies. On a negative note, they can be less transparent, often restricting access to their investor websites. While investors recognise the legitimacy of this practice, it further hampers sector comparisons.

One participant observed that family-owned companies may score poorly on governance if they are assessed by analysts using key performance indicators (KPIs) that are better suited to listed companies. At the same time, some family-owned companies can lack independent directors, thus reducing the checks and balances provided by their boards.

Private equity firms often set up complex structures for their holdings, to take advantage of the leverage used and to optimise taxation. As such, they can be reluctant to share information, particularly regarding debtholder protections in covenants or related to ESG data, and may even prevent their investee companies from making such disclosures. This contributes to a certain opacity in the financial reports of private equity-owned borrowers. Credit analysts place more importance on the transparency of

[4] In the remainder of the note, the abbreviations sub-IG and HY are used interchangeably.

financial disclosures – particularly of covenants – than private equity analysts, who are more focused on shareholder protection.

EMERGING SOLUTIONS

By having more regular meetings with bondholders and buyers of debt instruments, HY companies could help to overcome the barriers that their structures may pose, especially on governance issues. This type of interchange can be mutually beneficial, as analysts can convey their ESG expectations and understand which ESG risks and opportunities are most strategic for companies.

2. COMMUNICATION STILL IN FOCUS

Echoing previous workshops, investor and company participants called for two-way communication on ESG issues to improve.

Investors would like companies to provide better information. For non-listed HY borrowers, this is often limited due to their size. Furthermore, since buy-side analysts cover many issuers simultaneously and from different sectors, they would like to see companies communicating more proactively on ESG targets and sustainability plans, instead of needing to request these, which makes ESG investigation difficult. On a positive note, the participating companies all plan to publish ESG reports.

Companies expect more guidance from investors on ESG issues. They observe that credit analysts only ask a few questions on ESG issues, as their primary concern is the financial health of the issuers and their compliance with covenants.

Discussions with investors on social and environmental issues remain weak and companies have little visibility on what investors think of their ESG policies (what is good or what could be improved). This suggests that:

- investors struggle to link ESG factors to financial materiality; and
- companies' communication on ESG topics is primarily directed at third parties for now (customers, suppliers or ESG information providers).

> "It is important to converge ESG data and financial disclosures."

EMERGING SOLUTIONS

When publishing results, HY companies could dedicate some time to ESG topics and present investors with slides that link to the relevant financial information.

3. LINKING ENVIRONMENTAL AND SOCIAL FACTORS TO CREDIT QUALITY

Analysts are used to assessing the impact of governance on credit quality and they are beginning to focus on environmental issues, which are becoming more measurable and understood. Indeed, companies are addressing their Scope 3 emissions to retain their customers or avoid reputational risks in their supply chains.

For instance, one participating company has started making efforts to map its carbon footprint and has invested in cleaner equipment, driven by customer demand for low-carbon products and new regulations banning diesel in large cities.

Some large investors and CRAs have started to produce in-house financial materiality maps. Building a financial materiality map can be useful but it remains challenging to model the impact of ESG factors on operating and capital expenditures in the absence of harmonised data. While reporting frameworks such as the Sustainability Accounting Standards Board or the European Public Real estate Association exist, they are mostly used by equity investors and are not widely accepted yet.

There was agreement that the credit-relevance of social factors remains the most difficult to assess of the ESG categories.

Participants observed that among social factors, reputational risk can significantly impact a company's financial performance and the ability to repay its debt, as potential negative publicity related to poor workplace practices, product recalls or clashes with local communities have potential repercussions on costs and profits that could hit a company's credit quality.

However, reputational risk can also be linked to factors that are not within a company's direct control, caused by societal changes including varying consumer preferences or values. New behavioural patterns and technological change are affecting many service sector organisations. For instance, in the retail sector, customer attitudes towards animal welfare and organic food may require production changes that impact profitability.

EMERGING SOLUTIONS

In the absence of standards and a better understanding of what credit-material social factors are, companies could start regularly publishing a set of metrics and link them to financial items (such as how they affect production costs, value-add or EBITDA). The following metrics are a useful starting point: employee turnover and satisfaction rate, the level of employee training, work accidents, absenteeism and sickness statistics. Companies already produce these, but they are not always disclosed on a regular or comparable basis (i.e. they are not consistent, sufficiently frequent and cannot be found in the same document/sources). They should be published over a sufficiently long historical period to be useful.

4. IMPACT ON COST OF CAPITAL

A company's cost of capital will vary depending on whether it is IG or HY rated. However, some participants noted that a company's ESG performance (their disclosures or how ESG considerations feature in their business strategy and planning) had no obvious impact on its cost of capital. Whilst demand remains strong, sustainability bonds are also not better priced at present, although one observer noted that some differentiation is emerging in the IG market.

Nevertheless, participants noted that the cost of capital may rise if *access* to the funding pool becomes more limited because investor expectations about companies' ESG performance are changing or due to upcoming regulations (*see The EU taxonomy*).

"European economic policies will have to facilitate the necessary digital and ecological transitions. To achieve this, Europe needs to define more clearly the standards that will support the European growth."

HY companies can struggle to issue thematic bonds, as it is more difficult for small and medium-sized companies to find and provide verification data regarding the use of bond proceeds. Moreover, green bonds are not suitable for sectors that may have to continue relying on fossil fuels for a while. Some participants mentioned that they prefer to fund themselves through green loans, as the pricing is more attractive than on the HY bond market.

As a result, sustainability bonds (whose financial and/or structural characteristics can vary depending on whether the issuer achieves predefined sustainability/ESG objectives) are more suitable for HY companies. However, company objectives need to be realistic. For example, in the shipping sector, scalable technology for net-zero emissions vessels doesn't exist today, and the frameworks for issuing green or sustainability-linked instruments, which could help fund the transition, are too restrictive. Hydrogen is one option being explored to meet decarbonisation objectives.

THE EU TAXONOMY

The discussion partly focused on the EU taxonomy for sustainable activities[5], as investment managers may use the EU taxonomy to comply with the Sustainability-related disclosures in the financial sector regulation. It was observed that:

- the EU taxonomy will not start applying in practice until January 2022 at the earliest, but investor participants that have already started preparing noted that it is easier to gather the relevant information on IG rather than sub-IG firms, as they communicate comparatively more on environmental information;
- in large asset management companies, ESG teams rather than credit analysts process non-financial metrics and related EU taxonomy considerations, which can lead to contradictions between credit and ESG analysis of a company; and
- the EU taxonomy has not given much weight to social factors in its classification nomenclature, suggesting that market participants have underestimated that the definition of environmentally sustainable includes a social component.[6]

EMERGING SOLUTION

Investors need to support HY companies even when their financial performance is deteriorating, if such a situation is temporary and management has a clear, convincing medium-to-long-term strategy. Issuers could consider transforming their classic revolving credit facilities to those linked to ESG KPIs, as some have started doing. Furthermore, sustainability bonds could become more attractive for issuers if they start to be relatively better priced (in recognition of companies' efforts on ESG performance).

[5] The EU taxonomy came into force in July 2020. It helps investors determine which economic activities can be considered environmentally sustainable. It was designed to enable fund managers to gather reliable, consistent and comparable sustainability indicators from investee companies and to incorporate this data in investment and risk management processes. EU taxonomy disclosures will also feed into disclosure requirements under the Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector. For more information see also the PRI's dedicated webpage on this topic.

[6] The EU Commission will consider extending the EU taxonomy to social objectives in 2022. Currently, an economic activity will only be considered taxonomy-aligned if it meets minimum international human rights safeguards, including ILO minimum social standards. See Article 3 of Regulation (EU) 2020/852 of the European Parliament and of The Council of 18 June 2020.

5. SECTOR-SPECIFIC CONSIDERATIONS

The discussions highlighted several considerations specific, but not unique, to the industries of the companies represented – debt repurchasing (iQera), retail (Casino), shipping (CMA-CGM), rental equipment (Loxam) and facility management (Atalian):

DEBT REPURCHASING

- Debtor satisfaction and complaint rates
- Estimated remaining collections
- Fair customer treatment
- Privacy and data security
- Codes of conduct self-imposed by issuers, as no binding ESG regulation exists
- Responsible collection channels help to align stakeholder interests, enable higher and faster recovery than litigation-heavy solutions

RETAIL

- Direct climate impact is low, comes mostly from refrigerant gas
- Supply chain importance for carbon neutrality: sourcing of raw materials and selection and monitoring of supporting suppliers – how to reconcile cost and emissions?
- Enhanced focus on reforestation, waste reduction and animal welfare, responding to increased client demand for responsible products – what is the cost of developing more responsible offerings?
- Importance of dialogue with employees to deal with the social consequences of transition issues

SHIPPING

- Investing in clean technologies to reduce carbon emissions, comply with regulatory changes
- Protection of oceans
- Employee health and safety: work accidents, working conditions of seafarers (complexity related to vessel origins, as social regulations apply)

RENTAL EQUIPMENT

- Investing in less-polluting equipment to comply with carbon emissions regulation and customer demand
- Benefit-cost assessment of converting fleets to electrical vehicles
- Resource preservation (through sharing)
- Employee health and safety
- Employee training
- Reputational risk arising from the above

FACILITY MANAGEMENT

- Employee health and safety
- Employee training
- Absenteeism
- Social inclusion and diversity
- Reputational risk arising from the above
- Risk of social conflict
- Opportunities related to local employment
- Difficult to translate this information in annual reports – lack of professional standards, transparency varies among issuers

APPENDIX

Table 1: Participating organisations

Companies	
Atalian (Facility management)	iQera (Debt repurchasing)
Casino (Retail)	Loxam (Rental equipment)
CMA-CGM (Shipping)	
Investment institutions	
Alcentra	Generali Insurance Asset Management
Allianz Global Investors	Groupama Asset Management
Amundi	HSBC Global Asset Management
AXA Group	Kepler Cheuvreux
BNP Paribas Asset Management	La Française Investment Solutions Capital
Crédit Agricole CIB	Natixis CIB
Crédit Industriel et Commercial	OFI Asset Management
CNP Assurances	Ostrum Asset Management
Crédit Mutuel Asset Management	SCOR SE
Egamo	
CRAs	
Fitch Ratings	Qivalio
Kroll Bond Rating Agency	Scope Ratings
Moody's Investors Service	S&P Global Ratings