Principles for Responsible Investment

wbcsd

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

CHEMICAL SECTOR WORKSHOP

THE FINANCE HUB

GORDON AND BETTY MOORE FOUNDATION

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UN environment programme finance initiative

UN Global Compact United Nations Global Compact

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 (ESG) factors into credit risk analysis. This article summarises the key points from a workshop held with companies from the chemical sector, bringing together buy-side and sell-side credit analysts, representatives of credit rating agencies (CRAs), corporate finance and investor relations teams. This workshop, held in collaboration with the World Business Council for Sustainable Development (WBCSD), is the tenth of the series Bringing credit analysts and issuers together. As part of the PRI's ESG in credit risk and ratings initiative, the workshops aim to promote a transparent and systematic consideration of ESG factors in credit risk assessment.[1]

The 22 June 2021 workshop was hosted in collaboration with the WBCSD, reflecting synergies between the PRI's ESG in credit risk and ratings initiative and the WBCSD's Redefining Value Programme. The event attracted nearly 40 market participants, including representatives from seven corporates from the chemical sector (see Figure 1 below). Four CRAs and 15 investors from various organisations were also in attendance (see *Appendix* for the full list of participating organisations). The discussions were held under the Chatham House Rule and were structured around a set of guidelines that were circulated to participants prior to the event and tailored by sector.[2]

Figure 1: Participating chemical companies

Sub-sector	Companies
Agrochemicals	Bayer, Yara
Petrochemicals	Petkim/SOCAR, SABIC
Speciality chemicals	DuPont, Lanxess, Orbia

This report contains highlights from discussions held during the breakout sessions with companies in three chemical subsectors (agrochemicals, petrochemicals and speciality chemicals). Some observations were common or were covered in other articles of the series. In this report we address only new or sector-specific themes, and report on emerging solutions that participants have begun to consider.

[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.

Key findings of these discussions are grouped into four main areas, as follows:

1. Difficulty in defining which metrics to measure and report on
2. Importance of engagement
3. Increased focus on environmental issues
4. Sector-specific considerations

1. DIFFICULTY IN DEFINING WHICH METRICS TO MEASURE AND REPORT ON

As it is common in PRI workshops, participants frequently cited the availability, quality, and range of data as an issue. Investors and CRAs saw a need for more standardised data, improved responsiveness by borrowers and an increased number of data points on governance. Some investors expressed a preference for absolute rather than relative data, as companies may not use the same ratios, for example to assess emissions reduction targets.

“We would like to see raw data…We want to have visibility over the perimeter of the geography and activities included when it comes to data.” – Investor

Investors would find it useful to have more granularity on energy targets, on the energy mix in a company’s energy portfolio and on investments towards these targets. Focusing on plastics, investors are seeking to understand the percentage of plastics that can be recycled, what technologies are used in recycling and whether capex is consistent with targets.

“The EU regulatory push will start to encompass the circular economy. But on the metrics, the tech and the data, there is a long way to go.” – Corporate borrower

Investors, corporates and CRAs acknowledged it is challenging to define which metrics they should look at, measure and report on. For instance, which environmental and social factors can affect cash flow and liability profiles, and how does that change over short, medium and long-term horizons?

“What is good? How good is good enough? And then, based on that, do we only invest in the best performers and leave out the others? Investors do not know what they are measuring.” – Investor

There was consensus on qualitative data being as important as quantitative measures in assessing performance, for example when explaining the measures a company is taking to achieve targets and what lies ahead (including how many people are responsible for ESG, where they sit within the organisation, and who is in charge at management level). In addition, more reporting on employee skill levels and training would be welcome, given the importance of safety in the chemical industry and the need to attract and retain qualified staff.

Many borrowers noted they are reporting according to the Sustainable Accounting Standards Board (SASB), and some admitted that pressure to do so has increased following demands by large, influential asset managers. However, the Global Reporting Initiative (GRI), the Task Force on Climate-related Financial Disclosures (TCFD), Ecovadis and the UN Global Compact are also used, creating a desire for convergence.

> “We would like to have one consistent set of data. Similarly to accounting standards converging towards IFRS, we hope to see the same harmonisation for the various ESG-related reporting standards.” – CRA

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One borrower noted that, by developing ESG reporting, it realised how much data it produces internally that it has never published. It has begun implementing a more rigorous approach to gathering and reporting data.

One investor described a five-pillar assessment approach covering society, clients, investors, the environment, and people. For each criterion, ESG analysts compile information through reports from and interactions with companies. The company also incorporates data from third-party providers in its models.

2. IMPORTANCE OF ENGAGEMENT

Investors look at many factors to gauge management’s commitment to ESG risks. They value face-to-face meetings, which often are helpful in judging the sincerity of CEOs and CFOs. Investors and CRAs seek to answer questions such as:

- Is there an ESG specialist?
- How frequent are investor engagements?
- What is the responsiveness to engagement?
- Is ESG a consistent topic in board discussions?

In addition, if responsibilities are clearly delineated, investors can examine board members’ profiles or résumés to complement information about ESG competence and commitment.

“By attending roadshows and in-person meetings, we often see whether the mandatory ESG slide is there just for show, or is it really meaningful? It helps us gauge the importance of ESG for the board, how the board makes the strategic decisions.” – Investor

Investors also value transparency about performance against goals, as well as clarity around any shortcomings. A company not explaining reasons behind missing ESG targets could signal lack of transparency.

In response, one borrower noted that this year compensation includes a factor that will be weighed against not only financial performance but also sustainability performance annually. Another shared that the chief environmental officer’s compensation is integrated with ESG factors.

Borrowers added that they welcome opportunities for engagement as so often creditors focus only on downside risk, e.g. litigation or potential controversies. They do not believe creditors can obtain a full picture of the company’s ESG efforts and opportunities with such a narrow focus.

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Tying ESG goals and compensation together can ensure that the board and/or the top management is working towards such goals.

Borrowers reported that it is useful to have investors reach out to companies because the companies do not have a list of all bondholders.

3. INCREASED FOCUS ON ENVIRONMENTAL ISSUES

CRA and investor participants see performance on environmental issues as critical to the future of the chemical sector. Companies that cannot make the transition to a sustainable economy within the next two decades may not survive. The carbon intensity of nitrogen fertiliser, for instance, would make it a difficult business to invest in without major changes.

Investors are already seeing increasing red flags for holdings in the sector. A client asked one asset manager to add pesticides to the exclusion policy, including companies deriving more than 5% of revenue from the production of synthetic pesticides. This kind of demand could become the norm in a few years.

"If companies are not on the front foot, showing why they are improving and how they will get there on their own, they may be surprised by what happens. It can happen by accident, e.g. with companies that are on the right path but with legacy assets." – Investor

But at the same time, the chemical sector provides solutions for the energy transition and its products must be assessed through their contribution to extending life cycles. Borrowers saw both risk and opportunity. Addressing climate/energy efficiency adequately was seen as a risk while waste management, circularity and innovation presented opportunities. One borrower noted that exporting products to Europe means compliance with EU regulations on carbon emissions. On recycling, the opportunity is in strengthening the connection between waste collection and end products.

Finally, it was noted that biodiversity is an important issue for certain companies and that more information is needed for investors to be able to assess risks in this area. Chemical companies are large consumers of water, presenting drought-related risks. In addition, chemical companies are still occasionally polluting rivers.

The true challenge for investors is valuing and pricing transition planning. Companies are increasingly required to commit to long-term transitions but are measured against pricing models that do not factor in long-term challenges.

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While the industry faces reputational risk, companies that show they can recycle and that their products are circular will reduce investor pressure. Less than 50% of plastics are recycled in Europe, providing potential for improvement.

4. SECTOR-SPECIFIC CONSIDERATIONS

The discussions highlighted several other considerations that are specific, but not unique, to the industries of the companies represented. The following are examples of areas where investors may request more information for ESG analysis, and where borrowers may seek to improve disclosure.

<table>
<tr>
<td>AGROCHEMICALS
■ Biodiversity, from both a risk and opportunity perspectives
■ Climate change
■ Water consumption and pollution
■ Transparency on governance
■ Legal/litigation costs</td>
<td>PETROCHEMICALS
■ Carbon emissions reduction
■ Opportunities related to recycling and waste management
■ Circularity (i.e. chemicals are intermediate components used in other products encouraging the transition to a low carbon economy)
■ Consumer preferences
■ Health and safety
■ Impact on local communities
■ Links between governance/risk management and environmental factors</td>
</tr>
<tr>
<td colspan="2">SPECIALITY CHEMICALS
■ Biodiversity
■ Carbon emissions reduction
■ Plastics consumption and recycling
■ Health and safety
■ Diversity and inclusion
■ Cybersecurity</td>
</tr>
</table>

APPENDIX

Figure 2: Other participating organisations

Investment institutions	
Allianz Global Investors	Neuberger Berman
Bain Capital	Ninety One
ESG Portfolio Management	NN Investment Partners
Federated Hermes	Oak Hill Advisors
Franklin Templeton	SCOR SE
HSBC Global Asset Management	Sycomore Asset Management
Lord Abbett	UBS Asset Management
M&G Investments	
CRAs	
Fitch Ratings	Pacific Credit Rating
Moody's Investors Service	S&P Global Ratings
Other	
World Business Council for Sustainable Development	

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