8 December 2020

Bringing Together Company Advisers and Senior Fund Managers to Discuss ESG Disclosure

ISSUE #12

Discussions on ESG Disclosure

- ESG disclosure workshops hosted by the ELFA and PRI, engaging key stakeholders
- Understanding by participants of the drivers of ESG data disclosure advanced
- Clear need for standardisation and desire for incorporation into deal documentation
- ESG Fact Sheet and guidance on implementation to be published in early 2021

8 December 2020

Bringing Together Company Advisers and Senior Fund Managers to Discuss ESG Disclosure

Executive Summary

- For multiple reasons, the integration of environmental, social and governance (ESG) factors in the leveraged finance market is growing rapidly.
- The European Leveraged Finance Association (ELFA) and the Principles for Responsible Investment (PRI) have hosted two events during which investors conveyed to key market participants – including borrowers, bankers, lawyers, credit rating agencies (CRAs) and private equity sponsors – the rationale for and importance of company disclosure of ESG information and data.
- These discussions covered topics from the ELFA's Guide for Company Advisers to ESG Disclosure in Leveraged Finance Transactions (the "Guide"), drafted by senior legal and sell-side professionals, and forms part of the ongoing PRI's ESG in credit risk and ratings initiative.
- The input and perspectives received during the events will be incorporated into a revised version of the Guide to be published with sector-level ESG Fact Sheets currently under development, in the first quarter of 2021.
- Four key themes emerged from the November event : 1) understanding the drivers of the need for ESG data; 2) a need for standard ESG guidance in general and a desire for the incorporation of such ESG disclosures into primary deal documents; 3) the differences in the understanding of materiality between lawyers and investors; and 4) ideas for how borrowers can best disclose ESG information.
- We explore these themes in this Insights report and look forward to continuing our work with credit analysts, and companies and their advisers in our workshops scheduled for next year.

Introduction

The growth of ESG investment analysis in the leveraged finance markets is accelerating rapidly. Investors in high yield bonds and leveraged loans are increasingly focused on ESG topics, and sub-investment grade corporate borrowers are quickly scaling up processes to collect and report ESG data.

To foster a discussion on what ESG information investors would like companies to disclose, the European Leveraged Finance Association (ELFA) and the Principles for Responsible Investment (PRI) held a workshop in September 2020 between sub-investment grade corporate borrowers and credit analysts. Participants discussed materiality of specific ESG factors and data disclosure in the debt repurchasers, healthcare, paper and packaging, and telecoms sectors. As discussed in the briefing titled Sub-investment grade borrowers workshop – Part 1 (as part of the series ESG in credit risk and ratings: bringing credit analysts and issuers together), we learned at the event that borrowers are willing to make ESG disclosures, but would like more direction from investors on what, where and when to disclose the information.

However, disclosure by corporate borrowers is heavily disintermediated in the leveraged finance market. A host of company advisers, including law firms and banks, provide guidance to borrowers on what ESG data to disclose. In order to convey the importance of ESG information, and to explore regulations and issues related to diligence, disclosure and contractual provisions, an ELFA working group comprised of senior legal and banking professionals drafted the Guide for Company Advisers to ESG Disclosure in Leveraged Finance Transactions (the "Guide").

The ELFA and the PRI then held a virtual event in November to bring key stakeholders into the discussion about ESG data and disclosure. This workshop attracted over 80 participants, bringing together law firms, banks, private equity sponsors, CRAs and senior fund managers to discuss disclosure on material ESG information. Discussions focused on key aspects of the Guide, including practical issues relating to incorporation of ESG into the diligence and drafting process.

In this Insights report, we review the following four important themes that emerged from the November event:

- Understanding the drivers of ESG data disclosure
- A need for standard ESG guidance and a desire for incorporation into deal documents
- The differences in the understanding of materiality between lawyers and investors
- Ideas for how sub-investment grade borrowers can best disclose ESG information

We will be publishing revised ESG Fact Sheets using comments from participants collected during the September event. In addition, we will be creating a revised draft of the Guide, which will incorporate detailed feedback from the November event. This will be published together with the sector-level ESG Fact Sheets.

Understanding the drivers of ESG data disclosure

Similar to the findings from the September workshop, participants noted that more engagement with companies and their advisers is necessary. Investors need to explain their approach to ESG integration as well as the drivers behind the need for more data from borrowers.

"ESG factors are integral to our investment process, and central to our investment decision."

Investors reported that understanding key ESG risks and how the borrower mitigates them is an important aspect of their decision about whether to invest or not, and how to position themselves in the corporate capital structure. They noted an increasingly clear link between ESG issues and credit risk, and cited evidence that investors are deciding not to invest based on factors relating to ESG. One fund manager noted the fact that in about a year's time , providing disclosure on ESG information will become necessary in order for borrowers to continue to get sufficient investor interest and participation. A sell-side participant agreed, observing that anecdotally it already appears to be increasingly difficult to find a deep buyer's base for a company that has insufficient ESG disclosure.

"ESG has gone from a nice-to-have to a need-to-have within the last 18 months."

Another driver toward increased disclosure is that credit managers must be able to show their end-investors – who are increasingly focused on ESG risks – why they decided to invest in the debt of specific companies. Senior fund managers reported that their biggest investors are increasingly requesting data to back the allocation of capital to ESG compliant investments. According to one manager, companies who fail to disclose ESG information appropriately risk exclusion from the investable universe.

Finally, investors highlighted the significant regulatory disclosure requirements to which they will shortly become subject, in particular the EU Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy Regulation.

> **"There is a clear lack of appreciation for the urgency of informational needs derived from regulatory requirements."**

The imminence of upcoming regulatory requirements means that leveraged finance professionals must be well versed on the implications of the new rules. According to one lawyer, the SFDR is viewed as the global choice even for investors or borrowers operating outside the EU. Others thought that the EU Taxonomy Regulation would encourage borrowers to provide more consistent information.

What took some by surprise was the potential for the debt instruments of some companies to become un-investable. One senior fund manager summed it up this way: "We will not add capital to investments that don't meet [SFDR] requirements; it's like the LIBOR transition – would you buy new instruments that refer to LIBOR?"

"Investors must make it clear that whether a borrower includes ESG disclosure will influence whether a deal gets done or not."

Participants urged investors to make their needs clear in their discussions with management, as this would help move the needle on ESG disclosure. Sell-side participants observed that they would be in a better position to support investors on increasing ESG disclosure if the message was clear that a failure to disclose would come at a premium. Not doing so would even discourage some investors from buying the deal.

In fact, appropriate ESG disclosure can actually enable wider access to capital for borrowers. This was a message that banks were keen to convey, as some companies had not realised this.

A need for standard ESG guidance and a desire for incorporation into deal documents

The willingness to disclose was apparent on all sides, but participants conveyed a need for more specific guidance on what investors expect.

"A standard set of disclosures would help companies – the market needs consistency."

Currently, to address any gaps in available data, investors make requests via questionnaires directly to management, or in the case of a new deal, to the banks during the marketing period. The timing of requests is challenging for banks to manage, and it would be better for the process to be frontloaded, so that ESG information is included as part of the diligence process and in offering disclosures. Private equity participants agreed that having a standard list of topics would be helpful.

The ELFA and the PRI are seeking to address this by developing sector-level Fact Sheets, with three planned for publication in the first quarter of 2021. We will also continue engaging with borrowers and credit analysts from additional sectors over the coming months. According to investor participants, this sector-level approach is necessary and particularly relevant in areas such as healthcare, which itself is made up of multiple sub-sectors.

"We like frameworks for disclosure led at the industry level, particularly what the ELFA is working on."

There was a recognition that existing frameworks, like those developed by the Sustainability Accounting Standards Board and the Global Reporting Initiative, were relevant and could be useful touch points, but that these may be too comprehensive and aspirational for many leveraged finance borrowers. A few participants asked if borrowers would be willing to report in line with the European Non-Financial Reporting Directive (NFRD). This was viewed as a reasonable ask, and investors noted that alignment with the NFRD would show the market a commitment by a private issuer to reporting ESG information. Banks would like to see a minimum common denominator for disclosure by investors, which could then be followed up with additional, targeted questions.

Participants also noted that it would be useful for the Fact Sheets to specify which information requests were driven by regulation, and which were viewed as financially material, which will be covered in the Guide. Participants also noted that it seemed clear that a standard approach would particularly help smaller companies which have fewer resources to devote to ESG disclosure.

The differences in the understanding of materiality between lawyers and investors

Most participants agreed that materiality is something that influences an investor's investment decision – indeed this is broadly the definition used for U.S. regulatory purposes, which underpins the current practice with respect to diligence and disclosure for most leveraged finance transactions.

"Are we seeing a fundamental reset in the definition of materiality?"

The key question from lawyers hinged on whether the ESG information was "material", but views on how to make this determination varied somewhat between participants. Traditionally this decision has focused on a company's financial data. However, there is now an acknowledgement that a re-think of what is considered material to investors might be needed. For example, investors increasingly look at factors that could hurt a company's reputation as this may over time impact business performance.

"From the issuer perspective it becomes a different concept altogether as we tend to think about it in terms of 'what if we are wrong if we fail to disclose something?'"

Law firm partners noted that their focus is on liability issues for their borrower and bank clients, which may mean that they advise against disclosing projections on ESG targets. The view amongst lawyers was consistent: that a well-drafted offering memorandum should capture material ESG factors. Further, where the shareholders and management see tangible benefits in high quality governance and initiatives, these aspects of the business can become an important marketing tool.

Private equity sponsors noted that they are collecting and recording much more information than they have in the past, and that much of the information being sought by investors may already be in their possession. For them, a rigorous ESG analysis is vital, and a crucial aspect of their investment process. It was suggested that they could instruct counsel what to disclose.

One credit rating agency participant noted his organisation includes ESG factors in its credit rating analysis, not as separate measures, but linked to materiality. That said, because the typical corporate credit rating horizon is around four years, knowing that a company is targeting carbon neutrality by 2030 would not impact the current rating.

Several participants urged investors to continue engaging with management on ESG topics they consider material, as this will influence what is ultimately disclosed when the company comes to market.

Ideas for how sub-investment grade borrowers can best disclose ESG information

A consistent theme emerging from the discussions was that information gathering is an iterative process – the more investors, rating agencies and others ask ESG questions, the more ESG data and Key Performance Indicators become part of the drafting effort on future deals.

"Companies are better off disclosing on ESG than getting 50–100 questionnaires which might be out of scope."

Participants were broadly in agreement that the best place for ESG data disclosure is the offering materials, in addition to dedicated ESG slides within the roadshow presentation. This was certainly viewed as a more effective approach than answering a high number of unique investor questionnaires. One private equity sponsor mentioned that an added benefit of including ESG data disclosure in the offering materials would be that ESG information is considered at a much earlier stage during the due diligence process.

The overall message from participants was that contractual disclosures and covenants that align to ESG metrics will strengthen the overall ESG message and reinforce the commitment of both the investor and the borrower. A delicate balance is needed, however, between introducing contractual provisions that are both meaningful for investors, but do not create unnecessarily onerous obligations on the borrower. To this end, there was a sense that ESG covenants should initially focus on information reporting requirements, including with respect to the borrower's ESG policies and procedures.

> **"Smaller companies should not be penalised for their lack of resource, but investors want to see that there is a trajectory."**

"Investors would like to see similar disclosure in smaller companies as well as those with a more established capital markets presence."

While investors noted that they need ESG information for both large and small companies, their size and maturity need to be taken into consideration. There is a perception that it is costly to provide ESG information and yet for many companies, including smaller ones, the benefits can outweigh the costs even if this may not be immediately apparent.

One private equity participant commented that they support their companies in getting ESG reporting structures and systems in place. Although this may initially not be straightforward, tracking a company's journey towards their goals is important for investors.

"There has to be tolerance for where the company is in terms of size and maturity."

There was general agreement that smaller companies should not be penalised for their lack of resources and that a clear trajectory, a sense of progress and management commitment are powerful signals to investors. Since smaller companies without the support of a private equity sponsor may find ESG disclosure to be a daunting concept, a clear set of disclosure standards and engagement with investors will help to guide their initial efforts to collect and report on ESG information.

According to one investor, "It's about the issuer understanding that the more proactive they are, the more likely they are to be screened into portfolios." In this way, "companies can widen their access to capital."

Conclusion

Many of these key topics were explored in the September and November workshops. Important themes emerged that will play a large part in our revision and development of the ESG Fact Sheets and Guide. We are confident that the future of ESG investment analysis in the leveraged finance markets will no doubt offer more growth and ample opportunity for further dialogue. We look forward to continuing our work with companies and their advisers, and credit analysts, in the workshops scheduled for next year.

Upcoming Event: ESG Workshop

The ELFA and the PRI are hosting a new virtual workshop to bring together sub-investment grade corporate borrowers and credit analysts to discuss ESG factors that may be material to credit risk and topics that investors would like to see disclosed in offering materials and ongoing company reporting.

The ESG Workshop will begin at 14.00 (registration at 13.30) on 28 January and last for approximately two and a half hours. The event will begin with a short introduction by the PRI and the ELFA, following which attendees will break out into sector-focused group discussions. Discussion guides designed to focus on the relevant ESG topics for each sector will be made available to attendees prior to the event.

We are aiming to include the following sectors at the event: chemicals, industrials, retail / consumer, and technology / software.

Following the break-out sessions, we will come back together to discuss key points raised by each group. Information gained during the event will be used to create sector-specific ESG Fact Sheets for the leveraged finance market.

The event is part of a collaboration designed to create synergies between the PRI's ESG in Credit Risk and Ratings Initiative[1] and the ELFA's ESG Disclosure Initiative.

For more information contact: events@elfainvestors.com or sixtine.dubost@unpri.org.

[1]The PRI's ESG in Credit Risk and Ratings initiative is funded by the Gordon and Betty Moore Foundation through the Finance Hub, which was created to advance sustainable finance.

About the ELFA:

The ELFA is a professional trade association comprised of European leveraged finance investors from over 35 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.

About the PRI:

The PRI is the world's leading proponent of responsible investment. It works: to understand the investment implications of ESG factors; to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions. The PRI now has over 3,300 signatories who collectively manage US$100 trillion in AUM. For more information visit www.unpri.org

European Leveraged Finance Association
35 Ballards Lane, London N3 1XW
T +44 (0)7921 384457
E support@elfainvestors.com

European Leveraged Finance Association