ESG ENGAGEMENT IN PRIVATE INFRASTRUCTURE DEBT

SIGNATORY TYPE	**Investment manager**
OPERATING REGION	**United Kingdom**
ASSETS UNDER MANAGEMENT	**£282* billion****
FIXED INCOME AUM	**£180* billion****
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WHY ENGAGE WITH BORROWERS?

Given the long economic lives of many infrastructure assets, private infrastructure debt can be very long dated in nature, often having tenors of 20 to 30 years. It is therefore vital that lenders fully evaluate, mitigate where possible, and price all risks associated with the investment to ensure that underlying investors are adequately protected against, and compensated for, the risks they are taking on. This is particularly important for private debt investments as it is often harder to seek repayment or sell a private debt asset than it is for a public debt investment.

ESG factors can have a material impact on long-term investment outcomes, and as such they play an integral role in the lending decision-making process. Although debt holders typically have less involvement in the ongoing management and implementation of borrower strategy and policy (relative to equity holders), the inclusion of appropriate clauses in finance documentation and active engagement with borrowers on material ESG issues can encourage greater disclosure and transparency.

It can also ensure risks are dealt with appropriately to protect the value of investments.

Engagement can be particularly effective for private infrastructure debt because:

- There is often a sole lender or a small number of lenders – compared to multiple lenders in a public corporate bond issue – so lenders usually have closer relationships with borrowers and better access to engage early.
- Having an ability to negotiate on a purely bilateral basis allows for a closer dialogue with borrowers on ESG issues and other risks.
- Private lenders often have greater access to information about borrowers and have more influence on them since private debt can be an important source of funding for the borrower.

* Rounded to the nearest £ billion

** As at 30 June 2017

ENGAGEMENT PROCESS

PRE-INVESTMENT ENGAGEMENT

Private infrastructure debt deals usually take a long time to negotiate and involve extensive credit analysis. Due diligence is typically carried out before investing to determine the borrower's ability to repay and the quality of the assets to provide the required risk-adjusted returns over the long term. This allows time for engagement on ESG issues prior to new issuance, which is particularly important given the illiquidity of most private debt investments.

Part of our due diligence process involves working with third-party technical, legal, tax and insurance advisors, where available, to assess all investment risks which have the potential to impact on the performance of the investment – including ESG risks. These advisors are experienced specialists, well-versed in the many different aspects pertaining to a particular sector or industry. In practice, this is often an iterative process, with initial risks being identified by our advisors, then engaging with the prospective borrower to find ways to mitigate the issues before deciding whether to invest.

POST-INVESTMENT ENGAGEMENT

It is equally important to engage with borrowers through the lifecycle of the investment to ensure problems do not arise over time. The same analysts who negotiate the original transaction documentation remain responsible for the ongoing monitoring of these assets and liaise with technical advisors where appropriate. This can help highlight emerging issues and identify remedial action. Hence, knowledge and relationships are retained through the project life and there is a better alignment of interests for the long-term success of the investment.

Covenants can act as early warning signs to lenders. Private loans tend to have strong covenants and controls attached, so a lender can engage with borrowers if things start to go off track during the life of the investment. Our documentation, as standard, requires compliance with local laws and standards, and often includes a broad array of ESG considerations, while the key contractual terms of each deal are customised to protect the investment from adverse scenarios. An example of where we have included an ESG clause in our documentation requires each operating company to comply with and conduct all operations in accordance with all applicable environmental laws and environmental and social standards.

ENGAGEMENT IN PRACTICE

ENVIRONMENTAL: PURSUING SUSTAINABLE WASTE MANAGEMENT

Context	We provided debt to a company to build a facility that incinerates waste material and produces electricity to power homes in the UK. The project deals with the disposal of domestic and commercial waste, and some of the residue after the incineration – the 'bottom ash' – was originally sent to a secure and protected waste disposal site. With technological advances, it is now possible to treat the bottom ash so it can be recycled and used in the construction industry as a sustainable building material.
Engagement focus	The issue of how the plant intended to manage the treatment of the bottom ash arose during ongoing monitoring of the investment and in discussion about the plant's operations. Rather than simply agree to a change in the original approach to dealing with this potentially hazardous material, we wanted to verify that it was being processed in a sustainable manner by the new third-party recycling facility, and its usage presented no danger to the environment and public health. We felt that this issue warranted engagement with the borrower in order to protect against any negative implications for our investors and on our business resulting from improper treatment of the bottom ash. We believe it is important to ensure that any potentially adverse social and environmental consequences of our infrastructure projects are limited as far as possible and well managed, which further strengthened our motivation for engagement.
Outcome	At our request, the operator of the plant has visited the site to inspect the recycling of the bottom ash and has reported back to our technical advisor to provide us with the necessary comfort.

SOCIAL: APPRAISING WORKING CONDITIONS IN SUPPLIERS TO OUR SOLAR ENERGY INVESTMENTS

Context	We engaged with a prospective borrower in order to examine, where possible, the working conditions across its global component supply chain. This included occupational health and safety standards for staff involved in this type of high-tech production, and key safety standards that specify and describe the fundamental construction requirements for photovoltaic (PV) modules in order to provide safe electrical and mechanical operation.
Engagement focus	In all our potential investments, we typically look at a range of social considerations, and in this case, where solar panels were sourced from manufacturers outside the OECD, we wanted to make sure sustainable labour practices were being adhered to, given the lack of transparency in a number of countries. We were alerted to this potential issue after a number of media reports had uncovered poor working conditions for factory workers in other industries.
Outcome	We raised the issue with our technical advisor who was able to provide the required confirmation based on an inspection of a number of the manufacturing facilities. We were further satisfied that the panels used in the portfolio of solar projects being financed complied with relevant product quality assurance standards and environmental management standards for the safe disposal of waste electrical and electronic equipment (WEEE). For the collection and recycling of old PV panels, producers are legally required to join a producer compliance scheme (PCS) to meet their mandatory obligations. One such scheme, PV CYCLE UK, provides full compliance services under WEEE regulations. We proceeded with the investment taking into account the information disclosed as part of this engagement.

GOVERNANCE: SEEKING TO IMPROVE THE QUALITY AND ACCURACY OF INFORMATION

Context	We worked with a borrower in the renewable energy sector to improve the transparency and level of financial and written reporting from a project which had initially provided strong reporting, but which had deteriorated such that we deemed it to be poor and lacking in sufficient detail.
Engagement focus	Due to the deterioration in information, we met with the project company and its major shareholder to discuss these governance issues and how to get the investment back on track.
Outcome	The borrower ultimately decided to increase its finance team headcount, and employ more suitably qualified personnel. Engaging with the borrower on this issue meant that we were able to agree a constructive course of action and achieve an outcome that was both positive for our underlying investors and the borrower. It has also led to a better relationship with the borrower.

Context	In another example, we had concerns about the accuracy of a borrower’s reporting.
Engagement focus	We decided to engage with them after assessing that the risk was material to the investment. It was clear that the borrower was unable to provide the level of detail needed to meet the contracted information requirements.
Outcome	Despite granting the borrower sufficient time to address the situation and having consistent interaction with them, the situation did not improve. We took the decision to seek repayment as we were uncomfortable with the governance in place at the borrower – our ability to monitor the investment was materially diminished due to the quality of the data provided. Although it is often difficult to seek early repayment in private debt transactions, full repayment was achieved ahead of the legal maturity of the facility, with no loss to investors.

NEXT STEPS

As a responsible long-term investor, ESG risks and opportunities have always played an important role in our credit analysis, due diligence, investment and engagement processes. We will continually monitor our engagement process and continue to use our interaction with companies or projects to press for greater disclosure of ESG issues.