HOW TO IMPLEMENT ESG ANALYSIS IN CREDIT RESEARCH

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At Insight, we believe that incorporating environmental, social and governance (ESG) risks within credit analysis, alongside other investment considerations, is achievable and beneficial for investors. We have been investing responsibly on behalf of our clients across our corporate bond portfolios for over a decade, and our credit selection process fully integrates ESG risks.

In this article, we discuss how ESG risks are considered within our credit portfolios, and offer a case study that reveals how ESG issues had a direct impact on our investment decision-making.

WHY WE CONSIDER ESG FACTORS IN CREDIT RESEARCH

The characteristics of bond investing increase the importance of ESG factors. Bondholders do not get to vote on board re-election; raise objections at say-on-pay votes; reappoint auditors; or approve material acquisitions (that may have a negative credit impact).

Furthermore, bonds are less liquid meaning you are more likely to have to hold them until maturity. This raises the importance of understanding as much about the long-term and social term risks facing an issuer over the life of a bond.

CREDIT RISK ANALYSIS AND ESG RISKS

The universe for credit within our fixed income portfolios covers four main areas: investment grade, high yield, loans and asset-backed securities. In discussion with portfolio managers we apply filters to this universe to arrive at a smaller group of investable issuers, subject to rigorous fundamental analysis by our in-house credit analysis team. We screen out companies that offer insufficient access to financial data and company management and securities which are insufficiently liquid.

Figure 1: Insight's checklist for corporate bond analysis incorporates ESG risks

Liquidity	Assuming no access to capital markets in the next 24 months, what is the impact on the issuer's liquidity?
Contingent liabilities	What is the magnitude of the issuer's off balance sheet liabilities such as pension deficits, operating leases etc.?
Regulatory risk	To what extent is the issuer's industry subject to regulation and changes in regulation?
Event risk	Does the management have an appetite for debt financed M&A? Is the company's share price underperforming?
LBO risk	Is the business likely to be subject to an approach from or a bid by private equity?
Environmental, social, governance (ESG)	Is the issuer properly managing environmental, social and governance risks?
Each factor scored 1 (good) to 5 (bad)	

Source: Insight.

To evaluate the likelihood of future changes in a company's credit rating and the potential for a sudden change in credit quality, our analysts conduct detailed credit risk analysis. This involves a fundamental review of the company's financial risk, in particular its cash flow, revenue and profitability.

Particular attention is paid to the scoring of key business risks using a checklist. This checklist examines important sources of risk that can lead to a sudden deterioration in credit quality or that may not be readily apparent from an examination of a company's financial performance (see Figure 1).

Ultimately, default risk is the prism through which the analysts consider ESG issues. Our credit analysis team is charged with determining the materiality of ESG risks, defined as the contribution these make to the default likelihood of a potential investment.

A failure to meet recognised standards of good governance and responsible management may represent threats to financial performance that are not adequately compensated by the expected returns; indeed, effective management of the environmental and social aspects of the business are useful indicators of the overall quality of management. ESG data and research can provide indicators that management have adopted and implemented appropriate policies, systems and controls to manage risks and comply with relevant codes, laws and regulations and go beyond them to meet the expectations of key stakeholders.

The analysts also perform a comprehensive financial analysis, which typically includes an examination of the earnings of an issuer as well as its balance sheet structure, together with a forecast of a company's future cash flows, debt burden and credit metrics which can be benchmarked against other companies.

Insight's analysts assign credit ratings and a trend indicator to the companies they cover, providing our portfolio managers with an opinion on the creditworthiness of a borrower or bond issuer. A full investment analysis is required to inform an investment decision and ESG risk scores are a necessary element in assigning a credit rating that indicates the relative risk of default loss.

CASE STUDY: BRUSSELS AIRPORT, BELGIUM

In 2013 we invested in Brussels Airport's new bond issue. As our first investment in the company, we met with management during the roadshow to discuss the company's strategy, risks and financial position. At the time of issuance, we liked the solid security package offered to bondholders as well as the traffic growth experienced by the airport.

Risks we identified

At issuance we were given assurances that some of the financial reporting gaps would be improved. We requested the company disclose financial information in line with international standards: both IFRS and US GAAP require cash flow statements for larger issuers. We believe the cash flow statement is a critical tool for an investor to gauge the credit profile of an issuer.

For Insight, accounting risks are a corporate governance concern. The board has a responsibility to ensure that financial information is reported to investors in a fair, transparent and consistent manner and meets their expectations. Access to this information informs our decision to buy or sell an investment. It is a core reason why we look to see if an audit committee is independent.

Engagement

In September 2015 we asked the company for more clarity on their financial position. We were disappointed by the company's financial disclosure since the issuance of the bond. The lack of a full yearly cash flow statement and more detailed footnotes was an issue for us: we could neither reconcile the P&L statement, cash flow and debt numbers in their statement, nor could we make financial forecasts with the normal degree of confidence.

Result

We aim to invest in companies where we believe we have full transparency of their financial position. In this light, Brussels Airport's thin financial disclosure impacts our ability to invest in their bonds. With accounting scandals having a material business and credit impact, we are acutely aware that operating in line with international accounting standards and industry best practice is a fundamental prerequisite, and we believe that not doing so introduces unnecessary risk for investors. In October 2015, given the company's lack of response to our request, we decided to sell the bonds from all portfolios. We switched our position into a more robust issuer at comparable spread levels.

Implications

Our concern over companies' provision of transparent and accurate accounting was one reason for our decision to join a new investor initiative led by the Financial Accounting Standards Board.

Insight's ESG risk indicators

Insight uses independent third-party ESG research and ratings. We transpose all scores into a five-point risk scale for use within our credit risk checklist and in our internal investment platform. Our analysts use the separate scores for environmental, social and governance categories of risk, along with an overall normalised ESG score, as part of their analysis of non-financial risks in their credit risk templates. The database contains indicators in the following categories:

Governance
- Board accountability and effectiveness
- Executive pay policy and oversight
- Ownership structure and control
- Integrity of accounting practices
- Bribery and corruption

Social
- Health and safety
- Employee relations
- Supply chain control
- Product safety
- Product sourcing
- Labour management

Environmental
- Climate change risks and vulnerability
- Pollution and waste
- Biodiversity and land impact
- Product footprint
- Water usage
- Raw material sourcing

Accounting
- Securities class actions
- Litigation
- Transactions, including M&A
- Aggressive decision-making
- Basic financial disclosures

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