ESG: The PRI Report on Engagement

ESG & SRI Quarterly Letter

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SHENKMAN

New Report on ESG Engagement from the PRI

The Principles for Responsible Investment (PRI) released a report in April entitled "ESG Engagement for Fixed Income Investors." The report has some very valid points about the types of engagement fixed income investors can be effective with and where they probably cannot.

Shenkman Capital is a signatory of the PRI. However, we were surprised when the recently released Executive Summary of the report stated that, "… the materiality of ESG risks is less familiar to bond than equity investors…" We cannot speak for all bond investors, but we have a high level of conviction that ESG factors are very material to the leveraged debt markets.

We do understand there are limits to how debt holders can engage via corporate management versus equity stakeholders. Within these limits, however, debt investors can engage on many factors including some that equity holders cannot; they just need to choose to do so.

Engagement at Shenkman

A significant part of the requirements in our mandatory credit approval process has always focused on proper corporate governance, structure, contractual agreements, as well as management and underwriter track record. We have also included environmental and selected social issues as factors in our process for a very long time.

The materiality of governance factors in high yield has been apparent for some time, such as in the recent high profile battles over asset transfers. We were also involved with, and wrote a piece highlighting, bondholder push back on certain covenants that we viewed as egregious (see Under The Scope®: Bond Buyers Win a Vital Covenant Battle; February 2017). This battle received coverage in the business media as well. We have also communicated with investors about changes in loan covenants (see Under The Scope®: Arc of the Covenant; June 2014), a critical factor in that market.

Engagement with management is essential for investing in leveraged credits in our opinion. To get a credit through the approval process at Shenkman Capital, it is a requirement to have had communications with management. That engagement can focus on how management views their business plans and can be a forum where we can ask questions and express our views on ESG risks and other business concerns.

Our communication with management does not end at the approval process. Our research team is required to be in touch with all of our approved credits at least every quarter. This communication involves telephone calls as well as on-site visits and management presentations in our offices. We track these contacts, and they total several thousand every year. If we detect material shifts in a management's business approach, we are required to have a portfolio manager review meeting.

Ultimately, bond and loan holders do not have the same ability to undertake proxy votes that shareholders do, but they can engage with management, particularly at the time of initial financing and at times when refinancings arise or amendments are sought. The finite time frame of a debt instrument can be a benefit in engaging with managements. Once stock is issued, public companies do not necessarily need to return to reissue regularly (though they usually have an interest in how the stock trades). Debt has a maturity date, so an issuer will likely have to return to the credit markets to refinance, and investors can apply pressure to these "repeat" issuers. Credit investors also have opportunities to engage with private companies and, therefore, can sometimes influence a broader corporate audience than equity holders. Debt holders that operate in actively traded markets, such as high yield bonds and leveraged loans, can make decisions about how a company handles its ESG issues by deciding where to invest their capital. This can occur even after the initial purchase has been made by selling an investment. This is one of the attractions of investing in publicly traded, rather than private, investments.

Notable Corporate ESG Items

In this section, we highlight some recent events related to ESG factors involving credits within the leveraged debt markets.

A few years ago, we invested in a chemical company. After regular monitoring of the investment, however, we chose to exit the position, given our view that the company's disclosure over environmental issues was inadequate. The company has recently been sued by a state attorney general over release of toxic chemicals from one of its plants.

Within our convertible bond business, we have continued to add new issuers that focus on "non-fossil" energy sources. These alternative energy companies have been active issuers in the convertible bond market.

A number of companies in which we invest have made announcements about environmentally friendly initiatives. All of these companies deal directly with consumers, which may be meaningfully influencing these efforts. An operator of theme parks intends to make one of its larger parks completely powered by solar power. A manager of resort properties is looking to make one of its largest properties 100% powered by renewable energy by year-end. A U.K. based food retailer intends to remove all plastic from the packaging on its in-house items.

Our last comment is about a company that is no longer in the below investment grade universe, General Motors (GM). GM made a major announcement about its disclosures this past month. It stated that it would no longer release monthly auto sales. While we can understand, and respect, some of the rationale behind this decision, we do note that the level, format and consistency of disclosures are a critical part of governance in our view. Any change in the way a company reports financials or key performance indicators requires a deeper review of the rationale and impact of those changes.

Below is our table that highlights how credits that were recently brought to our Credit Committee for approval have fared on our ESG ratings. Recall from our prior ESG Quarterly Letter (January 18, 2018), this data is from our ESG assessment analysis and is a summary of our ESG tiering system where lower tiers are better ratings.

ESG Results (Tier I is Best)

January 1, 2018 – March 31, 2018	
Distribution	
ESG Score Tier	**Number of Instances**
Tier I	**40**
Tier II	**4**
Tier III	**0**
Tier IV	**0**
Total	**44**

We continue to move forward to build out our technical systems and data on tracking this information for our entire Approved List and have added team members to achieve these goals.

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