

# A Deeper Dive on Corporate ESG

## ESG & SRI Quarterly Letter

October 29, 2018



Risk assessment of ESG factors has a critical role in our investment analysis at Shenkman Capital, being a part of the approval process for every credit across our core strategies. ESG risks can materially weaken the investability of a credit. Proactive management of ESG risks can prove to be a positive for a credit. This can involve steps to mitigate many concerns even in an industry that tends to have high risks. We believe it is important to examine a company's negatives and positives in its approach to ESG-related issues.

In this quarterly ESG review we highlight Stora Enso which is in the lumber, paper and packaging industry. These are businesses that typically can attract a high level of concern over ESG issues, particularly regarding their environmental impact. However, the company has focused heavily on managing ESG risks and sustainability within its operations. The company has been a high yield debt issuer and this year, received a ratings move to investment grade from one of the rating agencies. We believe that examining their efforts in this quarterly review would provide insight into Stora Enso's highly visible approach on ESG standards. We have included information from its public filings and our recent conversation with management.

Stora Enso is focused on renewable solutions in the packaging, biomaterials, wood construction and paper business segments, and is vertically integrated as a large owner and manager of forests around the world. One of the company's goals is to replace products made from fossil fuels with sustainable wood-fiber products. Within its organization, the company has an individual EVP for Sustainability who reports directly to the CEO. The Board's Sustainability and Ethics committee oversees the implementation of the company's sustainability strategy. Each of the five divisions within the company (e.g. Biomaterials, Packaging Solutions) has its own sustainability head which aggregates key performance indicators (KPIs) for that specific segment, down to the individual mill level.

Selected KPIs are managed by internal subject-matter experts. For example, an individual who oversees waste improvement coordinates an appropriate water usage indicator which is then sampled and collected regularly. Stora Enso's pulp, paper and board mills are certified against the ISO 14001 environmental management standard which is third-party audited.<sup>1</sup> To illustrate, the company has a set target for water usage. Across Stora Enso's production footprint, 96% of water used in production is returned to the local environment, with the company processing used water through its treatment plants which are located on site. The company also looks to minimize and reduce other forms of production-related waste. In cases where Stora Enso owns a minority stake (i.e. Tornator and Bergvik Skog) or has entered a joint venture (i.e. Veracel and Montes del Plata), Stora Enso will have board representation to ensure the investment carries a harmonized sustainability approach.

Beyond Stora Enso's internally controlled processes, the company also engages with its suppliers to ensure compliance with Stora Enso's Supplier Code of Conduct which includes contractual requirements regarding human and labor rights, environmental commitments and responsible business practices. The company has also set a target to reduce greenhouse gas emissions from operations by 31% per tonne of pulp, paper and board produced by 2030 from the 2010 base-year, which is in line with the limit set for global warming by the Paris Agreement. The company also distributes detailed, public reports that list ESG-related key performance indicators (KPIs) across the company that will also include community engagement, lost-time accident rates and employee distribution data to ensure fair compensation and equal opportunity.

The Economist Newspaper published an article earlier this year about the potential for increased usage of plant fibers in production, which then can be utilized in producing toys, furniture and cars. The fibers lock up carbon and therefore have much lower emissions than large producers of carbon gases such as concrete and plastics. The article cited Stora Enso as developing ways to reuse waste from its production and reduce the need for fossil fuel-based products. Specifically, it noted that Stora Enso developed a way to take lignin, a waste by-product in the production of paper, using it as a substitute for oil based resins and adhesives in the making of plywood.<sup>2</sup>

Stora Enso is also tapping into the Green Bond market. It recently placed a revolving credit facility which has loan pricing based on the company's ability to reduce greenhouse gas emissions per tonne of pulp, paper and board produced. Management mentioned the company initially received a "small discount" versus that of a standard financing. While stating that sustainability initiatives are not taken into account by the rating agencies, management pointed out that the company has seen increased engagement from the investor community. To this extent, Stora Enso regularly organizes separate investor meetings which focus on ESG-related topics.

Even in industries that potentially have very high levels of ESG risks, companies can take steps to materially mitigate and manage some of these concerns. It is critical in the analysis of these risks to engage with management and question them on their practices. In this quarter's note we wanted to highlight an example of a company that is highly proactive in trying to mitigate ESG risks inherent to its business and industry. Stora Enso has worked diligently to improve its ESG status while also being good stewards of lenders' capital. As a result of these efforts, the company has also improved its overall credit quality.

<sup>1</sup>Stora Enso Sustainability Report (2017) Annual Group Sustainability reporting is externally assured by an independent third-party provider with a level of Limited Assurance. In addition, Stora Enso is one of the few companies in the world that assures its fossil CO2 reporting for stakeholders at Reasonable Level.

<sup>2</sup>The Economist Newspaper (14 June 2018) Making buildings, cars and planes from materials based on plant fibers.

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