ESG Incorporation in Practice

ESG & SRI Quarterly Letter

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SHENKMAN

ESG Incorporation

Through our formal investment process, Shenkman Capital seeks to consider all risks, including those related to ESG, that may have an impact on a company's future prospects, operating performance or valuation. By incorporating ESG factors, we can potentially uncover areas of risks or opportunities that were not raised by traditional analysis. As we have written about before, over the last couple of years we have taken a number of actions to systematize the incorporation of ESG factors involved in our credit approval and monitoring process. Additionally, we became a signator to the Principles for Responsible Investment ("PRI"), launched a firm-wide ESG policy and developed a proprietary ESG checklist.

ESG Checklist

Our ESG checklist was informed by a growing body of research and experience in the ESG space, as well as our 30+ years of experience assessing high yield companies. The checklist is the same for all companies regardless of industry, in order to create metrics that are comparable. Amongst other factors, these checklist items were informed by the UN Global Compact. Some of the specific topics that are addressed include:

- Emissions of carbon/greenhouse gas/pollutants
- Environmental liabilities/spending/regulations/violations
- Impact from climate change
- Access to skilled labor
- Child labor/human rights violations
- Community/stakeholder/labor/consumer relations
- Quality of financial reporting
- Management integrity/honesty
- Strategic/financial policy
- Board composition

We use this checklist to tier our companies into four categories. If a company's ESG ranking places them in the lowest two tiers then the credit must be reviewed by a member of the Risk Committee prior to being added to the approved list. The Risk Committee will then work with the analyst on communicating to company management the reasons for their ESG ranking and the types of activities necessary for improvement.

Any notable items on the ESG checklist are discussed during the credit approval process and serve as a way to foster conversations around any particular ESG issue. These highlighted risks and opportunities help to frame the investment thesis for the company. They also inform future dialogue with management teams.

The Checklist in Practice – Energy

We have gained experience seeing that the issues raised can vary by company and industry. One question that comes up – shouldn't all energy companies be in the lower tiers due to their environmental risks? This however is not the case, since the environmental questions are answered in relation to other companies within the same industry. Therefore, it is only weak performers that get flagged in any one industry. We would consider avoiding an entire industry if overall concerns on ESG factors were too high, however this is not the case in energy. We believe there is a balance between factoring in good operators in the sector with a heightened sensitivity to environmental concerns that are inherent in the industry.

Emissions of Carbon/Greenhouse Gas/Pollutants

While all non-renewable energy companies contribute to the emission of carbon, our process seeks to highlight any issues that could impact a particular company in a more meaningful way. For example, we highlight specific companies in the Bakken oil play where flaring is more prevalent due to the lagging infrastructure to process the natural gas produced from the wells.

Environmental Liabilities/Spending/Regulations/Violations

Another factor that we highlight regards environmental regulations. While many energy companies face uncertain future regulatory issues, we highlight the DJ Basin in Colorado. In November 2018, an issue made it onto the ballot regarding well setbacks, or how close an oil or gas well can be from homes or other occupied buildings. While the initiative failed, we highlight the increased risk of these actions in this part of the country.

Impact from Climate Change

Due to a shift away from fossil fuels, one could see that all coal, oil and gas companies are negatively impacted by climate change. However, our ESG checklist highlights companies that have a higher exposure to this risk relative to others in the industry. For example, offshore producers operating in the Gulf of Mexico would be flagged, as their operations are more susceptible to severe weather events. More recently, there has been a focus on water scarcity issues in certain regions. We have discussed the impact on producers in the Permian basin and any potential water availability issues.

Answer for Investors That Want a Different Approach

Some investors would prefer to have no exposure to certain industries, such as those that are involved in producing fossil fuels. We have also used our research resources to tag the credits on our approved list for various tolerances to certain industries or exposures. As a result of this work, if an investor wishes us to run a separately managed account with no revenue exposure to tobacco and fossil fuels, we can implement that. Additionally, if an investor was only focused on excluding investments that received more than 50% of their revenue from these industries, we could do that as well.

We believe that our systematic consideration of ESG risks combined with our flexibility and sensitivity to specific clients' SRI requirements allows us to better monitor potential risks, as well as customize portfolios when needed.

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