Environmental, Social, Governance Factors
In the Eyes of the Bondholder

Beutel Goodman became a signatory of the U.N.-sponsored Principles for Responsible Investment (PRI) in June 2019. On the credit research side, we have been incorporating Environmental, Social and Governance (ESG) factors into our credit analysis for the past several years; signing the PRI serves to formalize and augment the ESG integration.

This is the first in a series of "Topic of the Month" on ESG that we plan to roll out over the course of this year.

Source: Adobe Stock

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Beutel Goodman
Fixed Income Team

Historically, fixed income has somewhat lagged equity in embracing ESG. However, in the past several years, the application of ESG principles to fixed income has grown significantly, especially with the rise of sustainable finance and green bonds.

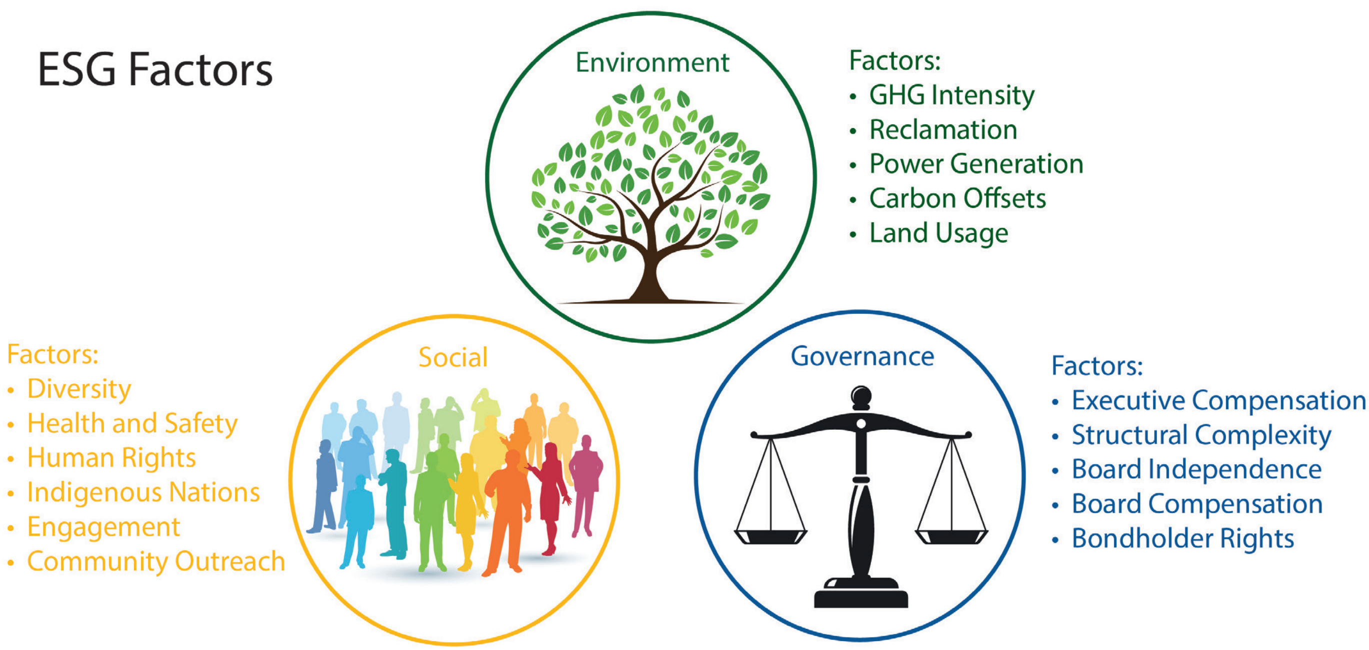
The long-term nature of fixed income investing generally fits well with the long-term nature of ESG risks and opportunities. Many of the ESG factors a fixed income investor considers would be the same as an equity investor — both are trying to assess the sustainability of cash flows in light of any ESG risks. The difference, then, is mainly on the governance side; equity investors have opportunities to vote proxies on items such as Say on Pay, while fixed income investors can only vote proxies when there are proposed covenant changes — a fairly rare occurrence. Just because fixed income investors can't vote, however, does not mean that they cannot engage with management teams and advocate on ESG issues. The frequency of debt issuance provides bondholders significant contact with issuers, and may afford them a stronger voice to effect positive change.

Simply speaking, ESG factors may affect a borrower's ability to repay debt. Significant ESG issues such as carbon-intensive business models, labour disputes, data breaches, and fraud can translate into credit risks that can negatively affect cash flows, capital costs, and reputation. ESG analysis can help to uncover likely risks or disruptions that could negatively impact spreads. Issuers with less balance sheet flexibility are typically less able to absorb the costs and fallout from an unexpected ESG event. For example, the Pacific Gas and Electric (PG&E) company's transmission lines triggered the deadly Camp Fire in California in November 2018. The subsequent investigation uncovered falsified natural gas safety records, inadequate maintenance of equipment, and transmission lines that were not buried even though the regulator had approved the capital budget for the project. The resulting fines and liabilities forced the company into bankruptcy.

ESG can also work on the positive side. In 2013, Rio Tinto experienced a landslide at its Bingham Canyon mine in Utah. No one was injured as the site was evacuated due to the company's early warning system. This incident underscores the importance of ensuring that a company has the necessary safety measures in place to either protect against an unforeseen event, or respond quickly to mitigate further damage.

Governance for corporate bonds takes on a different hue. Oversight, lack of transparency and accountability can negatively affect credit spreads. When meeting with management, fixed income investors need to evaluate whether management has adequately considered and responded to debtholders' needs and concerns. These issues may include explicit leverage and ratings targets; a capital allocation policy; a reasonable payout ratio; and management incentives that align with all stakeholders, not just equity holders. In addition, bondholders must take the experience of management into account. For example, do any members of the management team have previous experience with a defaulted company or a track record of disadvantaging bondholders? Bondholder governance can also be manifested in demanding stronger bond covenants and even asking for ESG-related issues in bond trust indentures.

Numerous companies over the past few years have taken advantage of low interest rates to issue debt at record levels. In many cases, the use of proceeds was not to fund capital expenditures, which generates cash flows to help fund the debt-servicing requirements.



Source: Beutel Goodman

Monies raised were used instead to fund share buybacks or dividend increases. While not all cases represent a major risk to bondholders, credit investors need to ensure that management takes into account leverage and credit ratings when they undertake shareholder-focused initiatives. In addition, credit investors need to be vigilant as to whether management is solely focused on actions that serve to drive the share price higher. This is particularly pertinent in cases where there is significant share ownership and share compensation by management.

Emphasis is also placed on the company's ownership structure, board composition and takeover defenses, with an eye to the potential threat of a private equity takeover and leveraged buyouts. In essence, governance for bondholders comes down to a question of trust; i.e., do we trust the company and the management team to pay its bonds back upon maturity? A company that ignores bondholders' interests could see its cost of capital increase or be left on the sidelines of the bond markets, unable to issue. Governance needs to be viewed through the lens of what is good for all stakeholders.

A common question in terms of integrating ESG into credit research is, does it contribute to value-added performance? At Beutel Goodman, we have a fiduciary responsibility to act in the best interests of our clients. As value managers, our primary objective is to deliver superior risk-adjusted portfolio performance over the long term. While the data is evolving as ESG integration is growing, there is evidence that ESG for credit investing does in fact enhance performance. A study undertaken by MSCI on U.S. investment grade and high yield corporate bonds found that companies with high ESG ratings tended to have tighter credit spreads, outperforming corporate bonds with lower ratings, especially during periods of market volatility [1]. A review in 2017 by S&P on how environmental and climate risks have affected global corporate ratings over a two-year period identified 106 cases where those risks resulted in a change of rating and/or outlook [2]. Additionally, S&P studied downgrades from the period 2010 through Q1/19, and found that approximately 57% of the downgrades from the "A" category to the "BBB" category were attributable to management decisions that led to a more aggressive credit profile [3].

In a recent report, the CFA Institute concluded that there is no best way to do ESG integration and no "silver bullet" [4]. Integrating ESG into an active investment management process requires analysis of both qualitative and quantitative data, engagement with the issuer, and then a judgement call on the potential impact of ESG factors. At Beutel Goodman, we have approached ESG not through negative screening, but through stewardship and having a seat at the table. In our view, divestment leaves the manager with no stake and therefore no potential to help drive responsible corporate practices. For example, a negative screen on carbon would likely exclude utilities with coal-fired generation. This exclusion would ignore an opportunity, as some utilities are undertaking projects to convert from coal to cleaner sources of power such as natural gas. Most of these conversion projects are rate-based (i.e., regulated) and therefore generating significant cash flow and returns. We consider ESG issues not only as potential areas of material risk, but also as opportunities to promote improvement. ESG-related risk exposure will not therefore preclude an investment, although as a rule of thumb, we will not make any investments where ESG factors make it difficult, if not impossible, to accurately assess the value of the business.

ESG integration into credit research at Beutel Goodman is an iterative process and we work closely with our equity partners to develop best practices. We pursue our objective to deliver superior risk-adjusted portfolio performance through the thoughtful and patient ownership of debt and equity positions in high-quality companies. Companies that gain high marks for their ESG practices often share many of the sound fundamentals that are attractive to our value investing approach; namely a business whose qualities and management practices generate stable, long-term cash flows. ESG factors have the potential to materially affect the long-term sustainability of a business and are thus an important part of our analytical process.

At Beutel Goodman, ESG analysis for corporate bonds is the responsibility of the credit analyst. We do not have a separate ESG team. The analyst is responsible for owning the decision on the company from a credit perspective that incorporates ESG, as well as on relative value basis. Currently, all of our credit research reports contain a write-up on ESG. We employ company sources, management interviews, rating agencies' research, and sell-side research, as well as third-party ESG research. In our reports we perform a peer analysis, identify the greatest ESG risks for the company, and make a list of issues to engage with the company on.

Engagement is both proactive and reactive. The companies on the Approved List run the gamut of ESG disclosure, from not producing any sort of sustainability report to best-in-class reporting. Issues we may engage companies on include the following:

- Improved disclosure, or disclosure that adheres to Sustainability Accounting Standards Board (SASB) or Global Reporting Initiative (GRI) standards;
- Direct ESG oversight at the Board level, and tying executive compensation to achieving ESG objectives;
- Making a net zero GHG emissions by 2050 commitment;
- Emission reduction targets;
- Projects that the company is undertaking to reduce its environmental footprint;
- Developing policies on human rights and bribery;
- Having a whistleblowing monitoring system;
- Tax transparency;
- Preparedness for events such as worker accidents, pipeline leaks, and mining spills;
- First Nations and other stakeholders engagement;
- Board independence;
- Executive compensation; and
- Diversity and inclusion in the company's workforce, senior management and on the Board of Directors.

The positive outcome of the rise of ESG is that engagement across the asset management industry is compelling companies to articulate to investors how sustainability creates value as part of their fundamental investment story and explain how they are addressing risks related to ESG matters. Integrating ESG into the investment process provides a more complete picture of the investment landscape.

Notes

[1] *Kevin. (2018) "Does High-Yield Receive The ESG Credit It Deserves?" MSCI.*

[2] *S&P. (2017). "How Environmental and Climate Risks and Opportunities Factor Into Global Corporate Ratings - An Update."*

[3] *S&P. (2019). "Credit Trends: To 'BBB', Or Not To 'BBB': Management Decisions Spur Most U.S. Corporate Downgrades To 'BBB.'"*

[4] *CFA Institute. (2018) "ESG Integrating in the Americas: Markets, Practices, and Data."*

BEUTEL GOODMAN
Investment Counsel