Engagement Series | **July 2021**

NEUBERGER | BERMAN

NON-INVESTMENT GRADE CREDIT TEAM

Developing a Roadmap for ESG Performance

Neuberger Berman's *Engagement Series* presents insights and case studies on our dialogue with companies, government entities and other securities issuers. In this edition, the Neuberger Berman Non-Investment Grade Credit team reviews the key takeaways from its 2021 roundtable discussion on environmental, social and governance (ESG) goals and disclosures for issuers.

For the Non-Investment Grade Credit team, ESG factors are closely integrated into our fundamental credit research process. Active engagement is a crucial element of our approach, helping to identify credit risk, and guide issuers toward practices that have the potential to enhance their credit profile over time.

In light of a changing landscape of disclosure standards and expectations, we recently conducted our second annual roundtable discussion on ESG engagement to explain our approach and general trends in the industry, as well as offer practical guidance for issuers. Joined by ESG Investing colleagues, we presented to senior management from 34 corporate issuers, who challenged us with a variety of thought-provoking questions.

Momentum in ESG

As noted by Joseph Lind, CFA, Senior Portfolio Manager for Non-Investment Grade Credit, ESG continues to grow in importance for investors. Whereas, a few years ago, the bulk of this interest might have come from Europe, today we find it across the globe. The number of investors who have become signatories to the UN-backed Principles for Responsible Investment has more than doubled in the past four years, while for our firm, roughly 7% of Non-Investment Grade clients have engaged in shifting their investment focus toward mandates that incorporate specific sustainability objectives. Moreover, major asset owners continue to tell us that they want their assets to reflect their values.

Jonathan Bailey, head of ESG Investing, reiterated this sentiment, noting that he had been impressed by the rate of adoption of ESG by our clients and policymakers, especially given the backdrop of enormous economic and market uncertainty, as well as serious health and social challenges. He observed that well over 50% of the due diligence questionnaires and requests for proposals received by the firm from potential investors now ask about ESG, and often in great detail. "It's no longer enough to say that you think about ESG—it's now much more about how that happens in the investment process."

ESG and Credit Analysis

As an investment manager, we believe it can be valuable for issuers to understand how our process works, and what we expect from them in terms of information flow and goal setting. Along these lines, the Non-Investment Grade Credit and ESG Investing teams provided a brief overview of how we incorporate ESG into the research process. As observed by Rachel Young, Co-Director of Non-Investment Grade Credit Research, this consists of two "pillars": (1) that our ESG analysis is not outsourced, but conducted by the same internal analysts who study issuer credit fundamentals, and (2) that we regularly take part in meaningful engagement, to encourage disclosures and to share with issuers the ESG risks that we believe may be material to their business. She outlined our proprietary ESG scoring system, which reflects our analysts' judgment as to material risks within a given industry, and highlighted our governance scorecard, which has been part of our framework for more than a decade; that scorecard is applied across all sectors to provide a consistent window relative to the broad issuer universe. Importantly, she noted that the Non-Investment Grade Credit Research team's investment committee assesses the various scores and analyst observations to identify the impact of ESG factors on credit prospects. The whole process is regularly revisited to fine-tune the value and accuracy of findings.

Key Data Sources

For investors, it can be valuable to understand the data sets being employed to judge their ESG performance. As explained by Steven Ruh, CFA, Co-Director of Non-Investment Grade Credit Research, we often draw on third-party data as a resource in the development of our own scores and analysis. These include specialist providers with a focused area of expertise (for example, TruCost for estimating Greenhouse Gas (GHG) emissions), mainstream data providers with a range of industry-specific metrics (MSCI on human capital policies in service industries), real-time data (employee sentiment from Glassdoor) and NGO/academic studies (such as the CPA Zicklin Index on corporate political contributions), among others. However, none of these sources is comprehensive, which is why we do a lot of our own work, for example, conducting proprietary credit-specific governance assessments based on qualitative analysis by our analysts.

As a firm, we are also increasingly focused on making sure we utilize data that can fill gaps where disclosure may be lacking, or in developing areas of research that may not yet receive much coverage by data providers. For example, data science can draw on credit card transactions, online activity, social media and more to help clarify the nature and impacts of corporate policy and practices. Another area of focus is increasingly scenario analysis in relation to climate risk. The idea is not to just look at the current footprint, but to assess how a company might be affected by changes in carbon pricing or carbon regulation, as well as the physical exposure to potential global warming.

Goal Setting

When it comes to ESG, the Neuberger Berman speakers explained that investors are increasingly bifurcating into two groups: those who want to hold companies that have already made a transition to low impact, and those who are willing to invest in companies that are a work in progress. The latter group of investors, which is probably the larger cohort, typically wants to see meaningful progress toward concrete goals. For the issuer, this means mapping out what the company wants to achieve, potentially with guidance from well-regarded frameworks including the London School of Economics' Climate Transition Program. The use of such frameworks can help with market understanding—and potential appreciation—of ongoing ESG efforts.

When setting goals, a trap for many issuers may be trying to be "all things to all people" with multiple initiatives across disparate areas. According to Chris Kocinski, CFA, Senior Portfolio Manager for Non-Investment Grade Credit, issuers can gain more traction if they focus on a more manageable number of goals that are aligned with their core business, employees or the communities they serve, martial needed resources and then execute effectively. Publicly disclosing their goals and then reaching them can help to bring external recognition. They can then repeat this process over time. For guidance on appropriate actions for a particular industry, the UN Sustainable Development Goals can be an effective starting point.

Looking specifically at equity, inclusion and diversity (EID), seeking broader racial and gender representation at the board level is a natural starting point, which has historically drawn attention from stakeholders as a way to achieve a diversity of viewpoints. However, ESG investors are increasingly looking for progress across entire organizations, understanding that the character of mid-level management can have a major influence on workplace culture. In this area, U.S. Equal Employment Opportunity Commission (U.S. EEO-1) data is becoming the disclosure standard around workforce demographics. However, investors will typically look beyond current information to assess corporate plans to enhance EID over time.

Cost of Capital

Given increased focus on ESG, a portion of investors are becoming more aggressive about reducing negative outcomes associated with their portfolios, with some of the largest institutions pledging the achievement of net-zero (reduced carbon emissions combined with offsets) by achieving better results from underlying companies or seeking to exclude certain industries from their portfolios. A standard approach is to start with a particular benchmark and then look for specific reductions over a number of years.

Although in some cases there is little room for dialogue, in others, investors may be reassured by proactive steps taken by companies. So, it is important for issuers to make measurable progress, particularly in natural-resource intensive industries, but extending to other sectors of the economy. As part of this process, investors will likely want greater information flow and dialogue around climate issues from portfolio companies. For issuers on "no-go" industries or that fall behind in terms of climate, the impact could be more than perceptional but affect cost of capital—incrementally at first, but perhaps more measurable over time.

By the same token it may be possible to clarify resolve on stated goals and reinforce reputation by linking cost of capital to ESG performance. Neuberger Berman, for example, has tied the borrowing costs in its corporate credit facility to sustainability goals. Issuance of "green bonds" may attract extra capital and come with modestly reduced yield expense, but they could also encourage a "halo effect" across a company's entire capital structure, with the potential for positive effects over time.

This also informs the work we do in our research processes and the dialogue with issuers, which is driven by credit analysts who also enjoy a deep understanding of company business models and can bring ESG performance into the context of broader prospects for those issuers.

Continuing the Dialogue

Engagement has always been a core element of our investment process, but is gaining nuance and precision through the array of data and disclosures discussed above. Moreover, it is taking on a more proactive and public role particularly through the *NB Votes* initiative, in which the firm reveals proxy voting positions in advance to encourage adoption of favorable ESG policies and clarify our thinking across a range of issues.

That said, the most effective engagement often comes down to direct dialogue with companies, to explain how the ESG landscape is evolving, what we are looking for, and how managements can enhance their prospects for credit stability. Over the years, the Non-Investment Grade Credit team has found many issuers to be appreciative of our constructive approach, and help in taking more concrete steps in their individual programs, at times weighing in on new approaches to financing, including social bonds. This latest roundtable was just one element in our overall approach, and we look forward to continuing the discussion in individual meetings, and again at next year's event.

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Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

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