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INSIGHT

How we manage ESG risks in our debt portfolios

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DEBT INVESTMENTS

IFM Investors integrates environmental, social and governance (ESG) considerations into its investment decision making and management processes across its equities, infrastructure and debt portfolios. This is an essential aspect of our approach to managing investment risk, and protecting and enhancing the value of our investments over the long term. We believe that poor practices in areas such as employee welfare, consumer protection, environmental management and corporate governance pose risks to the return of any investment.

This more in-depth, in-house ESG approach is more transparent for our clients and supports our increasing level of investment in private debt

While debt investments are not typically held for as long as some other types of assets, in debt markets we believe that well-governed and sustainably managed businesses are less likely to face unanticipated risks and therefore pose a lower risk of default or rating downgrade.

We have long incorporated ESG considerations into our due diligence and rating process as we believe that analysing and recognising the relevant ESG factors enables a deeper understanding of key business risks and the likely performance potential of an investment.

With this in mind, we have recently refined our approach to managing ESG factors within the IFM Investors Diversified Credit business, making it a separate but integrated part of our due diligence process. This more in-depth, in-house approach is more transparent for our clients and supports our increasing level of investment in private debt, which typically will not be covered by third-party ESG research providers.

Differences between ESG analysis for debt markets and equity markets

Whilst ESG considerations are relevant to all markets, there are subtle differences in the way ESG analysis needs to be applied in debt markets.

Equity investors own (in part or in whole) the companies in which they invest and have the ability to actively direct those companies and the manner in which they operate. An equity investor can have multiple points of influence including raising issues with management, making formal proposals at Annual General Meetings and actively voting on shareholder resolutions. Whilst thorough ESG analysis prior to making an investment is also important for equity investors, they also have the ability to exert influence on a company's ESG practices for as long as they remain invested.

In contrast, debt investors lend money to companies but do not have ownership rights, hence they typically have a lesser ability to influence company management over the life of the investment. Therefore, we believe an ESG approach for debt investing needs to be concentrated in the investment screening and due diligence phases, prior to entering an investment. Early stage screening enables us to avoid investments that do not meet certain ESG criteria, whilst our fuller due diligence in the underwriting process ensures that ESG risks are appropriately elevated in our credit assessment.

The other advantage of focusing our ESG research in the pre-investment phase in debt markets is that in cases where we identify material ESG risks, we can engage with the company's management and proactively seek mitigation to better manage these risks. This approach widens our acceptable ESG investment universe within debt markets and aligns with our preference to engage with the company rather than apply an exclusionary approach.

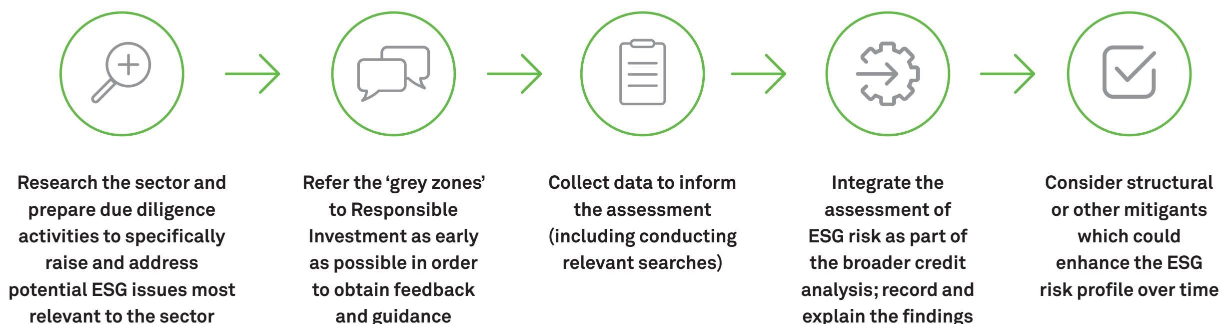
The other difference between debt and equity markets is the length of the investment. Lending facilities within private debt markets tend to have a tenor of between 3 and 5 years. This makes them potentially shorter term investments than those undertaken in equity markets. This shorter time horizon can impact the ESG considerations that are viewed as the most material from a debt investment perspective.

Our ESG assessment process for debt investments

To strengthen our approach to ESG in debt markets, the IFM Investors Diversified Credit business utilises an in-house ESG Scorecard that assigns a risk level based on a range of considerations. This ESG assessment is integrated into our due diligence process at the time of considering a potential debt investment.

The ESG Scorecard aims to highlight where an investment may be exposed to heightened ESG-related risk and considers material ESG factors that have the potential to impact the financial standing of the borrower and, as a consequence, the timely performance of the borrower's financial obligations. A high level overview of the steps involved in completing this analysis are detailed in Figure 1 below.

FIGURE 01 **STEPS IN THE ESG ASSESSMENT WORKSHEET**



Source: IFM Investors

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Whilst our focus is on company specific performance, our analysis also applies an industry overlay to identify possible sector-wide ESG risks or trends which could impact our view.

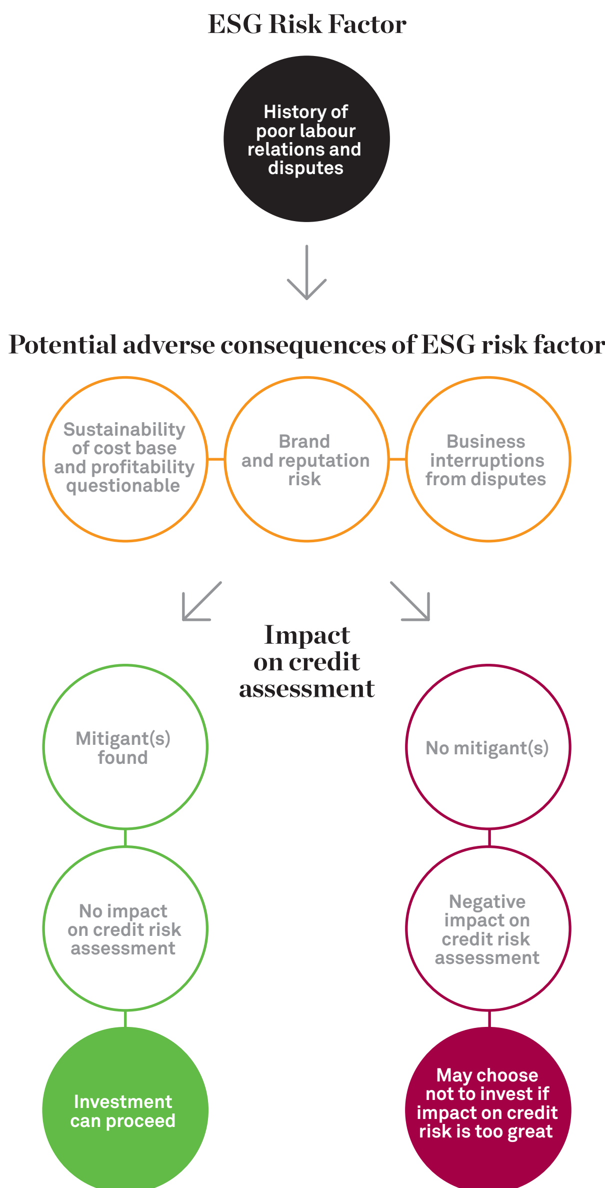
Within our analysis, potential investments are assigned relative risk assessments across key ESG categories. Within these categories, 'Higher Risk' and 'Highest Risk' are considered likely to have a negative impact on the company's credit rating over the investment horizon without appropriate intervention.

In addition to the key ESG categories, we also conduct various searches and enquiries as part of our due diligence which may comprise of:

- material litigation that can impact the sustainability or reputation of the borrower;
- historical and potential future regulatory intervention;
- workplace disputes and employee claims; and
- prior insolvencies.

The output of the Scorecard is an ESG rating that is factored into the team's formally assigned credit rating for the potential debt investment.

FIGURE 02 INCORPORATION OF ESG ASSESSMENT INTO THE CREDIT RATING



Source: IFM Investors. For illustrative purposes only.

Interpreting the output of the ESG assessment process

The ESG Scorecard is used to assign a separate risk assessment to each set of ESG issues - Environmental, Social and Governance.

Importantly, this assessment includes the impact of any mitigating factors (e.g. specific conditions to the investment, maintenance covenants, presence of an active industry regulator) and it is the 'net' ESG assessment that is incorporated into our assessment of the company's credit rating.

Figure 2 provides an example of an ESG factor that we have encountered in our investment decision making and explains how we have incorporated the potential risks into our credit rating assessment.

A summary of the ESG assessment is included as part of the Credit Approval Memorandum and is presented to the Investment Committee for consideration and debate. All 'Higher Risk' and 'Highest Risk' ESG issues must be satisfactorily mitigated prior to proceeding with a new investment.

The role of the IFM Responsible Investment team

The IFM Investors Debt Investments business has historically been closely supported in its ESG research by the IFM Investors Responsible Investment Team that oversees ESG integration and is consulted in cases of elevated risk. With the implementation of the ESG Scorecard, this collaboration continues.

When considering an investment in a sector that has known ESG challenges, the IFM Investors Diversified Credit team will engage with the Responsible Investment

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FIGURE 03 DEBT INVESTMENT ESG CASE STUDIES

CASE STUDY

Higher Education Provider

ESG Risk Assessment

ENVIRONMENT		Not Applicable
E1	GHG Emissions	Not Applicable
E2	Water & Energy Management	Not Applicable
E3	Waste & Pollution	Not Applicable
E4	Climate Change	Not Applicable

SOCIAL		Moderate Risk
S1	Community Relations Access and Affordability	Lower Risk
S2	Customer Privacy & Welfare	Moderate Risk
S3	Labour Practices	Lower Risk
S4	Employee Wellbeing, Diversity and Inclusion	Lower Risk
S5	Social Impacts / Attitudes	Moderate Risk

GOVERNANCE		Lower Risk
G1	Management Strategy	Lower Risk
G2	Group & Governance Structure	Moderate Risk
G3	Legal & Regulatory Environment	Lower Risk
G4	Business Ethics and Competetive Behaviour	Lowest Risk

FOCUS OF ESG DUE DILIGENCE

- Student cohort data (pass/fail, attrition rates)
- Student surveys
- Academic board structure and independence
- Regulator correspondence / reviews
- Product marketing / education agents
- Academic turnover

KEY FINDINGS OF ESG DUE DILIGENCE

- Social issues presented an elevated risk, particularly student welfare and quality of education product; increased risks in distribution of product due to high dependency on education agents.
- Governance issues would have presented an elevated risk due to involvement of financial sponsor but this was offset by the presence of the national regulator (TEQSA) and the detailed review and monitoring work that it undertakes.

STRUCTURAL ENHANCEMENTS REQUIRED FOR INVESTMENT APPROVAL

- Periodic issuer reporting on key student metrics.
- Notification of material regulator determinations.
- Transaction triggers/review events linked to turnover of academic staff, enrolment attrition, education agent miss-selling and regulatory action.

CASE STUDY

Food & Beverage Franchisor

ESG Risk Assessment

ENVIRONMENT		Lowest Risk
E1	GHG Emissions	Not Applicable
E2	Water & Energy Management	Lowest Risk
E3	Waste & Pollution	Lowest Risk
E4	Climate Change	Not Applicable

SOCIAL		Lower Risk
S1	Community Relations Access and Affordability	Lower Risk
S2	Customer Privacy & Welfare	Lower Risk
S3	Labour Practices	Lower Risk
S4	Employee Wellbeing, Diversity and Inclusion	Lower Risk
S5	Social Impacts / Attitudes	Moderate Risk

GOVERNANCE		Lower Risk
G1	Management Strategy	Moderate Risk
G2	Group & Governance Structure	Lower Risk
G3	Legal & Regulatory Environment	Lower Risk
G4	Business Ethics and Competetive Behaviour	Lower Risk

FOCUS OF ESG DUE DILIGENCE

- Franchise business model
- Franchise agreement, fee structure and training
- Regulatory findings / correspondence
- Management structure and incentives
- Past performance of franchisees and attrition rate
- Employee welfare management

KEY FINDINGS OF ESG DUE DILIGENCE

- Sector specific risks related to labour relations and employee wellbeing adequately mitigated by well-developed monitoring and supervision framework that assists with prevention, detection, escalation and remediation of non-compliance.
- Sound franchisee framework and franchisee relations underpinned by a range of policies, processes and initiatives which are viewed as being aligned with internal and external developments.
- Elevated but acceptable risk associated with Governance Structure which results from ownership and board composition.

STRUCTURAL ENHANCEMENTS REQUIRED FOR INVESTMENT APPROVAL

- No structural enhancements implemented as a result of satisfactory findings.

Source: IFM Investors. Case studies are provided for illustrative purposes only and should not be relied on to make an investment decision. Furthermore, no assumptions should be made regarding the investments' profitability based on the information provided.

team prior to commencing due diligence to ensure there is a full awareness of all sector-based issues early in our investment process. The Responsible Investment team is also involved during the due diligence process if our research uncovers any new or previously unidentified ESG issues that could materially affect a company's credit quality and potential investment performance.

Any potential investments that have an ESG risk that is considered 'Higher Risk' or 'Highest Risk' are referred to the Responsible Investment Team for further joint consideration before proceeding with a new investment.

Our ESG assessment approach in action

The case studies detailed in Figure 3 illustrate how our ESG analysis works in practice for two recent private debt investment opportunities considered by IFM Investors. These case studies highlight how we use the ESG Scorecard to better understand the ESG risks associated with potential investments and to inform our investment decision making.

In the first case study in the higher education sector, IFM Investors sought structural enhancements to the transaction as a condition of investing. These enhancements were designed to mitigate the ESG risks that we had identified in our due diligence analysis. The deal outlined in the second case study in the food and beverage sector did not require any structural enhancements as the potential ESG risks identified by our analysts were deemed to be satisfactory.

Our investment history and the above case studies reveal that many of the ESG issues within private debt markets tend to be focused on social and governance factors, rather than environmental considerations (which are often prominent in long infrastructure or project finance style investments). This is partly a function of the shorter time horizon of debt investments, but it also reflects the types of sectors and companies that are currently active in seeking funding through private debt markets.

Managing ESG risk is managing investment risk

In summary, ESG considerations have long been an integral part of IFM's investment process. Our decision to strengthen our Debt ESG process reflects our increased focus on private debt, where independent ESG research is less thorough, and the nuances of each individual investment or borrower that requires a more targeted ESG approach.

In debt markets, our ESG assessment process enables us to focus our investments in well-governed, sustainable businesses that pose a lower risk of default or rating downgrade.

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