ROBECO
The Investment Engineers

Sustainability in fundamental credits

Finding the downside risks in credits with ESG

Sustainable Investing Expertise by ROBECOSAM

- ESG is one of five factors in our structural issuer analysis
- This assessment is critical in managing downside credit risk
- In 24% of cases, ESG risks have material impact on our fundamental views

ESG considerations have been integral to our investment process since 2010, and are an essential part of our sustainable investing methodology in fundamental credits. Consistently integrating ESG information in our bottom-up credit analysis, and thus avoiding defaults or distressed situations, has helped us reduce downside risks in our credit portfolios. We strongly believe that using financially material ESG information leads to better-informed investment decisions and benefits society.

Robeco offers a range of approaches and tools to make a credit portfolio more sustainable. Among these are exclusion, ESG integration, engagement, environmental footprint reduction, green bonds, our SDG framework and our climate investing methodology. We focus in this article on ESG integration.

Article
For professional investors
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Head of credit research

ESG analysis is a critical element in determining issuer creditworthiness

Issuer selection as a key performance driver

Issuer selection is the most important performance driver in our credit capability. It is a two-step approach, with the credit analysts conducting thorough fundamental credit research and the portfolio managers selecting the most attractive credits during portfolio construction.

The credit analyst forms a view about the credit fundamentals of an issuer, based on its rating. This view expresses the current state of credit fundamentals as well as its expected development. The rationale for this setup is that in a perfect world, all credits with similar ratings and

maturities should trade at identical spreads. However, in reality, there are many possible reasons for credit spreads to differ between issuers, including uncertainty about future rating changes, differences in operating performance, ESG considerations, uncertainty about management strategy – such as decisions around acquisitions and divestments – and predictability of operating results. These spread differentials create attractive investment opportunities.

ESG as one of five pillars in the Fundamental score

The key focus of our credit analysis is the cash-generating capacity of the issuer, the quality of cash flows, and the ability to repay debt. We assess five factors to reach a conclusion on this. This conclusion is expressed in the form of a fundamental score, referred to as an F score. The issuer's ESG profile is one of these five factors.

Figure 1 | The five pillars of our credit analysis

Source: Robeco

The F score in short

The F score expresses the overall fundamental view on a company based on its credit rating, and can range from -3 (low) to +3 (high). For example, a score of -3 indicates that the credit's fundamentals are extremely weak given the current rating or that the fundamentals are expected to deteriorate substantially. A positive F score indicates that the analyst views the issuer's credit fundamentals to be (quite) strong for its rating. An F score of zero implies the analyst believes the credit fundamentals of the issuer to be in line with its current rating.

Note that fundamental scores do not necessarily reflect expectations of the credit rating going forward, and that companies with both high credit ratings as well as those with low credit ratings could have high fundamental scores. In addition to the fundamental score, every investment thesis contains an investment recommendation and a view on the attractiveness of the valuation.

The other variables that contribute to the F score are the company's business position, corporate strategy, financial profile and corporate structure. Rather than being standalone, the five factors are often inter-related. For instance, a change in ownership can have an impact on a company's financial position, and an international expansion strategy may introduce country-specific risks into the business position.

- Business position: we assess a range of factors such as the company's market position, revenue by segment and by geography, industry trends, growth rates, cyclicality, margins, the threat of substitutes, and sovereign risk.
- Strategy: we evaluate the type of products, the geographic focus, risk appetite, acquisitive stance, and the strategy relative to shareholders and bondholders.

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- **Financial position:** we assess the company's cash-generating capacity, financial forecasts, leverage, capitalization, liquidity, pension deficits, capex, asset coverage and expected recovery.
- **Corporate structure and covenants:** we analyze the quality of covenants, restricted payments, permitted collateral, maximum leverage, maintenance versus incurrence tests, and the position of the issuing entity within the corporate structure.
- **Sustainability**: we analyze each issuer to determine how it is positioned in terms of the key ESG factors defined by our team for each industry, including climate change considerations, and how this could affect fundamental credit quality. More detail on this process is provided in the next section.

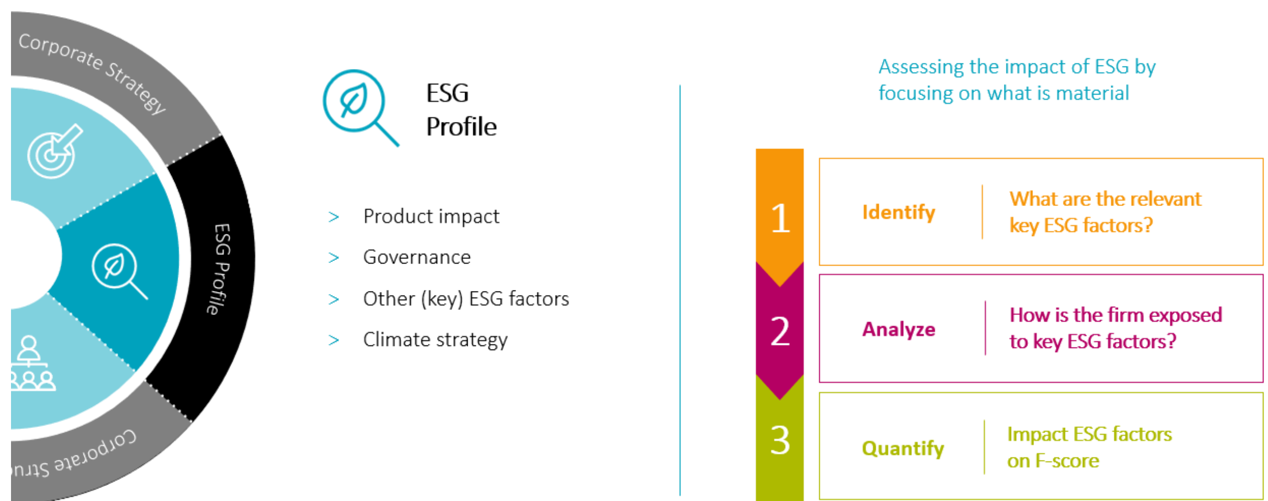
ESG analysis is fully integrated into our bottom-up security analysis – and for good reason: it enables us to avoid the losers in the universe of credit assets. Many credit events can be attributed to issues such as poorly designed governance frameworks, environmental issues or weak health-and-safety standards. We believe that by looking at ESG factors, we get a better and more complete picture of the companies we invest in, which supports our focus on selecting only quality assets for our portfolios.

A more detailed look at how ESG factors shape credit quality

A four-fold evaluation of ESG risks

Our assessment of ESG factors and their implications for an issuer's fundamental credit quality considers four elements. These range from the impact of the product or service produced, to the company's governance system and decarbonization strategy.

Figure 2 | The role of ESG integration in fundamental credit analysis



Source: Robeco

- **Product impact**: our view is that companies offering unsustainable products and services (e.g., oil, tobacco, refinery services, oil field services, manufacturers of internal combustion engine cars, coal miners) face additional risks. Demand for these products may shrink, while stricter environmental regulations may further constrain a firm's business model and result in higher capex and R&D expenses. The issuer's SDG score, determined by our proprietary framework which draws from the UN Sustainable Development Goals, helps to inform our assessment of the product impact. An overview of our SDG methodology is provided below.

- **Governance**: we rely on a variety of inputs to assess the quality of the governance framework. These are the S&P Corporate Sustainability Assessment scores, Glass Lewis and the Sustainalytics risk scores.

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- **Key ESG factors**: this step is aimed at determining how a firm is positioned in terms of our list of key ESG factors for each sector and sub-sector. The process starts with an analyst assessment that incorporates a range of inputs, including our research and meetings with management, the company profile reports created by our SI research team, the S&P Corporate Sustainability Assessment, Sustainalytics risk scores, and the company's track record in conduct.

  Depending on the company, other factors may be relevant, too. If a firm has been involved in a bribery scandal, for example, it would be important to examine this issue – even if bribery is not considered a key risk factor for the industry in which the issuer operates.

- **Climate strategy**: climate change has a prominent role in our credit research process. Our analysts follow a formal process which takes into consideration the philosophy of the Taskforce for Climate-related Financial Disclosures (TCFD) on climate risks and opportunities. The below section provides further detail on how this criterion is analyzed.

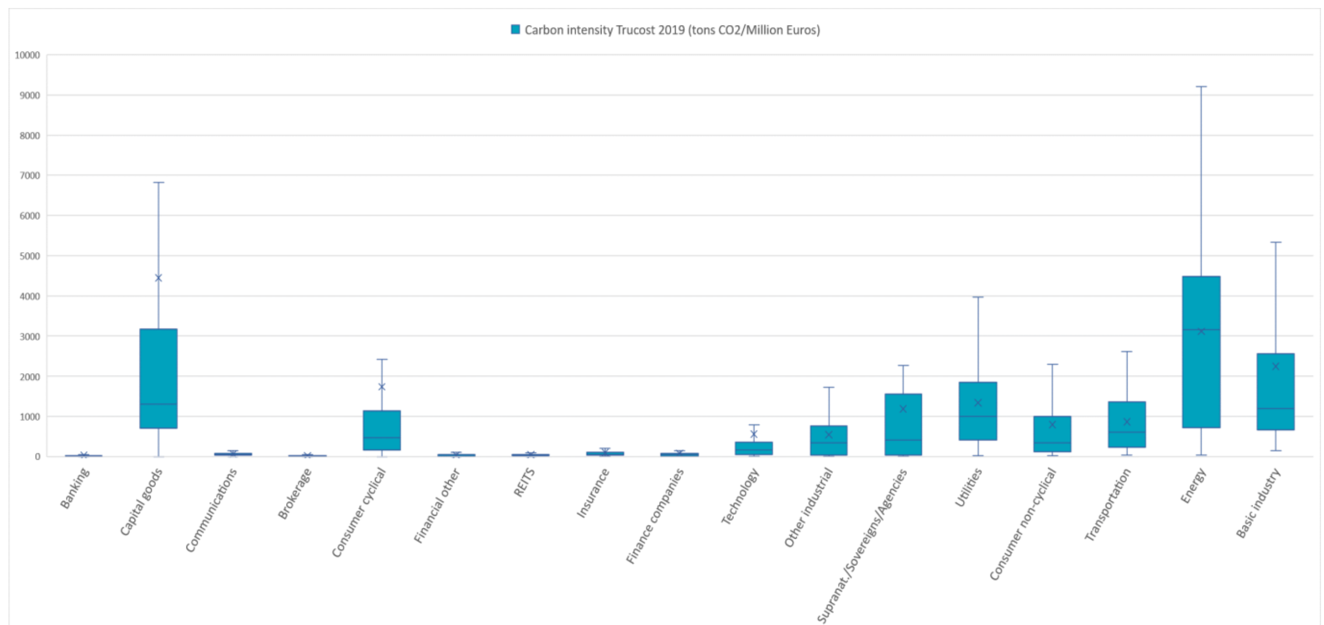
Assessing whether an issuer is climate-proof

The central question for this last criterion is to assess the extent to which a firm's decarbonization strategy – or failure to have an appropriate one in place – may have an impact on its fundamental credit quality. This assessment comprises three steps.

Step 1: *Identify*: determine the exposure to climate risk and opportunities

The average Scope 3 CO_2 intensity per sector is used as a starting point to assess a firm's climate-risk exposure (see Figure 3). A high CO_2 intensity, as is the case in the automotive, metals & mining and building materials industries, would indicate that the sector is vulnerable to climate risk. Among other reasons, this could be due to the high capex commitments needed for companies to improve their emissions profile. For lower-emission sectors, such as supermarkets, for example, the climate risk is significantly lower. Our overall approach is to evaluate the exposure to climate-related transition and physical risks, as well as the opportunities.

Figure 3 | Carbon intensity per sector
Scope 1, 2 and 3 emissions relative to EVIC-book (book value of debt and common equity).



Source:Trucost, 2019. Sector classification Bloomberg Barclays level 3. Outliers not shown in the box and whisker chart. Sample based on the Bloomberg Barclays Global Aggregate Corp, February 2021, for all constituents for which all relevant data is available. Data sorted per issuer. N (issuers) = 1340

Step 2: *Analyze*: what is the company's response?
We consider aspects such as a firm's climate strategy, GHG reduction targets, capex, R&D, and how all of this is embedded in its governance framework. Important inputs can also be derived from company rankings in the various Paris-aligned pathway assessments. These assessments include those from the Science Based Target Initiatives (SBTI) and the Transition Pathway Initiative (TPI).

Step 3: *Quantify*: draw a conclusion about the impact on the company fundamentals, including capex, margins, asset valuations, and cash flow. Critical questions are whether the issuer's plans are sufficient and whether it can afford the transition and related investment plans.

A similar three-step approach is used for the other ESG factors.

The Robeco SDG framework
The Robeco SDG framework provides an objective, consistent and replicable approach to assessing positive and negative SDG contributions in an investment portfolio. Using a three-step approach, the framework investigates the extent to which a company has a positive or negative impact on each of the SDGs, on a scale of -3 (very negative) to +3 (very positive).

- In step 1, the products or services offered by the company is linked to one or more of the 17 SDGs. Step 1 is therefore about what companies produce.
- In step 2, we consider how a company produces. Many SDGs also focus on items like less pollution, improvement of resource efficiency, gender equality, transparent and accountable institutions, etc. The credit analysts evaluate if the way the firm operates is compatible with these goals. Amongst others, they consider environmental policies, the company's conduct track record, governance frameworks, etc. If necessary, SDG rankings can be adjusted.
- In step 3, any controversies are taken into account. A company can make the right products, operate in the right manner, but still be embroiled in controversies. Examples include contaminations, spills, mis-selling, fraud and bribery; none of these activities are compatible with what the SDGs represent. If necessary, SDG rankings can be adjusted.

The results of this three-step analysis are quantified in a proprietary SDG score and each company is scored on the basis of its overall contribution to the SDGs (positive, neutral or negative) and the extent of this contribution (high, medium or low).

Source: Robeco

A range of sources of ESG information

To form an opinion on how companies are positioned on these factors, an analyst has multiple sources. We gather ESG information as part of our 'regular' analysis process, which for instance involves meeting with company management and industry specialists. Robeco employs a 'career analyst' model, the cornerstone of which is that analysts pursue a long-term career path in research. This enables them to follow a sector for many years, and thus structure their research and gain access to a network of information sources.

Proprietary research on specific ESG topics can also provide new information. Firstly, the results we gather from our engagement with investee companies on ESG topics provides our analysts with more relevant ESG data and knowledge on the companies in their sector. Secondly, we conduct industry-specific research projects on sustainability issues that have a large impact on a given business sector. Examples are health and safety in the clothing sector, the supply chain in the electronics industry, and the risk culture in the financial sector.

Another source is the annual S&P Corporate Sustainability Assessment, which contains detailed information on companies' ESG characteristics. We also use specialized external research from third-party providers such as Glass Lewis (on governance, voting) and Sustainalytics.

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Interpreting the F score in the investment process

Higher risk associated with ESG can translate into lower F scores for issuers. The five factors on which the F score is based do not have a fixed weight: their relative importance differs per sector and per company. An analyst can, for example, have a very constructive view on a company's business position and strategy. Yet, if leverage is high while the company's free cash flow is strongly negative, the weak financial position alone will have a very negative impact on the F score. The company profile in which these five factors are described is discussed by a credit committee, following which the final F score is assigned.

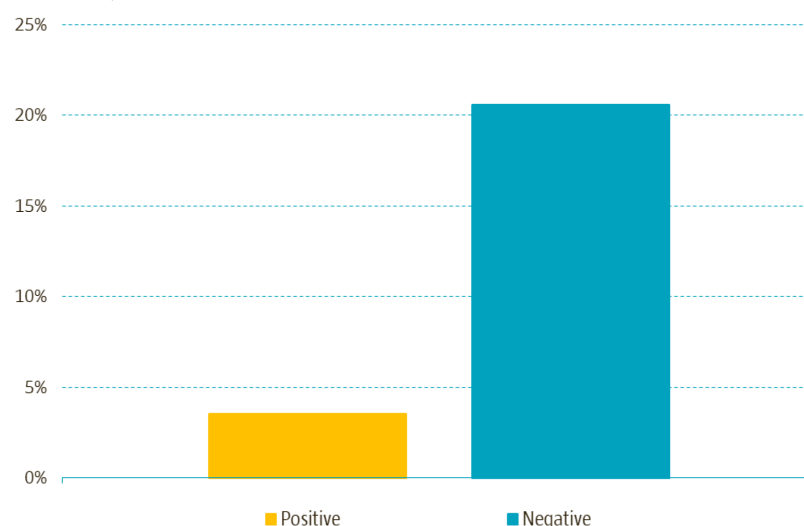
Does a lower F score mean we cannot invest in the company? When conducting a credit analysis, an analyst will formulate a view about the issuer's credit fundamentals relative to its rating. A lower F score means that the risk associated with that company is perceived to be higher than that associated with comparable companies in the same rating segment. This higher risk should be reflected in a higher credit spread relative to its peers. In practice, a lower F score therefore means we would demand a higher spread to compensate for the additional risk revealed by our analysis. We do not exclude assets on the basis of the scores. However, if additional risk is not reflected in the spread of a corporate bond, we would rather invest in bonds with a better risk profile. Such a decision can be altered if either the risk profile improves or the spread rises to an acceptable level.

ESG risks have a material impact on our fundamental views in 24% of cases

In analyzing and investing in corporate bonds, the focus is tilted towards detecting downside credit risk. This makes sense as risk is asymmetrical for credit investors. A good risk management system at a bank, for instance, does not lead to a strong improvement in credit quality; a weak one, though, could lead to its total collapse. In a limited number of cases, we do find companies where ESG factors contribute positively to the fundamental view. This is often owing to the product impact criterion, such as in cases where the product is a solution for a better environment.

We scan all the company profiles created by our credit analysts and keep track of the extent to which ESG factors have a financially material impact on these profiles. Our latest data shows that ESG information has a financially material impact in about 24% of company profiles. In most of these cases, the impact is negative (see chart) in the sense that it weighs negatively on our fundamental assessment of the company.

Figure 4 | Impact of ESG factors on credit research reports



Source: Robeco. Data as at the end of April 2021.

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Conclusion

ESG screening has been a fundamental aspect of our credit analysis for more than a decade, and is fully integrated in our bottom-up security analysis. We apply it to each company in which we invest – and across all our fundamental strategies, regardless of whether they have a specific sustainability focus.

Our proven methodology considers four distinct elements – product impact, governance, key ESG factors and climate – and helps shape our overall fundamental assessment of an issuer. In fact, our data shows that ESG information has a financially material impact in about a quarter of our company profiles.

The integration of ESG considerations in our fundamental analysis is critical in our management of downside risk in credit portfolios, and is important in enabling us to identify those issuers that will be part of a more sustainable future.

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The sale of the Fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. The Fund must not be offered or sold to the public in Uruguay, except in circumstances which do not constitute a public offering or distribution under Uruguayan laws and regulations. The Fund is not and will not be registered with the Financial Services Superintendency of the Central Bank of Uruguay. The Fund corresponds to investment funds that are not investment funds regulated by Uruguayan law 16,774 dated September 27, 1996, as amended.

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