ROYAL LONDON ASSET MANAGEMENT

Sterling Credit ESG Analysis

Quarterly Report

31 March 2024

ESG Analysis – Q1 2024 overview

Introduction

Evaluation of ESG risks and targeted engagement with debt issuers is a critical element of any effective credit process. RLAM's credit research approach has always focused on the stability of issuers' balance sheets and cash flows, requiring a broad-based understanding of credit risk, whatever the source. Our experienced credit and ESG specialists and an integrated investment process enhance our ability to identify, mitigate and price risk, ensuring RLAM's clients benefit from the established cornerstones of our differentiated credit proposition.

Sustainability-Linked Bonds (SLBs)

We have written extensively in previous updates about our scepticism towards the application of labelled bonds in the market. In the specific case of SLBs, we believe it is difficult to achieve a satisfactory and meaningful prescription around environmental Key Performance Indicators (KPIs). Over the period, there have been certain noteworthy developments that we feel warrant further consideration as the labelled bond market continues to gain traction.

In the social housing sector, London & Quadrant (L&Q) announced that it was set to miss one of its three KPIs embedded in a SLB issued in January 2022. While it has already met the KPIs regarding home-building and EPC ratings, L&Q will not achieve a necessary 20% reduction in scope 1 and 2 emissions by March 2024 due to "wider macroeconomic factors". This will trigger a step-up in the bond's 2% coupon by 12.5bps until maturity in 2032. We view this event as being due more to the construction of the targets and how they are measured, rather than being an insightful representation of L&Q's underlying climate progress – not least because the target's scope is solely limited to direct emissions. By far the largest element of housing associations' carbon footprint is associated with tenants' energy use i.e. scope 3, and this remains both the most challenging aspect of the sector's journey to net zero and the key basis for our own transition analysis.

Another interesting development was the issuance of an SLB by Heathrow Airport. Within a sector that is clearly a large carbon emitter, as the first airport to have Science Based Targets Initiative (SBTi) validated emission reduction targets, Heathrow has shown a more progressive approach towards tackling its carbon footprint compared to Gatwick, its closest UK peer. We welcome the broader scope of the bond's KPIs which target a 15% reduction in "in the air" (scope 3) emissions, as well as a 46% reduction in "on the ground" (scope 1 and 2) emissions by 2030 (vs a 2019 baseline). However, whilst the targets appear sensible, rather than a more conventional coupon step-up seen in previous SLBs, the issuer will make a 1% premium payment at maturity in 2032 for non-compliance, pushing back the financial consequences of missed targets. The potential for contrivance within the bluntness of this asset class further persuades us to focus our approach on the particular nuances of an issuer's fundamental ESG credentials. This allows us to evaluate overall environmental risks within the context of bond compensation.

Finally, the ongoing news flow from French IT company, Atos SE, is a clear reminder of why SLB features cannot be a substitute for effective credit analysis. Atos issued an SLB in late 2021 at a 1% coupon, with an additional 17.5bps coupon step if KPIs are missed. With the company now in deep financial distress, the significance of any coupon step has been monumentally dwarfed by the credit deterioration; bonds have traded as low as 17c and the rating has been downgraded to CCC. Any investors that bought on the basis of meeting labelled bond allocation targets, or as a demonstration of portfolio credentials, have received a salutary reminder that fundamentals must always take precedence.

As the bond market's relationship with ESG evaluation evolves, these practical case studies underpin our belief that it is insufficient to use labels to take a blanket view of either an issuer's ESG performance or a bond's attractiveness.

Credit & Climate Research

Climate considerations are increasingly an important element of our credit analysis. To inform our investments and help clients effectively respond to regulatory requirements for their portfolios, we have developed an approach to climate evaluation that is both practical and bespoke around the idiosyncrasies of credit.

Our solution is centred on Alignment Conviction (AC) – put simply, what is our level of conviction of an effective transition based on the available information and issuer specifics. An AC score is applied to issuers based on a blended approach encapsulating both comprehensive transition analysis and engagement and enhanced third party data. In turn, these insights are built on the knowledge we have garnered over the past years from our in-house carbon database. This helps to ensure that the foundation of our client reporting is high coverage and accuracy. We would be happy to provide further information on our approach on request.

Ahead of their recently announced merger with Nationwide Building Society, the research we undertook on Virgin Money UK during the quarter is one example of the transition analysis underpinning our approach. Given banks' large scope 3 footprint, we believe our framework is more effective in assessing transition capabilities rather than a 'data only' approach that relies on backward- and forward-looking climate metrics. Based on our framework, we deem the company to be "aligning to net zero" and welcome the level of transparency provided on both targets and actions being put in place across the main sources of financed emissions i.e. indirect emissions associated with the bank's lending activities. As a specific example, Virgin Money sees its Agri E Fund product as a key lever to incentivise and educate customers on reducing emissions in the food supply chain; with this lending, Virgin provides finance for green projects with no arrangement fee if farmers undergo a carbon audit.

Property – climate and biodiversity

Effective ESG integration into the analysis of the commercial real estate sector is increasingly critical, with clear evidence emerging of purchasers and tenants favouring properties with strong environmental characteristics. This shift is impacting all issuers in the sector, as companies managing newer and more energy efficient properties benefit from a rental and valuation 'greenium' that puts them in a better position to withstand the headwinds resulting from higher rates and other more secular dynamics, such as the shift to employees working from home. With environmental performance and, more latterly, biodiversity inexorably linked to issuers' ability to service debt and the sustainability of collateral values, we have been conducting a specific engagement project with the issuers of our property debenture bonds. As a lower profile subset of our wider real estate debt exposures, the relative scope for improved understanding and influence is greater.

We were generally pleased with the attention placed by our borrowers on sustainability and net zero more specifically. We believe all companies we spoke to show a clear recognition of the importance of strong climate performance, and all are well placed to meet regulatory requirements in the short term. We were also encouraged to learn that the companies with businesses that more materially depend on strong environmental credentials are the ones taking the strongest actions. This is an important conclusion given the immediate asset life and cash flow consequences of these risks, helping to underpin our current investment in the sector. In addition, we now have a clearer picture of where each of our borrowers stand on the journey to net zero, as well as the quality of the assets that we are secured upon, enabling us to integrate transition preparedness into the evaluation of balance sheet sustainability. We will continue working with the laggards, pushing them to improve their practices and better align to the expectations we have on material issues. A forthcoming property debenture paper will soon be available via the Our Views section of www.rlam.com.

RMBS and ESG (include for BPPEN)

During the quarter, privately owned specialist mortgage lender, Equifinance, announced an inaugural second lien RMBS transaction, EAST1 2024-1. The secured portfolio consists of a large number of second charge mortgages and a significant proportion of borrowers have challenged credit histories. Coupled with relatively high average loan-to-values involved there was a heightened onus on us to understand the capabilities of the mortgage servicer, as well as gaining assurance that the lender would appropriately manage interactions with struggling borrowers in the future.

Looking beyond the headlines of a strong credit rating, and against the backdrop of new Consumer Duty regulations, we found it hard to gain sufficient confidence in the servicer, based on a “below average’ rating from Moody’s and limited practical evidence, as Equifinance has only had 28 repossessions since it began trading in 2012. Furthermore, we retained some governance concerns as the majority owner of the business previously owned a payday loan company that in 2016 was ordered by the FCA to pay £34 million of redress to customers because of unfair practices. Ultimately, although the bond was secured and offered higher yield compared to other RMBS transactions, we determined that the compensation was insufficient for the wider risks identified.

Premium finance

Premium finance allows customers to spread the cost of insurance across monthly instalments and was in the news this past quarter after the FCA’s Insurance Director described it as a “poor product” in a press interview, hinting that the regulator could be undertaking some work to review industry practices. The scrutiny of premium finance is not new news, not least given the relatively high headline interest rates attached to the product, and previous comments from the FCA invited firms to ensure charges for products are consistent with Consumer Duty regulation.

As lenders to Premium Credit, a major provider of premium finance, through an ABS transaction secured on a portfolio of insurance receivables, we closely reviewed the FCA’s most recent comments and re-engaged the company on interest rates charged to its customers. The additional information confirmed our existing views obtained during previous interactions with the company. Whilst headline rates are significantly impacted by the size and nature of the individual product, Premium Credit’s dispersion of interest rates charged is well below the upper end of the industry, and the company continues to not charge commission to insurers. We also took comfort from the work conducted by the company, in response to Consumer Duty, on how its products demonstrate fair value to customers. More broadly, we accept the overarching consideration that the company’s core offering provides an alternative for customers who may otherwise have to rely on short-term, higher cost financing. When combined with significant protective features in the bonds we own, including cashflow diversion to senior noteholders on asset deterioration, and an attractive spread relative to unsecured credit, Premium Credit’s apparent responsibility in the delivery of their products, supports our continued investment in the company.

IMPORTANT INFORMATION

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