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For professional investors

ROBECO
The Investment Engineers

Credit analysis and ESG: a perfect fit


Robeco Credit team

- **ESG strengthens ability to assess downside credit risk**
- **Leveraging dedicated engagement and sustainability team**
- **A perfect fit with Robeco's proprietary research approach**

ESG integration in Robeco's credit investments

One of the cornerstones of the investment philosophy of Robeco's Credit team is that avoiding losers is more important than picking every winner. The team believes that integrating environmental, social and corporate governance (ESG) factors into its analysis strengthens the ability to assess the downside risk of its credit investments. The Credit team is therefore convinced that ESG and credit analysis are a perfect fit. This document describes how the team has fully integrated ESG factors in its investment process. This is illustrated with many detailed real-life examples.

Robeco: a strong proponent of sustainability investing

The integration of ESG factors in Robeco's credit investments is not a stand-alone practice. As a signatory of the United Nations Principles for Responsible Investment since December 2006, Robeco as a firm is committed to the integration of ESG factors into its investment decision making and ownership practices. In that same year Robeco acquired RobecoSAM, a dedicated asset manager and recognized leader in sustainability investing (SI). Robeco is convinced that taking financially material sustainable issues into account improves its clients' risk-return profiles and will also contribute to aligning the objectives of institutional investors with those of society at large.

Robeco's ESG analysis is research driven

Shortly after its establishment in 1929 Robeco's first director, Wim Rauwenhoff, decided that "every investment strategy should be research-driven". Today, Robeco is more convinced than ever that market inefficiencies can be exploited based on its proprietary research. The Credit team therefore takes its own knowledge and analysis as the starting point for its fundamental research, which includes its opinion on the ESG factors of all the companies under coverage.

Brief introduction to Robeco's credit process

Career analysts

Robeco's strong belief in proprietary research is reflected in the set-up of the Credit team, which is split up in portfolio managers and credit analysts. The portfolio managers are responsible for the management of all credit portfolios and the top-down assessment of the market cycle. The analysts perform the team's bottom-up research by covering sectors and companies across all rating categories and geographic areas. Robeco's Credit team has a unique career analyst model which encourages analysts to become high-level experts in their sector. The typical Robeco career analyst has extensive experience (often more than a decade) and deep knowledge on its sector. Therefore the credit analysts also know exactly what ESG sector trends are important.

Joint effort on energy sector study

Part of the knowledge sharing culture in our credit team is that analysts work together to understand the full impact of certain ESG trends. The analysts covering the utilities, oil, automotive, mining and chemicals sector joined their efforts to understand the impact of US and European regulations to reduce air pollution across their sectors. Based on this research, an article was published in April 2014 discussing the impact of these measures across sectors and the implications for Robeco's credit portfolios. Not only does the article show the extent to which sustainability is integrated in Robeco's credit process, it also displays the analysts' thorough sector knowledge and the knowledge sharing culture in the Credit team.


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The impact of ESG on credit portfolios: the energy sector

- Policy makers around the world are issuing regulations to limit CO_2 emissions and climate change
- Not only does this change the global energy market, it also influences the credit quality of sectors and individual companies
- We use real portfolio examples to show the impact of this sustainability theme on credit portfolio construction

Obama's clean air policy

ESG themes have a material impact on the selection of credits

Fundamental opinion based on five factors

The primary concern of a corporate bond holder is the company's ability to repay debt. Key focus of Robeco's credit analysis is therefore the cash generating capacity of the issuer and the quality of the cash flows. The team performs this analysis through a fixed format assessment of five different variables of which ESG is one. The other variables are the company's business position, corporate strategy, financial profile and corporate structure. Based on these five factors the analyst assigns a fundamental score which expresses the overall fundamental view on a company for the coming year. The five factors are not stand-alone but are often intertwined; for instance, a change in ownership can impact a company's financial position, and an international expansion strategy may introduce country risk into the business position.

Anglo American: blurred lines

It is often not possible to make a sharp distinction between the different variables impacting a company's fundamental score. For Anglo American, the line between the ESG factor and country risk is quite blurry. Anglo American is a large multinational mining company and the world's largest producer of platinum. Anglo American has mostly deep underground mines (for diamonds and platinum) which have a high cost base and are not very safe. The South African government has recently tightened safety regulations resulting in temporary mine closures and costly project delays. The annual costs of these issues are estimated to be several hundreds of millions of euros per annum. In July 2014 Anglo American said it planned to sell a South African mine that was hit by a five-month wage strike by a hardline union.

Is this ESG risk or country specific risk? The Anglo American example shows that this question is less relevant, as long as the risks are addressed properly. Therefore either way, the conclusion was that these risks warranted a more cautious stance on the company, demanding higher spreads to compensate for these additional risks.

The factors have no fixed weight

The five factors on which the fundamental score is based do not have a fixed weight; their relative importance differs per sector and per company. For instance, the business position is often quite important for companies with a solid credit rating. Corporate structure however tends to have a bigger impact on high yield companies and sustainability is more relevant to, for example, tobacco companies. Higher risk associated with ESG can translate into lower fundamental scores.

Plain packaging will hurt tobacco companies

It is common knowledge that tobacco products are addictive and not healthy. However, the major issue for our tobacco analyst is that plain packaging appears to be effective and will impact the sector negatively. Plain packaging, introduced in Australia in December 2012, means the removal of all branding on a pack of cigarettes. As the sector depends on branded consumer goods, removing the branding hurts the tobacco companies as smokers switch to cheaper brands. In addition, recently published results indicate the incidence of smoking has significantly reduced. Other countries such as the UK, Ireland and New Zealand also intend to introduce plain packaging. And in the EU, the new Tobacco Products Directive will put further restrictions on marketing.

Overall, there is clear material downside risk for the sector as revenue and profitability will come under pressure and funding for tobacco companies will slowly become more expensive. If not because of ESG considerations, a lot of investors exclude tobacco from the eligible universes, driving up funding costs. ESG factors therefore have a negative impact on our credit opinion on tobacco companies and on balance we therefore lowered their fundamental scores.

Understanding ESG's impact on credits

ESG helps to understand downside risk

The prime goal of integrating ESG factors into Robeco's credit analysis is to strengthen the ability to assess primarily the downside risk of its credit investments. Examples of these downside risks are the USD 28 billion scandal related fines for JPMorgan Chase; the USD 40 billion costs for BP related to the Gulf of Mexico oil spill; and the recent bankruptcy of Banco Espírito Santo as a result of weak corporate governance.

Using sustainability information in credit analysis perfectly matches the essential need to avoid the losers in credit portfolios. ESG and credit analysis are therefore a perfect fit.

Downside risk due to corporate governance

For different sectors, different ESG factors are relevant. Our financial analyst strongly believes, for instance, that corporate governance is very important for banks. At the same time this factor is difficult to measure. We try to get a good feeling for governance via management meetings, the analysis of corporate structures and the consultation of ESG related databases. It takes a career analyst, one with a lot of experience, to recognize these corporate governance issues.

Some telecom companies also have governance issues. In the case of South Korean Telecom, the credit analyst covering telecoms contributed to a RobecoSAM report which highlighted several governance issues. One issue concerned a former chairman of SK C&C, the de-facto holding company of the SK Group including SK Telecom. This chairman, Chey Tae-Won, is in jail for embezzling money through a SK Telecom fund. And it was not his first time behind bars; back in 2003 he served seven months for accounting fraud. Although SK Group has set up an emergency panel to run the group since Chey's arrest in January 2013, there are indications that Chey still wields control over the group. In this case too, SK Telecom was not put on the coverage list.

Only a limited number of positive adjustments

As the focus is on downside credit risk, the team has not often come across cases in which sustainability had a positive impact on a company's fundamental score. 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 but a weak one can actually lead to the total collapse of a bank. Positive ESG factors are often less tangible and sometimes only have a very long-term positive contribution to a company's fundamentals, which is outside the time frame of the credit assessment and only accrues to the company value for equity holders.

Positive ESG example: Robert Bosch

Robert Bosch is a German engineering and electronics multinational. Within all its product segments Bosch is focused on increasing the energy efficiency of its product offerings. Examples are components for more fuel-efficient car engines and refrigerators with AAA energy labels. As energy is becoming more expensive and more heavily taxed there is increasing demand for these energy-efficient products.

Bosch also consistently spends a large amount on research and development (R&D). The company is very successful in filing new patents, ranking number two in Europe. The high number of new patents will assure Bosch's future as a leader in its industry. This is seen as credit positive. Although not directly financially material, the analyst notes that via the Robert Bosch Stiftung GmbH the company sponsors many social and charitable projects. He concludes that Bosch materially benefits from ESG-related growth themes and from its high R&D spending. ESG factors therefore have a positive impact on the fundamental score of Robert Bosch.

Credit team considers the absolute impact of ESG

When conducting a credit analysis, Robeco's analysts form a view about the credit fundamentals of an issuer relative to its rating. For instance, the business position of a BB-rated cement company is compared with the business positions of other BB-rated companies in the telecom or the retail sector. The variables that are used to analyze a company are therefore *relative* to this rating, across sectors. ESG factors, however, are different to the extent that they have an *absolute* impact on the overall fundamental assessment. For example, downside risk coming from fraud is clearly independent of the credit rating. And environmental risk is not necessarily higher for a BB-rated cement company than for an A-rated oil company.

RWE's sustainability headwind

While the new German energy policy, the *Energiewende*, should deliver a cleaner energy supply, the opposite is actually true. Due to very low coal prices, electricity generators use more lignite than ever before. The credit consequences are huge; the energy policy has led to a dramatic deterioration in the profitability of energy generators like RWE. The consequences are much lower profitability and impairments on traditional unprofitable, and dirty, generation plants. Some have even been taken out of business. RWE recently reported its first quarterly loss ever.

As a consequence, the credit profile has deteriorated. A rating migration may be possible to close to, or even into high yield territory, coming from strong AA in the past. This may be accelerated if trading activities are increased to make up for the loss in the generation business. In the RWE example the sustainability factors have a clearly negative impact on the fundamental opinion on the company. The risks are not reflected in RWE's credit spreads.

Focus on financially material issues

Robeco believes that focusing on material sustainability issues will lead to measurable benefits for investors and society. When determining the relevancy of the ESG factors, the credit analysts therefore apply the same financial materiality principle, focusing on economically relevant issues. If these factors impact a company's credit quality, financial markets should reflect this higher risk in a spread premium on the bonds. Investors want to be compensated for taking investment risk, which includes ESG related risks.

Wynn Resorts' questionable ESG performance has limited financial impact

Wynn Resorts is a developer and operator of high end hotels and casinos. The company is mainly focused on growth in Asia. In 2012, Wynn's founders, the Japanese billionaire Kazuo Okada and Las Vegas veteran Steve Wynn, accused each other of making improper payments to win lucrative casino licenses in Asia. One issue was a pledge from Wynn to donate USD 135 million to the University of Macau Development Foundation.

It is clear that bribery risk could lower the analyst's fundamental opinion on Wynn Resorts. However, despite the accusations, the US Securities and Exchange Commission announced in July 2013 that it would not pursue any enforcement action against Wynn or Wynn Resorts. Next to that, Asia is the world's biggest and fastest-growing gambling market, and Wynn Resorts' ability to benefit from that was, and is, not hampered in any way by the accusations. In the meantime money-laundering legislation has also become stricter. Mr. Wynn has played a pivotal role in the 1990s resurgence and expansion of the Las Vegas Strip by changing it from a pure gaming industry into a leisure spending sector. He is now developing his Macau assets in line with what he did previously in Las Vegas and by doing so shifting it away from a sector traditionally associated with bribery and money laundering. Overall our conclusion is that the sustainability factors for Wynn Resorts are weak but do not have a significant financial impact on the company.

ESG is fully integrated in Robeco's credit research process

To summarize: the Robeco Credit team's sustainability focus is on downside risk, on absolute impact and on financially material issues. These principles are part of the clear and practical approach to integrating ESG in Robeco's credit research process. As a result, the credit analysts truly believe in this sustainability approach and perform the actual ESG analysis themselves. The Credit team treats the ESG variable as one of the five building blocks which underpin the final fundamental opinion on a company's credit. Just like the other factors, the ESG analysis is well documented in a research document. And a thorough review of that research report in a credit committee consisting of analysts and portfolio managers also includes an in-depth discussion of the ESG factors.


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How to assess the risks of deepwater drilling companies

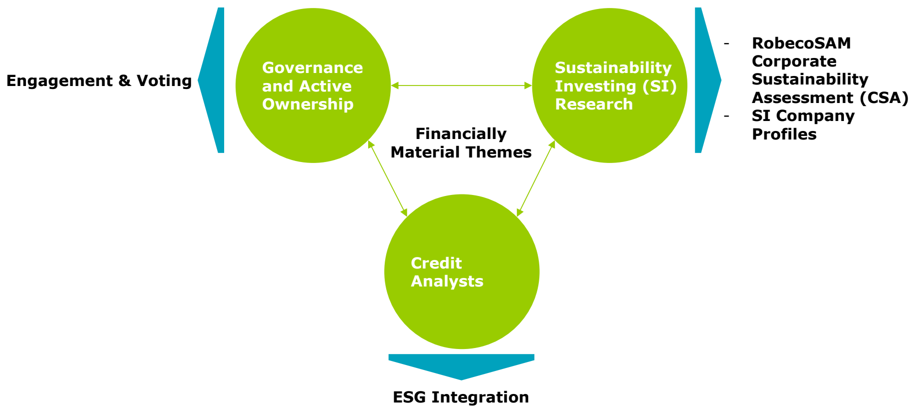
Risks and investment opportunities in deepwater drilling

Deepwater drilling analysis

An example is that our oil and gas credit analyst participated in a 'deepwater drilling risk assessment project group', which was formed to take a closer look at the risks and manageability of deepwater exploration and development. The group's findings were presented in an internal whitepaper, which formed a first important input on how to deal with these risks in our investment process.

Sustainability Investing well embedded within Robeco

Robeco is a strong proponent of sustainability investing. The integration of ESG factors in the investment strategies is therefore well embedded in the organization. Other teams with which the credit analysts interact on this topic are the engagement analysts from the Governance and Active Ownership team and the Sustainability Investing analyst team at RobecoSAM.



Own research as starting point

Robeco's credit analysts have many years of specific sector experience, built up long-term relationships with industry specialists like consultants and corporate management, and have gained deep sector knowledge. As a result, they have a thorough understanding of the relevant ESG trends in their sector and within their companies. The Credit team takes its own knowledge and analysis as a starting point for its fundamental research and this holds also true for its ESG research.

Next to this, the credit analysts have access to multiple providers of sustainability specific data and analysis. RobecoSAM is the preferred supplier of sustainability data and knowhow. With this information as input, the analysts form their own opinion on the ESG factors of all the companies under their coverage.

Hidden corporate governance issues at Gestamp

The fact that we take our own research as a starting point is illustrated by the Gestamp Automoción case. Gestamp Automoción is a Spanish company, a leader in the European automotive industry, which is controlled by the Riberas Mera family. There are several concerns regarding transactions between Gestamp Automoción and other companies controlled by the Riberas Mera family. The family owns, for instance, the steel trading company Govarri. Gestamp Automoción buys steel worth around EUR 1bn per year from Govarri. According to management these transactions are at arm's length, but they were not properly described in the bond documentation (the affiliate transactions covenant).

Another issue concerns Corporation Gestamp SL, which is the holding company of the Riberas Mera family. Gestamp Automoción and its subsidiaries guarantee debt issued by Corporation Gestamp SL for a total of EUR 175 million. These related party transactions are a financially material governance risk. These sustainability issues have a negative impact on our fundamental view of the company. As the company does not disclose the relevant information, this type of ESG-related information is often not picked up by ESG data providers. It takes a specialized credit analyst to be aware of these types of issues.

Exclusive access to RobecoSAM

RobecoSAM, where SAM stands for Sustainable Asset Management, was founded in 1995 and acquired by Robeco in 2006. RobecoSAM has compiled one of the world's largest sustainability databases and analyses over 2,000 listed companies annually. RobecoSAM is well positioned to identify companies leading and lagging their peers in terms of sustainability.

The credit analysts have access to the detailed assessment questionnaires, self-assessments and proprietary research done by RobecoSAM's dedicated SI analysts. The latter write company profiles, exclusively provided to Robeco's equity and credit analysts, on the companies of the coverage list. These company assessments give an insight into the company from a sustainability point of view. The SI analysts have also drawn up materiality analyses for all major industries, which are the basis for their company specific ESG analyses.

In return, the credit analysts share their sector knowledge to help the RobecoSAM SI analysts to further customize and improve questionnaires and research. Together they discuss all relevant ESG issues and when necessary, they team up to perform a sustainability analysis on certain sectors or companies.

Cement industry: example of close cooperation

Our industrials credit analyst works together with Robeco's industrial equity analyst and the sustainability specialist from RobecoSAM covering the cement sector. Goal of this cooperation is to analyze the sustainability impact on investments in this industry. The combined team of these analysts identifies the materiality of several factors by analyzing their size and impact on the cement companies. The results have been discussed with companies' management.

The current overall conclusion is that in the next five to seven years the cement industry is likely to improve on sustainability and benefit from this through energy and CO_2 savings. One key trend is mixing fly ash (a waste product from steel companies) into cement so less CO_2 is generated and less energy is needed. This trend is estimated to save European cement companies a cumulative value of 10-15% of EBITDA until 2020 (which is around 2% of EBITDA per year, after investments).

Governance and Active Ownership team

One of the ways in which Robeco integrates ESG factors into the investment processes is by exercising its investor responsibilities. This is done by Robeco's Governance and Active Ownership (GAO) team. With the engagement specialist from GAO the credit analysts discuss themes or company specific issues to be addressed via engagement and research studies. In return, the GAO team gives valuable information to the credit analysts on the results of their discussions with management. This close cooperation helps the credit analysts get more relevant ESG data and knowledge on the companies in their sector. And an active engagement with listed companies has also proven to Robeco to be a useful instrument to influence corporate behavior.

Working together on Petrobrás

Petróleo Brasileiro S.A. or Petrobrás is a semi-public Brazilian energy company, which faces several sustainability issues:

- Petrobrás has been investigated for the high-priced purchase of a company called Pasadena Refining
- Petrobrás and other oilfield service companies have been criticized for work accidents and anti-unionism in Brazil
- Growing environmental, social and governance concerns have been raised as the company was allegedly involved in multiple oil spills over least years
- The board of the company is dominated by representatives of the current Brazilian government. With the aim to decrease inflation the board forces the sale of gas at a loss.

In consultation with the credit analyst, the latter issue was selected to be addressed via engagement by Robeco's Governance and Active Ownership team. Together with other institutional investors Robeco nominated independent directors and succeeded in having them elected. The GAO team also requested the regulator's view on current investigations regarding the company and its stance on recent developments. The team shared all its findings and results concerning Petrobrás with our oil and gas credit analyst. This has further deepened our understanding of company-related ESG risks, and therefore improved the quality of her overall fundamental opinion of the company.

Conclusion: ESG integration improves the risk-reward profile

As a corporate bond holder's primary concern is the company's ability to repay debt, one of the cornerstones of the investment philosophy of Robeco's Credit team is that avoiding losers is more important than picking every winner. The team believes that integrating environmental, social and corporate governance (ESG) factors into its analysis strengthens the ability to assess the downside risk of its credit investments. It performs this analysis by assessing five variables of which ESG is one.

The credit analysts focus on financially relevant issues. If the ESG factors impact a company's credit quality, financial markets should reflect this higher risk in a spread premium on the bonds. Robeco believes that this focus on material sustainability will lead to measurable benefits for both investors and society.

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