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ESG Momentum in Non-Investment Grade Credit

Issuers are facing an increasingly high bar in relation to environmental, social and governance standards. Our recent panel discussion provided ideas on setting goals and working toward achieving them.

Neuberger Berman's Non-Investment Grade Credit team, in conjunction with the firm's ESG Investing team, recently conducted its fifth annual roundtable discussion with issuers, highlighting key trends in sustainability-related disclosure and practices, explaining our approach to ESG integration, and offering investor perspectives and paths forward for issuers. A key message for attendees, representing over $56 billion in non-investment grade issuance across multiple sectors, is that sustainability momentum continues to grow, requiring proactive steps to stay ahead of the regulatory and commercial curve associated with such considerations.

Our Approach to ESG

As an active manager, we have a longstanding belief that financially material ESG factors may be an important driver of long-term investment returns from both an opportunity and a risk-mitigation perspective. Therefore, we take a comprehensive approach toward managing client assets, including the integration of financially material ESG factors into the investment processes for many strategies. Our stance as an active manager in the non-investment grade fixed income market is to use issuer engagement as a key tool to better understand and potentially mitigate ESG-related financial risks, which we assess in the context of the relevant sector, asset class and investment strategy. We use third-party data for this process as well as our own qualitative insights, which we employ in proprietary models to better understand the businesses we analyze.

Engagement is a key part of our strategy, and we view our relationships with issuers as partnerships in which we maintain an ongoing dialogue over time. This gives us a chance to share our perspective on material financial risks and opportunities for their businesses and to learn how issuers are seeking to manage them. Further, these ongoing relationships provide us with valuable insights into management of ESG risks across sectors and markets, and position us as a resource for issuers in developing their company ESG strategies—all with the intention of achieving investment returns for our clients.

The Regulatory Landscape

Regulation is a front-and-center focus for issuers as they plan for new required disclosures and assess their in-house resources and capacity to meet them. In the U.S., regulations are trending toward greater standardization of climate reporting. The most prominent example of this is the U.S. Securities and Exchange Commission's (SEC) recent climate disclosure rule, which requires public companies to disclose material climate-related information, including material Scope 1 (direct) and Scope 2 (indirect) emissions and related financial data, and to provide additional disclosures where a company has set a net-zero or other commitments or targets.

This rule is currently the subject of litigation and has resulted in the court granting an injunction preventing the rule from becoming effective, but regardless of the outcome, many companies continue to face similar requirements in other jurisdictions; for example, the European Union's Corporate Sustainability Reporting Directive (CSRD) has strengthened rules on social and environmental disclosure, and requires disclosure of not only Scope 1 and 2, but also Scope 3 (i.e., emissions that a company is associated with indirectly, such as up and down its supply chain) emissions. This means that European companies will be requiring suppliers to provide Scope 1 and 2 information even if those suppliers operate elsewhere. The State of California has passed similar rules that apply to companies that conduct business in the state with annual revenues over certain threshold amounts regardless of where they are formed or domiciled. We believe these trends may increase the likelihood that an individual issuer will be subject to more stringent standards regardless of domicile.

Moreover, various other regulatory frameworks are growing in influence. For example, the reporting standards of the International Sustainability Standards Board (ISSB) have been embraced by approximately 20 markets thus far, and the Chinese Ministry of Finance has proposed new ISSB-aligned standards to establish a nationwide framework by 2030.

All told, several markets have moved from voluntary disclosure approaches to more systematic and mandatory reporting frameworks, and we expect this trend will continue with countries accounting for 55% of global GDP now working on mandatory ISSB-aligned requirements. From our perspective, the key takeaway is that companies should not wait for regulations to be adopted, but rather prepare in advance to meet upcoming disclosure expectations of investors on financially material ESG issues. Success in this regard could have a meaningful impact on the pricing of issuances and capital costs going forward.

ESG Integration

Across the globe, our clients in non-investment grade credit strategies have shown increasing interest in the integration of financially material ESG factors into portfolio management. At Neuberger Berman, "ESG integration" means that when we analyze a particular company in our normal investment process, we consider financially material ESG factors alongside many other traditional financial metrics and analysis. This type of integration allows us to take a broader, more holistic view of potential risks and opportunities each issuer may face, thus strengthening our analysis. These ESG factors are neither solely determinative nor more significant than other factors in our investment selection process, but to exclude financially material ESG components entirely would mean looking at an incomplete picture of a business' health and prospects. Just as incorporating traditional financial metrics into our investment process is a critical part of our duties as a fiduciary, so too is considering financially material ESG factors.

Additionally, we find that there is client demand for sustainability-related and impact strategies that go beyond the integration of financially material factors; we consider these approaches to be "outcomes-based". These strategies are firmly client-driven and, at Neuberger Berman, largely focused on climate transition considerations and engagement with issuers. Given our experience with these outcomes-based strategies, we believe we are well positioned to meet client demand should it continue to increase. Currently, these strategies represent a modest (but growing) proportion of our assets under management.

Beyond Bond Labels

Issuers often inquire about investor opinions on the use of labeled (green/social/sustainable) bonds to attract capital, and while bond issuance tied to sustainability goals can certainly be a useful tool, we look more to the substance of corporate activities to inform our investment perspective than to any bond label that may be attached. At Neuberger Berman, our research entails in-depth analysis of material ESG factors among a host of other considerations related to capital structure, balance sheets, cash flow and business prospects, and although we've seen a historical interest in green bond weightings in portfolios, we believe the industry generally migrates toward a substance-oriented viewpoint. This way, bonds from issuers who are hitting their sustainability goals are not excluded, regardless of label. We find our clients welcome this approach and appreciate its intuitive efficiency and fact-based nature.

Telling Your ESG Story

In our engagements, we find issuers may feel challenged and pulled in many directions when it comes to sustainability reporting. Fortunately, several common, well-regarded frameworks can help guide issuer reporting. As investors, we recommend evaluating the relevance of specific sustainability topics and disclosures to an issuer's individual business and focusing on what is most financially material for them, their sector and their industry. We generally recommend issuers utilize the recommendations of the TCFD and SASB, as these disclosure frameworks focus on financial materiality. For issuers that have reached a certain level of maturity on climate reporting, we recommend referring to the ISSB's baseline to report on broader financial material sustainability issues. We also encourage issuers to define specific targets and report on their progress toward those targets, which should be ambitious, but also measurable and science-based wherever possible. We do understand that it is not possible to plan for all contingencies, so where an issuer may not progress as expected, we think the most important next step is to analyze and provide transparency on what happened and attempt to course-correct. As part of our engagement, we strive to understand where each company is on its journey, and to provide our expertise to help keep things progressing in the right direction.

Zeroing in on Climate

Assessing the status of issuer climate transition plans continues to be a major focus in our fixed income engagements. This is due in part to the capital intensity of changes needed for the climate transition, which may come from either retained income or capital markets, both of which can affect issuer fundamentals. When it comes to net-zero goals, we also want to ensure that companies are taking the operational steps and making the necessary capital allocation commitments to deliver on their aspirations, which is a core reason for the development of our proprietary NB Net-Zero Alignment Indicator. This is a framework we have developed in conjunction with certain institutional clients that draws on quantitative data and qualitative judgment from our analysts to score issuer progress toward near- and long-term emissions reduction goals. We believe such benchmarking is crucial given clients' intensifying interest in climate impact; ensuring climate transition plans are credible and realistic is important for issuers. Moreover, hitting their targets may even help to ensure issuers' access to capital in the coming years, whereas a demonstrated lack of progress due to insufficient climate transition planning and execution may make those dollars scarcer or more expensive, posing challenges for a company's long-term viability.

Conclusion

Ultimately, we believe that decisions pertaining to financially material climate and sustainability practices more broadly must be made by each company considering its individual circumstances. For newer issuers, deciding on an appropriate framework and enhancing sustainability-related disclosures may appear onerous; those more experienced may need guidance on realistic goals and use of capital to achieve them. For both groups and all in between, as an active manager, we are committed to engaging with issuers to facilitate these types of improvements that go on to benefit our clients. Whether through a forum like our annual roundtable, individual analyst meetings or informal gatherings and discussions, we consider ourselves a partner to issuers and hope to continue offering valuable insights into investor perspectives across the spectrum of sustainability issues.

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