NEUBERGER BERMAN

NON-INVESTMENT GRADE CREDIT TEAM

Smoothing Long-Term ESG Transition

Our Non-Investment Grade Credit team explores key issues and trends facing issuers.

At Neuberger Berman, we believe that attention to material environmental, social and governance (ESG) factors will be crucial to managing investment portfolios over time. The Non-Investment Grade team closely integrates ESG factors into fundamental credit research, engaging rigorously with issuers to ensure that associated risks and opportunities are taken into account in business strategy and the allocation of capital.

For issuers, navigating this environment can be challenging. As attention to ESG standards intensifies, companies are facing an increasing array of demands from stakeholders and regulators as to disclosure and progress toward long-term sustainability goals. To help with this process, Neuberger Berman's Non-Investment Grade Credit team, in conjunction with the firm's ESG Investing team, recently conducted its third annual roundtable discussion to highlight key trends, explain our approach, and provide insights on managing the major shifts ahead. We provide some essential takeaways in this article.

Panelists

Jonathan Bailey, CFA – Head of ESG Investing

Christopher Kocinski, CFA – Co-Head of High Yield and Senior Portfolio Manager, Non-Investment Grade Credit

Steven Ruh, CFA – Co-Director of Research, Non-Investment Grade Credit

Rachel Young – Co-Director of Research, Non-Investment Grade Credit

Lilian Dube – Analyst, ESG Investing – Fixed Income

Moderator: **Savannah Irving,** Associate, ESG Investing – Fixed Income

ESG Focus Intensifies

The use of ESG factors is crucial to credit underwriting at Neuberger Berman, helping us avoid exposure to defaults over time and to heighten the potential for income. A core element of our investment process is to evaluate and score businesses on material ESG issues, both in the public and private sectors. We develop ESG risk profiles for every company we invest in, and engage in dialogue with issuers so they understand the criteria we apply before committing client capital.

Broadly speaking, we've found increasing demand from investors for more ESG-integrated assets. This includes two key areas: custom guidelines, for example to invest in climate transition, where the goal is to reduce carbon emissions over many years, and engagement-focused strategies, where the asset manager maintains systematic dialogue with issuers to support incremental actions to achieve the UN Social Development Goals. Expanding interest in ESG suggests that issuers are likely to be called upon for more disclosure, communication and progress in the coming years, making it crucial to effectively navigate these areas.

Engagement: Transition, Not Perfection

At our firm, we believe the transition toward strong ESG performance is incremental—it's not about building a portfolio of companies and issuers that are perfect in their practices. In our view, that's not realistic, and is unlikely to deliver on the financial objectives of clients and their desire to make an impact in the real world. Moreover, the capital provided by our clients and others can help companies make transitions over time, both in operations and through new products, services and technologies.

Rather than take a hard line of exclusion or divestment, we therefore typically employ more of a "work-in-progress" approach to our engagement, where we look for the appropriate level of disclosure and goal-setting to make us confident in a company's future. We keep our process in-house, leaning heavily on our credit analysts in the process given their intimate knowledge of issuers and sectors. With near- and long-term goals in mind, we apply targets and look for progress reports to clarify how capital is deployed and ensure that companies are on track, whether relating to diversity initiatives, reducing carbon footprint or other ESG concerns. In turn, many companies look to us for guidance on best practices.

Structuring Reporting and Goals

Issuers often say they are pulled in many directions by different constituents when it comes to structuring of ESG reporting and goals. We have found three voluntary frameworks to be particularly helpful in aligning issuers with these expectations:

- **Sustainability Accounting Standards Board (SASB):** This group provides broad sustainability reporting standards, highlighting material ESG issues that are most relevant to the financial performance of specific industries.
- **Task Force on Climate-Related Financial Disclosures (TCFD):** The TCFD framework helps companies more effectively disclose climate-related risks and opportunities through their existing reporting processes.
- **Science Based Targets initiative (SBTi):** This group provides guidance on setting climate targets that will be required to meet the overall goals set forth in the Paris climate agreement.

Regulatory Momentum

There has been a general push toward greater mandatory and standardized disclosure of environmental and social data. In the U.S., the Securities and Exchange Commission has proposed rules (currently in the comment phase), that would ask issuers to fortify disclosure of climate-related data, most prominently in Scope 1 (direct) and Scope 2 (purchased electricity, steam, heating and cooling), but also for those with material Scope 3 emissions, which consists of indirect emissions in the value chain. The SEC is also looking to ask companies that have made commitments to net zero or other climate goals to provide detail on how those goals are being achieved. The rules would increase the alignment of the U.S. with Europe's Non-Financial Reporting Directive in reporting on a range of ESG issues. More generally, we would note efforts to establish an array of global disclosure standards under the International Sustainability Standards Board. These would be voluntary, but history shows that many previously voluntary standards have eventually formed the basis of mandatory provisions. Global momentum is also evident in the efforts of previously lagging regions and countries such as Japan and Southeast Asia, which are taking positive steps on disclosure.

Moving Toward Net Zero

Emissions reduction has become a key ask from investors, who are looking for holdings to actively contribute to the net-zero pathway. This is a long-term journey—30 years for much of the developed world, and perhaps 40 or 50 years for China and India. Some areas are simply awaiting technology and innovation to curb impact—for example, aviation and cement manufacture. However, the path for other sectors, such as autos and energy, is clearer, and the question is more about the pace of change than how it will be achieved. For us as investors, therefore, it is important to understand how companies' capital allocation is going to keep them moving in the right direction. This may be a function of periodic benchmarking, but it also may be appropriate to introduce these steps into long-term compensation, aligned with tangible metrics. As part of our process, we have created a climate transition indicator to quantify where issuers stand on their journey, which helps us feel confident in the components of our overall portfolios.

Merits of 'Green' Debt

Innovation will be an essential part in the climate evolution in company operations, but is also likely to play a part in their financial approaches as well. A topic we are frequently asked about is the merits of bonds that are labeled as "green" or "ESG," with provisions tied to achieving goals in climate and overall sustainability. In our view, such bonds can be beneficial to an issuer's entire capital structure, helping to enhance transparency and clarify goals, practices and policies. As such, we encourage companies to incorporate those elements in their issuance. Characteristics we assess include the transparency around eligible projects and the use of issuance proceeds. We also look to ensure that the capital raise is additive to the company's strategy, whether there's accountability, and if key performance indicators are measurable and can be tracked over time. However, a crucial point is that we conduct the same exact research on a green bond that we would on any other issuance. There are no special allowances for the category, which means that bonds we might invest in would not only be fundamentally sound, but, in addition, meet stringent requirements for the potentially beneficial green labeling.

Looking Ahead

As we look to the future, we expect continued momentum on ESG integration. Although in early stages, some clients, particularly in Europe, are looking to expand risk assessments beyond greenhouse gases to broader environmental impact, such as in terms of "biodiversity." More concretely, the physical risk of climate change is becoming a key point of analysis: the degree to which property, plant and equipment are being adapted to limit the impacts of flood, extreme heat and the like. In the social realm, shareholders are increasingly looking for progress on equity, inclusion and diversity, while governance remains a core concern, with particular progress in regions that are seeking to catch up on practices already adopted globally.

Conclusion: A Consistent Resource

As investors, we recognize the important role we hold to influence and support positive corporate decision-making. We look to be viewed as a resource, to help with the adoption of best practices and to clarify what we are looking for as investors, as well as to help fulfill our commitment to exert leadership across ESG investment priorities. This roundtable was part of our educational outreach and partnership with issuers. We look forward to further communication and encourage you to reach out to us with any questions about the topics covered and broader issues of impact and sustainability.

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