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M&G INSTITUTIONAL

# Focus on Engagement

## ESG engagement in corporate debt investment

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- Engagement with companies on environmental, social and governance (ESG) characteristics offers a path to greater understanding and confidence about the suitability of an investment.
- At M&G, we take a systematic and methodical approach to engagement that involves identifying clear objectives for an engagement, then recording the actions achieved on an ongoing basis.
- Corporate debt holders can have a significant influence on the ESG behaviour and standards of companies, especially those reliant on regular debt issuance or borrowing.

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is shown, please note that this is not a guide to future performance.

### The responsibility to engage on ESG

Investors increasingly want to see their investments not only meet financial objectives, but also be a force for good. Consequently, they appreciate that additional value is likely to accrue to companies which act in a responsible manner and operate sustainable business models. That means investing at arms-length, without gaining the richest knowledge of a company's ESG objectives and practices, is unlikely to serve clients and investors most effectively.

Actively engaging with a company, to identify how it is embracing responsible behaviour and what it is both targeting and achieving may be the best way to gain that knowledge. In its best form, we believe engagement should be a two-way process. Companies provide information to assist with investors' decisions, while investors can provide with guidance on which factors are impacting their appetites to invest.

### Purpose and benefits of engagement

Applying exclusions has historically been the easiest approach to avoid investing in "bad" companies, but that fall shorts of today's standards for sustainable investors.

We, and our clients, also want to improve companies' behaviour and the outcomes of that behaviour, rather than sell the problem to another investor, who may then hold the investment and risk passively. We want it to be easier to see where companies are on their sustainability journey and what they are doing to improve it.

As investors on behalf of our clients, we also want to use engagement to add to and develop our own understanding of ESG and the risks that companies may be facing.

Figure 1. Purpose and benefits


Source: M&G, illustrative. August 2020

#### Disclosure and transparency

Investors crave ever-greater detail on a wide variety of sustainable behaviours, including such things as more efficient resource use, better waste management, improved workforce welfare and better corporate governance.

For companies to be transparent, disclosing what they are doing and have achieved, can help give investors greater confidence.

### Measurement of key performance indicators

Companies can build on the foundations of intention, and showcase the success of their efforts, by setting meaningful and measurable KPIs.

For example, a car manufacturer may measure and demonstrate, to both investors and customers, by how much and how quickly they are reducing the carbon footprint of the cars they produce.

### Improving understanding

Companies have become increasingly aware of the place ESG assessment is taking in the fund management risk analysis process. They can provide greater comfort to investors by communicating their ESG intentions and objectives clearly and publicly. It may help overcome situations where investors may otherwise be constrained from investing.

At the same time, we as investors, can share with companies what we believe is important to our clients.

The gravity of the consequences to a company of not being on the right path are increasing, particularly as consumer behaviours are becoming more important and influential.

## Systematic and methodical approach

In its best form, we believe engagement should be a two-way process. Companies provide information to assist with investors' decisions, while investors can provide guidance on which factors are impacting their appetites to invest.

The longer term nature of ESG risks and our investment approach make it essential to integrate ESG into our process. Additionally, the asymmetric return profile involved in bond investing (where the potential for upside is limited, while that for the downside is greater) means we focus our ESG analysis on understanding the downside risks. Important risks are not only financial but also now extend to others such as reputational, regulatory, cyber and climate risks. For us it is about being comfortable with all an investment's risks.

To achieve that confidence, we take a systematic approach to engaging with companies, and the process is usually led and undertaken by the credit analyst teams. The close relationship that analysts have with the companies and sectors they cover means they are well-placed to understand the ESG issues and challenges likely to influence each company's credit quality. The analysts are supported by the Stewardship and Sustainability Team (ESG team) and the fund managers as part of the engagement process.

We think deeply about what we want to achieve and will identify specific objectives for an engagement. Then we will seek particular outcomes from the actions taken.

M&G's scale in FI gives us the necessary access to issuers' senior management, where we can engage on ESG issues directly.

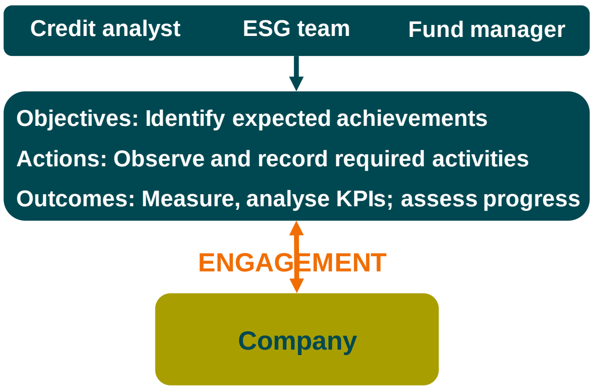
## Objective, Actions and Outcomes

Our ESG engagement framework begins with identifying and set out the objectives of an engagement.

Engagements might be motivated by a single theme or by some specific ESG weakness or controversy but it will likely have a number of objectives.

We then observe and record the actions undertaken and analyse the measured outcomes to assess progress toward the objective, on an ongoing basis throughout engagement. Continual dialogue is an essential part of an engagement activity.

Figure 2. Objectives, Actions and Outcomes




Source: M&G, illustrative. August 2020

Engagement is a collaborative process, and we dedicate extensive resources to it. The fund managers work closely with our credit analysts and our dedicated ESG team in the process of engagement to build a comprehensive understanding of a company's ESG attributes and its overall credit profile.

**Engagement in practice**

**Theme: Deforestation and sustainability strategies – Marfrig Global Foods**

Marfrig is the second largest food processing company in Brazil.

**Objective**: As long-term holders of Marfrig bonds we wanted to gain clarity and a better understanding of the company's sustainability strategy. Specifically we wanted to find out more about how it relates to deforestation in the Amazon biome. Following up, we also wanted an understanding about how they were dealing with Covid-19, particularly with respect to their employees.

**Actions**: Engagement was via a conference call with company representatives, including the head of sustainability. We raised questions about the details of Marfrig's deforestation policy and how the company can demonstrate the transparency and traceability in its supply chain. Within the engagement we also sought information on a range of other topics, including animal welfare, waste and effluence management, and bribery and corruption. Regarding Covid-19, the company provided a comprehensive response outlining how they were supporting employees in North and South America.

**Outcomes**: The company explained how they consider the origins of all raw materials, as well as the impact on biodiversity and deforestation in supply chains. This included sourcing cattle from farms free from deforestation. As a follow up, we requested further details on the key performance indicators (KPIs) they are using to measure their success. We will continue to monitor the situation. The company's responses on their Covid-19 measures gave us reassurance regarding their swift action in implementing preventative measures for their employees, in addition to adjusting some operations to manufacture hand sanitiser.

## Engagement for corporate debt holders

Far from not having "a seat at the table", or the kind of meaningful influence associated with ownership through equity stakes, debtholders can be instrumental to affecting corporate behaviour, through engagement.

Bondholder engagement can be especially important and influential when terms for corporate acquisitions and consolidation activities are being negotiated, or when smaller companies, or those in the high yield markets, need financing.

Beyond that, companies needing to refinance existing debt should welcome engagement on their ESG activities as an essential test for ensuring ongoing financing.

## Joint engagement

Often a joint engagement initiative can be helpful, particularly where, as a firm, we have a large exposure to a company, perhaps holding equity as well as debt, whether it be public or private.

Joint engagements can bring together different M&G investment teams. Combining the efforts and insights of the corporate credit team with the Leveraged Loans group and/or the Equities business, we can gain engage on different angles, achieving deeper, more rounded insights into companies.

They can also involve other investment houses, such as being part of the Climate Action 100+ initiative.

**Engagement in practice**

**Theme: Single-use plastics and climate strategy – Britvic**

Britvic is a large-scale supplier of still and carbonated soft drinks across Europe and is listed on the London Stock Exchange.

**Objective**: We wanted to understand how Brivic is going to meet its 2025 target commitments to eliminate unnecessary single-use plastic packaging. This includes the governance, board oversight and incentivisation in place to meet those targets.

**Actions**: As part of a joint engagement with our equity team, we held meetings with the company's ESG team on the subject, including the company's chief executive. We wanted to understand how Britvic planned to meet its commitment to ensure that all its products have 30% recycled PET by 2025.

**Outcomes**: We have gained clarity on the structures that Britvic has put in place to setting and meeting targets relating to sourcing recycled PET plastics. This includes the governance and board oversight procedures.

## Engagement topics

The range of subjects where engagement is most important can be extremely wide and diverse. As well as sustainability themes such as deforestation and single-use plastics highlighted in the case studies, others that we prioritise, include: paths to reducing carbon footprints and greenhouse gas emissions (GHG). We also focus on how companies are ensuring no instances of modern slavery in supply chains, combatting corruption and bribery, making efficient use of raw materials and managing waste effectively. There are many others, and new subjects emerge regularly.

The discussions we have with companies have changed significantly in recent years, as companies have recognised the positives of embracing responsible and sustainable business models. The move away from traditional linear “take, make and dispose” approaches towards more circular models, which emphasise recycling of waste and efficient use of resources, is accelerating.

For companies we may look to invest in, it is not only about applying a responsible approach but also includes demonstrating a clear plan to improve outcomes via a partnership of working together.

### Engagement in practice

**Theme: Green bonds – Landsec**

Landsec is one of the UK’s leading commercial property companies, developing and managing office, retail and leisure space across the country.

**Objective**: As a significant participant and influential investor in the UK and European bond markets, M&G was invited to provide input on the company’s green bond framework, prior to its publication.

**Actions**: We met with Landsec’s reporting manager, treasurer and insurance director to discuss the company’s green bond framework.

**Outcomes**: Having an ambition to be a leader on TCFD (Task Force on Climate-related Financial Disclosures) the company established strategies and internal training programmes to enhance awareness of the value of its green investments. An external consultant also helped by highlighting risks in its value chain that could arise from various climate scenarios.

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