M&G Global High Yield ESG Bond Fund

ESG engagement case study – assessing Huawei risk

Fund managers – James Tomlins and Stefan Isaacs

FOR INVESTMENT PROFESSIONALS ONLY
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- *With increasing concerns around the viability of Huawei as a supplier of telecom equipment, M&G senior credit analyst Simon Duff has instigated an in-depth review across the telecom sector.*
- *Through an active engagement process, we have sought to establish the extent of each company's Huawei exposure and the potential costs associated with replacing existing equipment.*
- *Through a combination of detailed credit analysis and active company engagement, we have been able to gain a much clearer picture of the Huawei-related risks for the sector and some of our portfolio holdings.*

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

Background to the issue

Chinese telecommunications equipment supplier Huawei has come under increasing pressure from the US in recent years due to concerns over a range of issues, particularly in relation to criticism surrounding intellectual property and cybersecurity. This has led to the banning of Huawei's equipment in the US, along with several other countries, such as Japan and Australia. The UK and Canada are poised to enforce similar bans, with the prospect of other countries in Europe and elsewhere following suit.

Huawei also faces pressure on the supply side, with the US recently announcing measures which seek to restrict the company's access to foreign-produced items that use US technology or components. This could effectively close-off the supply of cutting edge semiconductor chips from countries such as Taiwan and South Korea, and force Huawei to fall back on domestic supply which is several years behind in terms of technology.

An escalation of the situation and the imposition of further bans could have a significant impact on many telecom operators, especially those based in Europe and a number of emerging markets. While US telecoms would be largely immune given that bans on Chinese equipment are already in place, European telecom operators could face costs of around $3.5 billion if they are required to replace Chinese equipment, based on estimates from Strand Consult. As well as the financial costs, there are also operational risks to consider if Huawei ceases to be a viable equipment supplier or network management partner.

Assessing the risks

With increasing concerns around the viability of Huawei as a supplier, we have launched an in-depth review of the telecom companies held within our portfolios in order to establish the extent of any exposure to Huawei, and to identify any possible "safe havens" or, conversely, "land mines".

We believe that the work of Simon Duff and the credit analyst team highlights our ability to combine traditional credit research with an assessment of environmental, social and governance (ESG) factors to gain a more comprehensive understanding of the companies in which we invest. From a credit perspective, we assessed the financial costs of replacing Huawei's equipment, as well as the operational risks associated with switching suppliers. Our ESG analysis was mainly focused on governance issues, such as how companies managed their supply chain risks and their willingness to provide a thorough disclosure relating to their third-party equipment exposure.

While many of the large telecom companies, such as Vodafone and BT, have publicly provided the estimated costs of being forced to replace Huawei's equipment, disclosure has been generally poorer amongst smaller telecom operators. Given that many of these are high yield names carrying relatively high levels of debt, it is imperative to establish both the extent of any Huawei exposure they may have and their ability to deal with any costs should they need to switch suppliers.

We have therefore been liaising closely with the telecom companies which might be affected and where further details were required to properly assess the risks. The key questions raised included:

- Is Huawei a material supplier of network equipment or services?
- What is the size of that exposure in terms of either i) percentage of network supplied or managed by Huawei or ii) territories/region supplied or managed by Huawei?
- What are the estimated costs of replacing or phasing out Huawei as a network equipment supplier?
- What mitigating actions are being taken to minimise or eliminate this risk?

Preliminary conclusions

We believe the analysis undertaken by Simon and the team has enabled us to get a better understanding of an important risk factor currently facing the telecom sector. This in turn allows us to more accurately gauge whether bondholders are being adequately compensated for taking risk. While the identification of a risk factor would not automatically preclude us from holding a position if we thought we were being well compensated for taking risk, we believe the **M&G Global High Yield ESG Bond Fund** should be well shielded from Huawei-related risks as the situation unfolds.

M&G Global High Yield ESG Bond Fund	
Launch date	25 February 2020
Benchmark	ICE Bank of America Merrill Lynch Global High Yield Index (USD Hedged)
Benchmark type	Target
Sector	IA Sterling High Yield
Fund managers	James Tomlins Stefan Isaacs

*The benchmark is a target which the fund seeks to outperform. The index has been chosen as the fund's benchmark as it best reflects the scope of the fund's investment policy. The benchmark is used solely to measure the fund's performance and does not constrain the fund's portfolio construction.

The fund is actively managed. The investment manager has complete freedom in choosing which investments to buy, hold and sell in the fund. The fund's holdings may deviate significantly from the benchmark's constituents.

Given the generally poor levels of disclosure amongst many smaller telecom names, it can be difficult to precisely quantify the financial and operational impact of a Huawei 'rip and replace' scenario. Our direct company engagement programme was therefore vital in enabling us to build a more detailed picture of each company's Huawei exposure and the potential costs it may face.

The level of responses we received was wide ranging. While some companies were reluctant to comment, others provided a good level of detail, allowing us to gain a more accurate assessment of their underlying credit profile. The engagement process also gave us valuable feedback on each company's transparency and willingness to engage with its stakeholders. We regard disclosure as an important governance factor, which plays a key role in our overall ESG assessment.

By engaging with individual companies, we were able to gain additional comfort on a number of our key fund holdings, establishing manageable or immaterial levels of Huawei exposure. On the other hand, the engagement highlighted a number of issuers where we think Huawei-related risks are not fully reflected in bond prices. We remain cautious on several smaller players with higher leverage, which were not able to provide us with enough comfort on the potential risks.

We believe the engagement process also highlighted the benefits that can be brought to companies themselves. This is particularly the case for some of the smaller high yield names, many of which lack the capacity or expertise to gauge the level of information that investors increasingly require. As experienced high yield investors, with ESG factors closely integrated into our credit research process, we believe M&G are especially well placed to guide businesses on the type of information and disclosure that investors need to hear.

Investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund. High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries.

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The fund allows for the extensive use of derivatives.

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