HERMES
INVESTMENT MANAGEMENT

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Hermes Credit

# Spectrum

## Giving credit to ESG analysis

### Key points

The stocks of poorly governed companies underperform by an average of 30bps each month. Should credit investors take note?

Yes. The often diverging interests of shareholders and creditors do converge on enterprise value, which is influenced by governance.

Credit investors should assess and price-in ESG risks in the context of the broader strengths and weaknesses of debt-issuing companies.

Those who astutely integrate ESG factors into their analysis of companies should be able to better manage risk and outperform.

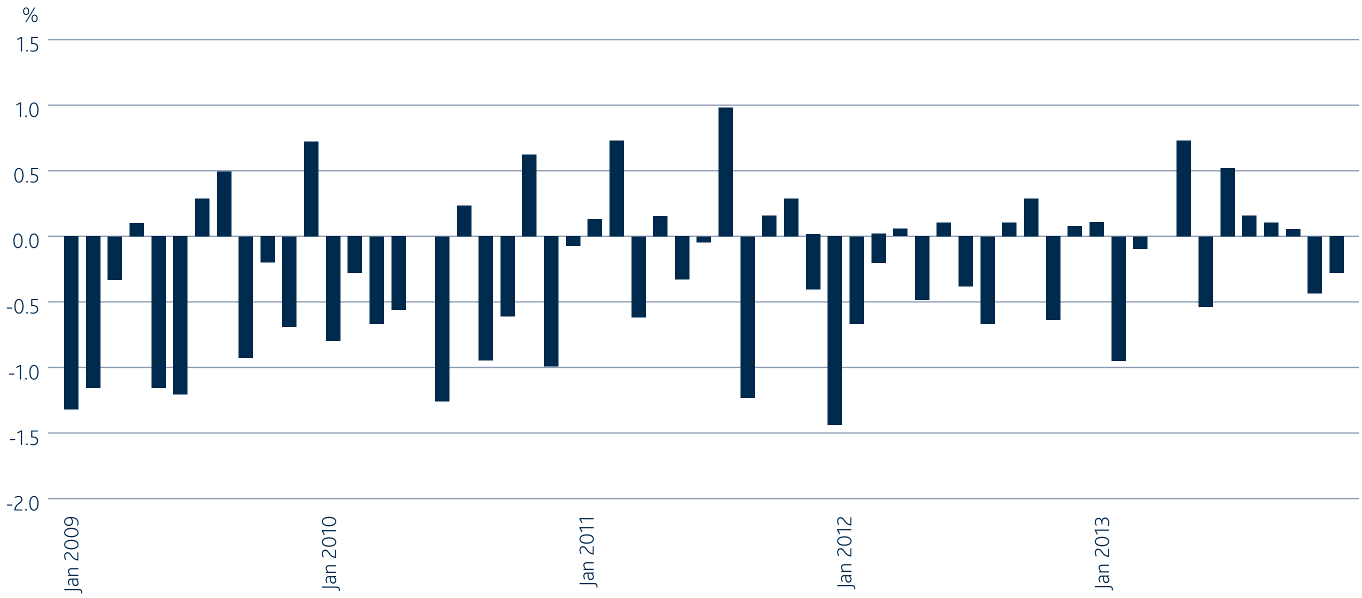
## The consideration of environmental, social and governance (ESG) risks in investment decisions has gained momentum. But aside from fulfilling socially responsible mandates or a moral obligation, should any investment manager – let alone a credit manager who has no shares to vote – really care?

After all, our primary fiduciary duty to clients is to make money and avoid loss. We have learned, however, that considering ESG factors improves our ability to deliver this by providing a more comprehensive view of risk.

Based on our experience as credit investors, and on research that Hermes Investment Management has carried out, we believe that analysing ESG factors as part of an investment process enhances performance.[1] To us, this is intuitive, because although the interests of shareholders and creditors do not always converge, poor ESG practices can erode enterprise value – which is negative for both shareholders and creditors alike. Therefore, in addition to assessing and pricing operational, financial and liquidity risks, we believe that investors should undertake ESG analysis to more comprehensively assess a company's prospects.

Last January, Hermes Global Equities published the results of a study that it conducted on the impact of ESG risk on shareholder returns. While it found insufficient evidence to link stock performance with social and environmental metrics, it found that stocks with poor governance typically underperformed. During a five-year test period ending in 2013, companies with the worst governance standards underperformed in 62% of the months compared to peers in the MSCI World Index[2] (see Chart 1).

**Chart 1.** Poorly governed companies tend to underperform




The monthly average return of stocks in the lowest governance decile relative to the average return of companies in the MSCI World Index, from 31 December 2008 to 31 December 2013

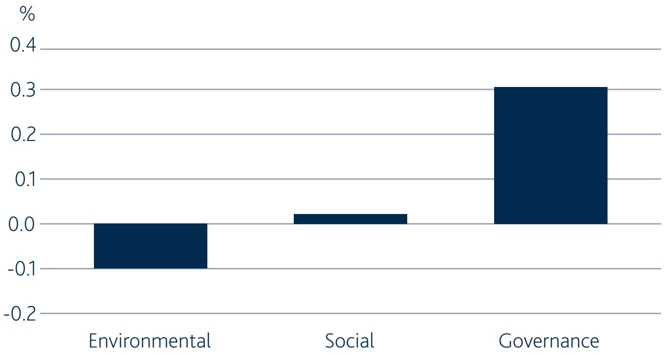
Source: Hermes

[1] Hermes has extensive experience in ESG analysis – particularly through Hermes EOS, our shareholder stewardship team. This commentary focuses on how we assess ESG risks as credit investors.

[2] "ESG Investing: Does it just make you feel good, or is it actually good for your portfolio?" by Hermes Global Equities, published January 2014.

Interpreting the data, the team concluded that good governance does not guarantee superior stock performance. Rather, avoiding companies with poor governance provided a better chance of avoiding 'blow-ups' – companies that fail due to inept management or regulatory scandal. As such, the 30bps difference in returns between well and poorly governed companies is principally driven by the underperformance of the latter (see chart 2). Overall, the study shows that worst-governed companies lag the market (see chart 3).

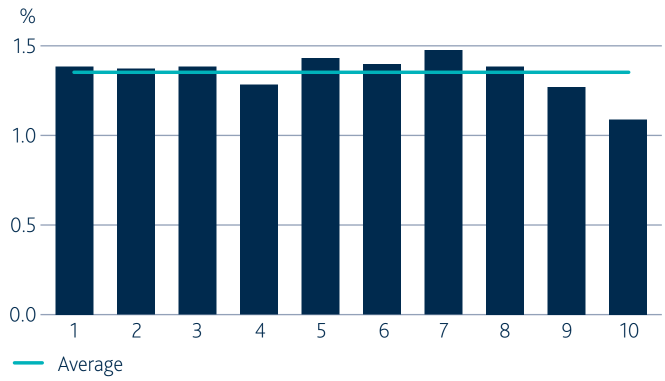
**Chart 2.** Governance risk is a source of value for investors




Average monthly dispersion in total returns between companies in top decile and lowest decile on environment, social and governance scores from 31 December 2008 to 31 December 2013

Source: Hermes

**Chart 3.** The most poorly governed companies typically underperform




Average monthly performance of companies split by decile, based on governance scores, from 31 December 2008 to 31 December 2013

Source: Hermes

# ESG analysis in credit markets

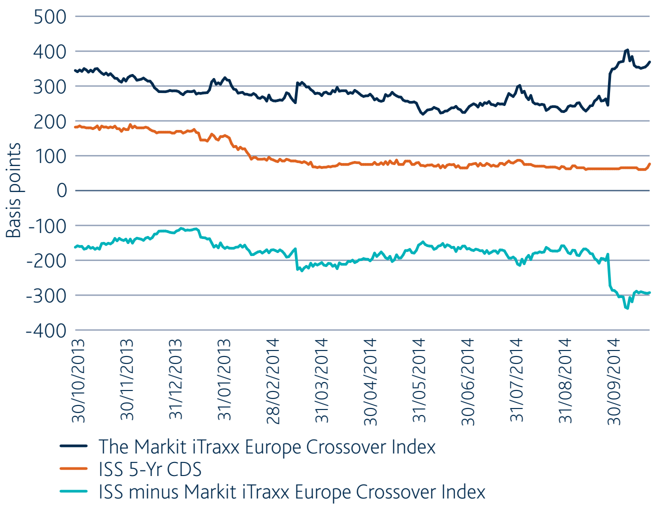
How can credit investors detect poor governance? In the study discussed above, the global equities team used the following factors: board independence, poison pills, remuneration, independent directors, combined chair-and-CEO role, risk management, business ethics and proxy voting. These metrics could be applied to most investment-grade credit issuers because they are often listed companies and must disclose this information. Similarly, although the study analysed equity performance, the conclusions about poor governance can be applied to investment-grade issuers, too.

But many issuers are private and, as such, these considerations are not relevant. A company could be 100%-owned by a private equity firm, which controls the board and thus the direction of the business. Little consideration is given to 'independent' views. In some cases this is not problematic and the interests of all stakeholders – equity and credit alike – are aligned.

For example, the private-equity owners and management of global facility-services company ISS believed that de-leveraging was the best way to de-risk the company ahead of its successful initial public offering (IPO) in March 2014 – which, in turn, was a de-leveraging event. The once-junk-rated company is now rated investment grade and is an example of the benefits of an alignment of interests for both shareholders and creditors.

In the United States, Intelsat, a highly leveraged satellite services company, has sent a very clear message that it sees de-leveraging as the best way to create value for shareholders. Having already paid down debt with proceeds from an IPO, it continues to reduce debt and refinance at lower interest rates, thus reducing its risk profile. This has rendered the spreads of the generously levered, low-rated company to perform in-line with, if not better than, the broader market.

**Chart 4.** Benign dictatorship: The interests of ISS and its investors are aligned, despite no formal interaction




Source: Bloomberg as at 30 October 2014

In other cases, however, shareholder actions are antithetical to the interests of lenders. The recent collapse of UK retailer Phones4U is an example of the highly destructive impact that aggressive owners can have on a business (see the case study on page 4 for details). Would an independent board have decided to issue a £205m holding company payment-in-kind (PIK) note to help finance a £225m dividend to shareholders? Given the elevated operating risks that the company was facing amid structural change in both the retail and mobile-device markets, it is unlikely. Consequently, the company's financial risks would have likely continued to decline rather than suddenly intensify as it entered tough negotiations with Vodafone, a key customer. While a PIK-dividend deal is not villainous in itself, a re-leveraging event needs to be considered in the context of the overall business and financial risks. Phones4U could have chosen to simply use excess cash on its balance sheet, generated from an asset sale, to redeem some of its 9.5% 2018 bonds, enabling it to refinance the entire issue at a lower rate. This would have reduced cash debt-service costs and thus the financial risks for a company that was struggling to grow.

# Phones4U: Signal failure

Until it recently filed for administration, Phones4U was a UK-based retailer of mobile devices and connections to wireless service providers' networks. It operated about 700 stores and concessions. At the time of its debut bond issue, the company's business was supported almost entirely by its long-term contractual relationships with three major wireless service providers in the UK: Vodafone, O2 and EE. It had annual sales of about £1bn and EBITDA of about £100m on a trailing 12-month basis in September 2014. Nothing in these figures foreshadowed the retailer's imminent demise.

## Chronology of a collapse

In 2011, to fund the leveraged buyout of the company by private-equity firm BC Partners, the company issued £430m in 9.5% 2018 bonds which had their first call date on 1 April 2014. This bond deal, plus proceeds from a credit facility and a £200m equity cheque from BC Partners, financed the acquisition. Fast forward to September 2013, when Phones4U used a holding company to issue £205m in payment-in-kind (PIK) toggle notes. Proceeds from this bond, along with cash on the retailer's balance sheet, were used to finance a £225m distribution to shareholders. With that payment, BC Partners recovered its original investment plus an additional £25m. The owners of Phones4U no longer had skin in the game.

A few months later, in January, the company revealed that it would no longer sell any connections to O2. Because O2 had already stopped selling new connections through Phones4U in February 2013, the carrier provided only about 8% of Phones4U's total connections business. However, it left the retailer principally reliant on EE and Vodafone for the sale of connections. (Three, the wireless carrier, stopped selling connections through Phones4U in 2012.) Then, in May, electronics retailer Dixons announced that it was planning to merge with Carphones Warehouse, the principal rival of Phones4U. What was so revealing – and painful – about this development was that Phones4U had an existing store-in-store agreement with Dixons. So, the fact that the electronics chain had reached a merger agreement with Phones4U's main competitor was a huge blow. A few months later in 2014, on 1 September, Phones4U stunned the high-yield market with a press release stating that Vodafone would not renew its contract when it expired in early 2015.

On the Friday before the press release was issued, Phones4U bonds closed at around £103, a little below the call price. One week later, they changed hands at £41. And the PIK-toggle notes? They dropped from £85 to £12 over the same period. A few days later, EE announced that it too would walk away from Phones4U when its contract expired in September 2015. All but dead, the retailer filed for administration.

## Unstable connection

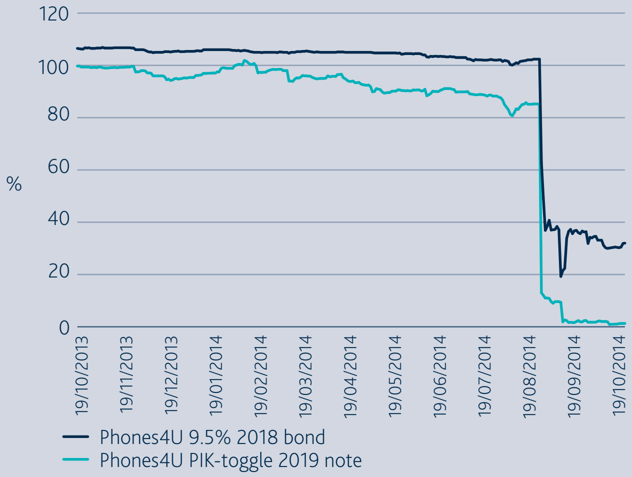
Before the PIK-toggle issuance in September 2013, Phones4U had been generating cash and had de-leveraged from 3.8x at the time of its 2011 bond issue to 2.5x. Moreover, in August 2013, the company had agreed to sell its insurance business, called LSG, for £106m – nearly the equivalent of one year's worth of EBITDA.

By September 2013, although financial risks had reduced with the decrease in leverage and the proceeds from the LSG sale, operating risks were rising, predicated on secular change in the retail and mobile-device markets. Consequently, Phones4U was struggling to find ways to reinvigorate its growth rate. So the company introduced the 'Jump' handset-upgrade program and 'Life' wireless-service offering. These, of course, required investment. Operating results were being further weakened as the company invested in growth, compounding the existing pressure on the business.

No one would have seen this more clearly than the owners of the company. While it is very unlikely that BC Partners decided to claw back its original investment due to a heightened fear of crippling contract losses, the fact that the company was so keen to recapture its original £200m investment (and then some) at a time when Phones4U was struggling, revealed a clear lack of confidence in the company and its prospects for a successful IPO. With the repayment, BC Partners was no longer invested and the interests of shareholders and creditors were no longer aligned. In fact, the re-leveraging event reflected a clear divergence in interests for the first time since the 2011 buyout. Instead of using the recently obtained cash to partially redeem the very expensive 2018 bonds, combined with a full refinancing at a much lower interest rate, it chose to extract cash from the operating company and combine it with cash from the holding company to facilitate its exit from Phones4U.

Would Vodafone have walked away from Phones4U in September 2014 if the PIK-toggle deal did not happen? It's tough to say. On one hand, you could argue that it would not have made any difference at all: Vodafone was going to cut the contract, no matter what. On the other hand, perhaps the hurdle rate to a deal with Vodafone, which had been negotiated over months, was higher because of the need to create implied equity above the PIK-toggle note so that the shareholders could benefit from that residual value. We will never know. But the point is this: a dividend deal in itself is not nefarious, but its impact on the health and fundamentals of the business from which it is struck must be considered.

Phones4U: Connection cut

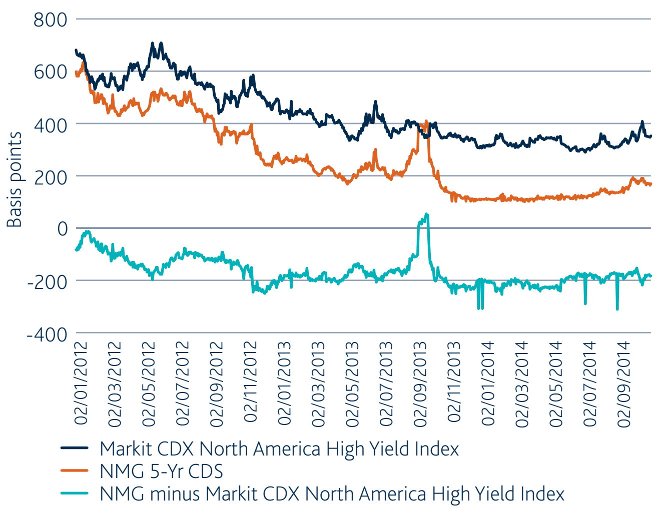



Source: Bloomberg as at 30 October 2014

In contrast, the business risks of Neiman Marcus Group (NMG) were moderated by its steady growth and skilful execution. In March 2012, NMG financed a $443m dividend using cash on its balance sheet and borrowings. Three months earlier, the spread on NMG's five-year credit default swap was about 580bps compared to the 680bps of the index. At the time of the announcement, which some market participants expected, NMG's CDS spread widened 50bps only to revert close to its previous level. Remarkably, it ended the year at 280bps compared with the index's 495bps: despite the re-leveraging event, NMG had significantly outperformed. Since then, the company filed a prospectus for an IPO but ended up being sold to another a private-equity group.

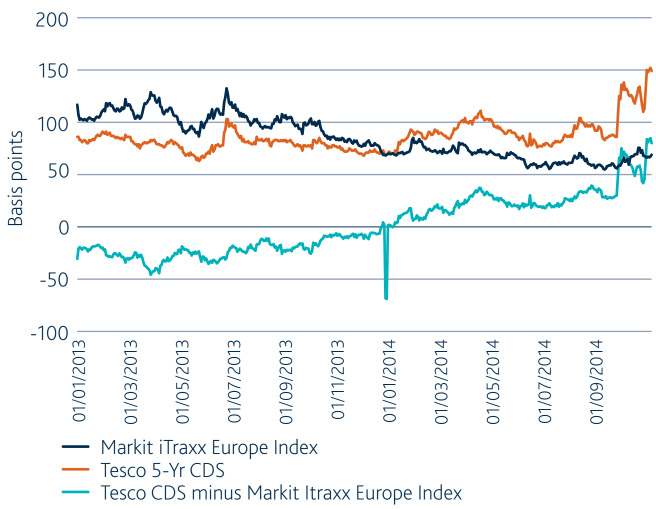
Pricing ESG risks is rarely simple. What can make it tricky is that high-quality governance is no promise that a company won't suffer a fall in enterprise value predicated on corporate activity. Witness the poor recent performance of Tesco after the company overstated its profits by £263m. It first communicated this on 22 September. Since then, the UK's Serious Fraud Office has launched an investigation. Its five-year CDS traded at about 155bps at the beginning of November, well off its previous level of around 90bps. This unexpected, negative event came from nowhere and defied the very high governance scores that it generated on the Hermes ESG Dashboard.

**Chart 5.** Dividend and conquer: NMG has appeased both shareholders and creditors




Source: Bloomberg as at 30 October 2014

**Chart 6.** Tesco: Checking out




Source: Bloomberg as at 30 October 2014

These two episodes highlight the imperative to consider ESG factors as part of a broader set of corporate risks. They show that fund managers should not take a dogmatic approach to such credit-negative events. Instead, we must analyse them in the context of the financial strength of the business itself.

Moreover, we do not encourage systematically avoiding all companies that have high ESG risks, as this would preclude investment in companies with improving ESG characteristics. As a credit fund manager, we price-in the risks of poor ESG exposure, and look favourably on companies aiming to improve their management of ESG risks. For example, although Vedanta has a poor ESG score, it has shown some improvements. Data from Sustainalytics, an ESG-focused researcher, show meaningful year-on-year improvements – particularly of environmental risks. Its turnaround is also being tracked by the Hermes ESG Dashboard, a proprietary ESG risk-management tool. The company's overall rating, called the QESG Score, jumped to 45 from 34 the previous year. Hermes Credit first invested in Vedanta in September 2013, when its 7.125% 2023 bond was priced $87, generating a 9.25% yield. When it rallied to $95, we trimmed the position because we did not think we were being adequately paid for the risks, including ESG factors. Over the past year, we have adjusted our position based on its price and our assessment of the risks, and finally settled into a convertible bond because of its shorter maturity and the value it offered.

## ESG: Cause for analysis, not dogma

What can we conclude from these case studies and research? Sometimes, companies like Tesco that score well on governance can shock the market and send credit spreads wider. At the same time, companies like NMG, which forsake creditors to benefit shareholders, can outperform. Notwithstanding these somewhat contradictory outliers, the results of the study by Hermes Global Equities show that companies with chronically poor governance tend to underperform. The dividend from Phones4U by the company's private-equity owners seems to validate this point.

While fund managers should watch for signals of governance risk, they must also keep an eye out for improving ESG stories that are under-appreciated by the market and present an investment opportunity. The case studies of ISS and Intelsat show that the interests of shareholders and creditors can be aligned – particularly in the de-risking of balance sheets, which can be good for all stakeholders. As credit fund managers, we should not be dogmatic in judging corporate behaviour. Rather, we must assess and price-in ESG risks in the context of the overall strengths and weaknesses of underlying businesses and the broader sectors in which they operate. By integrating this in their investment processes, credit managers gain an even better chance to outperform the market and their competitors.

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Hermes aims to deliver long-term outperformance through active management. Our investment professionals manage equity, fixed income, real estate and alternative portfolios on behalf of a global clientele of institutions and wholesale investors. We are also one of the market leaders in responsible investment advisory services.

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**Edge**

A focus on security selection through the capital structures, and across debt instruments, of issuers worldwide. We believe that capturing superior relative value depends as much on finding attractive securities as identifying creditworthy companies. This approach helps to deliver strong returns through the cycle.

**Rigorous, repeatable process**

Intensive relative-value investing in bonds, loans and derivatives. This bottom-up credit selection is guided by top-down analysis. Risk management is a core function at all stages of our investment process.

**Experienced team**

Skilled, integrated team whose principal members have worked together since 2004. We are expert managers of global multi-strategy, high-yield and investment-grade credit strategies.

**Aligned interests**

The autonomy of a boutique with the operational strength of an institutional fund manager. To ensure our interests are aligned with our clients', long-term outperformance is a condition of incentive pay. The Hermes Investment Office performs independent risk management.


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