DSC Meridian Capital LP is an opportunistic, event-driven credit investment firm founded by Sheru Chowdhry, the former Head of Credit Research & Co-Portfolio Manager of the Paulson Credit Fund (2004-2017). The firm seeks to generate absolute returns through the credit cycle. DSC Meridian seeks to prioritize principal protection, liquidity and shorting at the top of the credit cycle, while shifting portfolio focus to capital appreciation and equity-like upside at the bottom of the cycle. DSC Meridian invests both long and short, across small, mid, and large-sized capital structures, and across the full spectrum of credit opportunities from performing, stressed and distressed credit (bankruptcy reorganizations, litigations, liquidations) to post re-organization, event-driven equities and capital structure arbitrage. The firm integrates material ESG factors throughout the investment process and will often pursue an active corporate engagement strategy to help shape positive ESG-related outcomes.

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Crawl, Walk, Run:
Fit-For-Purpose Solutions to Address Climate Change

Executive Summary: The high yield universe has lagged the efforts of Fortune 500 companies to address sustainability issues material to their businesses. As a result, ESG risks and opportunities may be mispriced, and companies that do not disclose—and hence score poorly—may see adverse impacts on their cost of capital. For example, just looking at carbon disclosure within the MSCI USD High Yield Corporate Bond Index[1] reveals that:

- Only 15% of issuers report Scope 1 and 2 greenhouse gas emissions
- Even fewer have set targets to reach a below 2-degree warming scenario

Complicating the situation further is that high yield issuers typically lack the resources of their larger peers yet face similar and increasing pressure from stakeholders to address ESG risks and disclose. Our own research has found that on average high yield issuers have 0.5 full-time employees dedicated to ESG and sustainability[2]. We constantly hear our portfolio companies say: "We are inundated with bespoke data requests." "How should we focus?" "What can we do with our limited resources?" While it can be tempting to benchmark against the sustainability leaders, we recommend resource-constrained companies complete a materiality assessment, identify a handful of ESG issues that matter to their business, then craft a fit-for-purpose approach to ESG risk management and disclosure.

We offer the following framework when engaging with our portfolio companies:

CRAWL: *Commit to a materiality assessment*

WALK: *Willing to disclose*

RUN: *Ready to align*

CRAWL: Commit to a materiality assessment

The first step a company should take is to conduct a materiality assessment to understand which issues matter to the business and its stakeholders and how to prioritize them. Typically, a business will identify between five and ten issues to focus on, a manageable number even for a resource-constrained company to handle. An ESG materiality assessment requires the same process companies have created for other business functions: they should set targets, assign responsibility and accountability for execution, then measure progress over time.

Real Example: Materiality Assessment

Across our portfolio companies, two of the most consistent issues for management teams today are Covid-19 and climate change. While there is a vaccine for Covid-19, there is no panacea to abate rising global temperatures. Each company has to spend the time to authentically evaluate the long-term impacts of the physical and transition risk associated with climate change. From a manufacturing company with a physical plant on the Gulf Coast in the path of increasing hurricanes to a utility struggling with weaning itself from thermal coal, companies should take a close and personalized look at the ways climate change will affect them.

Moreover, companies need to scenario plan for the risks of carbon pricing. According to the IPCC, in order to limit temperature rise to 1.5 degrees Celsius this century, carbon prices would need to be at least \$135/MTCO2e in 2030, and \$245 in 2040. The World Bank estimates that almost half of emissions covered by an emission trading scheme today are priced at under \$10/MTCO2e. Today in Europe and California we are seeing upward pressure on prices as targets become more ambitious and regulatory requirements evolve.

WALK: Willing to disclose

When it comes to ESG issues, our view is that non-disclosure is not an option. Silence from a company adversely impacts their ESG ratings, which hurts their ability to attract new investors who factor ESG considerations into their investment process. Consistency of disclosure is key as well. For example, if a company identifies ESG risks in their 10-K, they need to demonstrate that they are managing those risks elsewhere—in the sustainability report, investor decks, etc.

When companies disclose, they frame and control the narrative. Companies must demonstrate that they have identified the risks, they are managing them, and they are communicating this effectively to investors and other stakeholders.

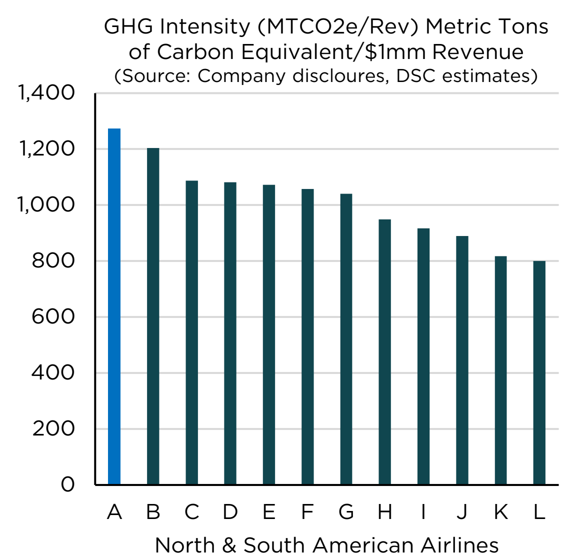
The companies in our portfolio are often overwhelmed by the veritable alphabet soup of disclosure frameworks—CDP, GRI, SASB, and TCFD to name a few. We advise them to first identify the most important ESG issues to their business and pick a framework that works best for them. For example, the CDP may be labor-intensive but we have had companies report that it serves as an excellent management tool for them. Others lean toward SASB and TCFD over GRI because the number of topics and indicators is more manageable and better meets the needs of their stakeholders.

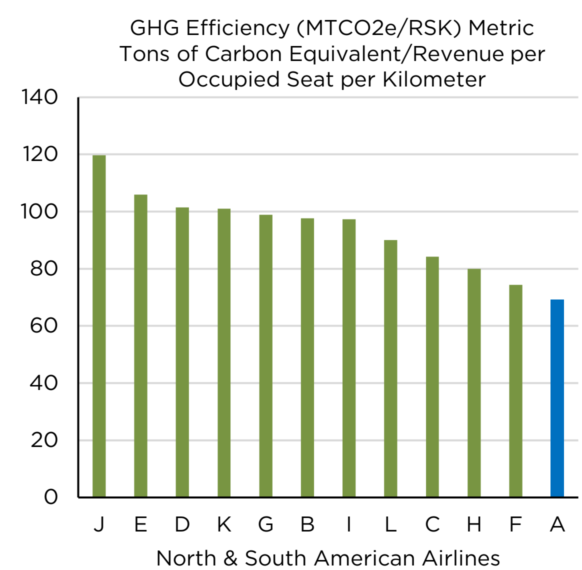
Disclosure should flow from a company's materiality assessment and serve a dual purpose: providing information to stakeholders and functioning as a management tool for the company. Disclosure should be complete, transparent, and balanced. Data is a first step, but context is key: companies must describe the journey so people understand the challenges they face, the complexity of the issues, and a clear sense of how the company is acting on the data.

Choosing the right denominators for the data also shapes the company's ESG story. Carbon intensity—metric tons of CO2 equivalent divided by million dollars of revenue—is the standard calculus across industries, but for airlines it obscures the true picture. Using revenue as a scaling factor is skewed by differences in currencies and pricing structures. Instead, using load factor as a denominator illustrates the carbon footprint per passenger revenue per mile travelled, which we believe more accurately captures "carbon efficiency" across the industry.

For example, the graph below measures carbon intensity of 12 airlines operating in North and South America. Airline A scores as the most carbon intensive business per $1mm of revenue. However, when you measure the same carbon emissions but change the denominator to "passenger revenue per unit of distance," airline A actually screens as the "most carbon efficient" of the 12 airlines.

There is no safe harbor in a sustainability report; disclosure can still make some CFOs and general counsels uneasy. But obscuring data about sensitive issues like carbon emissions, human rights or labor rights will, in our view, only backfire by weakening the disclosure's quality. For example, apparel companies disclose a number of supply chain sustainability metrics such as safe working conditions. If a company posts its supplier code of conduct on its website, but does not report on supplier compliance and corrective actions, it is impossible to assess performance and whether the company operationalizes the words in the policy. As investors, we advise companies to focus on crafting a disclosure that is balanced, transparent, and weaves together the story in a way that is compelling and communicates the information clearly.





Another consideration is the rapidly evolving regulatory environment around sustainability disclosure. The EU Commission's Directive on Corporate Sustainability Reporting requires public companies with more than 500 employees to disclose their sustainability performance. The Directive is slated to expand to private companies. The EU Sustainable Finance Action Plan is meant to reorient capital flows to sustainable investment. Key to the Plan is the EU Taxonomy which is a tool for both companies and investors and creates a common language for ESG and sustainability.

In the U.S. the Federal Reserve, the Department of Treasury, SEC, and the CFTC are all focusing on ESG and climate risk. Most notably the SEC has been engaging with issuers on disclosure quality and recently published a request for public comment regarding a regulatory approach to ensure consistent, reliable and comparable data on ESG and climate issues. We believe new rulemaking requiring increased disclosure is coming soon.

RUN: Ready to align

A company is ready to align when they have made an organizational commitment to net zero and are ready and willing to make operational and strategic changes, like divesting low value, high carbon businesses and using the proceeds to delever or invest in cleaner technologies, and dedicating additional CapEx to further "green" operations.

A first step may be simpler than most companies think even if they are too resource constrained to draft a dedicated sustainability report. We recommend companies start with a slide in the investor deck articulating the ESG issues identified as important to the business and how they are managed and measured. This slide may be an ESG fact sheet or simply an honest statement that the company aspires to net zero and is in the process of forming a plan for how to get there. The right fit-for-purpose solution will flow from the work done in learning to crawl, then walk.

The idea of setting net zero emission targets by 2050 may seem straightforward, but we often find there are serious impediments to achieving that goal. Obstacles include: choosing a "base-line" year to begin measuring annual reduction targets, finding the will to get buy-in and integrate climate change into enterprise risk, strategy and operations, agreeing to additional CapEx required to invest in new technologies, divesting from carbon intensive/low value businesses, etc.

Emissions reduction targets should be reasonable and laddered over a 3-, 5- and 10-year time frame. Best practices include not only linking executive compensation to these objectives, but also aligning incentives at the next layer below the C-suite and throughout the culture of the organization.

The truth is that all companies face ESG factors out of their control. For example, airlines could become much more carbon efficient if they could fly more direct routes. However, they are often limited by governmental regulations involving safety or congestion concerns. In addition, companies are not guaranteed to own and control innovation; that generally comes from the industry working together. But companies should focus on and demonstrate to their stakeholders how to become as efficient as possible with their existing resources.

CASE STUDY: INDUSTRIALS COMPANY B

One company we think has done this well is an industrials company we will call Company B. The business designs, manufactures, and markets high-technology components and systems for equipment producers in the worldwide aerospace, defense, land vehicle, and power and energy markets.

Background

During a diligence call, our analyst mentioned DSC Meridian's ESG focus to the company. We were intrigued when the company asked to meet with us to talk about their ESG strategy. Our own research indicated the company demonstrated real positive ESG momentum. The company's recent annual report details progress on emissions reduction (and improvements in safety performance) and lays out their new science-based target to limit the company's contribution to global temperature rise to 1.5 degrees. The ESG data providers, however, showed a drastically different picture depicting the company was not on a glide path to Paris alignment.

When we spoke, it turned out that Company B's journey is a classic Crawl, Walk, Run story of a hidden ESG leader well on the road to Paris alignment.

What We Learned

A substantive conversation with the head of IR and the Chief Sustainability Officer (CSO) revealed that Company B's ESG governance is quite robust. The CSO joined about five years ago and reports directly to the CEO. The entire Board is engaged in ESG oversight. The organizational structure and Board involvement indicates the company considers ESG to be central to its strategy and risk management, not just its reputation.

Company B has focused on improving performance on two issues that it believes are highly material to its business: workforce health and safety and carbon footprint. In 2015, the company set its first five-year targets and by the end of the performance period, they had reduced their GHG emissions intensity by 33% and their Lost Time Injury Rate by 69%. The company has been reporting on emissions to CDP since 2010 and has earned a score of A- for the past two years. The company has also committed to improving diversity at the management, Board, and staff levels. Company B focused on a handful of ESG issues that matter to the business, set meaningful targets, and executed them as part of operations. This represents measurable, positive ESG momentum.

Company B embarked on its next five-year plan and last June set science-based targets to align its carbon footprint with the Paris Agreement. Not only have they committed to net zero emissions by 2050, but they have also set aggressive reduction targets consistent with limiting warming to 1.5 degrees Celsius. Moreover, they have had the target independently verified by the Science Based Targets Initiative. While they focused on emissions under their direct control (Scope 1 and 2), they are in the process of addressing value chain emissions (Scope 3). As a first step, they are engaging with their suppliers and asking them to set science-based targets of their own. By engaging with its suppliers, Company B creates a multiplier effect, pushing more and more companies on their own path to Crawl, Walk, Run.

CONCLUSION

Above all, ESG should be treated like any other business function and managed as such. Operational excellence, resiliency, and strategy is the goal for engaging in this ESG conversation. Done well, the Crawl, Walk, Run process should set realistic but challenging targets that strike the right balance between aspiration and achievability. Every few years, or when a major change (like an acquisition or divestment) occurs, companies will need to revisit what is currently material to their business and how that flows into setting targets and appropriate disclosures.

LEARN MORE

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[1] Source: DSC Meridian estimates as of 2/28/21, MSCI USD HY Index, ISS. Scope 1 and Scope 2 emissions are defined by the Greenhouse Gas Protocol (www.ghgprotocol.org).

[2] Source: DSC Meridian estimate based of total engagements YTD 2021.