



ROYAL LONDON ASSET MANAGEMENT

Sterling Credit ESG Analysis

Quarterly Report
31 December 2023



ESG Analysis – Q4 2023 overview

Introduction

Evaluation of ESG risks and targeted engagement with debt issuers is a critical element of any effective credit process. RLAM's credit research approach has always focused on the sustainability of issuers' balance sheets and cash flows, requiring a broad-based understanding of credit risk, whatever the source. Our experienced credit and ESG specialists and an integrated investment process enhance our ability to identify, mitigate and price risk, ensuring RLAM's clients benefit from the established cornerstones of our differentiated credit proposition.

Aggregated Micro Power Infrastructure 2 plc

During the quarter, we arranged a site visit to see the assets of Aggregated Micro Power Infrastructure 2 plc (AMP) which we have helped fund since 2016. AMP owns and operates biomass plants that generate heat for industrial operations by burning wood chips.

We were particularly keen to gain a further understanding of AMP's operations given increasing contention around the sustainability credentials of biomass. For wood-burning biomass to be considered truly sustainable, the wood needs to be sourced from forests that are actively managed to maintain their productivity. This ensures that the forest continues to absorb CO₂ as trees are cut down, offsetting the emissions released when the wood is burned.

As part of the trip, we visited a biomass plant on the island of Islay. The plant generates heat for a whisky distillery, which is the first on the island to have transitioned away from oil fuelled boilers – saving 1.3m litres of oil per year as a result. The site consists of a 5.5 MW biomass boiler that is fuelled by the burning of wood chip and draff, a by-product of the whisky distillation process. AMP have stressed the importance of sourcing biomass from forests that are actively managed, so that the expected environmental benefits can be achieved; we are encouraged that while the wood chip is currently derived from scrap wood logs that are sourced from the mainland, the logs will soon be sourced directly from the island, and specifically from a forest nearby the distillery that was planted in the 1980s. Using local wood will result in cost savings but will also avoid the emissions associated with the transport of the logs to the island.

We found the visit highly informative on the nuanced credentials of biomass, with this particular plant showing that sustainably sourced biomass can serve as a viable alternative to decarbonise industrial operations with high energy needs. Our broader concerns are also mitigated by the sustainability criteria applicable to biomass in the UK, with strict requirements having to be met to access Government schemes such as the Renewable Heat Incentive.

The meeting with AMP also allowed us to discuss the company's gas power-peaking business. This consists of gas-powered plants across the UK that generate electricity when renewable power is low and results in AMP being a significant source of our portfolios' financed emissions. It is important for us to understand the drivers of the emissions we are financing, and the company was keen to demonstrate that the strong negative correlation of its plants with wind power production means that they are able to operate efficiently to meet energy demand at times when renewable power is lacking. While we believe the high emission intensity is mitigated by the 'renewable-enabling' role played by these plants, the questions around the viability of natural gas in the context of the net zero transition mean that we'll continue to scrutinise the longer-term outlook for this business.

RAC Bond Co plc

In October, the UK's second largest roadside assistance provider, RAC, came to market with a new bond issue. This provided an opportunity for us to engage with the issuer and expand our understanding of their ESG performance.

Crucially, with RAC being privately owned there is a lack of third-party ESG data available, providing greater scope for us to add value to our lending decisions through a bespoke assessment. As part of this we can also ensure potential ESG risks are viewed through a creditor lens. For instance, through the application of our private company framework, we consider that RAC's governance arrangements largely mitigate risks arising from the ownership structure, as the board includes non-executive directors independent of the shareholders. Furthermore, our lending is on a covenanted and secured basis, providing enhanced creditor control, helping to dampen unforeseen risk, and limiting the ability for the interests of management, shareholders and bondholders to misalign.

From an environmental perspective, RAC arguably lags its closest competitor, the AA, with a less defined approach to climate transition. It is incumbent on us to encourage the company's willingness to transition but we do not foresee significant impediments to RAC's ability to



decarbonise. For instance, we do not expect the necessary future shift to an Electric Vehicle (EV) fleet to require capital expenditures significantly ahead of its current budgeted investment plans. Although there is currently a constraint regarding the availability of suitable vehicles, as this is addressed there should be a relatively clear pathway for the company to address its material scope 1 emissions.

More widely, as a very large UK employer with a highly unionised workforce, we were keen to focus on potential risks within RAC's labour relations, which appear adequately managed with an improving employee engagement score and strong retention among roadside patrol employees. In addition, the company's focus on becoming increasingly digitised led us to seek more information on cybersecurity, as another key risk for the business. RAC noted that it has established a four-year cyber strategy, along with having an ISO 27001 certification and undertaking audits on its systems.

Our overall evaluation of RAC, with an effective encapsulation of ESG risks, helps us to take a more informed view on the sustainability of the issuer's balance sheet. Clear mitigants for the identified risks increases our conviction that currently strong cash flow margins are underpinned, supporting the value of the assets securing our lending.

APA Group Limited

APA Group, the Australian gas pipeline company, issued a new euro-denominated hybrid bond during the quarter. We have been a long-term investor in the issuer's senior bonds and, as a large contributor to our financed emissions, we were keen to take the opportunity to meet with management to review the updated transition credentials of the business.

As a central player in the country's natural gas industry, APA would appear to face asset stranding risks due to the clear conflict between gas and net zero. There are, however, two important considerations that need to be made for APA's role in the transition:

(i) the Australian economy continues to be heavily dependent on coal, which accounted for almost half of electricity generation in 2022 (compared to 19% for gas). Replacing coal with less carbon-intensive energy sources is therefore a key priority if Australia is to tackle its carbon footprint in the short and medium term. It follows that natural gas can provide immediate emission reduction benefits and demand for this fuel is therefore likely to continue to grow as it has done in the past 15 years, in which the electricity generated from gas grew 2.5% per year (compared to a 2.3% decrease for coal). Gas also acts as a reliable energy source that can efficiently meet demand as renewable power is further scaled up. For these reasons, we are more sympathetic to APA's view that it is a critical enabler of Australia's carbon reduction and is well-placed to meet the country's growing demand for gas.

(ii) unlike gas infrastructure companies in the UK, APA is not subject to a regulatory framework that constrains its ability to diversify its business model. As a result, APA can more proactively position itself as a transition enabler – as demonstrated by the recent acquisition of power assets from Alinta Energy. The assets acquired include renewables and electricity transmission assets located in Pilbara, a region in north-west Australia with a large presence of mining companies. The acquisition also comes with a significant investment pipeline – including 1 GW of renewables capacity as well as 600km of new electricity transmission lines – showing APA's commitment to strengthen its position as a provider of off-grid energy solutions for industrial customers operating in remote locations. To help customers decarbonise and move away from diesel-powered generation on their sites, APA can offer solar power generation, battery storage, and electricity transmission to efficiently meet customers' energy needs. We see this line of business as a positive development in APA's strategy.

As we have discussed in detail previously, following a widespread engagement project in 2019 we reduced funds' exposure to UK gas networks, reflecting a lack of cohesive, long-term transition planning in the sector and no apparent excess spread compensation for bond investors despite apparent asset stranding risk. However, it is important that our ESG-led decisions are situational and reflect the specific characteristics and relativities of our issuers. Despite our wider reservations about gas-related businesses, we have continued to lend to APA.

Stark Financing 2023-1 DAC

Stark Financing is a commercial mortgage-backed security (CMBS) transaction that came to market in October 2023. Sponsored by Blackstone, bonds are ultimately secured on a pool of 103 industrial and logistics properties located mostly in the north of England and the Midlands.

When evaluating CMBS opportunities, we need to formulate a view on the environmental credentials of the underlying properties, which can have a fundamental impact on the cash generation and ultimate realisability of properties, especially in the context of Minimum Energy Efficiency Standards regulation for commercial property.



For this pool of properties, we obtained information on EPC ratings and whilst only around 50% of the portfolio (as measured by floor area) is rated EPC C or above, we interrogated the planned capital expenditures by the sponsor, which is looking to bring all units to EPC C by 2027 and EPC B by 2030. The energy efficiency measures being targeted include: installation of LED lighting, air source heat pumps in office spaces and additional roof insulation, and the removal of inefficient heating equipment. Upon further engagement we were also able to obtain details on the physical climate risks faced by the assets, with the sponsor having carried out flood risk assessments for each property and having identified only a small number at medium/high risk.

A key aspect of our evaluation of CMBS is the collaboration with our property team. Through their direct exposures to various segments of the real estate market, including logistics assets, these interactions provide us with insights on valuations, asset quality and environmental performance that usefully enhance our lending decisions.

Social Housing

We manage our exposures to housing associations actively, recognising increasing idiosyncratic risk in the sector due to diverging balance sheet capacity to meet necessary environmental and asset condition improvements. Over the quarter, as well as meeting the regulator, we held conversations with associations covering a full spectrum of sector diversity. This included Hastoe, a small provider of social housing in rural parts of England, through to Places for People, which manages over 200,000 properties across the UK, including housing for the elderly, market rent and even leisure centres, in addition to its general needs social housing. We also sent a further letter to certain of our borrowers seeking additional information around their approach to 'damp & mould' monitoring and management.

Whilst our long-term experience of lending to the sector forms the foundation for our decision-making, it is critical to our approach that we maintain ongoing dialogues with issuers as they manage the often-competing claims on their limited capital.



IMPORTANT INFORMATION

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