Royal London Asset Management Sterling Credit ESG Analysis

Quarterly Overview

31 March 2025

ROYAL LONDON
ASSET MANAGEMENT

Overview

Introduction

Evaluation of environmental, social and governance (ESG) risks and targeted engagement with debt issuers is a critical element of any effective credit process. Our credit research approach has always focused on the stability 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 our clients benefit from the established cornerstones of our differentiated credit proposition.

Gas & Climate

We have long argued that effective integration of ESG analysis into our credit research helps to enhance our lending decisions. Practically, this helps inform the levels of compensation and mitigation we require from our issuers. Perhaps not surprisingly given the multitude of factors that drive investment, more isolated impacts on portfolios from specific ESG insights are rarer. However, in 2019, following extensive research into the UK gas sector and the impact of net zero, we concluded that an existential threat to the sector from the transition to electric heating for households was not priced into credit markets. Consequently, we substantially exited our positions, switching from gas to electricity bonds with no loss of credit spread.

Crucially, as the world evolves so must our ESG insights, and our latest gas sector review, built around ongoing engagement with issuers and stakeholders, has identified that the regulator is now acknowledging this stranded asset risk and is looking to implement an accelerated depreciation model for determining regulated returns. This approach will also help enable a just transition; reducing the risk that the fixed cost of maintaining the gas network is a burden on a smaller number of customers – including those who are forced to remain users of gas due to financial constraints – and will instead be shared across the wider base of existing customers now.

The UK is heavily reliant on gas for heating, and domestic usage must, and will, reduce, especially if the government introduces incentives and attractive subsidies to facilitate the move to electrification. So, whilst it may not be possible to avoid significant shrinkage, the regulator is at least now looking to provide a sensible safety net for investors. Despite this significant regulatory shift, gas bond spreads remain elevated against equivalent electricity bonds. In much the same way as we exited the gas sector when the risks were not adequately reflected, we have now selectively increased our exposure.

This selectivity, built off enhanced insights, was demonstrated when National Gas Transmission issued a 10-year bond at the beginning of the year. National Gas, formerly part of National Grid, operates in gas transmission, which is significantly different from gas distribution under the updated regulations. Gas distribution is expected to undergo some form of accelerated depreciation mentioned above, whereas gas transmission is not, due to the regulator viewing gas as having ongoing importance in industrial applications. Consequently, we felt that the bonds were priced too tightly and did not adequately compensate for the unaddressed stranded asset risk the company still faces.

As one of our earliest ESG credit projects, it was important that we revisited our gas network analysis and engagement to ensure our understanding of sector risks remains current. Usefully, the combination of ESG and credit analysis allowed us to assess and mitigate the asset stranding risks effectively. The fact that the same approach is now helping us to identify credit opportunities is even more encouraging.

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Banks & Just Transition

As part of the ongoing interaction with our Responsible Investment (RI) team, during the quarter we benefited from their engagement project on just transition practices and disclosures in the UK banking sector, which is a pivotal area for credit investment. The project has been focusing on engagement with a few large UK banks – Barclays, HSBC, Lloyds, and NatWest – to understand how the sector is integrating just transition considerations within their climate transition plans.

Discussions with the banks have been centred around three specific areas: first, products – ensuring inclusion/accessibility in new products that facilitate the transition; second, sectors – facilitating investment and supporting corporate/SME clients in high-emitting sectors to access capital; and third, place – leveraging regional presence to mitigate place-based risks and identify place-based opportunities.

The engagements and additional research conducted by our Responsible Investment team have furthered our understanding of borrowers' progress on these issues. Usefully, our research identified that each of the banks are demonstrating a foundation of just transition-related considerations, with Lloyds and Barclays standing out as providing additional evidence on their practical implementation in their activities/operations. For instance, Lloyds has carried out work alongside the British Chambers of Commerce to understand the challenges faced by SMEs across the UK in the journey to net zero, while Barclays discloses that just transition is one of the areas of review in their assessment of corporate clients' transition plans.

More information on this project is available at this link.

Mobility Operations

Motability Operations Group (MOTOPG) came to market during the quarter, issuing a 20-year bond. MOTOPG is the organisation in charge of delivering the Motability Scheme, enabling disabled people who receive a qualifying mobility allowance to lease a vehicle at favourable terms. Its service provides considerable value to people with a qualifying disability or illness, improving mobility for over 800,000 people at a cost that is reported to be 45% lower compared to alternatives.

The company has been in the spotlight lately, with recent growth of the Motability Scheme seen as representative of a welfare system needing reform to curtail costs. The new issue was therefore an opportunity for us to meet management and discuss the significant growth achieved in 2024, deemed by the company to be the result of the increased number of assessments carried out by the Department for Work and Pensions to address a backlog of cases, as well as the greater vehicle availability after a period of constrained new vehicle supply following the pandemic. As the impact of both factors eases, growth is expected to be slower going forward. In our view, it remains important to recognise that MOTOPG's customer base comprises individuals with serious mobility constraints who qualify for the government's higher rate mobility allowance, implying that absent any radical measures, the impact of welfare reform on the business is likely to be marginal.

We also discussed with management the programmes put in place to increase the affordability of the offering for customers. As a result of the limited new vehicle supply of the last few years, MOTOPG benefitted from higher-than-normal resale values for used cars, generating excess capital that was redeployed in the form of a £265m investment to support the transition to electric vehicles and £674m to reduce the advance payment made by customers on new vehicles. The scale of these investments resulted in a weaker balance sheet and lower future profitability than would otherwise have been the case. However, enhancing affordability for customers, in an environment of heightened scrutiny, is a good example of the need for the company to attain the correct balance between financial performance and discharging its charitable responsibilities.

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Despite some targeted criticism of the scheme, our opinion is that providing debt funding to MOTOPG delivers a critical social function, but it remains vital that we lend with the right degree of protection and mitigation for our clients. Our engagement with management and analysis of the credit, including structural protections, means that we are comfortable continuing to support the company as long-term lenders. We added to our exposures through the new issue at a spread that felt elevated due to an abundance of headlines rather than a material deterioration in either credit quality or social efficacy.

ESG & ABS Analysis Together

During the quarter, Together, a privately owned specialist mortgage lender, announced a new RMBS issue: TOGET 2025-2ND1. The secured portfolio consists of second charge mortgages, with many borrowers having challenged credit histories. We are familiar with Together, a regular specialist issuer, but given the 'riskier' nature of these loans, we wanted to understand further the capabilities of the mortgage servicer and ensure the lender would manage interactions with struggling borrowers appropriately.

In discussions with Together, the company explained that arrears typically result from significant life events. According to their forbearance policies, Together offers several options to assist customers, including payment holidays, temporarily lowering payments, adjusting or freezing interest rates, and changing products. For long-term situations, they can offer an assisted sale of the property, involving ongoing communication with customers and their estate agents. Importantly, the company clarified that arrears management staff are remunerated based on the quality of their calls and adherence to guidance, not the amount collected.

Ultimately, we concluded that Together employs appropriate arrears management practices, underpinning our view of the relative attractions of the pool, including a low LTV compared to other second lien RMBS deals, and the appropriateness of the new issue spread.

Aggregate Micro Power

Aggregated Micro Power is a company we have highlighted in previous reports due its material contribution to portfolio emissions, which are primarily due to its gas peaking business and biomass boilers. However, the gas peaking business is essential to support the deployment of renewable power generation, compensating for energy shortfalls when wind or solar power is insufficient, assisting the energy transition. In addition, AMP has been advancing the use of boilers that use a blend of biomass and electricity. For instance, their largest project involves the use of a 12MW electric boiler located on the border of Scotland that is able to adapt its energy use when wind farms face bottleneck issues.

This quarter, we extended our discussion with the company to focus more on its sustainable sourcing practices. In particular, we learnt that the biomass boilers in the entity we lend to, use wood pellets and chips that are sustainably sourced and comply with Ofgem's strict sustainability criteria. These pellets are primarily made from offcuts and sawdust from companies such as IKEA, which only use the central part of the tree. The less valuable bark and outer parts are typically used for Combined Heat and Power (CHP) or chipboard. Other parts of the tree, such as thinner branches, are usually left to decompose on the ground, releasing methane. Using these pellets also have lower moisture levels, making transportation from Europe more efficient by decreasing the weight of the water being transported. The company views sustainable forests as crucial, providing income for owners and encouraging continuous tree planting rather than clearing land for crops.

AMP continues to represent a useful example of why effective ESG analysis, and particularly an assessment of portfolio emissions, needs to go beyond the headlines, as insights can become blurred when we rely on blunt and historic data points in isolation.

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