FEATURE: Chenavari introduces ESG criteria in Toro CLOs; industry scoring scale in the works to ease investment process.

CapitalStructure

Chenavari Investment Managers has incorporated environmental, social and governance (ESG) criteria into its latest **Toro European CLO 6** transaction and is now hoping the industry will soon come up with a scoring system to help fine-tune the selection process.

In Toro European CLO 6, which priced in July, Chenavari introduced more explicit ESG language and more detailed criteria than for **Toro European CLO 5**, which priced in February 2018, but without using the ESG term as such. For instance, investments are not permitted if a company's principal business is to produce or trade in "controversial weapons (including antipersonnel landmines, cluster weapons, nuclear weapons and chemical and biological weapons) or the production of or trade in components or services that have been specifically designed or designated for military purposes for the functioning of such weapons".

ESG criteria prompted the firm's leveraged loan and CLO team recently to turn down two credits: Israeli software company NSO and Spain's Parques Reunidos. In the first case, this was mostly due to the risks relating to the future use of the technology developed by the company; in the second case, concerns centred around animal welfare (dolphins and orcas).

Responsible investing and ESG criteria are still a work in progress at a firm-wide level, without being a novelty, said Mick Vasilache, a partner and senior portfolio manager at Chenavari.

The ESG trend now seems irreversible in Europe and an increasing number of managers, such as Chenavari, are including specific provisions in their deals' prospectuses. But this is not an easy path and many CLO professionals remain sceptical.

ESG criteria are often seen as problematic for CLO managers because they reduce further the universe of investible credits – in a market where the supply of leveraged loans is generally viewed as insufficient. And when the arbitrage is tight, restrictions on the CLO manager's ability to select assets are unwelcome for CLO investors (especially equity investors) as this can adversely impact cash flows, or at least make cash flow generation less than optimal.

But Mr. Vasilache points out that incorporating ESG criteria into investment practice creates a difficulty of a different order: the selection process can be too crude and can exclude companies that only partly fall foul of ESG criteria. This is a problem that several CLO managers are trying to overcome.

"Choosing a credit is binary: it either fits or it doesn't. The market is now trying to avoid this and find a more refined way of selecting credits, through a scoring system," he said. Several CLO managers are discussing the possibility of creating a scale that could go from one to 10, with the top mark for credits meeting the tightest criteria.

"We are part of a consultation that is taking place: if this grading system is accepted by everyone, this would be helpful, but we are not there yet," he added.

There is no timeframe yet, but no agreement on a scoring system is expected until next year.

One of the ideas floated by CLO managers is that a third party could compile the answers from a corporate (a debt issuer) to a questionnaire, which would form the basis of an ESG rating. This may still be a long way off, but there are some encouraging precedents. Covenant scoring systems are becoming more established, while the securitisation market has been able to adapt in only a few months to the verification process required by the “Simple, Transparent, and Standardised” (STS) rules.