

# Invesco ESG Loan Investment Process Overview

October 2022

This document is intended only for Qualified Clients/Sophisticated Investors (as defined in the Important information at the end); in Hong Kong for Professional Investors; in Taiwan for Qualified Institutional Investors only; in Singapore for Institutional Investors, in New Zealand for wholesale investors (as defined in the Financial Markets Conduct Act), in Australia for Sophisticated or Professional Investors; in the USA for Institutional Investors. In Canada, the document is intended only for accredited investors as defined under National Instrument 45-106. In Chile, Panama and Peru, the document is for one-to-one institutional investors only. It is not intended for and should not be distributed to, or relied upon, by the public.



Invesco developed a proprietary framework for rating private companies and issuers for ESG risk.

## Invesco's ESG approach to senior loans

At Invesco, we manage roughly USD 38.6 bn<sup>1</sup> in senior secured bank loans for institutional, retail, and high net worth clients globally. Senior loans are an alternative asset class – they are privately arranged debt instruments (usually below investment grade). Investors look to add bank loans to their asset allocation strategies because they provide appealing returns through various economic cycles – they are senior in the capital structure, secured by all assets of the company, and they provide stable current income floating with prevailing interest rates. However, loans are not a security. Each loan has unique characteristics tailored to the underlying corporate issuer. Often senior secured loan issuers are private companies or may be sponsored by a private equity firm with no publicly available information.

In 2015, Invesco Senior Secured Management, Inc. (ISSM) began to formally incorporate ESG considerations into its investment process as part of its consideration of credit risks for each issuer. However, investors began seeking more quantifiable approaches to better understand Invesco's ESG considerations. Even more importantly, investors are expecting their bank loan managers to actively engage with management with respect to their ESG journey. ISSM's proprietary ESG process provides investors with a rigorous multi-pronged approach to ESG.

Because senior loans are private instruments, there is only a small pool of the investable universe that are rated by outside ESG

rating providers. For Invesco to offer an ESG product that would work with clients' needs, during 2018-2019 Invesco developed a proprietary framework for rating each issuer from an ESG perspective. During 2022, ISSM additionally enhanced its proprietary ESG rating framework to capture new metrics that enhance regulatory guidelines put into effect in the European Union in 2023 per the Sustainable Finance Disclosures Regulation committee (SFDR).

What results is that each credit analyst at ISSM is responsible for independently rating every issuer they follow from an ESG perspective. They conduct diligence reviews with issuers' management teams to inform a rigorous, multifaceted screening process in which each loan is measured on a scale of 1 to 5 (with 1 indicating "no risk" and 5 indicating "high risk") on numerous ESG factors, as listed in figure 1.

To derive an issuer-level ESG rating, ISSM uses a weighting schematic for the issuer's broad industry category. These ratings are averaged into an overall ESG score that is approved by ISSM's Investment Committee, subject to updates and reviews on at least an annual basis.

While management teams have generally been very receptive to ISSM's approach, facilitating active engagement with an issuer can sometimes present a challenge. ISSM excludes from its ESG portfolios any issuer whose management refuses to engage and/or for which appropriate ESG scores cannot be determined.

Figure 1

**Factors that are incorporated into our ESG rating include, but are not limited to:**

Environmental Pillar	Social Pillar	Governance Pillar
<ul style="list-style-type: none"> <li>Natural resources</li> <li>Pollution, waste &amp; carbon footprint</li> <li>Supply chain impact</li> <li>Environmental opportunities</li> </ul>	<ul style="list-style-type: none"> <li>Workforce</li> <li>Community</li> <li>Product responsibility</li> <li>Human rights</li> </ul>	<ul style="list-style-type: none"> <li>Management</li> <li>Shareholders</li> <li>Board of Directors</li> <li>Auditor</li> <li>Regulatory issues</li> <li>Corporate social responsibility Strategy</li> <li>Anti-corruption</li> <li>Business ethics</li> </ul>

Source: Invesco. For illustrative purposes only.

<sup>1</sup> Invesco Senior Secured Management, Inc. AuM as of 30 September 2022.



ISSM’s credit analysts are now leaders in understanding the implications of ESG issues across the investable universe – and, as such, they are able to make more impactful investment decision.

Applying the firm’s own proprietary ESG approach to senior loans has led to many positive outcomes, the most significant has been ISSM’s ability to provide an investment solution that meets its clients’ ESG objectives. ISSM has received considerable interest in its approach from existing and prospective clients alike, and the firm is always looking to broaden this capability.

Another major result is that ISSM has substantively enhanced its analytical skills with regard to ESG risks. Although the process of rating each issuer has been time-consuming and complex, ISSM’s credit analysts are now leaders in understanding the implications of ESG issues across the investable universe – and, as such, they are able to make more impactful investment decisions.

Engaging management teams on the importance of ESG from an investor perspective has been another benefit of ISSM’s approach. While the firm does not have voting rights or control over issuers’ ESG activities or conduct, ISSM’s position as one of the largest managers of multi-credit strategies enables us to emphasize to management teams the importance of ESG issues in relation to their ability to raise capital in this market.

**Initial credit screening for ESG portfolios**

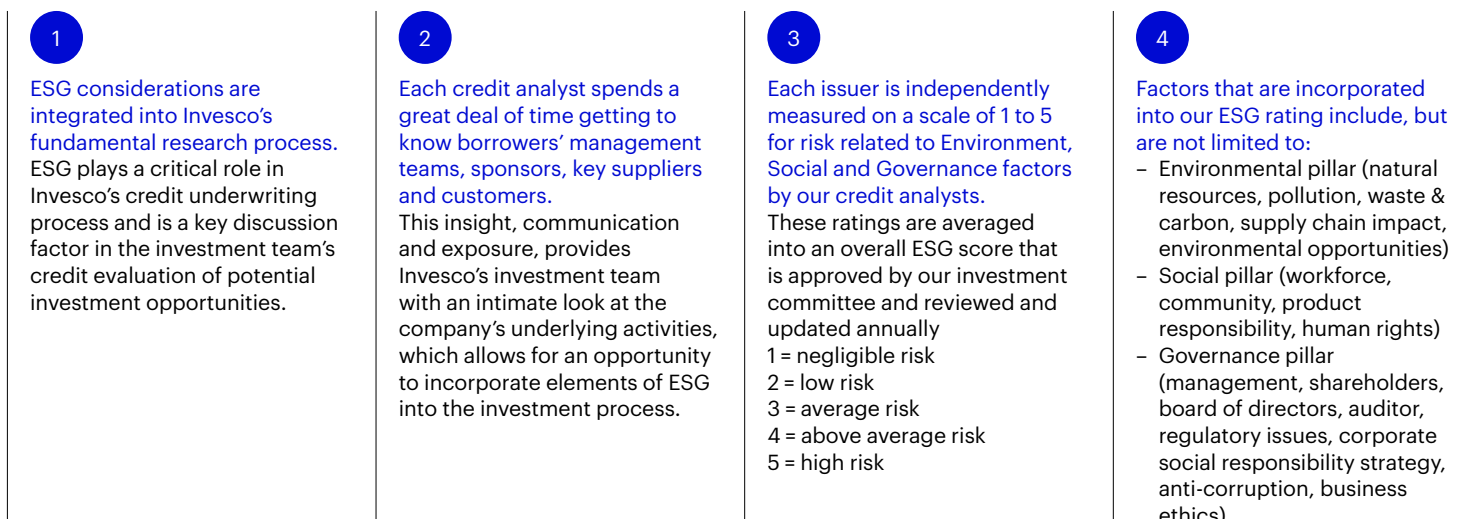
Screening is employed to exclude companies and/or issuers from the investment universe that do not meet the Invesco ESG Senior Loan Strategy’s (the “Strategy”) ESG criteria (including but not limited to: level of involvement in the production of tobacco and tobacco products, gambling, controversial weapons (including nuclear weapons), whole or partial engagement in the cultivation, production or distribution of cannabis or cannabis derived products for the purposes of recreational use (including any company that derives a part of its revenue from recreational cannabis), extraction of thermal coal, extraction of fossil fuels from

unconventional sources (including Arctic drilling, tar sands, shale oil and gas, or other fracking activities and/or mining of oil shale), generation of electricity above a defined percentage from coal-fired power plants, as well as status in terms of respecting the UN global compact principles). In addition, the Strategy may not invest in loans from companies that have an aggregated ESG rating or single category E, S, or G ratings above levels set within the internal ESG rating methodology.

The investment screening process begins with the analyst. ISSM maintains an experienced analyst team aligned by industry, with a dedication to being experts in each industry covered. The credit analysts are responsible for surveillance and analysis of issuers in their sectors. Invesco’s bank loan credit analysts conduct diligence reviews with issuers’ management teams to inform a rigorous, multifaceted screening process. Each loan is measured by our analysts on a scale of 1-5 for risks related to 16 ESG factors under separate pillars for E/S/G.

The fundamental bottom-up credit analysis conducted by the analyst determines the initial eligibility of an asset for inclusion in any portfolio. The analysts research all primary and secondary investment opportunities in terms of both appropriateness of credit quality and risk/return profile. The screening process includes a complete review of the issuer’s financial performance, discussions with the arranger’s banking team, and often times a discussion with the issuer’s management team. All primary investment opportunities undergo a formal review process, ending in either the preparation of a credit analysis memorandum and Investment Committee discussion for transactions that are recommended for approval or a decline memorandum circulated to the entire team.

Figure 2  
Invesco Bank Loan Platform: Responsible investing methodology



Source: Invesco. For illustrative purposes only.

For transactions that are declined, the analysts discuss their rationale with their team leader and often times with the co-heads of credit to ensure that each transaction receives due consideration.

#### ESG ratings process

As noted earlier, ISSM's credit analysts are responsible for independently rating each loan they cover from an ESG perspective. They conduct diligence reviews with issuers' management teams to inform a rigorous, multifaceted screening process in which each loan is measured on a scale of 1 to 5. 1 = negligible risk; 2 = low risk; 3 = average risk; 4 = above average risk; and 5 = high risk.

To date, Invesco's bank loan analysts have conducted ESG specific diligence reviews with issuer's management teams – often being cited as the first or the most progressive bank loan analysts from an ESG perspective. In doing so, we have independently rated over 800 issuers from an ESG perspective.

As mentioned above, each loan is measured by our analysts on a scale of 1-5 for risks related to multiple ESG factors under separate pillars for E/S/G. There are 16 factors within the E/S/G pillars that our credit analysts' rating contemplates (noted in figure 2 under #4).

As part of this process, ISSM will seek to engage with companies to ensure that they are minimizing and disclosing the risks and maximizing the opportunities presented by climate change by implementing a strong governance framework which clearly articulates their respective board's accountability and oversight of climate change risk and opportunities, taking action to reduce greenhouse gas emissions across their value chain and providing enhanced corporate disclosure on their carbon emissions.

Minimum ESG ratings criteria and certain sector exclusions are applied during portfolio construction. The Strategy's team employs screening to exclude companies and/or issuers from the investment universe that do not meet the portfolio's ESG criteria, including but not limited to:

- level of involvement in the production of tobacco and tobacco products,
- gambling,
- controversial weapons (including nuclear weapons),
- whole or partial engagement in the cultivation, production or distribution of cannabis or cannabis derived products for the purposes of recreational use (including any company that derives a part of its revenue from recreational cannabis),
- extraction of thermal coal,
- extraction of fossil fuels from unconventional sources (including Arctic drilling, tar sands, shale oil and gas, or other fracking activities and/or mining of oil shale),
- generation of electricity above a defined percentage from coal-fired power plants,
- status in terms of respecting the UN global compact principles), as well as based on the status of these companies and/or issuers in terms of respecting the UN global compact principles as assessed by third party providers for the global universe they cover, as updated from time to time.

In addition, the ESG strategy of ISSM may not invest in loans from companies that have an aggregated ESG rating or single category E, S, or G ratings above levels set within the internal ESG rating methodology, and will disinvest within 6 months from loans for which the aggregated ESG rating or single category E, S, or G ratings rise above these limits, as determined by the Investment Manager's internal rating methodology.

To derive an issuer level ESG rating:

1. ISSM averages the various factors under each E/S/G pillar to determine Pillar Ratings.
2. ISSM then weights each pillar by the average E/S/G pillar weights published by MSCI ESG Research by industry sector to come up with an ESG Composite Score. Those pillar weights as of 30 September 2022 are shown in table 1.
3. These ratings are averaged into an overall ESG score. Each overall ESG rating is reviewed with, and approved by, ISSM's Investment Committee (the same committee that approves all senior loans from a credit perspective).
4. Each ESG rating is included in any new deal underwriting and reviewed at least (minimum) annually. ESG criteria will be reviewed and applied on an ongoing basis by ISSM, integrated as part of the investment process for credit selection and portfolio construction.



We have independently rated over 800 issuers from an ESG perspective.

Table 1  
ESG pillar weighting by broad industry

To derive issuer level ESG ratings, we further weight E, S and G factors by broad industry pillars (in %) as follows:

GICS Sector	Environmental pillar	Social pillar	Governance pillar
Communication Services	5.0	50.1	44.9
Consumer Discretionary	17.8	44.1	38.1
Consumer Staples	29.4	35.6	35.0
Energy	41.9	24.3	33.9
Financials	9.2	51.5	39.1
Health Care	5.9	51.1	43.0
Industrials	20.8	34.6	44.1
Information Technology	14.7	44.5	40.8
Materials	45.2	21.7	33.1
Real Estate	28.5	29.2	42.1
Utilities	44.6	18.8	36.2

Source: MSCI ESG Research, average E/S/G pillar weights, as of 30 September 2022. For illustrative purposes only.

**Portfolio construction process**

The senior secured loan market is comprised of roughly 2,000 issuers globally. The team will maintain internal risk ratings on about half of these issuers at any given time. This pool of loans represents the eligible investment universe for portfolio construction. Portfolio managers have discretion to select from this pool within the predetermined limits established by the Investment Committee and group these investments in a manner consistent with the team's top-down view and portfolio-specific constraints (e.g., risk tolerance and investment guidelines). The portfolio managers work with the traders to source selected loans and execute trades at levels that seek to maximize return potential.

The rigorous application of the internal risk ratings is a central component of ISSM's portfolio management and construction process and is used to size position exposures and to help quantify

the impact that an individual credit decision will have on modelled portfolio returns.

**Portfolio construction and management decision making combines multiple disciplines**

Portfolio management and oversight is directed by the Chief Investment Officer and senior portfolio managers. The portfolio management process combines multiple core disciplines and is a collaborative approach among the Chief Investment Officer (CIO), the Investment Committee, the senior portfolio managers, the team leaders, and the credit analysts (figure 4).

Through this ongoing process portfolio managers are provided with inputs and tools necessary to dynamically manage portfolios within the objective, investment guidelines and risk appetite of each strategy's mandate, including minimum ESG criteria and certain sector exclusions (figure 5).

Figure 3  
**How does the ESG rating process work?**

**ESG research**

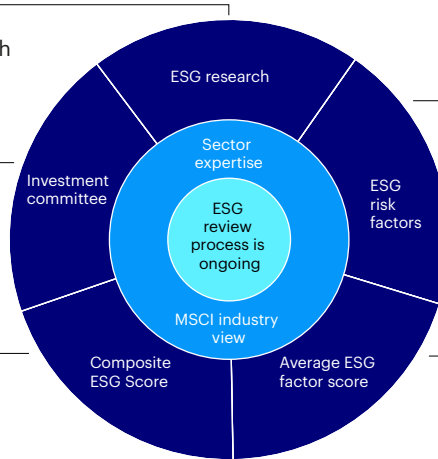
- Invesco analysts conduct proprietary research and interview management teams
- Due diligence

**Investment committee**

- Analyst presents key findings to senior Investment Committee
- Senior Investment Committee signs off on ESG rating

**Calculate composite ESG score**

- Weighted by industry
- Leverage MSCI E/S/G pillar weights for each respective industry



**ESG risk factors**

- Analyst assigns 1-5 rating for each of the 16 identified ESG factors
- 1 = negligible risk
  - 2 = low risk
  - 3 = average risk
  - 4 = above average risk
  - 5 = high risk

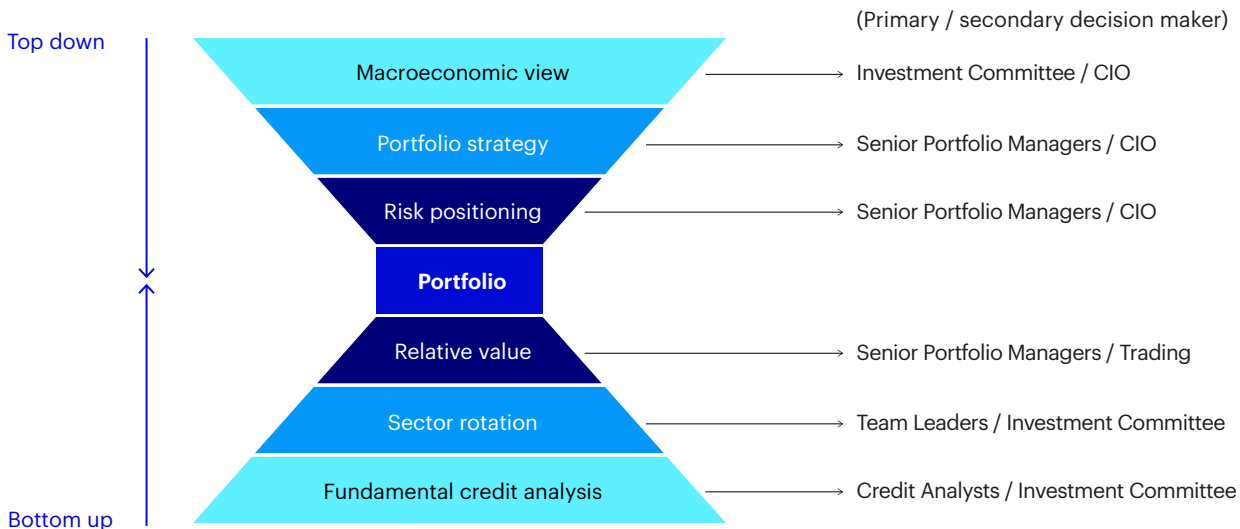
**Calculate average score for E, S and G pillar**

- Weighted average score determined for E, S, and G pillar
- Portfolio screen for maximum E, S or G score

Source: Invesco. For illustrative purposes only.

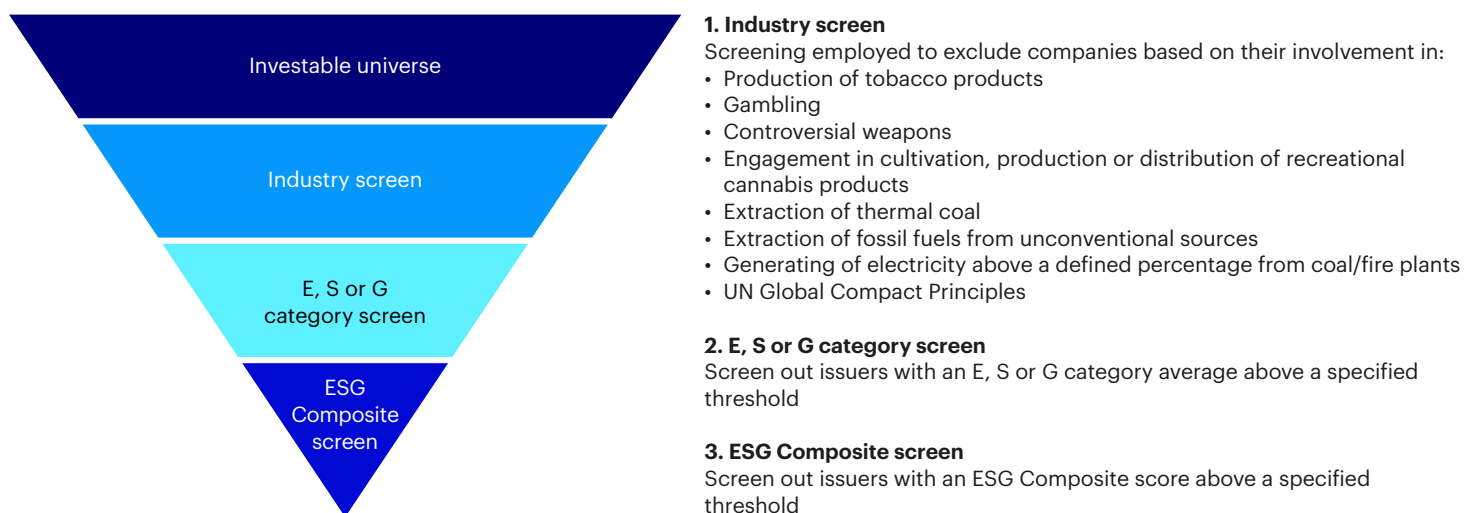
Figure 4  
**Fundamental investment process with clear decision making philosophy**

Disciplined and proven process drives strong investment results



Source: Invesco. For illustrative purposes only.

Figure 5  
ESG portfolio construction



Source: Invesco. For illustrative purposes only.

ISSM’s credit analysts and Investment Committee are focused on ESG issues surrounding the investment thesis for all investments.

#### Principal Adverse Impact metrics

Invesco has implemented systems to capture new metrics to address regulatory guidelines put into effect in the European Union per the Sustainable Finance Disclosures Regulation committee (SFDR). The SFDR committee outlined a list of Principal Adverse Impact (PAI) metrics that we have systematically incorporated into our internal portfolio analysis tools to be able to report on this at a portfolio level. These PAI metrics are to be obtained during each credit analyst’s annual ratings refresh process. The below is a list of new mandatory fields required to be requested by every credit analyst as part of the ESG due diligence process starting in 4Q2022.

#### Environmental

- Scope 1 GHG Emissions
- Scope 2 GHG Emissions
- Scope 3 GHG Emissions
- Total GHG Emissions
- Water Emissions
- Energy Consumption Intensity
- Hazardous Waste Ratio
- Non-Renewable Energy Consumption/ Production
- Participation in Activities Negatively Affecting Biodiversity-Sensitive Areas
- Involvement in Fossil Fuel Industry (production, storage, distribution, etc.)
- Business Operations in High Impact Climate Sector

#### Social

- Unadjusted Gender Pay Gap

#### Governance

- Violations of UNGC or OECD Guidelines
- Processes to Monitor UNGC/OECD Compliance
- Board Gender Diversity (Female vs Total)

#### Conclusion

ISSM invests and manages portfolios constructed of US, European, and global senior secured bank loans. As such, ISSM’s credit analysts and Investment Committee

are very focused on ESG issues surrounding the underlying and ongoing investment thesis for all investments. ESG plays a critical role in ISSM’s credit underwriting process and is a key discussion factor in the investment team’s credit evaluation of potential investment opportunities.

Prior to investing in a company and throughout the ownership of the company’s debt, the senior loan investment team will engage with company management on a number of issues – including environmental, social and governance. These discussions are designed to enhance ISSM’s understanding of the long-term economic value of the company which includes a thoughtful process and approach to determining whether to invest in a company.

ISSM’s senior loan team has a fundamentals-based, bottom-up credit process and determines the initial eligibility of an asset for inclusion in any senior secured loan portfolio. Given the depth, knowledge and experience of the investment professionals dedicated to senior secured loan investing, each credit analyst spends a great deal of time getting to know borrowers, borrowers’ management teams, sponsors, key suppliers and customers etc. Analysts are expected to interact with the management teams of their portfolio companies on a regular basis. These company meetings provide investment teams a better understanding of the long-term nature of the business, its key drivers, competitive position, and the achievability of management goals. This insight, communication, and exposure provides ISSM’s investment team with an intimate look at the company’s underlying activities, which allows for an opportunity to incorporate elements of ESG into the investment process.

## Risk warnings

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. The strategy is particularly dependent on the analytical abilities of its investment manager on senior loans. Many senior loans are illiquid, meaning that the investors may not be able to sell them quickly at a fair price and/or that the redemptions may be delayed due to illiquidity of the senior loans. The market for illiquid securities is more volatile than the market for liquid securities. The market for senior loans could be disrupted in the event of an economic downturn or a substantial increase or decrease in interest rates. Senior loans, like most other debt obligations, are subject to the risk of default. The market for senior loans remains less developed in Europe than in the U.S. Accordingly, and despite the development of this market in Europe, the European Senior Loans secondary market is usually not considered as liquid as in the U.S. Many senior loans are illiquid, meaning that the investors may not be able to sell them quickly at a fair price and/or that the redemptions may be delayed due to illiquidity of the senior loans. The market for illiquid securities is more volatile than the market for liquid securities. The market for senior loans could be disrupted in the event of an economic downturn or a substantial increase or decrease in interest rates. Senior loans, like most other debt obligations, are subject to the risk of default.

## Important information

**This document is intended only for Professional Clients in Continental Europe, Dubai, Guernsey, Ireland, the Isle of Man, Jersey and the UK; in Hong Kong for Professional Investors; in Taiwan for Qualified Institutional Investors only; in Singapore for Institutional Investors; in New Zealand for wholesale investors (as defined in the Financial Markets Conduct Act), in Australia for Sophisticated or Professional Investors; in the USA for Institutional Investors, and for Qualified Clients/Sophisticated Investors in Israel. In Canada, the document is intended only for accredited investors as defined under National Instrument 45-106. In Chile, Panama and Peru, the document is for one-to-one institutional investors only. It is not intended for and should not be distributed to, or relied upon, by the public.**

By accepting this document, you consent to communicate with us in English, unless you inform us otherwise.

This document is marketing material and is not intended as a recommendation to invest in any particular asset class, security or strategy. Where individuals or the business have expressed opinions, they are based on current market conditions, they may differ from those of other investment professionals and are subject to change without notice. Further information can be obtained from the contact details below.

For the purposes of this document, Continental Europe is defined as Austria, Belgium, Denmark, Finland, France, Germany, Italy, Luxembourg, the Netherlands, Spain, Sweden, Switzerland and Norway.

This document does not form part of any prospectus. It contains general information only and does not take into account individual objectives, taxation position or individual financial needs. It does not constitute a recommendation of the suitability of any investment strategy for a particular investor. Nor does it constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such an offer or solicitation. As with all investments, there are associated inherent risks. Please obtain and review all relevant materials carefully before investing.

Israel: This document may not be reproduced or used for any other purpose, nor be furnished to any other person other than those to whom copies have been sent. Nothing in this document should be considered investment advice or investment marketing as defined in the Regulation of Investment Advice, Investment Marketing and Portfolio Management Law, 1995 ("the Investment Advice Law"). Investors are encouraged to seek competent investment advice from a locally licensed investment advisor prior to making any investment. Neither Invesco Ltd. nor its subsidiaries are licensed under the Investment Advice Law, nor does it carry the insurance as required of a licensee thereunder.

This document is issued:

- in Australia and New Zealand by Invesco Australia Limited (ABN 48 001 693 232), Level 26, 333 Collins Street, Melbourne, Victoria, 3000, which holds an Australian Financial Services Licence number 239916.
- in Austria and Germany by Invesco Asset Management Deutschland GmbH, An der Welle 5, 60322 Frankfurt am Main, Germany.
- in Belgium, Denmark, Finland, France, Italy, Luxembourg, the Netherlands, Spain, Sweden and Norway by Invesco Management S.A., President Building, 37A Avenue JF Kennedy, L-1855 Luxembourg, regulated by the Commission de Surveillance du Secteur Financier, Luxembourg.
- in Switzerland by Invesco Asset Management (Schweiz) AG, Talacker 34, 8001 Zurich, Switzerland.
- in Dubai by Invesco Asset Management Limited, PO Box 506599, DIFC Precinct Building No 4, Level 3, Office 305, Dubai, United Arab Emirates. Regulated by the Dubai Financial Services Authority.
- in Canada by Invesco Canada Ltd., 120 Bloor Street East, Suite 700, Toronto, Ontario M4W 1B7.
- in Hong Kong by Invesco Hong Kong Limited, 景順投資管理有限公司, 41/F, Champion Tower, Three Garden Road, Central, Hong Kong.
- in Singapore by Invesco Asset Management Singapore Ltd, 9 Raffles Place, #18-01 Republic Plaza, Singapore 048619.
- in Taiwan by Invesco Taiwan Limited, 22F, No.1, Songzhi Road, Taipei 11047, Taiwan (0800-045-066). **Invesco Taiwan Limited is operated and managed independently.**
- in the UK, Jersey, Guernsey, the Isle of Man, Ireland and Israel by Invesco Asset Management Limited, Perpetual Park, Perpetual Park Drive, Henley-on-Thames, Oxfordshire, RG9 1HH, United Kingdom. Authorized and regulated by the Financial Conduct Authority.
- in the US by Invesco Senior Secured Management, Inc., 225 Liberty Street, New York, NY 10281, USA.

[2565323/2022]