

ESG, sustainability and impact investing at M&G

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Increasing awareness among institutional asset owners, pension scheme members and individual savers is shifting attitudes in favour of more sustainable approaches to investment. This imperative of sustainable finance is not new, but the impetus for action has been building since the dual ratification of the Paris Agreement and the 2030 Agenda for Sustainable Development – which led to the formulation of the UN Sustainable Development Goals (SDGs).

The growing ambition to develop more rigorous and sustainability-led investment portfolios that extend beyond risk avoidance and exclusion is helping to channel greater amounts of private capital towards investments that offer tangible, real world impact to tackle global challenges from climate change and pollution, to better healthcare and education.

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Global growth trends in ESG and sustainability investing

Figure 1. Growth of SRI assets by region, 2014-2016

Region	2014	2016	Growth over period	Compound annual growth rate
Europe	\$10,775	\$12,040	11.7%	5.7%
United States	\$6,572	\$8,723	32.7%	15.2%
Canada	\$729	\$1,086	49.0%	22.0%
Australia / New Zealand	\$148	\$516	247.5%	86.4%
Asia ex Japan	\$45	\$52	15.7%	7.6%
Japan	\$7	\$474	6689.6%	724.0%
Total	\$18,276	\$22,890	25.2%	11.9%

Notes: Asset values are expressed in billions.

Asia ex-Japan 2014 assets are represented in US dollars based on the exchange rate at year-end 2013. All other assets, as well as all 2016 assets, are converted to US dollars based on exchange rates at year-end 2015.

Source: Global Sustainable Investment Alliance's (GSIA) "Global Sustainable Investment Review 2016", March 2017.

All surveys that attempt to quantify the flow of capital into ESG and sustainable and responsible investment (SRI) strategies agree that investor inflows have continued to accelerate rapidly over recent years. According to the most recent European Sustainable Investment Forum (Eurosif) study, impact investing is the fastest-growing strategy in Europe, with growth of 385% in the period 2013-2015, followed by sustainability-themed investments, with growth of 146%.

The green bond market has experienced rapid growth particularly since 2013. US\$155.5 billion of green bonds were issued globally in 2017 compared to a mere \$3 billion in issuance in 2012. The current global green bond universe is estimated at around \$221 billion, based on September 2017 figures from the Climate Bonds Initiative, with the not-for-profit organisation forecasting the green bond market to top \$1 trillion by the end of 2020.

Investing responsibly and driving long-term portfolio returns

At M&G, we naturally allocate long-term capital to responsibly-managed businesses and have been financing impact investments on behalf of our clients since the 1930s. Today M&G has €24 billion invested in impact assets across fixed income¹. By demonstrating that investments can generate attractive risk-adjusted returns, as well as benefit society and the environment, we are able to work together with our clients towards achieving the same global goals.

As a long-term, active investor, ESG risks and opportunities have always played an important role in our analysis, due diligence, investment and engagement processes. We believe incorporating ESG factors into investment and asset allocation decisions where they have a meaningful impact on risk and return can help to better manage risk and generate sustainable, long-term returns.

Responsible engagement – agents for change

Active engagement is also crucial to ensuring specific ESG issues are managed responsibly, whether we are debt holders, shareholders or asset owners in an investment. Although debt holders typically have less involvement in the ongoing management and implementation of corporate strategy and policy (relative to equity holders), the inclusion of appropriate clauses in finance documentation and active engagement with companies on material ESG issues can encourage greater disclosure and transparency.

M&G has a growing suite of ESG-focused investment strategies that encompass a broad range of sustainable investment approaches, as illustrated in Figure 2.

¹ Source: M&G Investments, as at end December 2016. Figure includes public and private assets.

Figure 2. A growing suite of ESG-focused strategies

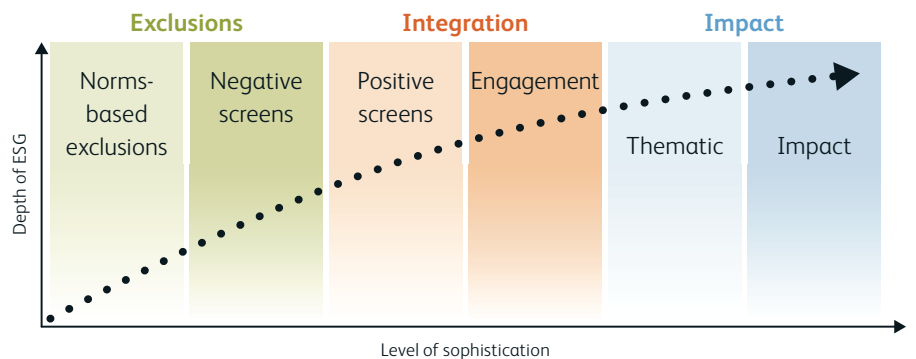


Source: M&G.

These strategies fit within a broader ESG spectrum (ranging from norms-based exclusions and negative screening to impact investing) each with their own risk, return and impact profile. While the aims of these investment strategies vary, the common theme underlying all these strategies is an explicit emphasis on environmental, social, and/or governance issues.

Several new initiatives are also underway, including a listed equity impact investment strategy that invests in companies that deliver a clear and demonstrable positive impact on society and incorporates targeted ESG engagement, and a flexible multi-asset strategy that uses a best-in-class ESG screening approach and targets sustainability-related outcomes through dynamic asset allocation.

Figure 3. The ESG spectrum



Source: M&G.

M&G Pan European and Global Select Equity

Pan European Select Equity and Global Select Equity along with European Smaller Companies are equity strategies that fully integrate ESG factors into the investment process. Pan European Select is the only strategy with an explicit sustainability mandate featuring in the Morningstar top five performers in its peer group (EUR Europe Large-Cap Blend Equity, 2015-2017, as at February 2018).

- **Proprietary ESG research:** Our research focuses on sustainable companies with inherent value creation characteristics. ESG measures help us define our watch list of potential candidates, in our business model and risk assessment.
- **UN Global Compact screening:** We apply UN Global Compact principles to exclude companies from our investable universe that are in breach of human rights, labour, environment and anti-corruption rules, as defined by ISS-Ethix.

UN Global Compact principles: A corporate sustainability initiative, asking companies to align strategies and operations with universal principles on human rights, labour practices, environmental concerns and anti-corruption, while taking actions that advance societal goals.

- **Sector screening:** We filter out and exclude companies that are involved in the production of tobacco and controversial weapons including cluster munitions, anti-personnel mines, chemical and biological weapons.
- **Active engagement stance:** We believe that the way in which a company is run and how it treats the environment, as well as its employees and the communities in which it operates, are fundamental to its long-term success. We therefore engage with company management when we see room for improvement or where there is a need to improve ESG awareness. This can be conducted through direct corporate engagement, filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines.

ESG engagement in action

Stericycle – seeking to improve long-term ESG risk management

We started engaging with Stericycle in June 2016 after becoming concerned that their sustainability report lacked sufficient detail and failed to contain proper measurable targets. As a US business specialised in handling waste for healthcare, retail and commercial clients, we were concerned about the ESG-specific risks the company was exposed to: emission risks from its incinerators and fleet of vehicles, as well as employee health and safety risks from handling toxic products.

Our engagement showed that the company's focus on optimising economic returns had led them to under-emphasise sustainability issues. We persevered and contacted Stericycle's largest shareholder at the time with a view to pushing for change – advised management on best-in-class practices in these areas and provided them with concrete examples of how to set targets. Since we first started engaging with the company, progress has been made and the company's latest sustainability report is considerably more detailed than the previous one. Specifically, it contains targets with regards to fuel consumption, emission levels and employee injury rates. While we acknowledge that this is a step in the right direction, we continue to engage with the company to push for more demanding targets that are broader in scope.

M&G Global ESG High Yield Bond

A diversified global high yield bond strategy that combines M&G's long-running expertise in high yield credit analysis with leading ESG research from MSCI, an independent research provider. All potential investments are filtered through a three-stage ESG screening approach.

- **Three-stage ESG screening approach:**

- 1) UN Global Compact – excludes companies assessed to be in breach of the United Nations Global Compact principles on human rights, labour, environment and anti-corruption
- 2) Sector screening – filters out and excludes companies that derive part of their revenues from controversial activities; and
- 3) ESG integration – filters companies according to their ESG credentials and excludes industry laggards that have an ESG rating below 2.9, based on ratings provided by MSCI.

- **Diversified investment opportunity:** High yield bonds remain an underserved part of the ESG landscape. In total, approx. 35% of the investable high yield market is filtered out once the three-stage screening approach is applied.

- **Measurability:** The strategy aims to provide investors with a measurable assessment of its overall ESG impact.

ESG and Fixed Income investment in action

Equinix – committed to sustainable business practices

We recently invested in a new issue from Equinix, a global interconnection and data centre provider. Equinix is not only well placed to benefit from the ever-growing demand for data services driven by the rise of mobile and cloud computing, but as a constituent of the MSCI Global Sustainability Index we believe the company offers strong ESG credentials.

Through a series of conservation and efficiency programmes – encompassing energy and water conservation, pollution prevention and recycling – Equinix has been instrumental in helping to drive energy efficiency improvements in its field. Its commitment to the environment and its innovative use of green technologies has been met with accolades from across the ESG industry, with the company a winner at the Green Power Leadership Awards in 2017. The company also scores highly on a range of other ESG metrics – especially its strong commitment to privacy and comprehensive personal data safeguards – and we therefore regard Equinix as an ESG industry leader.

M&G Impact Financing

An impact strategy investing in private and illiquid debt that has a measurable positive social or environmental impact and generates an attractive financial return.

- **A clear positive social or environmental impact:** We assess potential impact investments for their social and environmental impact against a comprehensive criteria developed in conjunction with Sustainalytics, an independent global ESG and sustainability research provider. These assets are also independently rated from a pure credit risk perspective by M&G's team of credit analysts.
 - This criteria classifies our impact investments according to one or more of our 12 thematic environmental or social impact areas.
 - Within each thematic area, we identify specific sub-themes with their own eligibility criteria and metrics to measure outputs that are tailored to the specific impact theme.

Targeting real world impact aligned with the SDGs: We have mapped our impact themes to the 17 UN Sustainable Development Goals. We have focused on making clear, tangible links, and by doing so, we have found that each of our own impact themes align to one or more global goals.

- **A competitive financial return:** We target investments that make a return in excess of similarly-rated public bonds; ie investments that offer an 'illiquidity premium'.
- **Flexibility to invest in a diversified manner across different asset types:** We aim to source impact assets across a wide opportunity set to ensure the best possible value for our clients. This not only helps to maximise returns but also creates scope to diversify portfolios. The strategy targets an average 'investment grade' credit rating.

Impact investment in action

US residential solar

M&G participated in a renewable energy transaction that finances a pool of loans to residential customers in the US who use the loans to purchase rooftop solar panels. These customers benefit from the long-term savings on energy bills from the clean energy produced by the solar panels, while the greenhouse gas emissions avoided by using the clean energy is estimated at over 50,000 tonnes of CO₂, and is equivalent to 10,700 cars off the road per year in the US¹.

Urban regeneration project

M&G provided £115 million in funding for a regeneration project based in the UK, as part of a 10-year private placement deal. The project qualified as an impact investment as it promotes economic inclusion through the creation of an estimated 14,500 jobs² in an area with relatively high levels of unemployment. In addition, a quarter of the residential developments on the project site will be social housing, approximately 4,000 new social homes, and most of the commercial developments are built to be highly energy efficient.

¹ Source: 'Passenger vehicles driven for one year' figure calculated according the United States Environmental Protection Agency (EPA) Greenhouse Gas Equivalencies Calculator.

² Source: M&G. October 2017. Figure includes approximately 1,500 jobs created for the construction.

M&G Real Estate

Our sector-leading approach to Responsible Property Investment (RPI) is fully integrated into day-to-day investment activities and is applied to the full range of M&G Real Estate strategies. We use our resources to enrich the lives of people and communities by creating and managing world-class places to live, work and play. This enables us to manage and respond to the growing range of environmental, social and governance issues that can impact property values, helping us drive asset performance for our clients and bring positive value to society and the environment.

M&G Real Estate's RPI strategy focuses on four key areas with 2025 objectives in these categories:

- **Socio-economic benefit:** Creating positive socio-economic outcomes by developing high quality places where people want to be. Through proactive participation in communities, we are able to support jobs, skills development and economic growth.
- **Environmental excellence:** Driving environmental improvements at our assets reduces operating costs, carbon emissions and the use of natural resources. This helps attract and retain occupiers, and ensures that we appropriately manage environmental risks.
- **Health, wellbeing and occupier experience:** People want to live, work and play in places that make them feel happier, healthier and productive. Considering health, wellbeing and experiential factors in how we design and manage buildings enables our occupiers to have happy productive employees, our retail destinations to attract customers and our homes to be places where people want to live.
- **Smart, secure and connected:** Smart physical and digital infrastructure is crucial to the competitiveness and success of countries, cities and buildings, as well as positively benefiting inhabitants. Understanding connectivity solutions means we can more effectively identify investment opportunities and future proof investments.

How we benchmark RPI performance: M&G participates in the GRESB Survey to benchmark Fund RPI performance and seven out of eight real estate strategies, with those submitted equating to 80% of assets under management, achieved a Green Star rating in the 2017 Global Real Estate Sustainability Benchmark (GRESB) assessment, positioning them among the highest ranked for sustainability globally.

Responsible Property Investment in action

Blekholmen 1, Stockholm, Sweden – high quality digital connectivity

In line with our strategy to acquire assets in major European hubs served by excellent transport links, M&G Real Estate purchased Blekholmen 1, a 34,000 square metre, multi-let office scheme comprising six linked buildings.

Blekholmen is popular with a range of occupiers owing to its excellent transport links, being very close to the central train station and the subway. Supported by strong, stable and secure connectivity, our RPI strategy for Blekholmen has led to several socio-economic, environmental and health and wellbeing benefits.

Key achievements against our impact areas:

- High quality digital infrastructure, including digital signs in the entrance displaying real-time transport information
- Broad mix of 30 tenants, some of which encourage more businesses to spend time at the asset
- Green lease clauses have been signed, a commitment to be more eco-friendly
- Three eateries available on-site and the plaza creates a community feel.

Greenfield infrastructure

An infrastructure equity strategy that invests in Greenfield opportunities and focuses on building fully diversified portfolios and delivering stable cashflows and long-term capital value to investors.

- **Infrastructure is essential:** Infrastructure, by its essential nature, can meet many social and environmental needs. Investments are made in new-build infrastructure across Europe in sectors, such as green energy, rural broadband, healthcare and transport.
- **The Greenfield approach:** For Greenfield opportunities, we typically aim to invest after the planning, design and consultation phases have been processed, rather than at inception. That way we can capture attractive returns, while avoiding the riskier, early stages ie the development period.
- **Long-standing commitment to active ownership and responsible investing:**
 - Given the long economic lives of many infrastructure assets, full consideration must be given to the physical location of assets, the likely impact on and by the environment in which they are located as well as the community in which it is situated, the dynamics of the industry in which they operate, among other factors.
 - At each stage of our investment process, we are focused on integrating ESG considerations as part of the value creation and management of our assets. We look to acquire significant minority or majority stakes when taking a long-term ownership position in our investee companies, and seek board representation so we have influence in making sure ESG issues are managed responsibly.

Responsible infrastructure investment in action

Eteck – sustainable heating for Dutch households and businesses

In July 2017, Infracapital provided £38 million to acquire a 60% stake in Dutch utility company Eteck Energie Bedrijven (Eteck). Eteck provides sustainable collective heating systems (SCHS) that supply central heating, cooling and tap water to residential and commercial customers in the Netherlands. Eteck owns and operates 191 SCHS systems¹ and services around 25,000 contracted home equivalent connections.

In the Netherlands, a reported 38% of energy consumption goes to heating and half of this is used by residential buildings, while 89% of Dutch households have a gas-fired boiler. However, energy supply in the Netherlands is set to change significantly as the Dutch government pushes forward with its ambition for the country to be gas-free by 2050.

Eteck is well positioned to benefit from the ongoing transition towards alternative fuel sources with lower emissions in the Netherlands in the coming years and beyond – the market for sustainable energy sources is expected to reach circa 12% of total national energy usage by 2020. Eteck develops energy systems, using warmth generated by surface water, residual heat generated by industries and shops, and solar heat (energy roofs), and all the electricity used for energy systems is 100% generated by green sources.

¹ Source: Eteck, as at February 2018.

Risks associated with the Global Select strategy

The value of investments and the income from them will rise and fall. This will cause the strategy price, as well as any income paid by the strategy, to fall as well as rise. There is no guarantee the strategy will achieve its objective, and you may not get back the amount you originally invested.

Changes in currency exchange rates will affect the value of your investment.

This strategy holds a relatively small number of investments and, as a result, may experience larger price rises and falls than a strategy which holds a larger number of investments.

The strategy will invest in emerging markets which are generally smaller, more sensitive to economic and political factors, and where investments are less easily bought and sold. In exceptional circumstances, the strategy may encounter difficulties when selling or collecting income from these investments, which could cause the strategy to incur a loss. In extreme circumstances, it could lead to the temporary suspension of dealing in shares in the strategy.

Where market conditions make it hard to sell the strategy's investments at a fair price to meet customers' sale requests, we may temporarily suspend dealing in the strategy's shares.

Some transactions the strategy makes, such as placing cash on deposit, require the use of other financial institutions (for example, banks). If one of these institutions defaults on their obligations or becomes insolvent, the strategy may incur a loss.

Risks associated with the ESG High Yield Bond strategy

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When interest rates rise, the value of the strategy is likely to fall.

The value of the strategy may fall if the issuer of a fixed income security held is unable to pay income payments or repay its debt (known as a default).

The strategy may use derivatives with the aim of profiting from a rise or a fall in the value of an asset (for example, a company's bonds). However, if the asset's value varies in a different manner, the strategy may incur a loss.

If the share class is hedged (H share class), it aims to mirror the performance of another share class. We cannot guarantee that the hedging objective will be achieved. The hedging strategy will limit holders of the hedged share class from benefiting if the hedged share class currency falls against the US dollar.

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Some transactions the strategy makes, such as placing cash on deposit, require the use of other financial institutions (for example, banks). If one of these institutions defaults on their obligations or becomes insolvent, the strategy may incur a loss.

Risks associated with the Impact Financing strategy

The strategy may be exposed to the possibility that a debtor will not meet their repayment obligations. Where market conditions make it hard to sell the strategy's investments at a fair price to meet redemptions, we may suspend dealing in the strategy's shares.

Please note this is not an exhaustive list, you should ensure you understand the risk profile of the products or services you plan to purchase.

M&G's ESG credentials:

- ESG factors integrated into investment analysis
- UNPRI signatory since 2013:
 - As of July 2017, M&G were awarded an A+ Strategy & Governance score and currently have representation on the UNPRI Fixed Income Engagement sub-committee
- UK Stewardship Code
- Cluster munitions exclusion policy
- Member of the UK Sustainable Investment and Finance Association (UKSIF)
- Climate Bonds Initiative (CBI) Partner and member of:
 - Climate Bonds Industry working group for hydropower investments
 - Climate Bonds Industry working group for marine renewable energy investments
 - Climate Bonds Industry working group for bioenergy
 - European Green Securities Steering Committee
- Member of the Loan Market Association (LMA) Green Lending working party
- Member of the Global Impact Investing Network (GIIN). Our membership signifies a commitment to deepening our engagement in the impact investing industry
- Signatories to Green Bond Principles
- Member of the Institutional Investors Group on Climate Change (IIGCC)
- Member of Climate Action 100+
- Member of the International Corporate Governance Network (ICGN)
- Member of the Asian Corporate Governance Association (ACGA)
- Member of Better Buildings Partnership (BBP)
- Member of GRESB Real Estate

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