



# ESG INTEGRATION *INSIGHTS*

## Payden & Rygel Case Study

Q1 2017 ISSUE





**Welcome to the latest edition of SASB's ongoing thought leadership series, *ESG Integration Insights*.**

SASB launched *ESG Integration Insights* in December 2016 to highlight case studies written by investors, who shared insights into their use of SASB standards to inform investment decisions. The premier edition of *ESG Integration Insights*, [available in the SASB Library](#), includes case studies from investors using SASB standards across a variety of asset classes. In that publication, UBS and Terra Alpha Investments discuss their use of SASB standards in equity analysis, whereas Breckinridge Capital Advisors provide a view to their use of SASB in credit analysis; additionally, Wespeth demonstrates how SASB is incorporated into their manager selection process, and we also get a view from Partners Group on using SASB to inform their private equity due diligence process.

In this latest issue, the following case, written by Payden & Rygel, is particularly exciting because it demonstrates the utility of SASB standards for evaluating corporate credit risk in emerging markets, where disclosure on ESG factors may be thin, and third-party data may be insufficient for making investment decisions.

Please contact me if you are interested in submitting a case for inclusion in future editions of SASB's *ESG Integration Insights*.

We hope you enjoy the case.

Best regards,

A handwritten signature in black ink that reads "Janine Guillot". The signature is fluid and cursive, with the first name being more prominent.

Janine Guillot  
Director, Capital Markets Policy and Outreach



# Executive Summary - Case Study

This case study shows how Payden & Rygel integrates the SASB industry guidelines for reporting in our EM credit analysis. This is the first EM, fixed-income specific case study SASB has published and we are honored to set the standard.

## What is SASB?

The Sustainability Accounting Standards Board (SASB) is a non-profit organization interested in defining and developing consistent accounting measures for environmental, social and governance indicators. SASB has worked with investors and issuers to incorporate these more standardized ESG disclosures into existing regulatory filings. To date SASB has developed provisional disclosure standards for 79 industries across 10 sectors.

► SASB's leadership team boasts profound industry and regulatory experience. Founded in 2011 by CEO Dr. Jean Rogers, Michael Bloomberg, founder of Bloomberg LP, is the Chair of the Board. Mary Shapiro, former Chair of the SEC, is the Vice Chair of the SASB board.

## Report Highlights

- Over the past five years, Payden & Rygel has noticed a significant increase in client demand for thorough analysis of ESG considerations in Payden's portfolio decisions. Meeting this demand, however, has been frustrated by the lack of consistent, comparable ESG data. Thus, Payden & Rygel finds tremendous value in the Sustainability Accounting Standards Board's (SASB) business-relevant, industry-specific standards.
- In determining the attractiveness of EM corporate debt for our portfolios, we use a multi-step process – working from the issuer level up to the country level – to explore and vet nonfinancial-statement business risks to the fullest extent possible. In this example, SASB's Restaurant Industry Standards were integral to our analysis of Arcos Dorados, an EM restaurant debt issuer.
- Three SASB disclosure topics from the Restaurant Standards were found to be most salient to our analysis of the company: management of environmental and social impacts in the supply chain; nutritional content; and fair labor practices. In addition to evaluating the company's overall governance, examination of Arcos' position through their 20-F disclosures, alongside consideration of broader implications of how the company manages ESG-related risks, yielded what we believe to be a more comprehensive view of Arcos' credit-worthiness.
- The Arcos Dorados case is an excellent example of the applicability of SASB standards to an emerging market, fixed income investment. A review of the credit using only vague, third-party ESG scores might have soured an investor's opinion on Arcos. However, augmenting our credit analysis with SASB's industry-specific standards helped better contextualize ESG risks and opportunities at Arcos, and gave us confidence that the company is focused on the management of ESG-related issues that could impact its business and investors in the future.

► Since the inception of our emerging markets (EM) strategy in 1998, Payden has sought to invest in those countries and companies which take seriously all risks: immediate and long-term, financial and non-financial.



# Payden & Rygel - Case Study

## Emerging market credit analysis, augmented by SASB standards

### Arcos Dorados

Investor concerns about environmental, social and governance (ESG) risks now extend from individual investors to mainstream institutional investors, and span all corners of the global capital markets. Across the investment management industry, “growth for ESG assets, in the aggregate, has consistently outpaced growth in total assets under management,”<sup>1</sup> with the sum of global ESG assets under management estimated to have reached \$22 trillion in 2016.<sup>2</sup>

Growth of investor interest in ESG factors’ impact on value, however, has been accompanied by the realization that “traditional” methods for evaluating performance on ESG factors are inadequate. Particularly at the investment-decision level, translating often abstract ESG factors into meaningful measures of risk and return is imprecise and hampered by inconsistent communication from companies about how they are managing these issues. A new approach was necessary.

Founded in 1983, Payden & Rygel is a leader in the active management of fixed income and equity portfolios, and is one of the largest privately-owned investment advisers globally. Advising the world’s leading institutions and individual investors, we provide strong performance, customized solutions, and real-world strategy on the global economy and capital markets from offices in Los Angeles, Boston, London, and Paris. The firm manages \$110 billion in assets, including \$9 billion in emerging market strategies. Over the past five years, Payden & Rygel has noticed a significant increase in client demand for thorough analysis of ESG considerations in Payden’s portfolio decisions. Meeting this demand, however, has been frustrated by the lack of consistent, comparable ESG data. Thus, Payden & Rygel finds tremendous value in the Sustainability Accounting Standards Board’s (SASB) business-relevant, industry-specific standards.

This case study demonstrates how Payden & Rygel utilizes SASB’s standards to complement traditional company and sovereign analysis to better evaluate an emerging market (EM) debt investment in one corporate issuer—Arcos Dorados—in Brazil.

► Payden & Rygel uses the SASB industry standards to complement traditional company, sovereign, and ESG analysis in our credit research process. As shown in the following examination of one emerging market corporate debt issuer—Arcos Dorados—integrating SASB’s standards into credit analysis keeps investors focused on material risks related to portfolio companies.

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<sup>1</sup> State Street Global Advisors (2016). “ESG Investing.” Accessed 30 January 2016.

<sup>2</sup> *ibid.*

## For Emerging Market Debt Investors, ESG May Not Be as Easy as 1, 2, 3

Since the inception of our emerging markets (EM) strategy in 1998, Payden has sought to invest in those countries and companies which take seriously all risks: immediate and long-term, financial and non-financial. In our experience, corporate transparency and the quality of ESG stewardship and disclosure by companies in emerging markets sometimes lags the corporate transparency found in European and North American markets. Quantitative ESG metrics are especially wanting in smaller EM company disclosures.

This fact makes quantitative ESG analysis based only on third-party ESG scores more difficult in emerging markets. Indeed, with a limited pool of quantitative and standardized information on which to draw, we find third-party ESG scores are often insufficient for making sound investment decisions. SASB's industry standards provide a superior guide for analysis.

► Particularly in emerging markets, with a limited pool of quantitative and standardized information on which to draw, we find third-party ESG scores often insufficient for making sound investment decisions. SASB's industry standards provide a superior guide for analysis in these cases.

## SASB's Standards in the Context of Emerging Market Debt: Payden's Integration Process

In determining the attractiveness of EM corporate debt for our portfolios, we use a multi-step process – working from the issuer level up to the country level – to explore and vet nonfinancial-statement business risks to the fullest extent possible. In this example, SASB's Restaurant Industry Standards were integral to our analysis of Arcos Dorados, an EM restaurant debt issuer.<sup>3</sup>

Arcos Dorados is the largest McDonald's franchisee in the world, currently operating 2,140 McDonald's restaurants across Latin America and the Caribbean. Founded in 2007 by Woods Staton, who previously served as the President of McDonald's Latin America South division, Arcos Dorados is a key strategic partner to McDonald's. With Arcos currently registering \$2.9 billion per annum in sales, and with fast-food chains growing rapidly in Latin America, the Golden Arches look set to gleam on.

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ESG data available from third-party data providers has been limited and/or not targeted enough to inform our investment decisions. For example, the Bloomberg ESG disclosure score is one indicator an investor might use to evaluate Arcos' performance on ESG factors. Proprietary Bloomberg scores are industry-specific, importance-weighted, and, "based on the extent of a company's Environmental, Social, and Governance (ESG) disclosure...that ranges from 0.1 for companies that disclose a minimum amount of ESG data to 100 for those that disclose every data point collected by Bloomberg."<sup>4</sup> Bloomberg considers up to 270 possible ESG data points in their calculation of this score. On this measure, Arcos registers only 9.09, among the lowest in its peer group. But a low score in this case can be misleading.

Payden & Rygel believes that the management of *material* ESG factors can enhance or diminish the ability of issuers to repay corporate debt. Bloomberg's ESG disclosure scores largely reward companies for the volume of disclosure, not necessarily for the quality of disclosure on industry-specific factors that can affect a company's ability to repay debt. This may be because, until recently, standards identifying likely material ESG factors at the industry level were not available. We have found SASB's standards an invaluable framework to guide our analysis of a broader range of issues likely to be faced by companies in our portfolio.

<sup>3</sup> Restaurants Sustainability Accounting Standard, Sustainability Industry Classification System (SICS™ #SV0203, Prepared by the Sustainability Accounting Standards Board, December 2014 [provisional standard])

<sup>4</sup> Bloomberg L.P. (2017). "ESG Disclosure Score Definition."

In the case of Arcos Dorados, an in-depth analysis of their master franchising agreement with McDonald's, as well as a comprehensive review of their SEC filings for SASB Restaurant Industry Standards disclosure topics, yielded insights into the credit-worthiness of the company not readily available through other means.

In particular, three SASB disclosure topics from the Restaurant Standards were found to be most salient to our analysis of the company: management of environmental and social impacts in the supply chain; nutritional content; and fair labor practices. In addition to evaluating the company's overall governance, examination of Arcos' position through their 20-F disclosures, alongside consideration of broader implications of how the company manages ESG-related risks, yielded what we believe to be a more comprehensive view of Arcos' credit-worthiness.

## SASB Restaurant Industry Standard Disclosure Topic #1 – Supply Chain and Food Management

Critical to the success of a restaurant business is the quality and consistency of the food which makes it onto customers' plates. Mishaps or oversights in a restaurant's food supply chain can threaten even the largest of restaurant businesses.

Arcos Dorados manages supply and distribution in accordance with the International Organization for Standardization, the British Retail Consortium and other entities considered to represent the highest supply and distribution industry guidelines. These standards include cleanliness, product consistency and timeliness in terms of food delivery to the restaurants. The company publicly identifies supply chain management as an "important element of [their] success and a crucial factor in optimizing [their] profitability."<sup>5</sup>

Additionally, the company strives to meet or exceed all local food regulations. Arcos has established its own Hazard Analysis Critical Control Plan, or HACCP, a systematic approach to supply chain management that monitors third-party suppliers' processing facilities through analysis, inspection and follow-up.

With respect to raw materials, Arcos Dorados ensures that its produce suppliers undergo verification audits. All of its protein suppliers also undergo Animal Welfare Policy, "mad cow" disease and HACCP audits. Arcos Dorados conducts seminars annually with all key suppliers on topics such as standards calibration, product sensory evaluation and best practices; and all suppliers are audited annually by a third party for compliance with McDonald's Supplier Quality Management System.

Furthermore, in April 2014, the company committed to ensuring that, by the end of 2016, all pork procured by Arcos Dorados would be sourced from producers that can document plans to promote group housing for their pigs. In March 2015, Arcos Dorados announced that it would only source animal protein from suppliers who can guarantee that their animals (i) are raised without growth-stimulating antibiotics; (ii) have only received antibiotics to cure or prevent disease under veterinary supervision; (iii) are only administered antibiotics approved for veterinary use; and (iv) are raised in environments that encourage healthy animal welfare and husbandry conditions to help reduce the need for antibiotic use. Most recently, Arcos announced in October 2016 that their McDonald's restaurants would serve only cage-free eggs by 2025.<sup>6</sup>

► **SASB's Supply Chain and Food Management Metrics** are designed to help track conformance with environmental and social standards as well as conformance with animal welfare standards and best practices.

**SV0203-15:** Percentage of food purchased that meets environmental and social sourcing standards, and the percentage that is third-party certified

**SV0203-16:** 1) Percentage of eggs purchased from cage-free sources and 2) percentage of pork purchased from gestation crate-free sources

**SV0203-17:** Discussion of strategy to manage environmental and social risks within the supply chain

► The company committed to ensuring that, by the end of 2016, all pork procured by Arcos Dorados would be sourced from producers that can document plans to promote group housing for their pigs. Arcos announced in October 2016 that their McDonald's restaurants would serve only cage-free eggs by 2025.

5 Arcos Dorados (2011). SEC Form 1 Registration Statement (accessed March 2017).

6 Business Wire (2016). "Arcos Dorados To Exclusively Source Cage-Free Eggs." Accessed March 2017.



Arcos Dorados is a member of the Global Food Safety Initiative (GFSI), and 100% of Arcos' suppliers have committed to ending procurement of any goods from the Amazon region. Even at the broader corporate level, in October 2011, McDonald's signed a global moratorium on harvesting soy from the Amazon region and has maintained this commitment every year since, including actively supporting the 2014 renewal of the Brazilian Soy Moratorium.

## SASB Restaurant Industry Standard Disclosure Topic #2 – Nutritional Content






Arcos Dorados was the first restaurant chain in Latin America to provide full nutritional and calorie information about its menu on its websites in every country, as well as provide consumers with printed nutritional information on every tray liner at the restaurants.

This conscientiousness around product health and nutrition puts Arcos in a respectable place compared to other emerging (and even some developed) market food retailers. Their push to inform consumers of their product's nutritional content even stretched to their website, where, in 2014, Arcos Dorados added a nutritional calculator for consumers to check and monitor their food intake.

Arcos Dorados' willingness to take product health and nutrition seriously will only grow in importance. Our conviction on this front stems from the outsized growth of chain-restaurant fast food in Arcos' largest market, Brazil (*see Figure 1*). According to Euromonitor, growth of fast food chains in Brazil over the past five years has outpaced that of overall fast food restaurants, with a compound annual growth rate of 22% for the former compared to 16% for the latter (and 11% for food services overall). Chain-store fast food now accounts for 31% of total fast food sales, compared to 25% in 2010. Keeping consumers aware of what they are eating will only become more important as more consumers turn toward Arcos' McDonald's products.

Recent studies from the market research group Mintel indicate that consumers in Brazil increasingly see healthy eating as an essential element of twenty-first-century life. Indeed, when surveyed, 83% of Brazilian adults "agreed that it is worth spending more on healthier food options."<sup>7</sup> In a bid to meet consumers where they are, Arcos has worked incrementally to improve the nutritional content of their offerings by reducing the sodium content of Happy Meals, as well as cutting 40% of the added sugar from their smoothies.

Figure 1: Burgers Are Flying Off the Grill as Fast Food Chains Gains Market Share in Brazil

R\$ Billions	2010	2011	2012	2013	2014	2015	Trend	CAGR 2010-2015
Chained Fast Food	9.7	11.8	15.7	19.0	22.7	25.7		22.0%
Independent Fast Food	29.5	33.8	39.6	46.0	51.6	56.7		14.0%
<b>Total Fast Food</b>	<b>39.2</b>	<b>45.6</b>	<b>55.3</b>	<b>65.0</b>	<b>74.3</b>	<b>82.4</b>		<b>16.0%</b>
% of Total								
Chained	25%	26%	28%	29%	31%	31%		
Independent	75%	74%	72%	71%	69%	69%		

Source: Bloomberg

► **SASB's Nutritional Content Metrics** reflect increasing consumer preferences for healthier choices. Companies that are able to offer more nutritious menu options are likely to capture new markets for health-conscious consumers and improve market share with mainstream consumers. A higher share of nutritious options may have a beneficial effect on a company's reputation and revenue growth in the long term.

**SV0203-08:** Percentage of meal options consistent with the Dietary Guidelines for Americans, or foreign equivalent, sales from these options

**SV0203-09:** Percentage of children's meal options consistent with national dietary guidelines for children or foreign equivalent, sales from these options

**SV0203-10:** Number of child advertising impressions made, percentage promoting products that meet national dietary guidelines for children or foreign equivalent

7 Zegeler, Jennifer (2016). "Four Key Food and Drink Trends for Brazil in 2016." Mintel Group Ltd. (accessed March 2017).



## SASB Restaurant Industry Standard Disclosure Topic #3 – Fair Labor Practices

As a food retailer with 83,348 employees, labor is one of Arcos Dorados' largest costs. Labor practices are also important for investors to monitor in Arcos' case because the company operates across numerous geographies.

While the company's most recent 20-F filing does include some boilerplate information relating to minimum wage and Arcos' labor force, it is not comprehensive or decision-useful for investors. For instance, Arcos does not provide a dollar amount or percentage of in-store employees earning minimum wage, one of the suggested metrics included in the disclosure topic covering fair labor practices in SASB's Restaurant Industry Standard. We have asked the company for additional information on minimum wage across its workforce, both in terms of the extent and geography of these workers, to better understand the cost structure.

By contrast, the company's commentary on its Brazilian labor relations is an example of constructive and relevant information for creditors. Since 2012, Arcos has been litigating a civil complaint brought against the company by the Public Labor Ministry of the State of Pernambuco (a state in northeast Brazil). The complaint seeks to compel the company to transition all workers at its 14 locations in Pernambuco to fixed, not variable, work schedules. In addition to the operational changes, the state is seeking fines for non-compliance. Litigation such as this in Brazil, Arcos' largest market, could appear to be highly problematic.

However, because Arcos does disclose some fair labor factors included in the SASB Restaurants Standards – specifically a full schedule of the penalties and costs related to the case – investors can better contextualize the implications of this case. It does not appear that this litigation threatens Arcos' business. The company's disclosures indicate the complaint applies to only 20% of the company's Brazilian employees. In the interest of better understanding, we have engaged Arcos Dorados' investor relations, asking for additional insights on the Pernambuco litigation.

## Sovereign-level ESG Analysis

Another critical step in any credit analysis within Payden's emerging market strategy occurs at the portfolio and sovereign level. Our portfolio managers and sovereign analysts contemplate the relative value and ESG performance of the countries in which the corporate issuer does business. Strategists and analysts filter each issuer country through a proprietary scoring system to produce a proprietary internal ESG score for the country. While countries are scored quarterly with regard to credit, rates, and currency, the starting point – the sovereign view – is the product of collaboration between country analysts and local strategists. Each factor is assigned a score between 1 and 5 (5 signaling strong improvement and 1 strong deterioration). Unlike a credit rating agency, we score countries with a six-month forward-looking view, which allows us to compare across credit quality. Factors are weighted based on dynamic individual country considerations. The subjective weights allow us to properly capture the relative importance of a single factor for a country's outlook.

In the case of Arcos, the most important country scorecard from an investment standpoint is Brazil. While 70% of Payden & Rygel's Brazil country scorecard is a weighted average score of other macroeconomic factors, 30% of the scorecard is dedicated to ESG analysis (see Figure 2).

► **SASB's Fair Labor Practices Metrics** reflect the international nature of franchised restaurants and the impact labor issues at franchises can have on brand image across markets. Properly managed human capital, competitive wages, and safe working environments can improve employee morale while reducing turnover rates and related administrative costs involved with employee acquisition and training.

**SV0203-11:** 1) Voluntary and 2) involuntary employee turnover rate for restaurant employees

**SV0203-12:** Average hourly wage for restaurant employees, by region; percentage of employees earning minimum wage

**SV0203-13:** Amount of legal and regulatory fines and settlements associated with labor law violations

**SV0203-14:** Amount of tax credit received for hiring through enterprise zone programs

► Because Arcos complies with SASB's fair labor standard, which asks for reporting on the amount of legal and regulatory fines and settlements associated with fair labor practices, the implications of the Pernambuco case can be better contextualized.

Figure 2: In Payden & Rygel's Country Scorecards, ESG factors Comprise 30% of the Country Weight

BRAZIL  
COUNTRY  
SCORECARD

Brazil (Ba2/N, BB/N, BB/N)					
FACTOR		SUB-FACTOR	ANALYSIS	WEIGHT	SCORE
ESG	Governance	Institutional strength	• Michel Temer has assumed office in 09/16. Given Temer's more competent team and better political relationships, impeachment has paved the way for a fresh start and hope that a new structural reform agenda will take root. The next presidential elections will be held in October 2018.	25%	3.5
		Corruption			
		Regime stability	• Political uncertainties still remain. One watch point is whether the electoral court determines that illicit campaign financing disqualifies the Rousseff/Temer ticket. This is a tail risk but quite serious. Another is the fallout associated with the Odebrecht plea bargain.		
		Rule of law			
	Social/ Environmental	Human capital	• Against a backdrop of recession, unemployment has surged from 6.5% (12/14) to 11.6% in 07/16.  • The middle class in Brazil has become more cognizant of the quality of state services and corruption issues. This may ultimately lead to stronger institutions, but, in the meantime, there have been a number of social protests expressing discontent with the political system.	5%	2.0

Source: Payden & Rygel

## Tying It All Together

A number of factors make it difficult to contextualize third-party data on ESG performance of companies in emerging markets. Thus, SASB's standards are helpful to investors interested in characterizing material ESG risk at both the industry and issuer level. The addition of an industry lens directs investor focus and inquiry towards ESG factors most likely to impact investment performance.

The Arcos Dorados case is an excellent example of the applicability of SASB standards to an emerging market, fixed income investment. A review of the credit using only vague, third-party ESG scores might have soured an investor's opinion on Arcos. However, augmenting our credit analysis with SASB's industry-specific standards helped better contextualize ESG risks and opportunities at Arcos, and gave us confidence that the company is focused on the management of ESG-related issues that could impact its business and investors in the future. Analysis of these factors, which were previously obscured in third-party ESG scores, improved our investment decision. Strong growth of fast food chain restaurants in Brazil, a unique McDonald's partnership, and the importance of brand-building across emerging markets for McDonald's – coupled with their management of material ESG factors for the restaurants industry – made Arcos Dorados appear to be an attractive investment.

► Overlaying issuer-level analysis of ESG-related credit risk using SASB's industry-specific standards helped contextualize ESG risk in ways previously impossible using third-party ESG scores and country-level analysis.

The information provided herein is not designed to be representative of any particular reader's financial needs. Nor does the information contained herein constitute financial management advice. Payden & Rygel makes no warranty or representation regarding the accuracy or legality of any information contained herein, and assumes no liability for the use of said information.





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