Breckinridge CAPITAL ADVISORS

ESG NEWSLETTER

THE COVID-19 CRISIS AND ITS IMPACT ON SOCIAL ISSUES FOR CORPORATIONS AND U.S. CITIES

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Ever since the COVID-19 pandemic surfaced in the U.S. in January 2020, its impact has been swift and severe. Its effects include a devastating loss of human life and a major recession, which has left over 40 million unemployed. Favorably, there are signs that social distancing appears to be flattening the infection curve, at least in some regions. As a result, states are finding ways, with limitations, to reopen their economies.

We commented in our *Perspectives* article on April 7 how the crisis brought on by the pandemic afforded Breckinridge analysts with a better view of corporate environmental, social and governance (ESG) practices and management priorities. The quality of the responses can shed light on potential ESG risks and, ultimately, credit quality.

In this follow-up article, we share our observations of how the COVID-19 crisis is affecting two corporate social issues, labor and supply chain management, and how management teams are seeking to manage them. We also offer our perspective on the pandemic's influence on inequality and community engagement, two key social issues for U.S. cities.

CORPORATES

An important ESG consideration related to the COVID-19 crisis is how corporate management teams are treating their employees. Suffering from a dramatic decline in demand, companies have reduced operating expenses, which include labor costs. Labor management decisions have both short-term and long-term implications. In the short-term, layoffs may appear as the clear decision when management is looking to maintain profitability. However, terminated workers could possess critical knowledge that would prove invaluable to the company over the long run.

Through our ESG research and engagement discussions, we are evaluating management's decisions regarding labor during the crisis. For a recent example, we engaged with a major restaurant chain that, in our opinion, acted quickly and effectively to support its employees affected by the slowdown. Labor expense is this retailer's largest variable cost and labor practices is a material ESG issue for the industry. Demonstrating a desire to retain and reward its store employees, the company pledged full pay to all workers for a period of time despite store closures.

Additionally, among the largest U.S. banks, disclosures and management commentary during the first quarter earnings cycle illuminated an increased focus on a broader set of stakeholders during the COVID-19 recession. In reviewing first quarter company presentation slides it is notable that two large U.S. banks that we engaged with following earnings included slides on stakeholder focus in the front of their earnings decks. The thrust was on supporting employees, customers, and communities. One large U.S. bank we spoke with is committed to no COVID-19-related layoffs in 2020, and has expanded employee benefits, including moving to a $20 minimum wage. For customers, another bank we engaged with is offering fee waivers, payment deferrals and expanded assistance for a range of consumer lending products including credit cards, auto loans and mortgages.

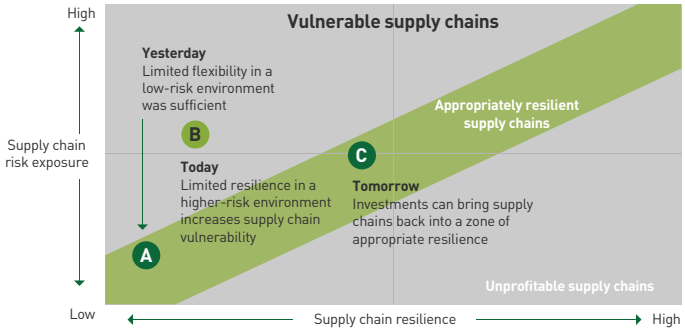
Secondly, the COVID-19 crisis is causing management teams to reconsider the structure of corporate supply chains. As noted in research from Bain & Company, the consulting firm, companies have long sourced materials and components from the lowest cost providers and provided on a just-in-time basis.[1] The strategy worked in a world that was relatively benign from economic, social and environmental perspectives.

However, as Bain & Company notes, "the COVID-19 outbreak isn't an isolated event. Disruptions are increasing in frequency and magnitude, including geopolitical events, climate-related disasters and public health crises." The reliance on a few inexpensive suppliers situated in distant locations has become a risk in a more volatile world. For example, as China addressed the spread of COVID-19, local suppliers closed operations to quarantine employees.

Customers were left without key materials for their products. Companies affected by the shutdowns were forced to find new suppliers on short notice, with no guarantee they could meet quality, environmental, and workplace condition standards.

Breckinridge agrees with the conclusion of this Bain & Company study, in which consultants predict that the pandemic's impacts will push management teams to focus on resilience in their corporate supply chains (Figure 1). They may shift to a closer and more diverse base of suppliers, thereby building redundancy and reducing risk.

FIGURE 1: A GROWING NUMBER OF RISKS THREATEN SUPPLY CHAINS TODAY, BUT INVESTMENTS CAN RESTORE RESILIENCE



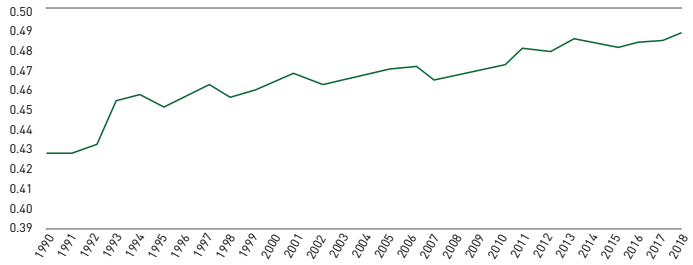
Source: Bain & Company

Breckinridge is assessing corporate supply chain risks magnified by the COVID-19 crisis through engagement and ESG research. During engagement discussions, we ask about management's decisions to either shift away from or support its suppliers. Many companies with complex supply chains, including one that we recently engaged with, are providing liquidity and financial assistance to suppliers struggling to stay afloat.

U.S. COMMUNITIES

It is well documented that the COVID-19 crisis is exacerbating the issue of inequality in the U.S. As noted in Figure 2, income inequality has been on the rise for many years. In addition, income level disparities can be seen across racial groups.

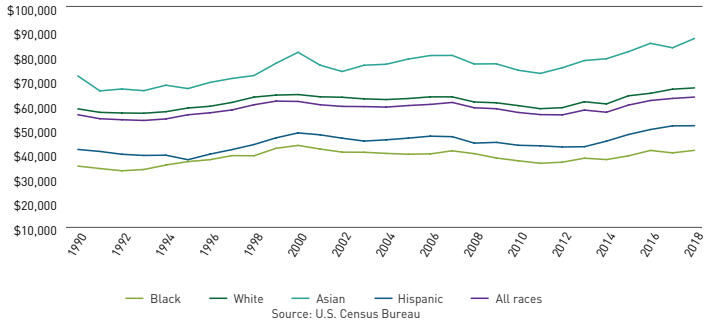
FIGURE 2: U.S. INCOME INEQUALITY CONTINUES TO INCREASE TO RECORD HIGH LEVEL
Gini Index



"The Gini coefficient ranges from 0, indicating perfect equality (where everyone receives an equal share), to 1, perfect inequality (where only one recipient or group of recipients receives all the income)," according to the US census Bureau.

Source: U.S. Census Bureau, Moody's

FIGURE 2: RACIAL DISPARITIES IN INCOME ARE LONG-STANDING AND GROWING
Real Median Household Income By Race



Source: U.S. Census Bureau

The recession brought on by the pandemic is worsening inequality. As noted by Federal Reserve Chairman Jerome Powell, 40% of all U.S. households making less than $40,000 lost their jobs during the month of March 2020.[2] Moody's Investors Service commented in a recent report that the "pandemic has also highlighted other shortcomings and inequalities in the US healthcare system, with coronavirus infection rates and deaths significantly higher among racial and ethnic minorities and lower-income populations."[3]

The killing of George Floyd sparked countless protests and vigils about systemic racism, police behavior and its impact on black and minority communities. However, protesters are also calling for a more equal and just economy and healthcare system. Moody's stated that inequality along with other social issues represent additional sources of credit risk for communities across the country.

From an ESG research perspective, Breckinridge aligned its framework to evaluate ESG risks for cities and counties with the *Social Progress Index* (SPI) in 2016. The alignment reflected our belief that local governments that consider the needs of all residents and strive to be inclusive communities are likely to be more economically resilient, poised for future growth, and overall less risky investments over time.

To monitor inequality and inclusivity, Breckinridge's ESG city/county framework includes such measures as the GINI coefficient, a measure of economic inequality, and a social infrastructure index. Social infrastructure captures the level of social support services in area, including libraries, green space, and day care providers.

Public engagement by elected officials and governmental agencies is another social issue that is being influenced by the pandemic. A crisis requires coordinated and steady communications from officials to inform community residents about the best ways to respond. The Centers for Disease Control encourages messaging during a health crisis to be "credible, correct and timely."[4]

The ability to communicate effectively during a crisis is complicated by the fact that people access their news today in variety of ways. During an engagement discussion in late 2018 with a city located in northern California, we learned how officials developed a strategy to engage with residents during natural disasters. The city formed a network of organizations and volunteers to ensure accurate information is directly shared with elderly and other at-risk groups.

To help systematically evaluate a government's ability and willingness to communicate with residents, Breckinridge is adding a community engagement indicator to the updated version of city/county ESG framework. Analysts are asked to consider a variety of topics, including how well government leaders communicate and involve constituents in capital planning and economic development projects, whether the issuer systematically considers racial, gender and economic disparities in its polices and planning, and whether the governing body is representative of the community. It is our belief that governments that engage and communicate effectively with their constituents will lead to more equitable outcomes and enjoy stronger taxpayer support for services and projects, providing extra stability to a community.

CONCLUSION

The COVID-19 crisis is impacting social issues for both municipal and corporate bond issuers and, in our view, heightens the value that ESG analysis can bring to credit research by adding extra-financial considerations to our evaluations. Breckinridge made the decision to integrate ESG considerations into our investment process back in 2011, with the primary objective to mitigate credit risk. We remain committed to this approach. We believe the evaluation of material ESG factors combined with fundamental analysis provides our analysts with a more comprehensive understanding of a borrower's credit profile.

FOOTNOTES:

1. Schatteman, O., Woodhouse, D., Terino, J. (2020, April). Supply Chain Lessons from Covid-19: Time to Refocus on Resilience. Retrieved from: *https://www.bain.com/insights/supply-chain-lessons-from-covid-19/*.
2. Moreno, J., (2020, May). 40 percent of households earning less than $40k lost jobs in March: Fed Chairman. The Hill. Retrieved from: *https://thehill.com/policy/finance/497527-40-percent-households-earning-less-than-40k-lost-jobs*.
3. Samuels, N., Richman, N., Blake, T. (2020, June). Social Unrest and underlying inequality pose fiscal and governance credit risks. Moody's Investors Service.
4. Newcombe, T. (2020, April). Governments Ramp Up Communications as COVID-19 Accelerates. Governing. Retrieved from: *https://www.governing.com/now/Governments-Ramp-Up-Communications-as-COVID-19-Accelerates.html*.