TD Asset Management

TDAM Sustainable Investing + 10 Minutes = New Thinking

The Importance of Environmental, Social and Governance Factors in Managing Private Credit Strategies

Within alternative investment strategies, integrating environmental, social and governance ("ESG") considerations into investment practices can help investors to capture sustainability-related opportunities and mitigate risks. Empirical evidence reveals that real asset owners who consider ESG factors in their processes are better able to compete in the markets where they operate, stay ahead of changing regulation and reduce resource use, which may lead to lower operating costs and higher risk-adjusted returns.[1] These implications directly impact the origination market. Ultimately, climate change is an increasingly prominent global issue driving the need for action within the investment industry including by private lenders.

At TD Asset Management Inc. ("TDAM"), ESG integration aligns with our philosophy to seek investments in sustainable, long-term assets through a risk-managed process. We were among the first Canadian bank-owned asset managers to sign the United Nations-backed Principles for Responsible Investment in 2008, and since 2016 we have been an active participant in external ESG benchmarking for real asset portfolios through the ESG Benchmark for Real Assets ("GRESB"). Broadly, the breadth of TD Bank's global footprint, with offices in more than 20 countries, equips the team with tools, resources and perspectives to apply when analyzing ESG factors. For example, all external major relationships are reviewed through TD Bank's Wealth Reputation Committee, while political, legal and regulatory considerations are also assessed by the Strategic Sourcing Group as well as the Material Change Oversight Committee. In this paper, we expand on the importance and relevance of integrating ESG factors in managing TDAM's private credit strategies.

Private Debt

Our Commitment to ESG

Private debt credit analysis at TDAM considers ESG factors in its internal credit rating methodology. As buy-and-hold investors, it is imperative that we assess the potential impact of ESG-related risks on the creditworthiness of a transaction prior to investing as ESG risks can potentially impact its credit profile.

The first step in our assessments is compliance under all relevant ESG related regulations. For example, in all real estate debt transactions TDAM invests in, land conditions must meet all applicable environmental laws. The borrower, at its cost, must deliver to the lenders a clean environmental site assessment (also known as "Phase 1") produced by an authorized environmental consulting firm. If contaminants are found to be in excess of the applicable legal limits, the borrower must remediate any deficiency and deliver a Phase 2 (or Phase 3) report to the lenders before the transaction takes place. Why is this necessary? TDAM may not be able to refinance the loan at maturity or worse, may suffer a capital loss in a realization scenario, among other potential liabilities.

The same logic applies to the social and governance factors: do we want to be tied to a borrower with little regard to labour laws or engages in anti-competitive practices? As senior lenders, we have no equity upside potential and such risks expose our capital to economic and reputational impairment.

Our preference is to pursue financings that feature very strong ESG credentials, as illustrated in the New Brunswick Wind Farm case study insert.

As a second step, TDAM's public and private investment grade credit research teams systematically analyze ESG risks and opportunities within their credit research as part of the approval process. Not only does every investment-grade issue on our Credit Committee approved list have an internal credit rating but is also ascribed a "TDAM ESG Risk Score". The score identifies the potential ESG risks faced by borrowers, mainly in terms of financial and/or ratings impacts. The overall output of this process is a score from 1 (lowest risk) to 10 (highest risk) reflecting the relative ranking of ESG risks.

Our Commitment in Action: New Brunswick Wind Farm

- TDAM financed the construction and operation of a 167MW wind generation facility located near Moncton, New Brunswick
- TDAM's financing supports the transition to renewable power, helping both New Brunswick and Canada achieve carbon reduction
- Helped a key power producer with a century-long reliance on coal in their evolution to renewables
- In assessing ESG risks, the TDAM Private Debt team analyzed the environmental impact of the project, including wind resource risk, in conjunction with independent experts
- Attractive location on rural Crown land, combined with experienced ownership by a public company mitigates Social and Governance risks

No industry-wide consensus provides quantifiable, precise risk scores across the myriad of different ESG factors. Instead, TDAM analysts use their best judgment to identify and score a comprehensive set of ESG risks. Quantitative scores on standardized criteria allows comparability to similar transactions across similar industries. These scores are explicitly integrated into the final credit rating – and subject to standard TDAM processes of peer review and Credit Committee vetting.

ESG findings and scores are documented and stored in a database in a standardized format. This ensures a robust and repeatable process, and consistency for reporting and auditing purposes. Ultimately, the ESG score allows portfolio managers to assess ESG-related risks associated with a borrower and make portfolio construction decisions accordingly.

Evolution of TDAM ESG Focus

Credit Risk Rating Analysis

- ESG factors historically considered in "Event Risk" sub-category

Separate ESG Analysis & Scorecard

- To draw greater attention to ESG factors specifically, a separate analysis process was initiated

Credit Research ESG Database

- Internal ESG Database created
- Database leveraged by Portfolio Managers to track ESG exposure

Future Initiatives

We invest on behalf of our clients in fixed rate loans that provide stable and predictable cash flow over the investment period. Locking into multi-decade investments demands investment resilience and sustainability. It also requires a clear view of how future developments could introduce new risks – particularly from ESG-sensitive elements such as climate change, societal inequality or disruptive technological change. While an ESG focus has long been an integral part of our underwriting processes, TDAM's commitment to industry leadership in this area requires a focus on continually gathering, refining and applying ESG criteria to increase the resilience of our investments.

Resilience

Commercial Mortgages

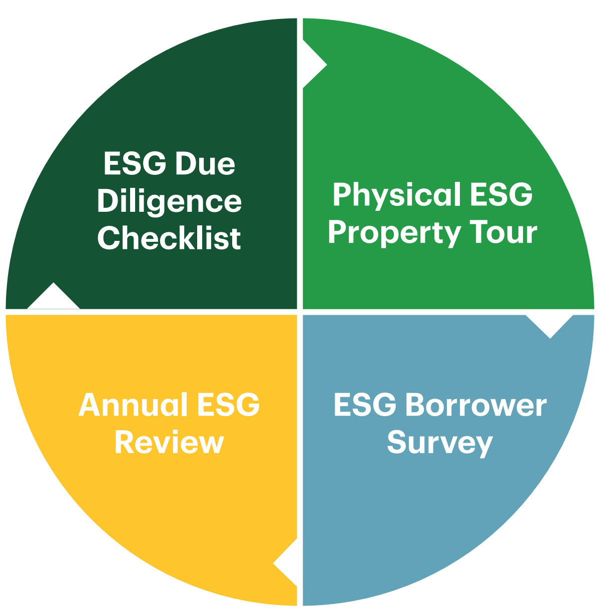
Our Commitment to ESG

The TD Greystone Mortgage Fund (the "Fund") integrates ESG best practices into its process in order to enhance risk-adjusted returns, to play its part in responsible investing, and to raise ESG awareness in the market. Moreover, investments in sustainability can improve real estate marketability to environmentally and socially conscious tenants and enhance operational efficiency by reducing utility and insurance costs, which benefit the tenant, the landlord, and ultimately the lender.

The Fund has developed a multi-faceted approach to incorporating ESG into its underwriting and portfolio management practices. During origination, each mortgage opportunity has its own dedicated ESG Due Diligence Checklist where environment, social and governance factors are evaluated. Underwriting ESG is then bolstered by a physical ESG Property Tour, where ESG Strategies, Energy Efficiency, Waste Management, and Utility Targets are gathered on site. ESG is also integrated into portfolio management process through the Fund's ESG Borrower Survey and the Annual ESG Review. While the ESG Borrower Survey and Annual ESG Review are subsequent to the underwriting stage, information is tracked and incorporated into future originations.

As a result of ESG initiatives, the properties underlying the Fund's loans may achieve superior efficiency versus other comparable buildings in the market. Operating efficiencies can be difficult for mortgage lenders to model, especially if a building is being retrofitted or is under construction. Lenders will often rely on comparable properties that do not have the same sustainability factors. The Fund is afforded the luxury of more accurately incorporating the operating efficiencies of ESG factors into our underwriting as a result of the information advantage of being fully integrated with the TD Greystone Real Estate team. For instance, a new apartment building that invests in energy efficiency will typically observe operating costs less than 30% of the gross revenue, while older generation apartment buildings have operating costs closer to 45% of the gross revenue. Lenders who solely rely on market comps for underwriting will not fully incorporate the ESG benefits, will inflate operating costs and underestimate the free cash flow generation of the building, and ultimately misprice the opportunity.

ESG Investment Approach of the TD Greystone Mortgage Fund



Our Commitment in Action

One York, Toronto, ON

The Fund advanced a $60 million 10-year first conventional mortgage secured by a recently completed office tower and retail podium located in the heart of Toronto right next to the Scotia Bank Arena. With an attractive coupon (GoC + 195 bps) and a loan-to-value below 60%, the stability of income from this property was bolstered by best-in-class ESG metrics. The commercial tower and its dedicated portion of the podium not only achieved LEED® Platinum certification, but also earned 89 points – the highest score ever awarded to a Toronto building.

The following was accomplished:

- 15% recycled and 35% regional materials used for construction
- 300 bike racks and shower facilities
- Preferred parking spaces for carpool vehicles
- Electric charging stations have been provided on site
- 5 million litres of annual water savings through rainwater cistern and plumbing system
- A solar panel array, which produces 86,000 kWh of energy annually
- Occupancy and daylighting sensors are installed on all interior office lighting
- A podium roof top garden provides a venue in which to enjoy an outdoor space in a dense urban area
- Forest Stewardship Council wood was used exclusively for the building
- Connected to the EnWave district energy system
- Certified low-emitting products were used in construction, including paints, adhesives, flooring and manufactured wood
- Underfloor demand control air distribution system.

Future Initiatives

Through the Fund's multi-pronged ESG approach, we believe our strategy can enhance risk-adjusted returns for investors, play a role as a responsible lender, and raise ESG awareness. We continue to enhance these benefits through better data tracking, increased touch points with borrowers, and improved ESG coordination at the TDAM firm level. As of March 31, 2021, 38% of the Fund's conventional commercial mortgages are BOMA/LEED® certified and we are looking to drive this number higher in the future. Ultimately, the Fund aims to increase ESG property certification and sustainability measurements through our ESG Due Diligence Checklist, Physical ESG Property Tour while tracking progress through our ESG Borrower Survey and Annual ESG Review. This will allow for enhanced portfolio management while providing additional information to be integrated into future underwriting opportunities. Furthermore, we believe the Fund's ESG initiatives are raising awareness of ESG issues in the commercial real estate community.

Going forward, our goal is to continue to implement best-in-class sustainability practices that may lead to enhanced risk-adjusted returns and better outcomes for clients, as we tackle challenges including climate change and social justice. ■

[1] Green Certification and Building Performance: Implications for Tangibles and Intangibles http://jpm.iijournals.com/content/41/6/151

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