Private Debt Investor

The A-Z of ESG

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26 ways to approach responsible investing

PEI

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The A-Z of ESG

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Insight

Key takeaways **Lenders have a central role in pushing the ESG agenda**

Whether it's through dialogue or data, sustainability-linked loans or social responsibility, gender diversity or GP engagement, there's a growing realisation that private debt fund managers have a crucial role to play in ensuring better environmental, social and governance outcomes, ***writes Graeme Kerr***.

To take stock of recent developments in the responsible investing arena, *Private Debt Investor* asked leading fund managers to help compile this A-Z of ESG and to comment on the topics that resonate most strongly with their operations. Here are seven key takeaways from the report.

Data matters more than ever

ESG data and KPIs are moving up the agenda in private debt, especially where due diligence and sustainability-linked loans are concerned.

"The market right now is volatile and exacerbated by macroeconomic factors, which makes ESG more important as a tool for business resilience," says Salma Moolji, European ESG lead at Ares Management.

For Ares, the priority is sustainability-linked loans with a focus on "measurable indicators", KPIs with an emphasis on more credible and measurable data, and "deepening our commitment across our portfolio to more specific and more urgent themes, including climate change and diversity, equity and inclusion", Moolji says.

Due diligence is at the heart of ESG

Lenders are now increasing their focus on ESG credentials at the start of the investment process and are devoting more resources to due diligence.

"The due diligence process for direct lending takes multiple weeks and has different stages, with ESG analysis featuring throughout," says Michael Curtis, head of private credit strategies at Fidelity International. "This includes during our loan documentation negotiations, because there will be commitments that we will be looking for from borrowers that pertain to ESG."

Curtis says a key factor in the overall perception and rating of a business is the assessment of the company's general commitment to engagement and change on ESG: "You can send a 160-page questionnaire to a company to fill out and they can respond, but we are not just looking for disclosure, but a genuine assurance from companies to commit to substantive ESG targets."

Lenders are becoming ever more mindful of social issues

Environmental and governance considerations in ESG have typically taken priority as they were considered easier to understand and track, but there is growing commitment to social responsibility.

Social factors should be embedded into all risk management and investment decision-making frameworks, says Paul Woods, director of sustainability, at Arrow Global.

"Organisations need to be able to understand and quantify social considerations alongside any other investment criteria irrespective of the economic cycle, because if a manager is going to generate a long-term return, then neglecting the 'S' is going to create problems down the line," says Woods "This is now so embedded in most firms' investment approaches that it is unlikely to slip away."

Carbon reporting is a growing priority

Private debt firms are increasingly making commitments to reduce their portfolio-level emissions – which entails measuring and reporting emissions across portfolio companies. But this is easier said than done.

"Very few private middle-market companies have been able to calculate their Scope 1 and 2 emissions and almost none [for] Scope 3 emissions – they generally don't have the expertise or resources to do so," says Mickey Weatherston, head of sustainability and ESG integration at Churchill Asset Management, an investment specialist affiliate of Nuveen.

In the meantime, given the difficulty in collecting data, Weatherston says that modelling is the "best way to provide our investors with a reference data point on carbon emissions". Churchill engages specialist third-party data providers to model emissions for its portfolio companies, based partly on emissions reported by companies with similar characteristics.

Private debt is starting to embrace impact investing

Achieving positive social and environmental impacts is a top priority for a growing range of investors, with the market for impact investing estimated to have reached $1.164 trillion, the Global Impact Investing Network announced in October.

The private debt industry is looking to impact investing, partly in response to pressure from asset owners.

"There is a growing trend for investors to demand impact alongside financial returns," says Coralie De Maesschalck, head of CSR and ESG at Kartesia. "We have seen that quite strongly, especially since covid – I think the pandemic made everyone realise that we need to change the way we are living."

De Maesschalck notes that the EU's Sustainable Finance Disclosure Regulation, or SFDR, which created the Article 9 designation as a label to allow managers to differentiate impact funds, has helped spur investor interest. "The SFDR helps investors to understand which funds are actually offering real impact, which is making LPs more comfortable investing into funds that have the appropriate labels," she says.

Alignment can achieve better outcomes

Private debt managers can achieve better ESG outcomes if they align their interests with multiple stakeholders – including sponsors, LPs and the management teams of portfolio companies.

While still nascent in private debt, Emilie Huyghues Despointes, ESG officer at MV Credit, says the European credit specialist plans to link carried interest in its future funds to ESG metrics. This would see executives rewarded for the firm hitting its KPIs relating to ESG.

Meanwhile, it is, of course, also critical that private debt lenders align with sponsors in their approach to ESG. "We used to hear a lot that it's not the place of the lender to engage the borrowers and try to provide support on ESG," says Huyghues Despointes. But things are changing. She says she is regularly invited by MV Credit's main private equity sponsors to attend quarterly calls or site visits, and notes that sponsors and lenders are working together to find ways to help streamline ESG reporting for portfolio companies.

LPs are demanding more transparency

Investors and regulators are demanding greater transparency from lenders on the ESG performance of their portfolio businesses. Antoine Peter, manager at Arendt, cautions that transparency "can be a bit of a double-edged sword".

"On the one hand," says Peter, "many asset managers want to inject more transparency into their fund offering documents in order to protect themselves against mis-selling claims and make sure that they are meeting the expectations of their investors. Everyone has a different definition of what 'sustainable' is, and so greater transparency helps fund managers avoid some of this confusion.

"But, on the other hand, increasing transparency also risks exposing fund managers to greater levels of scrutiny and criticism by allowing investors to gain a better insight into what is actually going on. This is not just about what NGOs and journalists might think. It is also about how investors see things." ■

Editor's letter

The shifting ESG agenda

Graeme Kerr
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When we surveyed fund leaders earlier in 2022, there was overwhelming agreement that a stronger ESG vision and culture creates value for a business. The environmental, social and governance agenda has, as one respondent put it, moved from a "nice to have to a need to have", with LP pressure the main driver, according to the *Private Funds Leaders Survey 2022*.

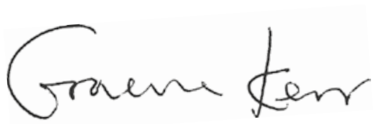
Those responses are mirrored in our latest *LP Perspectives* survey, where 69 percent of investors believe adopting a strong ESG policy will lead to better long-term returns in their private markets portfolios.

The big caveat, of course, is what exactly constitutes a strong ESG policy. Opinions differ widely. Just 1 percent of LPs in our latest *Perspectives* survey described diversity, equity and inclusion performance at GPs as "excellent" and only 10 percent strongly agreed that GPs are taking the risks of climate change seriously enough in their own investment policies and practices.

"ESG is about much more than just three letters"

For this A-Z, we have canvassed the opinion of leading fund managers and investors to ask the elements an effective ESG policy should comprise of. What are the focus points for fund managers and investors? And where exactly can lenders align with private equity sponsors to create a meaningful approach to responsible investing?

Some tough decisions were involved in selecting a single topic for each letter. You might not agree with all our choices, but that's what makes ESG such a rich area for discussion. So, whether it's A for alignment or active ownership, B for biodiversity or best-in-class, C for carbon reporting or climate change, one thing is absolutely clear: ESG is about much more than just three letters.



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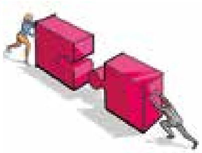
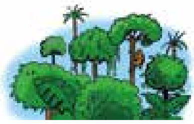
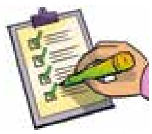
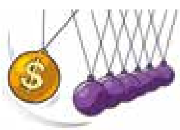








The A-Z of ESG

To say that environmental, social and governmental issues have been rising up the agenda for private debt would be something of an understatement.

Whether it is the need to consider climate change, the growing importance of diversity and inclusion or the increased emphasis on due diligence as LPs up the ante on transparency, ESG and responsible investing have become two crucial areas of difference between fund managers.

In our A-Z of ESG in private debt, we have identified 26 topics that illustrate what a socially responsible approach to credit markets should embrace. The topics were the result of extensive canvassing of the opinion of ESG leaders, fund managers and investors as to exactly what each letter should stand for.

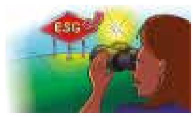
The choices highlight just how fast responsible investing is growing as a subject area and how quickly the debate is changing. For instance, B is for biodiversity. With all the focus on carbon emissions and climate change, it is easy to overlook other human impacts on the environment – including the grave crisis facing the world's biodiversity as a result of human activity.

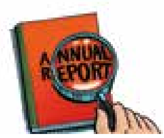
While few private debt managers have made biodiversity a focus area, the asset class will inevitably face growing pressure to compel borrowers to assess and disclose nature-related impacts. Indeed, biodiversity is in the crosshairs of regulators in some jurisdictions, such as France and the Netherlands, where financial institutions are required to identify their exposure to biodiversity risks.

There's something for everyone in this A-Z, whether it is A for alignment, I for impact investing or Z for zero emissions. That's the benefit of the A-Z format for ESG. It expands the sustainability debate beyond its titular three letters to offer some thought-provoking examples of just why responsible investing has become an area of such importance to fund managers and investors alike.

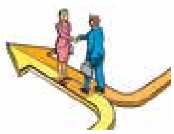








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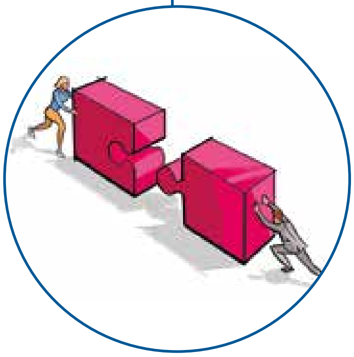

Alignment

Private debt managers that want to achieve better ESG outcomes need to align their interests with multiple stakeholders – including sponsors, LPs and the management teams of portfolio companies.

An increasingly prominent way to achieve alignment with portfolio companies is through sustainability-linked loans. These contain ESG ratchet mechanisms, which allow borrowers to benefit from cheaper financing if they can achieve KPIs linked to ESG metrics.

Rita Mangalick, global head of ESG at Blackstone Credit, told a *Private Debt Investor* panel in May that SLLs are a "key tool that credit can use to track and measure ESG value creation". Providing that "KPIs and the sustainability performance targets are appropriate and clearly defined" it is possible to ensure that "all stakeholders' incentives are aligned".

Ares Management agreed a £1 billion ($1.19 billion; €1.15 billion) loan with environmental engineering consultancy RSK Group in August 2021, one of the largest such deals in the market to date. As Blair Jacobson, partner and co-head of European credit at Ares, told us in January: "In order to work well, the target KPIs on these loans have to be real, measurable and quantifiable by a third party, and it can't be a one-way street."

RSK will receive a discount on its interest rate if it meets its KPIs – but the rate will increase if it fails to do so. Borrowers need to "take it seriously", Jacobson told us. "It can't be a free option – it needs to work for all the stakeholders. When it works, it's beautiful, and we believe it's going to become much more common."

Although there is still much discussion about the relevance and measurability of KPIs, these types of financing structures are becoming relatively commonplace in European private debt. Some private fund managers believe a similar approach can also bring about greater alignment between GPs and LPs by linking carried interest to ESG performance.

While this is still nascent in private debt, Emilie Huyghues Despointes, ESG officer at MV Credit, tells us that the European credit specialist plans to link carried interest in its future funds to ESG metrics. This would see executives rewarded for the firm hitting its KPIs relating to ESG.

Meanwhile, it is, of course, also critical that private debt lenders align with sponsors in their approach to ESG. "We used to hear a lot that it's not the place of the lender to engage the borrowers to try to provide support on ESG," says Huyghues Despointes. Now, things have changed. She says she is regularly invited by MV Credit's main private equity sponsors to attend quarterly calls or site visits, and notes that sponsors and lenders are working together to find ways to help streamline ESG reporting for portfolio companies.

E X P E R T Q & A

MV Credit's Emilie Huyghues Despointes discusses how lenders need to collaborate with multiple stakeholders

Finding alignment on ESG

Over the past few years, private debt lenders have come under ever greater pressure from LPs to demonstrate their ESG credentials. At the same time, they need to build good working relationships with portfolio company owners (typically private equity sponsors) and their management teams to effect change.

Emilie Huyghues Despointes, ESG officer at MV Credit, tells us that a range of incentive schemes can help ensure that all stakeholders are able to align their interests when it comes to ESG. Helping companies to improve their ESG performance, she notes, will ultimately be a lever for value creation.

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Q Why is it important to bring all stakeholders onto the same page when it comes to ESG?

ESG needs to be inherent to the business – part of everything we do. At MV Credit, we have fully integrated ESG throughout our existing investment procedures, and as an organisation, we follow the same ESG principles we expect of our portfolio companies. In the end, it helps to be fully transparent and to make sure all our stakeholders understand that we do what we say we'll do.

Q How do you assess ESG when you're making investments?

Our ESG investment procedures are fully integrated into our investment approach. We invest in transactions alongside private equity owners, so in the pre-investment phase our deal team will start by assessing the ESG profile of the private equity sponsor. The idea is to make sure we invest alongside private equity sponsors that are aligned with our values. We look at whether the sponsor is a Principles for Responsible Investment signatory or has made equivalent commitments – this should confirm that the principles are being followed throughout the life of the investment.

Then we have the screening phase. The deal team applies a negative screen via our exclusion lists. MV Credit does not invest in certain sectors, industries or activities. For example, the list excludes industries involved in weapons and fossil fuels. We also exclude some sectors based on our own strong convictions, as well as market standard exclusions. We have chosen not to invest in nursing or care homes because we think these businesses with vulnerable customers do not fit well with private equity ownership.

The next step is to perform a controversy analysis, which is performed by an independent expert that works with us and uses a proven methodology. The purpose of the controversy screening is to make sure that we have not missed an incident involving a company that may negatively impact the stakeholders or the environment. This could harm the reputation of the company, and ultimately affect its financial profile.

The deal team is also responsible for identifying, evaluating, and managing ESG opportunities and issues within each investment. For that, the borrower will fill in a proprietary ESG assessment questionnaire that we have co-designed with an external adviser. It includes 55 KPIs, covering E, S, G and stakeholder topics.

Q How do you incentivise borrowers to improve their ESG performance?

Roughly 20 percent of the transactions we see in the market include ESG ratchets in the structure. These sustainability-linked loans are designed to incentivise the borrowers to improve their performance against ESG criteria that are predetermined before the closing of the transaction.

It is not included in all our transactions, but it's something we see more and more in the market. We offer these sustainability-linked loans to borrowers and will help the private equity sponsor and a company's management team select the KPIs we want the borrower to focus on.

For ratchet mechanisms to be effective, we really need to have tailor-made structures and select the right KPIs. For example, if we invest in a company with a big workforce that has a lot of workers earning the minimum wage, then we'll tend to focus more on the social aspects. We really try to adapt to the business itself.

Overall, these loans are a very good

Q How do you ensure alignment with LPs?

We now get a lot of requests from LPs on ESG. Even just three years ago, we would only receive ESG questions from investors every two or three months – and these would be at the bottom of the list investors would send to us. Now, things have changed a lot. We can see that LPs are very focused on ESG.

We are fully transparent with our LPs. We provide them with a dedicated ESG report annually, in which we summarise everything we have achieved on ESG and set out our objectives for the coming years. We provide scorecards for each borrower and compare their performance to a benchmark.

The other mechanism we have developed for one of our latest funds is ESG-linked carried interest. This is a way to align with both ESG and the LPs, and it follows a similar approach to a sustainability-linked loan. We link some of the carried interest against three KPIs. The first one covers the percentage of senior women in the firm. The second KPI is the overall response rate to the fund's annual borrower ESG questionnaire – which incentivises us to enhance engagement and transparency with the portfolio companies. And the final KPI is the fund's overall ESG score; this is based on the questionnaire we send on an annual basis to each borrower.

signal to the market that companies and investors want to do things the right way and go down the road of sustainability.

However, it is still early days. The ratchets down or up are still very low – normally between 7 basis points and 10bps on the margins. But these structures nevertheless put ESG front and centre for borrower management teams.

Q What actions do you take as an organisation to demonstrate a commitment to ESG?

We apply, as a firm, the same kind of requirements that we ask of our borrowers and partners. So, we are signatories of the PRI and other major initiatives. We are also active in supporting various charities. For example, we began a partnership earlier this year with a charity called Raise Your Hands. They act as a broker for smaller, local charities and our team spends volunteering days with one of these charities once or twice a year.

We are very focused on diversity and inclusion. Women represent more than 50 percent of the total headcount at MV Credit. Additionally, the percentage of women in senior executive roles is more than three times the estimated average for private debt (11 percent). We have 16 nationalities among 68 people working at the firm, showing that we really believe that diversity adds to our work.

Finally, we calculate our carbon footprint as a corporation, and take actions to reduce our negative impacts.

Q Do you agree that there is now greater collaboration between private equity and private debt firms on ESG?

Yes – in respect to ESG we have the same goals, so it's always positive to work together. We used to hear that it's not the place of the lender to engage the borrowers and try to provide support on ESG. But we typically have very good access to the management team of the company – certainly compared with listed equities, for example. We clearly have a role to play, alongside the sponsor.

"In the UK, investors are very focused on climate but may not place the same emphasis on the SFDR classification"

"Roughly 20 percent of the transactions we see in the market include ESG ratchets in the structure"

I regularly meet with the four or five sponsors with whom we have the most transactions to discuss the portfolio companies and how we could better work together.

We all want to work closely with the companies and support them on their ESG journey. As such, it's important we're fully aligned to make the borrower's life easier. We try to be clear and simple to reduce the number of requests the borrower receives. It would be tedious to send out our questionnaire and then two or three other lenders send theirs, as well as the sponsor itself – usually with all the same questions. So, we work hard to avoid multiple requests going out to the same company.

Q How is ESG regulation affecting your work?

We already have two existing funds classified as Article 8, and we are committed to ensuring all future funds will be classified as Article 8. Whether the Article 8 classification is important for LPs tends to vary depending on where they are based.

We find French investors are very focused on SFDR classification and some have already asked for funds to be Article 9. In the UK, investors are very focused on climate but may not place the same emphasis on the SFDR classification.

My opinion is that Article 8 will become a must-have, but we haven't been down this road for regulatory reasons – it's really by conviction. We believe in the positive aspects of ESG on the investment side and the fact that it helps achieve positive outcomes for society and the environment. From an investor perspective, I strongly believe that ESG adds value. In the long term, the more sustainable a company is, the more profitable it will be. ■

Biodiversity

With all the focus on carbon emissions and climate change, it is easy to overlook other human impacts on the environment, including the grave crisis facing the world's biodiversity.

According to the World Wide Fund for Nature, monitored wildlife populations have declined by an average of 69 percent since 1970. A 2019 UN report warned that one million plant and animal species are threatened with extinction. Many scientists argue that the extent of damage to biodiversity is such that the Earth is entering its sixth period of mass extinction.

The biggest threats to plants and animals come from changes in land use, notably deforestation and urbanisation. Climate change is another key driver of biodiversity loss: extreme climate events such as floods and drought can cause mass animal mortality.

Investors are beginning to wake up to the threat. The Taskforce on Nature-related Financial Disclosures (TNFD) was established in 2020 to develop a risk management and disclosure framework to encourage organisations to report on nature-related risks. The goal, according to the TNFD, is to support "a shift in global financial flows away from nature-negative outcomes and towards nature-positive outcomes".

While few private debt managers have made biodiversity a focus area, the asset class will inevitably face growing pressure to compel borrowers to assess and disclose nature-related impacts. Regulators in several jurisdictions, including France and the Netherlands, are taking a keen interest in biodiversity. In those countries, financial institutions are required to identify their exposure to biodiversity risks.

Ashim Paun, head of sustainable investing at Triton Partners, told affiliate title *New Private Markets* in April that fund managers need to see biodiversity as a priority. "Private capital is particularly well placed to help the world address biodiversity issues, both by encouraging best practice within investment portfolios and by backing innovative businesses proactively tackling the crisis," he said.

One way to address biodiversity impacts is through a 'natural capital' approach. This is based on an understanding of nature as an asset that provides benefits to human society. The approach provides a system that helps account for gains and losses to biodiversity. Investors are then better placed to measure how their activities affect biodiversity, and to prioritise investments that produce net benefits for nature.

"We also seek to invest in companies offering products and services that are well placed to provide solutions to biodiversity loss," Paun said. "We view natural capital as an investable theme in and of itself, not just an exercise in risk management."

Carbon reporting

Private debt firms have increasingly made commitments to reduce their portfolio-level emissions – which naturally entails measuring and reporting emissions across portfolio companies.

This is easier said than done – there is much uncertainty over what should be measured and reported. Even calculating Scope 1 and 2 emissions, which cover emissions in companies' own operations and the emissions generated in producing energy that companies use, is far from straightforward. And Scope 3 emissions – the upstream and downstream emissions that companies are only indirectly responsible for – are considerably more difficult to estimate.

By no means all publicly traded companies report Scope 1, 2 and 3 emissions. Reporting is also still less advanced among mid-market companies that tend to receive financing from the private debt market. "Very few private middle market companies have been able to calculate their Scope 1 and 2 emissions and almost none on Scope 3 emissions – they generally don't have the expertise or resources to do so," says Mickey Weatherston, head of sustainability and ESG integration at Churchill Asset Management, an investment specialist affiliate of Nuveen.

On the positive side, managers can access a growing toolkit of resources to help with carbon reporting. In May, for example, the Initiative Climat International published guidance for GPs that promotes a consistent approach to reporting emissions at portfolio company and fund levels.

"As we partner with more PE sponsors on emissions reduction plans, and as investors request better emissions data, we hope that middle market companies will improve their capacity to calculate their true carbon footprint," says Weatherston.

In the meantime, given the difficulty in collecting data, Weatherston says that modelling is the "best way to provide our investors with a reference data point on carbon emissions". He tells us that Churchill engages specialist third-party data providers to model emissions for its portfolio companies, based partly on emissions reported by companies with similar characteristics.

Regulatory pressures, meanwhile, are driving managers to develop their approach to carbon reporting. In the EU, SFDR requirements for reporting Scope 1, 2 and 3 emissions, among other data, will be tightened from January 2023.

Kirsten Lapham, partner at law firm Proskauer, said the limited availability of data on ESG is a key issue. Some managers, she said, are insisting on contractual provisions in loan agreements to ensure access to relevant data. She told *Private Debt Investor* in May the supply of data will improve as regulatory requirements become embedded: "We expect to see a hotch-potch of best efforts to start with, and disclosures will all look a bit different, but after a few years the market will evolve."

EXPERT Q&A

A detailed assessment of ESG performance is required for effective due diligence – a harmonised approach needs to be adopted, says Churchill Asset Management's Mickey Weatherston

ESG data takes centre stage

Over the past few years, the private credit industry has realised that a thorough assessment of a borrower's ESG exposure is critical to effective underwriting. Moreover, LPs are putting pressure on private credit lenders to supply data on the ESG performance of portfolio companies, most notably around carbon emissions.

Mickey Weatherston, head of sustainability and ESG integration at Churchill Asset Management, an investment specialist arm of Nuveen, reflects on some key ESG trends facing the asset class. He tells us a more harmonised approach to ESG reporting is needed to allow the industry to move forward.

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Q How do you integrate ESG factors during pre-investment due diligence?

We consider ESG factors from the moment an opportunity comes across our origination team's desk. ESG issues are front and centre for every deal we review and underwrite. They are as important as any of the other credit metrics we use in our underwriting process. We start by screening a potential investment against our firmwide exclusion policy – if a company participates in an industry or sells a product or service that appears on our exclusion policy, we decline the deal at that very first stage.

If an opportunity passes this initial screen, we run our materiality assessment on the business. The materiality assessment helps us identify broader ESG issues. It also helps us narrow down the questions we will focus on during the management assessment we complete for every company. Environmental topics might not have been considered by our underwriting teams four years ago, but now that there is a push towards a low-carbon economy, it is critical that we consider how businesses are affected by transitional risks, as well as physical climate risks.

The assessment uses a proprietary rating tool that Churchill developed in partnership with Nuveen's responsible investment team. It assigns a risk exposure score to sector-specific ESG issues for every portfolio company we review. It also looks for alignment to the UN Principles for Responsible Investment (PRI), the UN Sustainable Development Goals (SDGs), and it helps us identify if there's a potential violation of the UN Global Compact, or the OECD Guidelines for Multinational

Enterprises. If something is flagged as a violation, we'll immediately decline the deal.

Q In terms of reporting and disclosing ESG performance, do you see a need to harmonise different approaches?

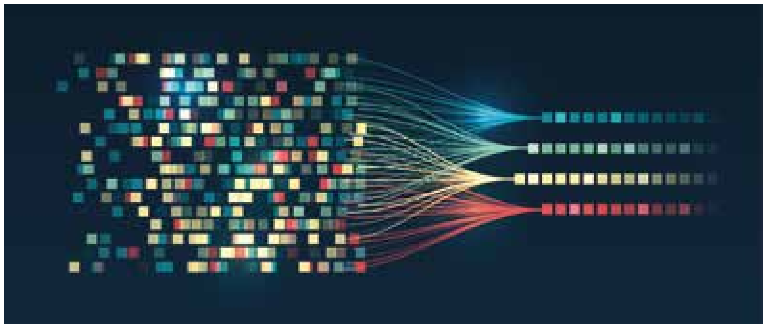
It is very important, especially on the private credit side, where we rely on the sponsor to provide as much information as possible. The breadth and quality of the ESG data we receive on a potential opportunity increases our chances of identifying material ESG risks and opportunities. This then maximises the quality of due diligence and underwriting we can perform for our investors.

Right now, a large number of industry groups and data vendors are coming to the market trying to help portfolio companies track what are deemed the most important issues and metrics. However, one of the data collection efforts needs to win out and become the most prominent, so we can all start applying the same framework. As a lending partner to the private equity community, we recognise that having to complete multiple different ESG questionnaires from lenders creates inefficiencies for PE firms.

Fortunately, the industry is moving towards harmonisation. We partnered with the UN PRI and other signatories to help develop the Private Credit-Private Equity ESG Factor Map, which promotes information sharing during pre-investment due diligence. We are also supporting the Loan Syndications and Trading Association (LSTA) in its partnership with the Alternative Credit Council (ACC) and PRI on their ESG Integrated Disclosure Project, which is pushing for consistent disclosures across the credit market.

If all market participants work from a standardised data set, which maps to some of the key industry frameworks like the Sustainable Finance Disclosure Regulation's (SFDR) Principal Adverse Impact indicators or the LSTA's ESG Data Harmonization Project, we can more effectively implement ESG integration internally.

The ideal is to work from the same large data set as other market participants. We can then bring the data inhouse, use it in our proprietary rating tool, and factor it into our due diligence process.



Q Which types of ESG data are key priorities for your investors?

Carbon emissions data are top of mind for all our investors. The types of data being requested become more granular by the day. I just received a 120-itemised ESG questionnaire from an investor, and two-thirds of the questions were on environmental factors, with a great deal of information on carbon emissions requested.

Right now, European LPs are leading the charge. This is due in large part to regulatory requirements under the SFDR, as well as end investors placing a high priority on a transition to a lower carbon economy. Oftentimes, the investor has already made a net-zero commitment, so it needs to compile data across all its funds and investments. A lot of investors are asking for information on the carbon intensity of their funds, including Scope 1, 2 and 3 emissions data.

"ESG issues are front and centre for every deal we review and underwrite"

Q How do you ensure you are aligned with PE sponsors on ESG?

This is where the power of Churchill's platform plays a really important role in our ESG integration process. Along with being a lending partner and equity co-investor to the private equity community, we're also an LP in more than 250 private equity funds and sit on over 200 advisory boards.

This gives us a deeper understanding of the practices of the sponsors we partner with. We can align on ESG risks and opportunities in ways that we otherwise might not have identified had we not been an important investor to the sponsor.

In addition to that, the number of third-party ESG due diligence reports we receive from sponsors is rapidly increasing. The data harmonisation efforts are also leading to greater collaboration with our sponsors on ESG due diligence, and on portfolio monitoring. We re-rate our portfolio annually, based on a quarterly portfolio review, to identify any material issue risks that might have arisen since we first rated the company. Partnerships with sponsors are very important to us. The harmonisation of data and the power of being an LP with top-tier sponsors has been a great advantage.

"Carbon emissions data are top of mind for all our investors. The types of data being requested become more granular by the day"

Q Given that asset owners are increasingly looking for data on carbon emissions, how do you estimate the carbon emissions of the companies you lend to?

Very few private middle market companies have been able to calculate their Scope 1 and 2 emissions and almost none their Scope 3 emissions – they generally do not have the expertise or resources to do so. We felt that the next best thing was to model emissions for all the portfolio companies we lend to.

We are working with Persefoni, a top-tier climate disclosure and carbon management solution, to compile data points and draw on data from public companies that have disclosed emissions data. We can use these datasets as proxy data to model the emissions of private middle market companies that operate in similar subsectors.

As we partner with more PE sponsors on emissions reduction plans, and as investors request better emissions data, we hope that middle market companies will improve their capacity to calculate their true carbon footprint. But our current feeling is that modelling is still the best way to provide our investors with a reference data point on carbon emissions. I've been very impressed with the quality of the data we've been able to generate.

Q Sustainability-linked loans (SLLs) have attracted a lot of attention recently, especially in Europe. Can these be a game changer for private credit in promoting sustainability?

The US is probably at least a couple of years behind Europe, but the potential benefits of SLLs are obvious. These loans enable lenders to partner with a sponsor and a portfolio company to identify the key ESG priorities. Then they encourage the company to focus on making changes in its business practices to address the issues. If a company is properly incentivised to tackle the challenges – for instance, lowering emissions or reducing waste – then the odds are that the issues will be addressed more quickly than they would otherwise have been.

It's probably the next frontier for ESG investing in private markets – for now, we're taking a cautious approach. We'd like to see the US market for SLLs evolve and mature a little bit more. It's taken a few years for the European market to develop – we need to see the US also put some controls in place to ensure that lenders do not get caught up in greenwashing claims.

Q What are the key challenges in ensuring SLLs are effective?

The common feedback we hear on the first wave of SLLs in the US market is that they still have a lot to deliver. There is no real penalty if the company does not achieve its goals. I think to be credible, there has to be a penalty for not achieving goals, in the same way companies get a price reduction for hitting their target. And both the penalty and incentive need to be meaningful – at least 15 basis points.

Also, it's important that the criteria and KPIs used to determine whether the borrower gets a discount are determined through a partnership approach. The lender needs to have a seat at the table. If the borrower or sponsor just says: 'here is the goal, give us a discount if we meet it', that will carry less credibility.

Ideally, there should be interim targets to track progress, and KPIs should be audited by a third party. Data transparency is critical. There's going to be a greater regulatory focus on ensuring these products are working effectively and adhere to the metrics that they claim that they are tracking. ■

Due diligence

As ESG moves up the agenda for lenders, most are now increasing their focus on ESG credentials at the very start of the investment process by devoting resources to ESG due diligence.

Claire Hedley, ESG director at 17Capital, says: "ESG due diligence is now widely accepted as a standard part of a due diligence process. In most instances, it has evolved from a light-touch checklist approach to a more sophisticated and detailed approach that includes both qualitative and quantitative elements.

"Investors want to understand specific policies, procedures and initiatives on climate, diversity and other ESG topics. There is increasing focus on data so that ESG objectives can be quantified and progress against targets can be measured over time."

The process and approach varies between lenders. Davide Stecchi, managing director in underwriting at Arrow Global, says: "When it comes to a specific investment opportunity, the first thing we do is ask whether an investment is right for us. Following an upfront screening process that includes some mandatory exclusions, the origination team starts by identifying any ESG risks. As we move into the formal due diligence, an essential part of the underwriting process, we then collect, analyse and assess those ESG considerations in greater depth, often involving third-party advisers where necessary."

Michael Curtis, head of private credit strategies at Fidelity International, says that Fidelity embeds a full ESG assessment into its structured due diligence process – one carried out by its own team as part of the standard investment process: "We firmly believe that an ESG assessment should not be a separate process, or carried out by a third party, not least because it is increasingly difficult to separate ESG risks and opportunities from broader commercial considerations."

Challenges can arise due to a lack of harmonisation in approach. Stéphane Badey, partner at Arendt, says the problem for the borrower when it comes to due diligence is that there is no harmonisation in terms of requests, so different asset managers have varying processes and requirements. "Every single entity has its own due diligence framework, so that is not easy for a borrower to navigate," Badey says.

Neale Broadhead, partner at CVC Credit, agrees there is still progress to be made: "Despite the clear observation that ESG-specific due diligence can help map borrowers' existing control systems and ESG commitments, such information is seldom made available as part of diligence packs. However, we see the market realising rapidly that lenders can use it to structure bespoke financing, which incentivises the transition to a sustainable future."

EXPERT Q&A

By putting ESG at the heart of due diligence in private debt investing, lenders can focus on sustainable companies that will deliver better investor outcomes over time, says Fidelity International's Michael Curtis

The value of embedding ESG in due diligence

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Q Why should investors consider ESG when conducting due diligence as we go into a more recessionary period?

Investors should always consider ESG when conducting due diligence – even more so during a recessionary period.

We firmly believe that ESG should be a core part of due diligence, both to derisk an investment from a credit perspective and because – given the increasing regulatory focus on ESG – it is increasingly important to avoid potential material regulatory risks arising through the life of a loan.

Taking this one step further, in a recession and a complex geopolitical environment, gaining access to capital is much harder than it has been for a long time. Incorporating ESG risk into your analysis not only means that you will be lending to more sustainable companies, it also means you will back companies that will continue to have a higher chance of accessing the capital markets going forwards. If there are two companies and one does not focus on ESG and the other does, it is now common to find a greater willingness among lenders to provide capital to the latter over the former. In the mid-market, businesses increasingly appreciate that there are real implications for those who do not take ESG seriously, in the same way public markets have had to adapt over the past decade or so. Our firm belief is that sustainable companies are stronger companies that will ultimately deliver better investor outcomes over time.

Q What are the key things to focus on when conducting due diligence?

Due diligence carried out at a company level is usually comprehensive. It will include the traditional elements including company fundamentals, the macro environment, the capital structure, how

> *"We are not just looking for disclosure, but a genuine assurance from companies to commit to substantive ESG targets"*

Q How should investors approach their own due diligence on ESG?

There are lots of products that declare they champion sustainability and show off convincing ESG policies, but having a policy is not the same as ESG being an authentic part of a manager's investment philosophy and process. Investors have to do their own due diligence and seek out managers that share their values when it comes to ESG, and assess who they believe will deliver on these values.

Investors need to ask detailed questions around a manager's philosophy, values and policies, as well as the frameworks they use to assess the companies that they lend to. Does a manager use third-party providers or does it have its own proprietary framework? Is it a framework that purely assesses what disclosures are available from the company, or does it try to understand what the company is doing on both a qualitative and quantitative basis? There are many people out there selecting two or three KPIs, such as carbon emissions targets, but they are not all asking how the KPIs really relate to a specific industry or business.

Fidelity has had the advantage of building private credit investment strategies with ESG at the centre from the outset. We have had a positive response on our proposition from investors and borrowers alike in the private and specialist credit capabilities we have built.

the company has performed in previous recessions, and so on. What we do at Fidelity is embed a full ESG assessment into the structured due diligence process. This assessment is conducted internally by our private credit team, supported by our team of fundamental research analysts and ESG analysts.

This provides a level of granularity and insight that using a third-party provider, who is not close to our different strategies and investment processes, cannot provide. One reason for this is that it is very hard to separate out all the different risks and opportunities – in terms of what is ESG and what is normal credit work – because a company that is not strong on ESG may eventually be impacted in an economic manner.

A good example of the intertwined risks is a consumer products company that holds consumer data, where data protection and the safeguarding of customer information is very much an ESG issue. In our ESG analysis, we look at the policies and procedures in place to safeguard customer data, but if we were to ignore these and focus only on traditional financial analysis, we could ignore the risk of being exposed to a company that is at risk of significant fines for not treating customer data appropriately.

In terms of the key things to focus on during due diligence, we have a framework that we developed over a number of years in the public markets based on our coverage of more than 4,000 companies. It has since been applied to private markets. Our knowledge base allows us to understand what best-in-class looks like, and this also enables us to materiality map our investee companies, to what is important in their respective industries.

An ESG assessment will be very different for a software company versus a consumer staples company, and as such our framework assigns a company to a subsector and then outlines what should be the focus of an ESG assessment in relation to environmental, social and governance factors. The same analysts responsible for the fundamental research carry out a thorough assessment of the company, so we are in a strong position to produce an appropriate ESG rating for each company.

Q At what stage of the process do you consider ESG?

We certainly look at ESG factors at the outset, but the due diligence process for direct lending takes multiple weeks and has different stages, with ESG analysis featuring throughout. This includes during our loan documentation negotiations because we will be looking for commitments from borrowers that pertain to ESG.

A key factor in our perception and rating of a business is our assessment of what that company's general commitment is to engagement and change on ESG. You can send a 160-page questionnaire to a company to fill out and they can respond, but we are not just looking for disclosure, but a genuine assurance from companies to commit to substantive ESG targets.

Once we actually complete the investment, we then look to engage with the borrower on ESG as part of our regular catch-ups with sponsors and management teams. These typically take place once a quarter and ESG will be a topic of conversation. We also carry out an independent quarterly portfolio review, with ESG assessed during those reviews, alongside the financial performance of the companies.

Q How do the private markets differ from the public space? What can private markets learn from public? And are there attributes within private markets that are beneficial compared with public markets?

The public markets have traditionally been ahead of the private markets on implementing ESG, and of course there are additional challenges for private markets. A large part of this is because – from a private equity sponsor perspective – ESG has only become more of a core focus relatively recently. For a long time, the primary approach has focused on exclusion criteria and this created the lag in private markets, rather than any inherent difference between public and private companies.

Although ESG has long been an important part of our analysis in the private markets, we have more recently been able to supplement our approach by drawing on and implementing our substantial public framework with an even more defined framework and more substantial data, which has accelerated our expertise on the private markets side.

For example, when we launched our CLO management business in 2021, we led the market on ESG by being the first CLO to align to Article 8. There were more than 60 managers in the European CLO market, and who all had detailed ESG policies, but almost all of those were exclusion-criteria based.

We were the first, even though the CLO market had been around for 20 years, to not only score all our names on ESG but to commit to specific ESG targets in our CLO documentation. The majority of our investments in the CLO are in what we consider to be sustainable companies based on our ratings methodology.

"The due diligence process for direct lending takes multiple weeks"

In the direct lending market, it is a similar process, and we are able to bring the expertise we have developed within our syndicated loans business and our public markets business to our direct lending capability. In fact, in private markets, we are generally able to have substantially more influence because of the direct relationship we have with the borrower and the sponsor. Moreover, the duration of our expected relationship with the borrower creates significant potential to make ESG impact.

Q How do you ensure management oversight through the life of the loan?

As a direct lender, we catch up with management on a regular basis, normally at least quarterly, and our investee companies are subject to specific reporting requirements. Incorporated into these reporting requirements will be ESG considerations – we will require companies to report on the KPIs we agreed with them as part of our investment plan.

Reporting is reviewed by our investment committee throughout the life of the loan, so it is very much a case of active monitoring and continuous dialogue with our borrowers in an ESG context. We are dedicating resources to the specific oversight of ESG and to delivering our ESG strategy for direct lending, as well as driving forward engagement and oversight.

In addition to the oversight carried out by the investment team, who are monitoring the transaction over its lifetime, we also have specific governance and oversight activity to monitor ESG progress. These include the Fidelity Sustainable Investing Oversight Committee and Compliance Function, which ensure we are delivering the ESG commitments we make to our investors. ■

Michael Curtis is head of private credit strategies at Fidelity International

Energy usage

Following the rapid rise of energy prices over the past year, a reduction of overall energy use and improvements to energy efficiency have become key economic priorities, particularly in Europe.

Advocates of energy efficiency have spent years pointing out that the greenest energy is the energy we don't use. However, progress towards greater energy efficiency has been limited. According to the International Energy Agency, global energy intensity improved by just 1.3 percent a year between 2016 and 2021, falling far short of the 4 percent annual improvement the IEA says is needed to achieve net-zero emissions by 2050.

The Russian invasion of Ukraine, with its massive impact on energy prices, has brought energy efficiency back into the spotlight, adding an economic imperative to the environmental rationale for conserving energy.

Private debt managers recognise the importance of incentivising borrowers to use energy more efficiently, notably for real estate loans. Lenders often include criteria around making buildings and operations more energy efficient as KPIs in sustainability-linked loans (SLLs). Energy usage is, in fact, specifically included as a suggested indicator in SLL guidelines produced by Japan's Ministry of the Environment in 2020.

Requirements for real estate loans to be considered green may include a commitment to energy efficiency. As Thomas Garnier, originator in Natixis's green and sustainable hub, told *Private Debt Investor* last year: "In a refurbishment, to be eligible for a green loan, the borrower would need to demonstrate that such renovation will improve the building's energy efficiency by at least 30 percent in absolute terms."

Financial returns

Does ESG come at the expense of financial returns? This question has loomed over sustainable finance for decades, with critics of ESG never satisfied about the answer.

The debate has plumbed new depths this year with the anti-ESG backlash in the US. While announcing restrictions to prevent state pension funds from taking ESG into account in investment decisions, Florida governor Ron DeSantis declared in August: "Corporate power has increasingly been utilised to impose an ideological agenda on the American people through the perversion of financial investment priorities under the euphemistic banners of environmental, social and corporate governance, and diversity, inclusion and equity."

But the notion that factoring ESG into investment decisions harms returns finds little support among private debt managers. In fact, considering ESG factors that may impact a company's value is self-evidently an essential part of good underwriting.

"We have always found addressing ESG factors central to our ability to deliver attractive returns," Kevin Magid, president of Audax Private Debt, told us in May. "As private debt investors, we carefully identify material ESG factors early in the underwriting process and continue to monitor these factors during the holding period of the investment."

A trade-off with returns is more likely at the impact end of the responsible investment spectrum. Investments intended, for example, to benefit underserved communities can entail higher risk and offer below market rate returns. Those who believe this represents a "perversion" are, of course, under no obligation to allocate to impact funds.

Gender diversity

Having a diverse team is critical for innovation to thrive, so firms are making steps towards a more inclusive future.

"A diverse team, with different thinking styles and visions, will bring deeper discussions and more innovative ideas and solutions," says Coralie De Maesschalck, head of CSR and ESG at Kartesia. "It also allows us to retain our current employees and to attract great new talent."

Research by the IFC found that gender-balanced teams at private equity and venture firms can produce up to 20 percent higher net IRRs.

Considering this, private debt firms have been upping their efforts when it comes to hiring women. Global advisory and executive search firm Jensen Partners' most recent private debt industry diversity snapshot revealed that for front-office distribution roles, women made up 43 percent of hires during 2020-21, while they comprised 51 percent of hires between 1 January 2022 and 26 May 2022.

In addition, more and more firms are setting diversity targets. Esther Peiner, managing director and co-head of private infrastructure in Europe at Partners Group, adds: "The fact that organisations are willing to set goals on gender diversity, because they understand the strategic importance, is an achievement in itself."

However, trying to retain diverse talent can be a cause for concern. An Investec survey found 25 percent of women planned to depart their firms in the near-to-medium term, compared with only 16 percent of men. "The reality is that many people still feel as if their gender is a potential obstacle to their promotion pathways," says Ben Way, group head of Macquarie Asset Management.

Human capital

Creating an environment that enables employees to develop their skill sets and perform to a high level is essential in driving strong returns.

Shared experiences are important, says Tim Schifer, managing partner at Twin Brook Capital Partners, adding that a positive working environment helped the firm navigate covid.

"Experience proved to be an important element on several fronts. Every period of disruption is unique, but I think the experience of working through multiple cycles definitely enhances your ability to effectively and efficiently assess, address and manage future situations," he says.

"At Twin Brook, many members of our team have not only spent 20-plus years focused on this space but have also worked together for much of that time. I think that level of shared experience supported our ability to seamlessly transition to a remote environment, continuing to work as a team and serve as a reliable lending partner."

Mentorship programmes are another way firms can invest in human capital, as such initiatives not only teach employees new skills but also offer a support network. Darnell Jones, global director of diversity, equity and inclusion at real estate investor Hines, says: "We know that a lot of times it is who you know and can learn from that really matters in terms of how well you progress, so it is very important to put more women and underrepresented minorities in front of the people that matter at the firm through these mentorships."

Impact investing

Asset owners increasingly demand that their investments achieve more than financial returns, going even beyond the 'do no harm' approach of ESG. Achieving positive social and environmental impact is a top priority for a growing range of investors.

The market for impact investing has reached $1.164 trillion, the Global Impact Investing Network announced in October. This figure has grown rapidly in recent years – GIIN estimated the market size to be $715 billion in 2020 and $502 billion in 2019.

The private debt industry cannot claim to have been at the forefront of impact investing – but the asset class is catching up, partly in response to pressure from asset owners. "There is a growing trend for investors to demand impact alongside financial returns," says Coralie De Maesschalck, head of CSR and ESG at Kartesia. "We have seen that quite strongly, especially since covid. I think the pandemic made everyone realise that we need to change the way we are living."

De Maesschalck notes that the EU's Sustainable Finance Disclosure Regulation, or SFDR, which created the Article 9 designation as a label to allow managers to differentiate impact funds, has helped spur investor interest. "The SFDR helps investors to understand which funds are actually offering real impact, making LPs more comfortable when investing into funds that have the appropriate labels," she says.

Sustainability-linked loans (SLLs) offer one route to achieving impact – much as they can be used to incentivise progress on ESG criteria. De Maesschalck adds, however, that to truly incentivise impact, SLLs have to offer a margin discount of up to 50 basis points – far above the 5bps to 15bps discount more commonly available.

Another strategy is to lend to impactful businesses that typically struggle to access finance. In Africa, for example, impact investors that seek to improve healthcare often provide loans to clinics. It is typically harder for private equity investors to find opportunities to support small healthcare businesses.

"We don't have that many companies that have that critical level where they are interesting for a private equity firm," Vincent Lecat, head of impact and ESG at Development Partners International, told affiliate title *Private Equity International* in November.

As an increasingly wide range of asset owners begin to consider impact, more and more market actors will seek to refine their solutions. "Our intention is to push our sustainable loans range forward with a view to seeing our green products overtake our traditional loans range in the very near future," Impact Capital Group's founder and chief executive, Robert Whitton, said in August.

KEYNOTE INTERVIEW

Ratchet mechanisms provide a powerful means to incentivise good performance on impact, says Kartesia's Coralie De Maesschalck

Ratcheting up impact

The ability to generate impact in solving social and environmental problems has become increasingly important for private debt managers in recent years. With more and more LPs looking beyond a narrow focus on financial returns, and European regulation creating a framework for labelling funds, ignoring impact is no longer an option.

Coralie De Maesschalck, head of CSR and ESG at Kartesia, says that linking financing costs to impact performance through a ratchet mechanism can be an effective way of incentivising good performance. The key to success, she says, is carrying out thorough due diligence to select relevant and measurable KPIs for borrowers and ensuring that ratchet mechanisms are linked to a broader sustainability plan.

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Q Why should impact matter for private credit investors?

As an industry, we have a role to play in addressing the social and environmental challenges that the world is facing. The 17 Sustainable Development Goals (SDGs) adopted by the UN in 2015 are an urgent call to action to end poverty, to improve health and education, to reduce inequalities and to tackle climate change. As a lender, we can be a part of that global partnership to achieve the SDGs.

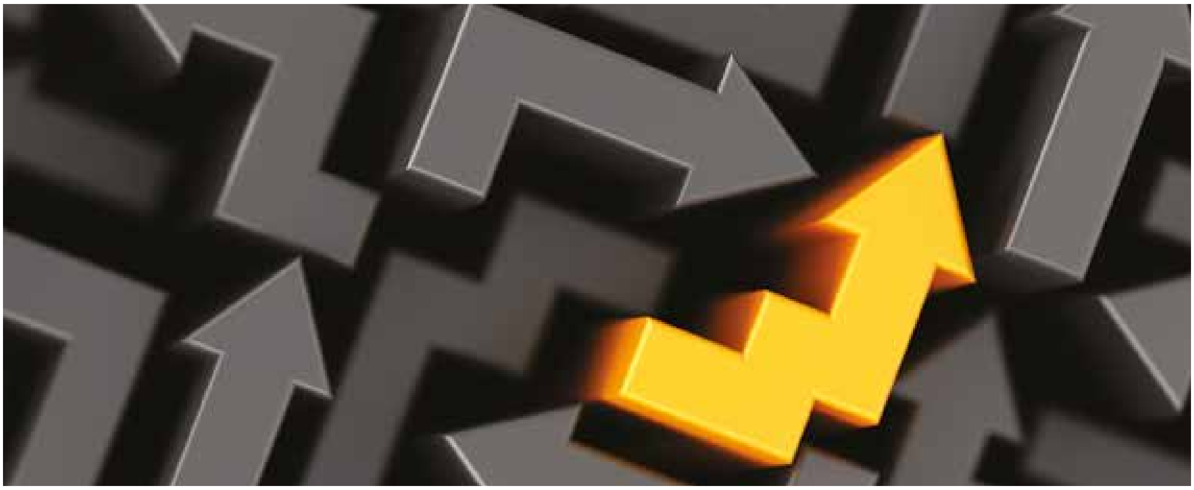
There is a growing trend for investors to demand impact alongside financial returns. We have seen that quite strongly, especially since covid – I think the pandemic made everyone realise that we need to change the way we are living. Regulation is also encouraging LPs to take impact into account.

The SFDR helps investors to understand which funds are actually offering real impact, making LPs more comfortable when investing into funds that have the appropriate labels. Additionally, many investors now have specific mandates to invest into Article 8 or Article 9 funds, creating

Q How will impact strategies evolve in the private debt sector over the next few years?

I strongly believe that demand for impact is going to grow substantially. I also believe that impact strategies in the private credit industry will be impacted by the evolution of the SFDR, but also by other regulations and frameworks like the taxonomy or the TCFD. Those regulations already exist, but they will continue to evolve in order to ensure that sustainable investment funds are comparable for all investors.

I also expect to see sustainability-linked loans with increasingly complex ESG ratchet mechanisms that will add greater value. For instance, the number of different criteria and the complexity of those criteria will increase. Borrowers will have to show progress against both static and dynamic KPIs. We could also see carried interest be increasingly linked to philanthropy projects, on top of the margin discount. Overall, I expect ESG ratchet mechanisms to develop so that they become more complete and more complex. Many GPs are already thinking about how to accelerate progress on this topic.



additional demand for impact orientated products. These trends present an opportunity for us to offer impact for LPs, along with competitive rates of return.

Q There's a perception that private debt has lagged behind private equity on ESG and impact. What can be done to address this?

Private debt has been behind but has now caught up. Until recently, we had very few ESG tools dedicated specifically to private debt. For instance, the UN PRI only produced its first guide for integrating ESG into investment decisions in private debt in 2019 – several years after it had developed tools for private equity.

Additionally, there were limited tools available for private debt players from data suppliers. As such, we had to work on the basis of guidelines that were really intended for the private equity market.

Things are changing. The market is growing, and private debt firms have demonstrated a will to also be active players in the development of ESG approaches. For example, we have developed a partnership with the asset management firm Candriam, so that we can combine Kartesia's expertise in credit solutions with Candriam's impact know-how.

We seek to invest in companies that can have an impact on at least one of 11 SDGs on which we focus. With the support of Candriam, our impact partner, we perform full ESG due diligence prior to our investment. Working with Candriam's ESG analysts, we select relevant KPIs so that we can measure impact across the lifetime of our investment in the company.

Q What are the most effective ways for private debt lenders to create impact?

It will vary, depending on each firm's values, expertise and resources. We believe that we can drive change by tying our loans to well-designed ESG ratchet mechanisms. With this approach, we can offer an incentive for companies – they get lower-cost financing if they can meet their impact targets.

One challenge is to select the relevant margin discount. We often see discounts of 5 basis points to 15bps being offered as incentives to borrowers. But at Kartesia, we believe that discounts of as much as 50bps are more appropriate to act as a strong incentive.

We determine two KPIs for each

company that borrows from us to report on – typically, these would cover a combination of social and environmental factors. An effective ESG ratchet mechanism needs to be accompanied by a well-designed strategy, so that we can really create results that add value. In today's world, an ESG ratchet mechanism is necessary, but not sufficient.

One of the pillars of our strategy is to undertake deep ESG due diligence prior to our investment. This is critical to ensure that we select relevant and measurable KPIs for the company. Moreover, we also ensure that the two KPIs used in the ratchet mechanism are accompanied by a full sustainability development plan for the company to improve its performance across all aspects of ESG.

Q What are the best ways to include margin ratchets into practice? Is it more effective to offer incentives, rather than penalties?

The advantages and disadvantages of different types of margin ratchet mechanisms depend on the strategy in which they are used. To achieve impact, we see more advantages from positive margin ratchets that seek to encourage the portfolio companies, which is what we aim to do with our strategy.

"There is a growing trend for investors to demand impact alongside financial returns"

Over the last couple of years, we have noticed that pressure on ESG is not only coming from our investors. At Kartesia, we invest in small European companies that are increasingly eager to improve and have started to request our help on ESG. This is mainly because the management teams of European SMEs are realising that SMEs that fail to address ESG matters might not survive in the medium term.

Therefore, in this context, a positive ratchet mechanism is more aligned with the idea of supporting management teams that really have a will to achieve their ESG improvement objectives.

Q How do you ensure that there are no suggestions of 'greenwashing' or 'impact-washing' associated with the companies that you invest in?

We have been thinking about impact for a long time at Kartesia, but we didn't launch our strategy until we were sure that we could avoid greenwashing. We waited until we found a good partner, Candriam. The expertise of Candriam and the reputation of the firm enabled us to feel comfortable in terms of impact, particularly as they have more than 20 years of experience conducting ESG due diligence processes.

We also held on until we had the right internal resources. When I joined Kartesia in 2015, we only had 10 employees – I was head of portfolio alongside my ESG role until 2021, when we grew enough for me to only focus on ESG and CSR. Since then, we have also hired an ESG analyst to help us make sure that we are doing enough work to avoid greenwashing.

And finally, we waited for proper European regulation to be sure that what we call an 'impact fund' is officially, according to the law, an impact fund. And this happened with the SFDR last year. Article 9 defines what is called "dark green funds", which include impact or taxonomy-aligned funds. So, we align with all the requirements to ensure that what we are doing is really recognised as impact.

"One of the pillars of our strategy is to undertake deep ESG due diligence prior to our investment"

Q What have been the broader consequences of the SFDR and other regulatory developments on the impact market?

At Kartesia, we feel more comfortable operating an impact fund with the appropriate regulatory framework in place (SFDR). Asset managers like us must demonstrate that their ESG ambition and engagement complies with the very detailed SFDR requirements. All these obligations might be seen as painful, but actually helped to set up an efficient and transparent impact strategy.

The new European regulations aim to bring more transparency, thanks to all the disclosure requirements. That transparency, plus the fact that the sustainability profile of funds labelled as Article 9 is easier for an investor to understand, reducing the risk of greenwashing, brings more appetite for sustainable debt funds. It's actually the purpose of the regulation – to make the sustainability profile of the funds easier to understand, more comparable, and reduce greenwashing. Therefore, the SFDR actually creates more demand for impact. ■

Job creation

As debt funds hone their focus on ESG measurement, reporting and tracking, many are turning to the UN's Sustainable Development Goals as a good basis for setting priorities. Goal 8 of the SDGs spotlights decent work and economic growth, with many funds getting behind the aim of promoting sustained, inclusive and sustainable economic growth, full and productive employment, and decent work for all.

While direct lenders may not have the same ability to influence job creation as their private equity counterparts, a number include it as one of their key ESG drivers. Permira's PE business has been part of an initiative supported by the Institutional Limited Partners Association to agree a common set of metrics and definitions for reporting ESG data, identifying six priority areas.

Last year, Permira's head of ESG Adinah Shackleton told *Private Debt Investor* that Permira Credit would prioritise those same six areas: "That makes a lot of sense because it means we should be more aligned with the equity sponsors of the companies we lend to when it comes the information we are asking of those businesses."

A number of sustainability-linked loans have featured job creation metrics in KPIs as private markets emphasise job creation as part of their social remit. Invest Europe said in its *Private Equity at Work* report that PE and VC-backed companies employed 9.9 million people in Europe at the end of 2020, creating 2 percent more jobs versus a 1.6 percent fall in the broader job market.

Financial services and insurance companies, and biotech and healthcare businesses, recorded the highest employment growth in 2020: 7.7 percent and 7.5 percent, respectively. Creating productive employment opportunities for all women and men, including young people and persons with disabilities, is another element of Goal 8, with DE&I efforts moving up the agenda for all credit funds – both across their portfolios and in their own teams.

Sharadiya Dasgupta is the founder of Blue Dot Capital, which partners with investment management firms to create their ESG programmes. She says: "Whenever we are looking at any asset management firm's ESG programme, the framework that we use is to look at materiality considerations at both GP level and portfolio level. Diversity and inclusion is perhaps the only topic where there is unanimity that it is material across GP and portfolio levels."

The need for ESG talent is also driving job creation in funds themselves. Jan Wade, chief people officer at Arrow Global, says: "Having ESG expertise in-house to advise investment professionals is essential, as is the upskilling of origination, underwriting, portfolio management and servicing teams to ensure a sustainable approach to investments is pervasive throughout an organisation's DNA."

KPIs

The need for harmonisation around industry-wide approaches to KPIs is becoming more apparent as lenders increase their focus on ESG metrics for due diligence and ongoing reporting purposes.

François Lacoste, managing partner in private debt at Eurazeo, says: "We are seeing an increasing number of sustainability-linked loans in private debt as they become more mainstream. It is crucial for the industry to aim for the harmonisation of the methodology – around the number of KPIs and the need to be aligned with the Paris Agreement, for example – as well as the harmonisation in the calculatsion of the KPIs."

Eurazeo will push strongly for the use of the SBTi – Science Based Targets initiative – methodology for carbon footprint measurement and reduction trajectory.

Many managers are getting involved in efforts to foster harmonisation. Michael Kashani, head of ESG Credit at Apollo Global Management, says the availability of quality ESG data continues to challenge investment managers, particularly in private credit. "The recently launched ESG Integrated Disclosure Project is designed to help address this by encouraging transparency and consistency for private companies and credit investors through a voluntary standardised format for ESG disclosure," he says.

"A harmonised approach that increases the availability of ESG information for both LPs and GPs is also beneficial to borrowers by helping to reduce the burden of different ESG KPI requests from prospective lenders during underwriting and due diligence."

Laure Villepelet, head of ESG at Tikehau Capital, highlights the need for accountability: "A primary source of ESG data results from organisations making ESG disclosures that are based mostly on self-assessment, with varying degrees of audits. The alignment of the International Sustainability Standards Board and the EU's corporate disclosures will be key for defining a robust global baseline."

Lenders are also working hard to enhance the credibility of the KPIs they are focusing on. Salma Moolji, European ESG lead at Ares Management, says: "Working in close collaboration with a company on target setting helps make sure we establish objectives that are business-relevant, purposeful and meaningful. Specific and measurable targets, for example, focused on carbon intensity reduction, improvement to health and safety management or ethics, can work well."

The big advantage of reporting KPIs is that borrowers are treated more favourably throughout their financing processes, says Neale Broadhead, partner at CVC Credit: "Borrowers must make every effort to report, monitor, control, and improve upon these KPIs to minimise regulatory, financial and reputational risks."

EXPERT Q&A

ESG data and KPIs are moving up the agenda in private debt, especially where due diligence and sustainability-linked loans are concerned, say Jason Park, a partner in the Ares Credit Group, and Salma Moolji, European ESG lead at Ares Management

Setting goals and measuring progress through KPIs

Q What steps have you taken to mature your approach to ESG integration in the investment process over the past year?

Salma Moolji: The market right now is volatile and exacerbated by macroeconomic factors, which makes ESG more important as a tool for business resilience. We have worked to integrate ESG into our investment processes over several years, creating a pool of knowledge among our 'ESG Champions'.

Now we are in the process of institutionalising that knowledge, taking lessons from markets that have moved faster on ESG, including Europe, and adapting those learnings into our global processes.

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Our approach has focused on three key areas: sustainability-linked loans, where we focus on measurable indicators that are tailored to the company's overall ESG profile and areas of improvement; KPIs, where we are working to make sure we are calculating more credible and measurable data; and deepening our commitment to more specific and more urgent themes across our portfolio, including climate change and diversity, equity and inclusion (DE&I).

Q How are your investment professionals using ESG data to enhance due diligence?

SM: ESG-related data, while not explicitly defined as such, has been part of due diligence for a long time. For example, traditional governance assessments have been core to our investment process. At a fundamental level, it is used as both a negative and a positive screening tool to analyse transactions that are within our risk appetite and to understand the extent to which our partners and companies are actively invested in ESG.

The story is now evolving towards using that information to engage with portfolio companies, build

> *"The market is pushing solutions forward, including consolidation of global data standards, converging on clearer metrics, language and methodologies"*
>
> **JASON PARK**

Q How do you see the EU's Sustainable Finance Disclosure Regulation changing the market for ESG data in private debt?

SM: Regulation is trying to address a lack of transparency and confusion in the market around ESG, to some extent with a targeted focus on ESG data. The efforts we see with SFDR are echoed by investors, who want to focus on Article 8 funds and get behind that initiative. We are committed to demonstrating transparency, and we understand the demands for operating in this environment.

Most of our new funds are Article 8 light at minimum and are meeting the ESG standards described in the regulation. But SFDR is driving a data collection effort, and we are working to meet that regulatory need through enhanced KPI collection.

In addition to encouraging greater transparency, this should also lead to information sharing and insights that can help improve ESG in portfolio companies. Ares has always leveraged data – and the scale at which we can collect it – to inform and improve our practices, and we intend to do the same with ESG-focused work.

relationships and drive more meaningful conversations. We want to be a strong voice in collecting more quantitative metrics, engaging with peers and helping move forward standardisation.

Q How are you helping to improve ESG performance in your portfolio companies?

Jason Park: Ares supports private equity sponsors with long-term capital. Our capital represents a material part of the overall capital structure, often as much as 50 percent. Because of this, we believe we have the opportunity to promote change within many of our portfolio companies.

Our approach might include providing our internal ESG team's experience to help portfolio companies and private equity sponsors set up their own policies and frameworks. We know there are quite a few sponsors and companies out there that are very early in this journey relative to Ares.

We are also pitching and investing in sustainability-linked loans, where we are seeking to increase our participation. We seek to drive ESG improvement through ongoing monitoring of ESG risks that we identify either up-front or through the life of an investment.

Q Last year you reached a major milestone with your £1 billion ($1.2 billion; €1.1 billion) sustainability-linked loan to British environmental and engineering services provider RSK Group. Can you explain the defining factors of sustainability-linked loans compared with green bonds?

JP: The defining feature of green bonds is a use of proceeds test, where the money raised must go towards an environmentally-focused initiative.

Sustainability-linked loans are differentiated by their potential scale and impact. Instead of a use of proceeds test, these loans have a margin adjustment benefit – and sometimes a penalty – based on the borrower achieving agreed upon KPIs. Those KPIs can be anything across the ESG spectrum, including, for example, reducing carbon intensity, improving employee diversity, closing the gender pay gap or improving workplace health and safety.

In addition, almost any company can be eligible for this type of loan because all companies have room for improvement, and the potential list of KPIs can be vast and specifically tailored.

Q Since the RSK deal, how has your approach to sustainability-linked loans evolved?

SM: The RSK deal was a watershed transaction for Ares, and we have become much more efficient at scaling sustainability-linked loans, both in terms of the variety of investees and across geographies. We have done transactions in Europe, the US and Australia, with a diverse range of companies. We believe there is strong demand for SLLs as we seek to continue building on the momentum we've achieved.

We have learned we need to have a deep dialogue with companies to set sustainability performance targets and make sure they are business-specific and meaningful. As Jason noted, we have also found two-way margin adjustments work well for making sure we have transparency and accountability.

Q What are the main challenges or roadblocks you see ahead for ESG data? And what are some of the solutions?

JP: I believe our greatest challenge is that we are primarily servicing mid-market borrowers, and many of

> *"ESG-related data, while not explicitly defined as such, has been part of due diligence for a long time"*
>
> **SALMA MOOLJI**

them are earlier on the ESG curve than public issuers and larger companies. They might lack formalised internal ESG functions or policies, and they may not easily be able to collect the data or calculate KPIs – or at least do so in a cost-effective way. Private equity sponsors, too, are at various stages of maturity.

The market is pushing solutions forward, including consolidation of global data standards, converging on clearer metrics, language and methodologies. There are more and more software vendors that help collect this data and provide portals for borrowers to roll up the data and use it to support management teams.

Ares has dedicated resources to provide guidance and experience to help portfolio companies work through the specifics of calculating and monitoring KPIs, while collaborating on the evolution of ESG strategies.

Q What international ESG standards or industry initiatives are you actively contributing to in order to drive improved maturity to ESG KPIs across the industry?

SM: This is a very collaborative space. Many of the GPs and LPs we work with are asking businesses for this information and diverging requests can create a major drain on resources for portfolio companies. In an ideal scenario, there would be a consistent set of criteria that everyone could use, which would provide strong alignment in the positive outcomes we seek to achieve.

We think it is important for us to lead the way where we can. For example, we chair the new Private Debt Advisory Committee of the UN Principles for Responsible Investment (UN PRI). We are also supporting and participating in other initiatives more focused on specific ESG factors, such as the Initiative Climat International's private equity working group, ILPA's Data Convergence Project and the Partnership for Carbon Accounting Financials (PCAF).

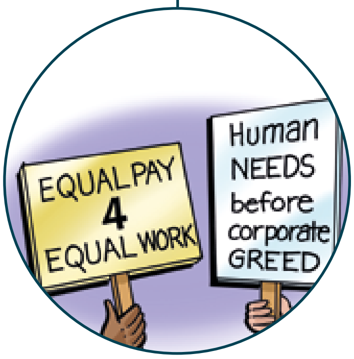
We have also aligned Ares' reporting with the Task Force on Climate-Related Financial Disclosures and produced our inaugural *Climate Action Report* in 2022. We are practising what we preach by collecting data on our own practices across a number of ESG criteria. We believe this improves our ability to understand the challenges and collaborate with and support portfolio companies, GPs and partners as we share this important journey together.

Q As a lender, how do you plan on incorporating the increasing focus on climate commitments in your portfolios?

JP: We have three focus areas. First, we are working on a top-down carbon footprint estimate across our portfolio to establish a baseline. We are starting that process in a subset of companies in the US and Europe and then plan to roll it out across the portfolio.

The second element is collecting actual emissions data and decarbonisation targets for our portfolio companies. We are using software vendors to help and are doing pilots with a small number of companies to see what responses we get and what issues we encounter. Again, we will use those learnings across the portfolio over time.

The final focus is on the use of sustainability-linked loans as a means to continue engaging along the way. We think that's a differentiated tool that creates immediate incentives for borrowers to improve their environmental impact and to build out their data collection capabilities. This is an exciting time for everyone, and we are very focused on realising the potential benefits of this work. That said, we recognise that we are still in the early stages of these efforts and will continue to refine and enhance our approach to optimise our impact. ■



Labour rights

As efforts increasingly prioritise the 'S' of ESG, enlightened credit fund managers are looking more closely at labour rights and the impact that failings in that area can have on a company's reputation and valuation.

"Human rights has always been an important topic, but what has changed is the level of awareness about these issues and the availability of information," Carmela Mondino, head of ESG and sustainability at Partners Group, told *Private Debt Investor* in May.

"We can now access information instantly from all over the world, so if there is a company in Asia that doesn't meet minimum human rights standards, there will be an NGO or other organisation that can raise awareness of this."

Labour rights are a key element of the UN Guiding Principles on Business and Human Rights (UNGPs). Due diligence obligations, as outlined by the UNGPs, are relevant for funds in every sector and jurisdiction, with modern slavery risks a global problem, for example.

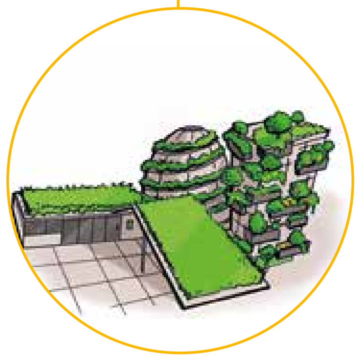
Management oversight

One of the biggest challenges for lenders on ESG is maintaining adequate oversight of the actions of borrowers through the life of a loan.

Management oversight can take many forms, but needs to go beyond the most basic levels of reporting, according to Michael Curtis, head of private credit strategies at Fidelity.

"To really have an influence over ESG as a lender, it is about bringing something to the relationship with the sponsors and the companies and ultimately finding ways to help them on their journey," says Curtis. "As part of that, we will seek to have an ongoing dialogue on how that journey is progressing, what milestones the company is reaching and what their challenges are. Management oversight really is a lot more than relying on a report every year."

Curtis says it is also important that the company has independent verification. "You don't really want the CFO marking their own homework. You want some independent oversight."



Nature-based solutions

Proposed solutions to global problems such as climate change typically involve tech and engineering. But what if the answers lie in harnessing the power of nature?

The World Bank defines nature-based solutions as "actions to protect, sustainably manage, or restore natural ecosystems, that address societal challenges… simultaneously providing human wellbeing and biodiversity benefits". One example is coastal flood prevention – traditional approaches involve building expensive sea walls, but an alternative could be protecting or restoring mangrove trees in coastal areas to helps to guard assets and providing a habitat for certain species.

"The global community must shift from a mindset of extraction and depletion to one of regeneration," Amit Bouri, CEO of the Global Impact Investing Network, told us last year. "Nature holds the answers to restoring the planet – meaning, starting immediately, we must drive more investment into nature-based solutions and treat nature with far more respect."

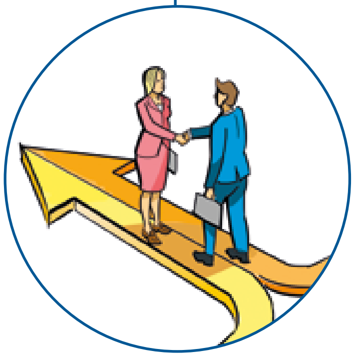
Occupational health and safety

When Ares Management Corporation, the world's largest private debt manager, completed the groundbreaking £1 billion ($1.2 billion; €1.1 billion) ESG-linked loan to UK-headquartered environmental and engineering business RSK Group in 2021, occupational health and safety featured heavily.

The RSK deal included an annual margin review based on the achievement of sustainability targets broadly focused on carbon intensity reduction and continual improvement of health and safety management and ethics.

Salma Moolji, European ESG lead at Ares, says: "The performance targets within a sustainability-linked loan should be relevant to the core business of that company and help drive positive change. For example, if health and safety is relevant for business operations, we find emphasising improved performance in this area can help drive positive outcomes from ESG and business perspectives."

Permira Credit also highlights health and safety metrics as a priority for reporting ESG data. Permira's head of ESG Adinah Shackleton explained last year how it works with companies on health and safety: "There have been times where issues have arisen during diligence, but instead of walking away from the deal, we have engaged with the company on addressing those issues. For example, there was a company facing a potentially material fine over a health and safety incident. We worked with the business to understand how it was responding and what improvements were being made to health and safety practices."



Partnerships

While the public credit markets are some way ahead of the private debt markets when it comes to ESG data and reporting, there are many lessons to be drawn from knowledge-sharing across the two constituencies.

Michael Curtis, head of private credit strategies at Fidelity International, says: "As we have embarked on bringing ESG to the forefront of what we do in private markets, which is now very much part of our core strategy, we have been able to bring the same framework that we use in the public markets where we have had many years of experience and data to help us.

"That means our private markets ESG strategy has been accelerated, and while there are additional challenges around access to data in private markets, our ability to exert influence as a borrower in the private space is enhanced."

Paul Woods, director of sustainability and ESG at Arrow Global, adds: "While there are good practices available in public market disclosures, it is imperative that the private credit markets meet investor expectations to ensure private debt continues to grow its allocation of investors' portfolios.

"Clearly, there will be areas that are specific to individual firms and their operations; however there are also opportunities for asset management good practice that increase the reputation of the wider sector while helping to streamline and reduce the need for multiple similar reporting requirements. Convergence of reporting metrics whilst challenging is something the industry should aspire and work towards."

Quality outcomes

Private credit funds are under pressure to demonstrate to investors and regulators that they are not only prioritising ESG during investment processes, but also demonstrating quality outcomes as a result of their work.

Michael Curtis, head of private credit strategies at Fidelity International, says his team is able to bring a unique perspective to measuring outcomes: "By having a broad view across the global markets we can understand what good looks like, because we see a whole range of companies from large-listed businesses to the medium-sized privately-owned."

He adds: "We have the ability to really help our borrowers set appropriate targets and goals in a holistic way, and in the long run that will lead to a much more sustainable business model for the company in question – stability in earnings and cashflows, and ultimately a higher valuation. It is not just about de-risking the company, it is about de-risking us as lenders and generating enhanced outcomes for all stakeholders."

Paul Woods, director of sustainability and ESG at Arrow Global, says data has a key role in demonstrating outcomes: "The need for data and quantitative assessment of ESG characteristics is increasingly evident. This is not simply about meeting regulatory requirements but to intelligently articulate assessment of ESG risks and opportunities – and impact where appropriate – in a meaningful way that demonstrates progress for all stakeholders.

"In all cases, the need for better quality data gathering, clear definition and timely reporting is paramount," he adds.

Renewables

Due to the energy security crisis, in 2023 the chance for private credit to back green energy in Europe will be in the spotlight for funds and their investors.

Hugo Thomas, head of credit research at Sienna Private Credit, says: "Europe plans to install 85GW of new PV power plants and 50GW of onshore wind farms by 2025, requiring €50 billion of investment needed per year. Renewable energy represents an exceptional market opportunity, driven by increasing European energy independence ambition, and global transition towards clean energy."

These renewables energies are becoming increasingly competitive and there is a shift in renewables revenues from feed-in tariffs towards bilateral contracted or merchant exposure. Thomas says: "This comes with reduced bank-driven senior debt gearing and an increasing need of equity or subordinated debt injections. This triggers a growing demand to private debt funds that can cope with more volatility to sustain the growth of greenfield renewables projects and provide at a higher yield the much-needed extra leverage through junior or unitranche structures."

Jerome Neyroud, head of infrastructure debt at Schroders Capital, told *Private Debt Investor* in October that concerns around security of supply had created opportunities on the generation side, especially as Europe seeks alternatives to fossil fuels in the form of renewables: "We continue to see a huge opportunity in energy storage, but remain cautious around retail due to its exposure to price volatility, and around newer technologies like hydrogen where business models have not been tested yet."

Social responsibility

While lenders initially focused on environmental and governance considerations in ESG as being easier to understand and track, there is growing commitment to social responsibility as the conversation matures.

Ralph Hora, partner and chair of the Pemberton ESG Working Group, says: "We take a similar approach to addressing the 'S' as we do the 'E' and 'G', with a comprehensive questionnaire for new direct lending deals that tracks 20 'S' questions across key metrics, such as a company's equal opportunities policy and its employee performance tracking process. This helps us both screen potential risks, and track progress over time.

"We are seeing improvements in scores and have had feedback that tracking helps those we work with focus on these issues and raise it up their agenda."

It's a similar picture at European fund manager Arrow Global, where Paul Woods, director of sustainability and ESG, says social responsibility matters to both long-term commercial success and the ability to attract and retain key talent.

"An inability to properly understand and action concerns around the 'S' factors of ESG is more than likely going to result in the manifestation of some reputational risk for the business or the portfolio," he says."An ability to look at how the company has performed over time, and record that change, demonstrates the right culture and management controls."

Woods recommends seeking external input to shape internal thinking: "It is easy to think you are doing a great job and it can be difficult to open up to scrutiny from a third party. However, if done correctly it can enhance understanding, develop collective leadership commitment and drive real change across an organisation," he says.

François Lacoste, managing partner in private debt at Eurazeo, says lenders have the potential to make a big difference if they get this right: "A GP like Eurazeo can help bring about a multiplier effect to encourage a more inclusive society because it can act on both its direct and extended perimeter through the 530 companies in its portfolio – this is the extra-financial leverage effect."

Laure Villepelet, head of ESG at Tikehau Capital, agrees that private credit has a responsibility to step up and make a change: "Asset managers have a social responsibility to actively participate in ensuring the transition towards low-carbon, more circular and resilient models," she says. "This transition is critical and necessary, but there are barriers because the value chain is fragmented and shared between different actors, which is due to many actors focusing on the short-term cost rather than the long-term investment in the energy transition."

E X P E R T Q & A

Managers continue to up their efforts with colleagues and communities, despite the economic challenges, say Paul Woods, director of sustainability, and Jan Wade, group chief people officer, at Arrow Global

Prioritising the 'S' of ESG

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Q Will rising inflation and interest rates increase the threat of ESG neglect – in particular the 'S' of ESG?

Jan Wade: Absolutely not. We are very committed – our ESG approach, and the 'S' especially, sits at the heart of our heritage and our values. The economy and the global situation has been quite volatile for the last three years and we have continued with a firm commitment to the position we want to take. That has been a longstanding approach that we have taken both as a PLC and now as a private equity-owned business, and we are aligned with our owners TDR Capital as well.

There are economic pressures but we have consistently taken a socially responsible approach with our colleagues, communities and customers, and we continue to have an active dialogue with them. During covid and also at the moment, we have been clear on our position, providing cost of living support to our colleagues and increasing our activities in our communities, which our colleagues have been keen to engage with. We are planning our approach for 2023, aware of the inflationary pressures. Our strategy of making sure we are doing what we can to support people remains unchanged.

Clearly, we are ambitious, and we want to deliver really strong results for our investors as well. But, if anything, we are now focused on the 'S' more than ever.

Paul Woods: More broadly, from an investment perspective, social factors should be embedded into all risk management and investment decision-making frameworks. Organisations need to be able to understand and quantify social considerations alongside any other investment criteria, irrespective of the economic cycle, because if a manager is going to generate a long-term return, neglecting the 'S' is going to create problems down the line. This is now so embedded in most firms' investment approaches that it is unlikely to slip away.

Q Is the 'S' a differentiator or hygiene factor when raising investor capital?

PW: Increasingly, we see investor sentiment pushing these topics up the agenda, with investors asking more questions and demanding more rigour, both during due diligence and in ongoing reporting. We have moved beyond the hygiene factor approach. The direct linkage between investor concerns and capital raising is maybe more difficult to assess, but as an area of concern that needs to be adequately addressed throughout the lifetime of an investment, this is at the front of investors' minds and will increasingly be a key differentiator.

JW: As we are building and scaling our platform, we are very conscious that we need to hire and develop people with expertise in ESG products, strengthening the capabilities that we already have in-house.

Q How do company-wide ethics deliver accretive results to investors?

PW: Company-wide ethics are important to both long-term returns and performance track record. Clearly, an inability to properly understand and action concerns around the 'S' factors of ESG is more than likely going to result in the manifestation of some reputational risk for the business or the portfolio. An ability to look at how the company has performed over time, and record that change, demonstrates the right culture and management controls.

With non-performing loans and the purchasing of distressed assets, there are often elements that need to be addressed on day one of our acquisition of a portfolio. So that forms part of our investment decision-making,

"Investors are asking more questions and demanding more rigour, both during due diligence and in ongoing reporting"

PAUL WOODS

but also the plans we make for the life of the investment. This has to be a long-term approach, with governance around it, to be accretive for investors. For Arrow, our selective investing, underwriting insight and proprietary dealflow, underpinned by an ethical lens, drives sustainable, long-term attractive risk-adjusted returns for our investors.

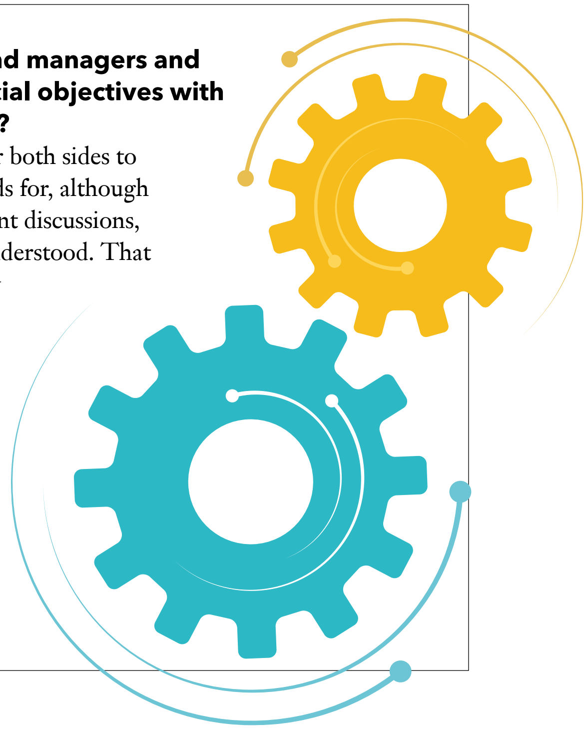
JW: In the last 12 months, we have really bolstered our approach to this, aligning our governance with our investment decision-making. We have strong leadership; it is really strongly integrated into everything we do. Arrow has always embraced the benefits of strong governance, both for our own perspective and because of the confidence it gives our investors.

Q Should the industry give precedence to 'S' over 'E' and 'G' or does it depend on the investment strategies?

PW: On the investment side, clearly where we have well-defined investment strategies that are delivering on specific 'S' or 'G' outcomes then that defines itself.

Q Is it important for fund managers and investors to align social objectives with their core business model?

Paul Woods: It is important for both sides to understand what the other stands for, although by the time you get to investment discussions, it is likely that is already well understood. That alignment becomes increasingly critical when you are trying to drive specific investment outcomes that require a different level of emphasis and transparency around ESG. We will see a move towards more specific standards and certifications that provide investors with more comfort and understanding.



More generally, we are seeing a greater integration of the three elements of ESG. For example, a transaction that might help to finance residential real estate development will come with a raft of social and environmental considerations, both in terms of environmental impact and in terms of social opportunities to provide affordable housing, additional infrastructure, schools and so on.

JW: When I think about our strengths in terms of ESG, I think the three strands are really inter-related. Our approach is based on our heritage and that strong governance approach to investments and the way we operate our business.

Striking the balance in terms of 'S' and 'E' across our portfolio is evolving – we will see further developments around what we are doing on environmental impact. We are very focused on the 'S'. That is driven at a corporate level and at a 'local, local' platform level by our colleagues. This isn't just a corporate position; we have 2,500 colleagues who are really focused and engaged, so it is at the heart of what we are. We are pleased with our position on ESG but we want to build our commitments and contributions across all three aspects.

The local, local model we possess is a differentiator for us and for our investors. Our local platforms are empowered to generate unique investment opportunities. There is a huge amount of pride over how they operate and how integrated they are into their territories, so as much as investments are driven locally, so are many of our ESG activities across all the countries we operate in.

Q Is it important to benchmark and report on 'S' priorities? What do you consider best practice in this space?

JW: For the last few years, we have been very mindful that every organisation has its own perception of how it is doing in this area. But ESG does require you to challenge yourself on that thinking, so external benchmarking is very important. On the 'S', we chose to have an external audit of how we are doing on diversity and inclusion. We partnered with The Clear Company, a D&I consultancy, and their findings shaped our strategy going forward.

We have also partnered with other external providers that can provide us with insights into best practice. On the social side, going through covid, we partnered with an external provider to benchmark what we were doing on the office environment and hybrid working, and our response to the cost of living crisis has been based on what we feel is right considering our values and external benchmarks. So, we use those external voices all the time because we feel it is dangerous to be too inward-looking – we always want to be stretching ourselves and improving what we are doing.

PW: Generally, what I have seen across the investor space is maybe less consistency around what people want to talk about under the 'S', because priorities vary so much. The level of regulation also varies across our markets, whether in relation to treating customers fairly or other areas such as data privacy.

There are obviously attempts under initiatives like the UN Sustainable Development Goals and the Global Compact to use global frameworks to align activities to the priorities of counterparties, but the challenge is that those can be so broad that we risk losing sight of what each company is doing; while investors need to be able to compare one opportunity against another in a consistent way. People need to understand both the qualitative and quantitative data being shared, and we will see more alignment on that and progress on standardisation of metrics.

> *"Striking the balance in terms of 'S' and 'E' across our portfolio is evolving"*
>
> **JAN WADE**

Q How do you engage senior leaders with 'S' programmes – do you appeal to their hearts and minds, or is it much more commercially driven?

PW: There are formal and informal approaches. From a more structured standpoint, we do operate a sustainability and ESG forum, which we benchmark against other firms. That is about getting a cross-section of the leadership group around these topics on a regular basis and providing them access to external subject matter experts to educate and raise awareness on key topics.

JW: We have very clear priorities across our group – we emphasise the local, local model but we also have 12 clear strategic priorities and a clear focus on those. This discussion starts from when we engage with candidates and onboard them around how we do business and what is important to us. We are clear about our expectations and values, and that runs right through to rewards decision-making. We pay attention to hearts and minds and we promote an environment of learning on this.

PW: For the industry as a whole, driving the right behaviours raises questions for individual firms, particularly around remuneration and linking performance to ESG. Every organisation has to work out how their systems can encourage and recognise positive contributions. ■

Transparency

Investors and regulators alike are demanding greater transparency from lenders on the ESG performance of their portfolio businesses, driving a requirement for data that is trickling down to borrowers.

While most companies are getting on board with what is needed, achieving transparency still presents challenges. Ralph Hora, partner and chair of the ESG working group at Pemberton, says the fund manager expected a degree of pushback when it expanded its ESG questionnaire from around 30 questions to 80. The reaction has, in fact, been positive, with companies keen to measure and understand where they sit in relation to their peers and their sector more broadly, he says.

But it is not all smooth sailing. "One of the challenges is when dealing with smaller companies who may not be tracking Scope 2 or Scope 3 indirect emissions," he says. "In the first instance, we will work with companies and introduce them to consultancies to help measure these. If companies are still unable to source this data, we work with specialists to identify a proxy, based on a company's likely Scope 2 or 3 emissions, that we will use to track."

Hugo Thomas, head of credit research at Sienna Private Credit, says transparency has become a prerequisite under disclosure regulations being implemented across jurisdictions. "Meeting these requirements is a major challenge in terms of data collection for private debt investors managing more demanding Article 8 and 9 funds [under the EU's SFDR regime] and dealing with non-listed corporates not subject to corporate sustainability reporting requirements.

"To improve data collection campaigns, investors may assist their counterparts in measuring their ESG KPIs, or incentivise them by rewarding transparency efforts on ESG matters."

Laure Villepelet, head of ESG at Tikehau Capital, shares a similar view: "Transparency is essential for the asset management industry and when it comes to ESG disclosures, we recognise the key role that regulators play. The challenge we face with sustainability is that we need to implement standards, while not limiting innovation and progress towards the energy transition."

Antoine Peter, manager at Arendt, cautions that transparency can be a bit of a double-edged sword: "On the one hand, many asset managers want to inject more transparency into their fund offering documents in order to protect themselves against mis-selling claims and make sure that they are meeting the expectations of their investors. Everyone has a different definition of what 'sustainable' is, and so greater transparency helps fund managers avoid some of this confusion.

"But, on the other hand, increasing transparency also risks exposing fund managers to greater levels of scrutiny and criticism."

E X P E R T Q & A

Transparency is improving as new regulatory initiatives take hold, but fund managers still need to work hard to get a better understanding of what their investors need, say Arendt's Stéphane Badey, Nicolas Bouveret and Antoine Peter

Promoting transparency in ESG

Q Given the current regulatory backdrop, how crucial is ESG transparency in the private debt market these days?

Stéphane Badey: It is definitely becoming more and more important for our clients. When the European Commission launched its sustainability finance action plan in 2018, it put the transparency exercise ahead of anything else. Private funds have to be extremely clear about what they do regarding ESG and show that they are being transparent towards investors.

This has resulted in funds being split into different categories. Asset managers are now routinely asked: what is your categorisation under the EU's Sustainable Finance Disclosure Regulation (SFDR)? This has put pressure on many funds to work towards becoming either an Article 8 or an Article 9 fund, which has caused them to reach for an ever-greater level of transparency and ambition to demonstrate their ESG credentials and justify the category to which they claim to belong.

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Q How can funds best demonstrate that they are ESG-compliant?

Antoine Peter: We get asked this question a lot, but it is difficult to answer because for Article 8 funds, for example, there aren't any minimum ESG requirements (yet).

The EU framework is not to be seen as a labelling regime but rather a transparency regime. If you have given the impression, either directly or indirectly, that your fund is an ESG fund, then you will fall under the scope of Article 8 or Article 9 of the SFDR regulation and must make the necessary disclosures.

The European Commission has deliberately left things very open because it is trying to catch as many fund managers as possible to be more transparent in their disclosures. Regulators maintain that it is not their job to judge the credibility or the materiality of what is on offer, but rather to make sure that investors understand the products that they are being sold. For them, this is a consumer protection issue.

But this is also where some confusion creeps in. Since there is no minimum threshold, it is up to the market to set the limits, and to determine what funds should or should not do. Where is the bar set? Where is the threshold? Where do the limits lie? It is then up to the investors, to the NGOs, to the journalists to decide whether what is on offer is credible. This is definitely the part that most people are struggling with at the moment.

Nicolas Bouveret: I have noticed there are two different approaches being used at the moment. One is the check-box approach that many private debt funds investors use to determine which category of funds they can invest in. For these players, regulatory classification is really important.

The other approach is to rely on their in-house due diligence, with institutional investors imposing their own criteria on the ESG mandates that they are prepared to give. This approach tends to be more popular with larger institutions, particularly those making substantial commitments or using SMA [separately managed account] structures.

Q Are investors being given enough information to properly evaluate funds?

SB: This is where transparency becomes key because investors have embraced the topic for which they have developed expertise. When subscribing to a financial product, investors are presented with a lot of information. Much of this is rather technical and not easy to understand. It is in a way far easier for investors to question a portfolio of investments linked to the oil and gas sector than, for example, to criticise the technical computation of carried interest.

Investors can quickly lose trust if the underlying portfolio of a fund promoting itself as ESG-friendly is very similar or identical to that of another fund without such ESG credentials. This becomes a particular danger when markets are facing downward pressure. Investors may claim that they were wrongly informed and that the fund has been less resilient because it has been investing in the wrong things.

"The EU framework is not to be seen as a labelling regime but rather a transparency regime"

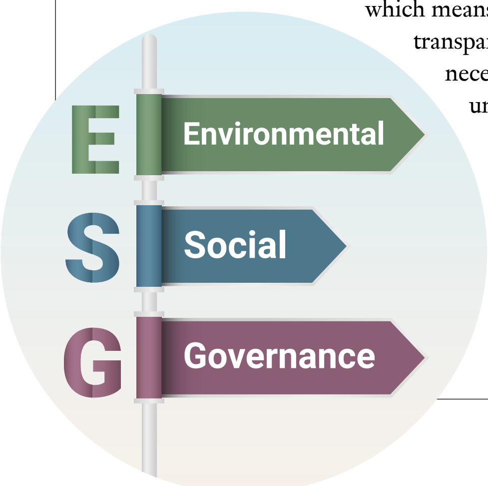
ANTOINE PETER

Q Is there a sufficient level of transparency in the market?

SB: Transparency has definitely been improving – and it has got to. After all, the deadline for the implementation of SFDR is the end of this year. People are now really starting to understand the difference between financial materiality and looking at this from a risk management point of view. In other words, is the company doing this for profitability or because it wants to sell the latest ESG fund?

This is an important distinction that companies need to make. We have seen a number of cases where disclosures fail to adequately address this, which means that, while the spirit of transparency might be there, it doesn't necessarily provide a particularly good understanding of what is actually going on.

Of course, improvements can always be made: better financial literacy and availability of data from the underlying companies into which funds invest would help, for example.



AP: Transparency can be a bit of a double-edged sword, though. On the one hand, many asset managers want to inject more transparency into their fund offering documents to protect themselves against misselling claims and make sure they are meeting the expectations of their investors. Everyone has a different definition of what 'sustainable' is, and so greater transparency helps fund managers avoid some of this confusion.

But, on the other hand, increasing transparency also risks exposing fund managers to greater levels of scrutiny and criticism by allowing investors to gain a better insight into what is actually going on. This is not just about what NGOs and journalists might think. It is also about how investors see things.

Q So too much transparency might not necessarily be a good thing?

NB: It's not really a question of whether there is too much transparency or not. It's more a question of what transparency means to different people. This comes down to fund managers really knowing who their investors are, and what they would like to see in terms of disclosures. SFDR doesn't make this distinction, but this is something that needs to be reflected in the markets.

Conversations with institutional investors usually revolve around a dialogue between the asset manager and the ESG team. It's a very different story, though, if asset managers are trying to sell funds to private bank clients or to a broader retail network. Education has an important role to play here, too. The ESG dialogue will obviously be very different for an illiquid loan origination fund compared with a more liquid strategy, but the individual investor might not fully understand that. There is a big push within the private debt space to move beyond traditional institutional investors – and so this has become a very important part of the transparency exercise.

Q What role do ESG-linked financings play in improving the overall level of transparency in the market?

AP: It has become more-or-less standard practice these days for private debt funds to have some sort of sustainability-linked financing, with additional marginal financial benefits linked to meeting certain KPIs. In fact, so standard is this practice now that we regularly see sustainability-linked financing referenced in investment strategy presentations without it even being perceived as a promotion of ESG.

In this way, an Article 6 fund, for example, may claim that it doesn't want to be anything higher, but in reality, it has already introduced some ESG criteria into its financing agreements in order to foster more transparency at borrower level, for example, which in turn is perceived to reduce downside risk. The idea in this set up is to give a small incentive to portfolio companies and borrowers to gather and disclose some non-financial information and to undertake some preliminary ESG-related actions that are perceived as good risk management.

This shows how ubiquitous sustainability-linked financing has become, but it also highlights a potential challenge: how can industry practices be reconciled with the SFDR categorisations?

This is where fund managers have to be careful. When it comes to things like setting up reporting standards and establishing mechanisms for sustainability-linked bonds, the industry is actually ahead of the regulations, but fund managers need to be aware of any regulatory spillover from the actions that they are taking.

ESG-linked financing definitely helps in terms of increasing transparency. If you look at a lot of sustainability-linked KPIs, you'll find the main goal is to make sure the underlying company is transparent. So just the fact that fund managers can start gathering data and thinking seriously about how to measure their non-financial KPIs is an important step towards a more transparent world. This is something that private debt investors will reward.

> *"Transparency has definitely been improving – and it has got to"*
>
> **STÉPHANE BADEY**

> *"It's more a question of what transparency means to different people"*
>
> **NICOLAS BOUVERET**

Q To what extent can third party data providers help with any of this?

SB: To be honest, I'm not sure if data providers are particularly relevant in the private debt market. As soon as you start dealing with mid-market non-listed companies, data sourcing is going to be pretty much directly from the investee company itself – and that means educating the investee companies about the disclosures that they should be making.

This is a different story when it comes to public debt, but even here the value that data providers bring depends on the quality of their methodology and the data that they can source. This is why asset managers often rely on more than one data provider: the ESG score for each firm tends to vary widely according to the methodology being used and who is doing the rating. ■

Stéphane Badey and Nicolas Bouveret are both partners at Arendt; Antoine Peter is a manager specialising in ESG and sustainable finance solutions

Underwriting criteria

Investors need to ensure that ESG is strongly embedded in their investment choices as investors and regulators intensify their focus on ESG.

Davide Stecchi, managing director in underwriting at Arrow Global, says it forensically scrutinises every single investment for ESG-related risks to ensure these meet investor expectations. "In doing so, we take a holistic underwriting approach considering reputational, environmental and social considerations," he says.

"We actively prioritise investments beneficial to the environment or local community, believing they will maximise value for our investors. Above all, we always treat our customers fairly."

Ralph Hora, partner and chair of the ESG working group at Pemberton, says his firm's approach to underwriting involves a three-stage process for all of its new direct lending funds: "First, we negatively and positively screen companies. Here, we rule out companies we won't be working with, and in line with SFDR Article 8, identify those with positive ESG features. Then, we issue an 80-question questionnaire for companies, covering environmental, social and governance criteria metrics that is tracked over time, that helps us further understand the businesses we work with.

"Finally, if we want to proceed with a transaction, we will discuss how we can further encourage progress on ESG, such as by offering a margin ratchet if companies are willing to commit to six KPIs."

Vision

Private debt firms require vision to invest in the future – to achieve this they can prioritise innovation and look towards sectors that will likely gain traction in the years ahead.

ESG is on the rise amid growing concerns about climate change and social inequality. According to an Intertrust survey, 95 percent of CFOs view ESG as important.

Jon Patty, partner at the White Oak Impact Fund and managing director at White Oak Global Advisors, agrees: "We seek to partner with management teams who have been thoughtful about the ESG challenges facing their sector, who are aligned on taking specific actions on ESG issues, and who are open to ongoing dialogue with their financial partner about continuous improvement."

Following the introduction of regulations surrounding ESG such as the EU's SFDR, firms need to set their own targets when it comes to investing. "Investors are increasingly wanting to see transparency as to how ESG factors actually impact investment decision-making: both in terms of whether we make an investment or not, and then in terms of any follow-on portfolio management activities," says Monique O'Keefe, executive director, governance and risk at Arrow Global.

Looking ahead, Dodson Worthington, principal, junior capital and private equity solutions at Churchill Asset Management, presumes that investing in ESG and DE&I will "become standard practice".

Ultimately, having the vision to prioritise ESG and DE&I will only make private debt firms more equipped to handle volatility and generate better returns.

Waste reduction

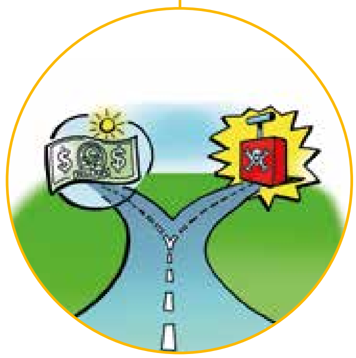
The need to reduce waste has moved towards the top of the sustainability agenda – driven partly by outrage over single-use plastics and their impact on the world's oceans.

Good waste management is fundamental to effective environmental management. The improper disposal of waste can have disastrous effects on ecosystems, in extreme cases leading to large-scale damage to biodiversity and even impacting human health. Reviewing the environmental and waste management practices of borrowers is therefore an essential part of ESG due diligence.

But the gruesome consequences of ocean plastics have helped to draw attention to deeper questions around the wasteful consumption of the Earth's resources and problems caused by improper waste disposal. The concept of a 'circular economy' – which challenges the 'take-make-waste' model of production – has grown in popularity.

This means that lenders increasingly look for evidence that borrowers have targets for reducing waste volumes, as well as increasing rates of recycling. Waste management metrics may be factored into sustainability-linked loans, ensuring incentives for improved performance.

Meanwhile, waste recycling companies are increasingly acquisition targets for private equity firms, reflecting the sector's growth potential as consumer and governments demand better recycling options. Energy Capital Partners announced in September that it would acquire UK waste management company Biffa in a $1.4 billion deal. Private debt lenders can expect to see more opportunities to help finance transactions that support waste management the coming years.



eXit strategy

By prioritising ESG throughout the investment process, private credit funds can hope to secure better outcomes for their investors when exiting the investment.

Richard Roberts, head of origination at Arrow Global, says: "For a responsible investor in non-core, stressed or distressed assets, exiting an investment in an ESG-compliant way can take many forms. In its ideal form, the investor has been able to work with the underlying borrower to rehabilitate their credit position such that we can be refinanced out on terms which are better for the borrower. In the period of our investment, we will have had a constructive relationship with the borrower and supported their goals. Amicable settlements are not only the right course of action for ESG, but frequently the economically best result too."

He adds that ESG should also be a consideration when it comes to the sale of the asset: "To the extent we have invested in an asset versus a loan, our exit would come from the sale of the asset to a responsible new owner, committed to own and develop the asset in the medium to long term," says Roberts. "In both examples above, the exit counterparty will have undergone 'know your customer' and anti-money laundering, compliance and other relevant checks."

Nathan Brown, chief operating officer at Arcmont Asset Management, told *Private Debt Investor* last year: "Ultimately, ESG should be something managers think about all the way through from due diligence to exit, with the most mature funds using quantitative metrics and encouraging good ESG behaviour among their borrowers."

Youth

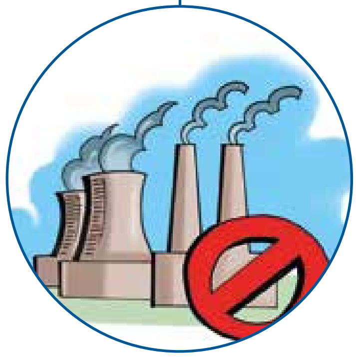
Giving more of a platform to younger employees will benefit the industry as they hold the future of the asset class in their hands.

Younger people can give fresh perspectives, which can enable firms to make better decisions. Marisa Hall, co-head of the Thinking Ahead Institute at Willis Towers Watson, says: "You are highly unlikely to achieve strong cognitive diversity and hence good collective decision-making when everyone has a uniform set of experiences. Representative diversity is also very important. It isn't enough to say we may all look the same but we are cognitively diverse."

However, it is often the case that younger people are misrepresented, particularly at a board level. Nuveen's chief executive of real assets and real estate Mike Sales believes the representation of youth is one of the biggest missed opportunities on boards. "The accepted way is to have boards dominated by experienced custodians, but for me that youthful perspective is important."

Focusing on youth is another way firms can ensure gender diversity becomes part of company culture. For instance, entry level recruitment is arguably where most of the progress is being made when it comes to hiring diverse talent – in 2021, women made up 56 percent of EQT's new hires at an entry level basis.

Gail McManus, managing director and founder of Private Equity Recruitment, says: "Massive strides have been made in the recruitment of entry-level women." This is promising and suggests that youth may have the power to change the make-up of the asset class.



Zero emissions

Net zero is the North Star of the responsible investing movement. A vast institutional architecture has emerged to put the financial sector on a course to net zero – and private debt firms are expected to play their part.

"It used to just be private equity sponsors that were driving the agenda, and portfolio companies had the option to say they didn't want to implement certain initiatives, and private debt investors were more dependent on the sponsor to effectuate change," Adam Heltzer, global head of ESG at Ares, said last year. "Today, that is no longer the case."

As well as developing instruments such as sustainability-linked loans to incentivise emissions reductions, private debt firms have focused on building in-house capabilities on ESG over the past few years. This is boosting their ability to measure and monitor progress towards net zero.

But the journey is more complicated than it first appears. For one thing, what if the aim of building a net-zero portfolio actually conflicts with progress in reducing real world emissions?

"When we look at divesting from fossil fuels, it is tempting to pursue companies that are already green to bring down CO_2 emissions in the portfolio," Claus Fintzen, CIO and head of infrastructure debt at Allianz Global Investors, told *Private Debt Investor* in August. "But there is some merit in saying we should invest in 'dirty' companies and invest to allow them to make their business cleaner, as this would have the effect of reducing overall emissions within the economy."