Principles for Responsible Investment

SPOTLIGHT ON RESPONSIBLE INVESTMENT IN PRIVATE DEBT

UNEP FINANCE INITIATIVE | United Nations Global Compact

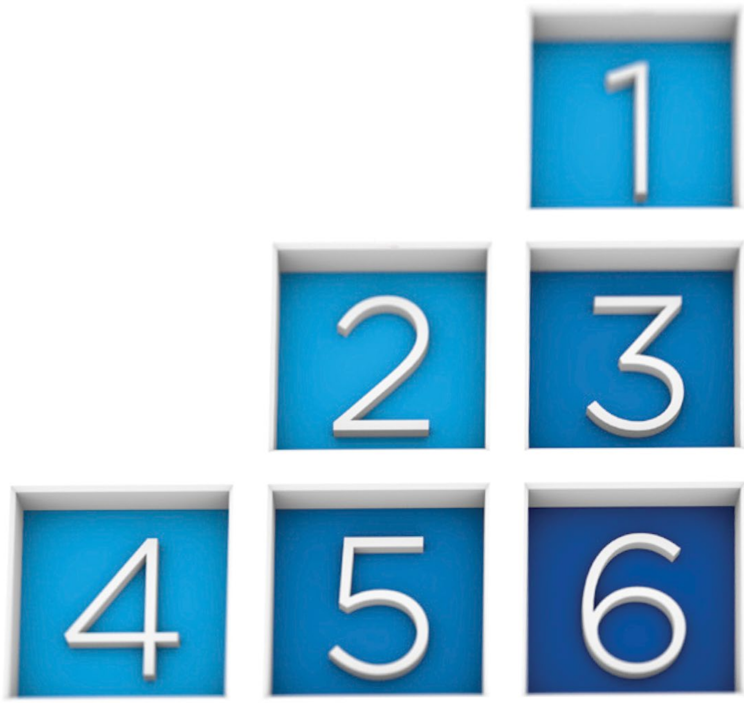
An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.



PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

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INTRODUCTION

The core concepts of responsible investment are the consideration of environmental, social and governance (ESG) factors in investment decisions and investor stewardship, alongside a commitment to both corporate and investor transparency. Such concepts apply to all asset classes, but there are differences in the way practitioners implement responsible investment depending on whether they invest in public or private debt or equity, and in liquid or illiquid markets.

The theory and practice of 'mainstream' responsible investment and institutional investment in private debt have both matured during the decade since the financial crisis of 2007/8. However, little has been written about how investors can invest responsibly in private debt. This paper aims to promote better understanding of the rationale for responsible investment in the context of private debt investments. Through this work, the PRI aims to fill an industry knowledge gap by providing guidance and examples discussed with practitioners across various private debt strategies. This report will be complemented by the PRI's upcoming industry guide for responsible investment in hedge funds.

The paper is based on desk research, interviews with 18 investors and industry stakeholders, and group discussions among PRI signatories (see contributors). Although the funds that participated in developing this report are all domiciled in Europe, the guidance is not specific to any particular region. Private debt professionals, including deal teams, portfolio managers, risk and compliance officers, and ESG functions working for asset owners, investment consultants and investment manager organisations, will find this report useful when considering the application of responsible investment in their investment processes. Relevant investor case studies can be found in the Appendix.

Note to readers: This paper is not intended to be a commentary on the pros and cons of investment in private debt as an asset class and should not be interpreted as such.

TELL US WHAT YOU THINK

The PRI welcomes readers' feedback on the content of this paper as we work towards building consensus among private debt investors on best practice responsible investment. Please contact info@unpri.org to share your thoughts.

PRIVATE DEBT OVERVIEW

DEFINING PRIVATE DEBT

Private debt has only recently been considered an asset class in its own right, and the term covers a range of different investment styles and strategies. The term 'private debt' is typically applied to debt investments which are not financed by banks and are not issued or traded in an open market, while the word 'private' refers to the investment instrument itself and not necessarily the borrower – i.e., public companies can borrow via private debt just as private companies can. Private debt falls into a broader category termed 'alternative debt' or 'alternative credit', and is used interchangeably with 'direct lending', 'private lending' and 'private credit'.

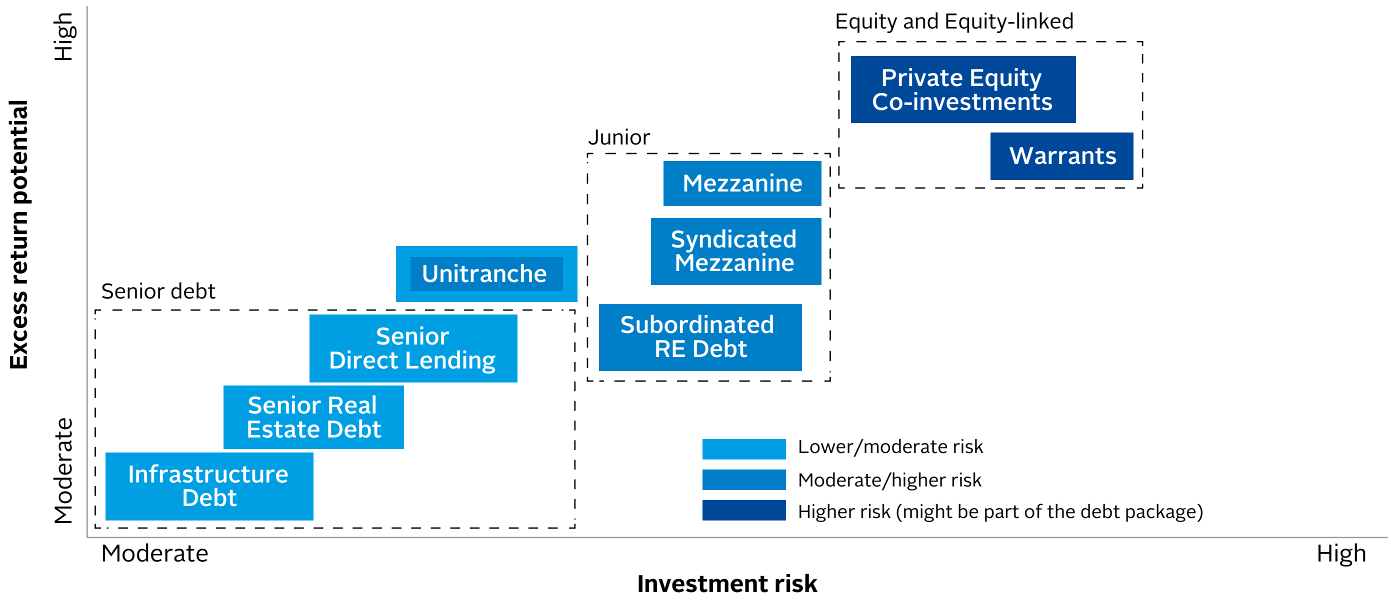
Within the private debt market, investors lend to investee entities – be they corporate groups, subsidiaries or special purpose vehicles established to finance specific projects or assets – in the same way that banks lend to such entities. Private debt investments are typically used to finance business growth, provide working capital, or fund infrastructure or real estate development.

Figure 1: Comparing private debt to other asset classes

	EQUITY		DEBT	
	PUBLIC	PRIVATE	PUBLIC	PRIVATE
Investee entity	Public company	▪ Private company ▪ Special Purpose Vehicle (SPV)	▪ Government-related entity ▪ Public company ▪ Private company ▪ SPV	▪ Public company ▪ Private company ▪ SPV
Investor/investee relationship	Legal owner (partial)	Legal owner (full or partial)	Lender (contractual relationship only)	Lender (contractual relationship only)
Returns profile	Investor potentially participates in both upside and downside	Investor potentially participates in both upside and downside	Investor participates in downside only	Investor participates in downside only
Investment holding period	Potentially unlimited	Potentially unlimited (typically seven-15 years for Private Equity funds)	Limited by bond tenor	Limited by terms of loan (illiquidity typically requires hold-to-maturity approach)
Liquidity	Most liquid	Somewhat liquid	Most liquid	Least liquid
Investment objective	Growth (occasionally income)	Growth	Income	Income
Investor control over investee	High (via voting and engagement)	High (via engagement and board seats)	Medium to low (limited opportunities to engage)	High to low (dependent on access to management)
Investee reporting requirements	Stock exchange requirements and national legal minimum	National legal minimum	Stock exchange requirements (public companies only) and national legal minimum	National legal minimum (for private companies)

(Note: the authors recognise that some points are generalised and therefore exceptions may arise)

Figure 2: The risk-return profiles of different investment strategies. Source: IHS Markit (2017) The Rise of Private Debt[1]



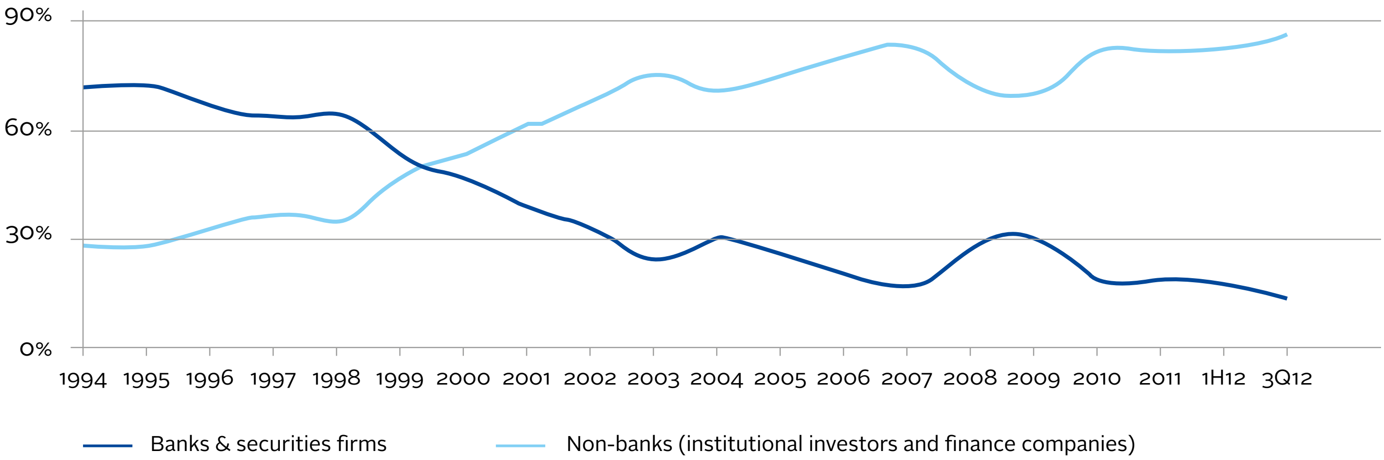
STATE OF THE PRIVATE DEBT MARKET

The global market has grown considerably as a result of both supply and demand factors.

SUPPLY FACTORS	DEMAND FACTORS
▪ Banks have reduced lending (particularly to smaller private companies) to meet EU regulatory capital requirements by deleveraging, thereby limiting sources of capital. ▪ In turn, that has made direct lending more attractive to investors, as yields may be higher than public debt and flexible terms may allow interest payments to be index linked.	▪ Investors are seeking to increase yield in an ultra-low interest rate world. ▪ Investors are seeking diversification from traditional asset classes. ▪ Investors are seeking floating interest rates to protect against rising rates. ▪ A recovering global economy has driven considerable demand from companies to (re)finance loans to enable growth.

1 IHS Markit (2017) The Rise of Private Debt

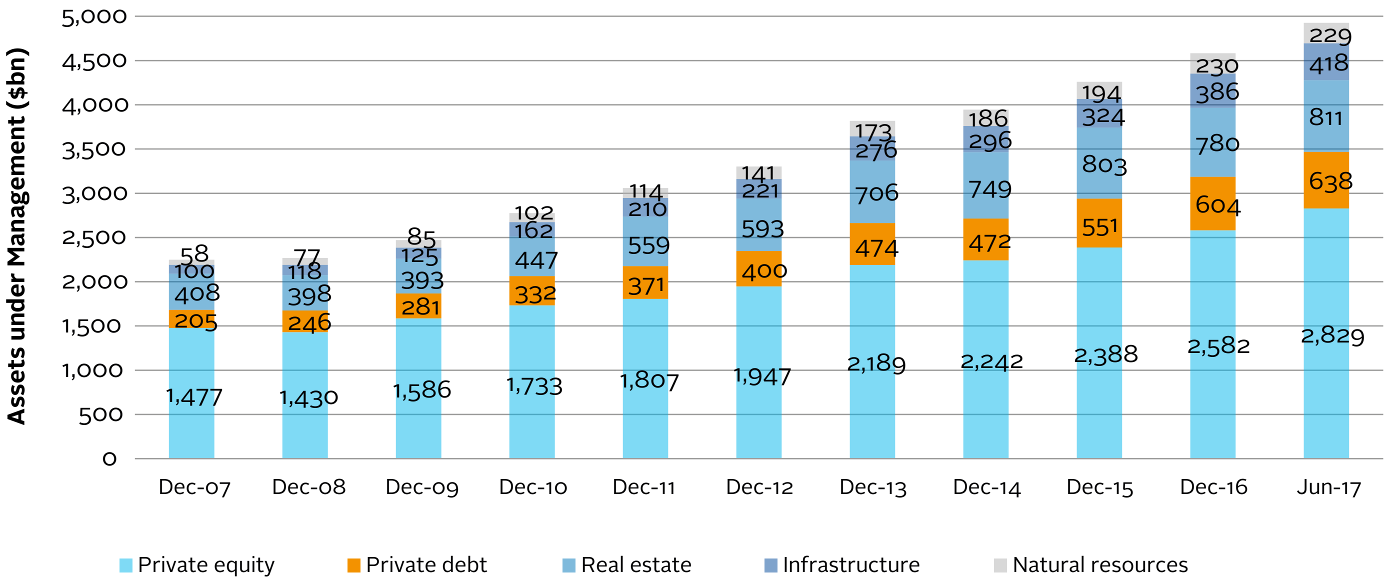
Figure 3: Relationship between bank and non-bank lending for leveraged loans from 1994 to 2012. Source: S&P Capital IQ LCD[2]



The total volume of institutional assets under management allocated to private debt is estimated to be around **US$638bn** globally[3]. There are two dominant private debt markets globally, in the US and Europe. The US market is larger and more mature than that of the EU (which is predominantly comprised of UK and French issuers).

Roughly **US$107bn** of new capital was raised by private debt funds in 2017 globally[4], of which **US$67bn** was raised by funds in the US, US$33bn by funds in Europe, and **USD$6bn** by funds in Asia[5]. Elsewhere – particularly Germany and the Nordics – banks still dominate the lending market for historic and/or regulatory reasons.

Figure 4: Growth in private capital assets under management by asset class from 2007 to 2017. Source: Preqin (2018) 2018 Preqin Global Private Debt Report[6]



2 S&P Capital IQ LCD, appearing on leveragedloan.com
3 As at June 2017. Preqin (2018), 2018 Preqin Global Private Debt Report, Sample pages
4 Preqin (2018), Special Report: The Private Debt Top 100
5 McKinsey (2018), "The rise and rise of private markets", McKinsey Global Markets Review 2018
6 Preqin (2018), 2018 Preqin Global Private Debt Report, Sample pages

The most active investors in the private debt market are pension funds, foundations, endowments and insurance companies (see Figure 5). The sectors which are likely to attract the largest allocations from investors in the next 12-24 months (based on Q4 2017) are real assets such as infrastructure and commercial real estate, followed by private equity-sponsored companies (see Figure 6)[7].

Figure 5: Breakdown of investors participating in private debt market. Source: Preqin Private Debt Spotlight March 2018[8]

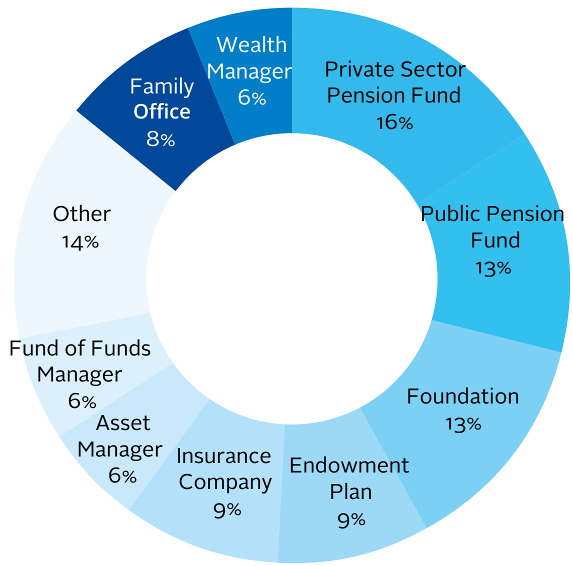
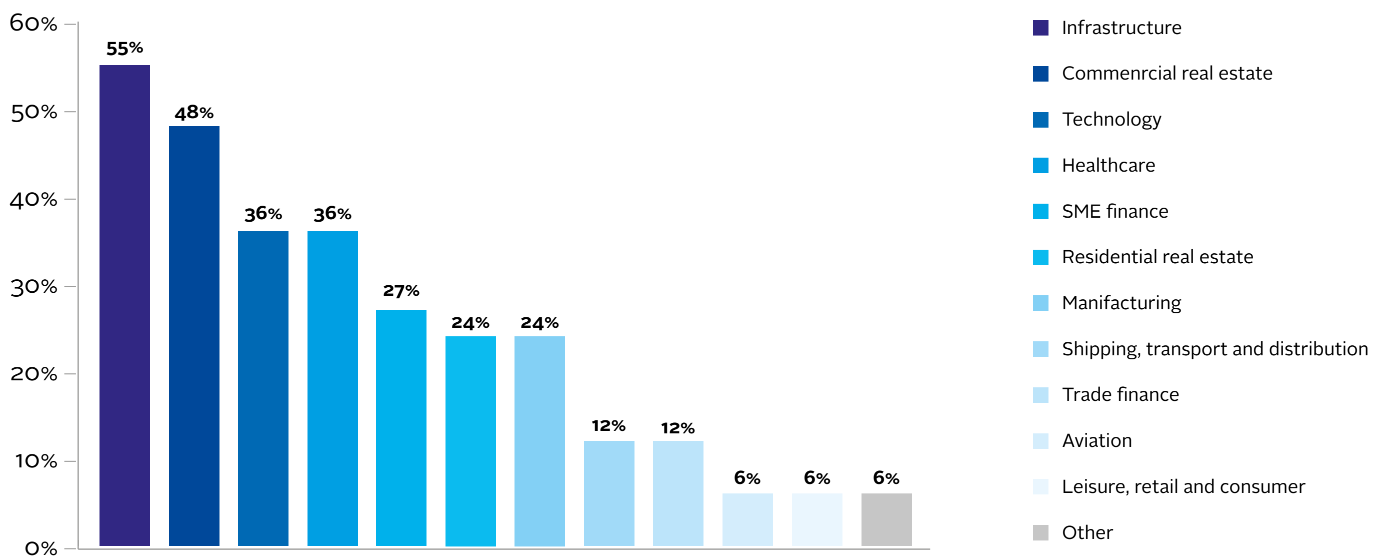


Figure 6: Expectations of private debt funds for sectors that will attract the highest levels of investment from private debt funds. Source: Intertrust (2018) Changing Tides: Global Private Debt Market in 2018[9]



7 Intertrust (2018), Changing Tides: Global Private Debt Market in 2018
8 Preqin (2018), Preqin Private Debt Spotlight March 2018
9 Based on responses from 80 private debt and private equity professionals globally and Prequin data. Intertrust (2018), Changing Tides: Global Private Debt Market in 2018

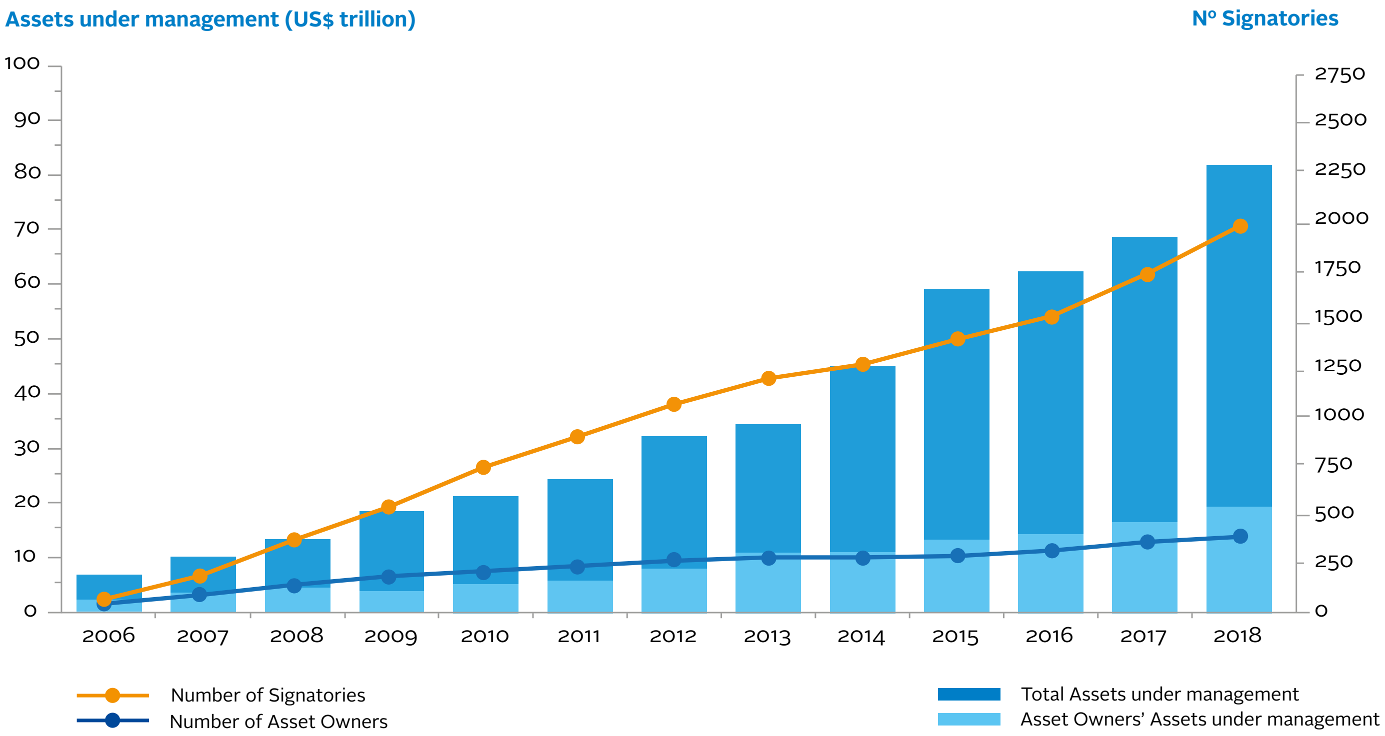
RESPONSIBLE INVESTMENT OVERVIEW

The six Principles for Responsible Investment are non-prescriptive and aspirational[10]. They are designed to be applicable to investors in any asset class. For private debt investors, the most pertinent features of the Principles are commitments to:

- Incorporate ESG factors into investment decisions;
- Engage investee entities to actively manage ESG-related risks and opportunities; and
- Ensure investors and investee entities are transparent and accountable.

Over 2,250 investment organisations, representing over US$85trn, have signed up to the six Principles[11]. Twenty two of the world's 50 largest private debt investors are PRI signatories[12].

Figure 7: Growth of PRI signatories and assets under management from 2006 to 2018. Data and methodology available [here](), updated annually



10 See '[About the PRI]()'

11 For a list of PRI signatories see the [PRI Signatory Directory.]() The total assets under management of PRI signatories is taken from the 2018 PRI Reporting Framework.

12 Based on a review of [Private Debt Investor's Top 50 Private Debt Managers (2018)]() which is ranked by capital raised by each manager over the past five years through closed-end funds and separately managed accounts.

ENVIRONMENTAL, SOCIAL & GOVERNANCE FACTORS

The investment industry uses a variety of definitions for ESG. The term is generally considered to refer to factors that, while not measured in traditional financial units, are important to corporate financial performance and, therefore, investment performance. Rather than considering an 'ESG checklist' of factors that investors should incorporate in their investment analysis, it is more constructive to consider ESG as a lens through which investors can identify potential investment risks and opportunities in a systematic way.

There are a number of angles from which investors can consider ESG factors:

1. **Macro ESG** – issues that are likely to impact the economy as a whole (either negatively or positively), such as climate change, which represents both physical risks (flooding, drought) and regulatory risks (carbon tax, emissions restrictions).
2. **Micro ESG** – issues which have the potential to impact individual sectors or companies in different ways. These include social issues (e.g. labour relations) or governance (e.g. board independence).
3. **Values or norms-related ESG** – issues which are not necessarily deemed financially material but which are not aligned with an investor's internal viewpoint, such as the production or sales of controversial weapons and tobacco products, or gambling services.

Figure 8: Summary of the most commonly practiced responsible investment approaches in terms of objectives, key considerations and examples (continued overleaf).

	OBJECTIVE	KEY CONSIDERATIONS	EXAMPLES
Negative screening	**Do no harm**. Excludes entities from investment universe based on sector, products or services, or certain behaviours that an investor deems undesirable for moral reasons.	▪ Clearly defined screening criteria ▪ Possible implications for investment returns ▪ Regular reviews of portfolio for compliance to screening policy	▪ Tobacco-free portfolios ▪ Controversial weapons screening
Positive screening*	**Do well by doing good**. Actively targets companies which score well on ESG metrics relative to benchmarks with the objective of generating positive financial, environmental or social outcomes, or all three.	▪ Determine balance of desired financial, environmental or social outcomes ▪ Identify ESG value drivers ▪ Sector or universe-level ESG benchmarks	▪ ESG leaders exchange-traded fund ▪ Clean energy fund ▪ Social enterprise fund
Thematic*	**Seek to address a specific problem**. Actively targets companies which demonstrate ability to address specific environmental or social challenges via specific products or services.	▪ Broad versus specific ESG themes ▪ Clear definition of ESG themes to be addressed ▪ Options for measuring positive impacts of investment	▪ Microfinance lending ▪ Clean energy assets ▪ Social housing fund
Impact investing*	**Do good (and do well)**. Actively targets positive environmental or social impacts where intentionality, additionality and impact reporting are explicit. Targeted investment returns may be competitive or below market rates.	▪ Potential trade-offs between positive impact and financial returns ▪ Impact reporting criteria ▪ Trade-offs between negative ESG impacts and positive outcomes	▪ Venture funding for social enterprise ▪ Low-cost healthcare fund

*Note: Positive screening, thematic investing and impact investing are frequently used interchangeably by investors.

Figure 8: Summary of the most commonly practiced responsible investment approaches in terms of objectives, key considerations and examples (continued).

	OBJECTIVE	KEY CONSIDERATIONS	EXAMPLES
ESG integration	**Manage risk holistically**. Integrates qualitative and quantitative ESG information into traditional investment decision-making processes, such as valuation and portfolio construction, with the objective of enhancing investment decision-making.	▪ Source quality ESG data ▪ Understand materiality of individual ESG factors ▪ Ensure ESG analysis leads to meaningful decisions	▪ Adjusting internal credit ratings for heavy emitters based on shadow carbon price
Engagement	**Monitor and manage ESG challenges**. Uses investor influence as lenders of capital to manage exposures to ESG risks and/or enhance transparency of a borrower.	▪ Efficiency of implementation ▪ Sharing engagement outcomes among investment team ▪ Tracking and reporting success of engagement activity	▪ Engaging a food and beverage company to disclose plans to address regulation on sugar content ▪ Requiring a manufacturer to produce regular reports on health and safety
Reporting	Ensuring transparency on ESG factors up the investment chain from portfolio company to investment manager to asset owner	▪ Objectivity, timeliness, incident reporting, adherence to investor policies	▪ Investor reporting in alignment with Task Force on Climate-related Financial Disclosures recommendations ▪ ESG questionnaires for portfolio companies

There remains a misconception about ESG that the term relates exclusively to an investor's moral or norms-based views, and might therefore harm investment performance. In fact, rather than excluding undesirable companies from their investment universe, PRI signatories more commonly apply an ESG integration approach as a way to avoid risk or enhance investment value over the long term. In most cases, however, these different approaches overlap, as they are not mutually exclusive.

DRIVERS FOR IMPLEMENTING RESPONSIBLE INVESTMENT

The growth in responsible investment activity globally has been driven by a number of complementary factors:

ESG ANALYSIS CAN ENHANCE RISK ANALYSIS

The analysis and integration of ESG factors into investment decisions has been embraced by a growing number of investors because it provides an additional level of risk analysis, helping to identify exposures that can be financially material. It is particularly complementary to private debt investment given these investors' primary focus on downside risk.

This approach helps investors to consider risk in a more holistic way to identify hidden drivers of risk which may impact a borrower's credit strength. When considering the typical hold-to-maturity approach for relatively illiquid markets, the case for considering ESG factors becomes stronger, especially over medium- or long-term investment horizons. There are a number of academic studies which support the case for ESG integration, such as Barclays' research on sustainable investing and bond returns[13], and Friede, Busch, and Bassen's research on ESG and financial performance. However, previous studies have predominantly focused on public markets[14].

> "From a business standpoint, [borrowers] with better ESG practices are lower risk investments."
>
> Partners Group[15]

13 Barclays (2016), Sustainable investing and bond returns

14 Friede, G., Busch, T. and Bassen, A. (2015) "ESG and financial performance: aggregated evidence from more than 2000 empirical studies." Journal of Sustainable Finance & Investment, 5(4), pp.210-233.

15 Direct quotes are derived from interviews that were conducted by the PRI for the production of this report unless indicated otherwise by footnotes.

RESPONSIBLE INVESTMENT HAS BECOME PART OF THE NORMATIVE FRAMEWORK

Much of the growth in the breadth and depth of responsible investment activity over the last 10 years can be put down to demand from large institutional investors such as public pension funds and insurers. When the six Principles were launched in 2006, responsible investment was a niche activity, but it is now considered to be critical for all but the smallest funds.

Some interviewees suggested that increased responsible investment activity among private debt funds has been led more by their own internal drivers than pressure from investors – which tends to be a more prominent driver in other asset classes. This is explained by the fact that many private debt investment management teams have been keen to better understand how ESG issues are linked to credit risk. Nonetheless, interviewees consistently noted a steady increase from almost no investor questions about ESG five years ago to such questions becoming the norm today.

> "We see it as not only necessary but also a competitive advantage, so we like being asked about responsible investment."
>
> BlueBay Asset Management

THE REGULATORY ENVIRONMENT IS INCREASINGLY SUPPORTIVE OF RESPONSIBLE INVESTMENT

Policy makers are increasingly codifying ESG requirements in financial sector regulation. In the largest 50 economies in the world, the PRI has identified almost 400 policy instruments which encourage or require investors to consider long-term value drivers, including ESG factors. More than half of these were introduced in the last three years. Recent developments, including the Paris climate agreement, the recommendations of the EU Action Plan for Financing Sustainable Growth, as well as regulations in California, Ontario, Brazil and South Africa, point towards increasing regulatory focus on responsible investment over the coming years[16].

MANAGING REPUTATIONAL RISKS

The burgeoning use of social media and changing views of the role of business in addressing the world's problems has sharpened investor minds about managing reputational risks. Analysing ESG factors by directly engaging borrowers and monitoring media feeds for negative news coverage, for example, can help investors identify potential reputational hazards relating to undesirable corporate behaviour. Such risks require regular tracking as they may develop through the life of the investment. Consideration should also be given to issues of emerging importance, such as cyber risk.

> "If you compromise on the covenants, you have to live with that and, if you take on too much leverage, there will also be consequences to suffer. You do not want to be a forced seller."
>
> M&G Investments[17]

16 For more information on regulatory and policy developments relating to responsible investment see the relevant pages on the PRI website here

17 William Nicoll, co-head of alternative credit at M&G Investments, quoted in Professional Pensions (accessed 4 May 2018)

RELATING RESPONSIBLE INVESTMENT TO PRIVATE DEBT

It is difficult to generalise about implementation of responsible investment in private debt as the latter comprises so many different investment strategies. Instead, we have identified the main characteristics of various private debt strategies.

In the section A framework for responsible investment in private debt we explain how these characteristics relate to different responsible investment approaches.

Figure 9: Key characteristics of various private debt strategies.

Private debt strategy/type	Description	Typical credit rating	Flexibility of terms	Stakeholders (excluding borrower)	Availability of public ESG data and related ESG research	Extent of lender influence	Level of liquidity
Leveraged loans	Loans made to companies typically to finance acquisitions, mergers and leveraged buy-outs by private equity sponsors and other leveraged owners.	High yield	Fixed	Multiple investors	Good for public companies	Medium	Average
Private placement	Unlisted debt securities typically issued by investment-grade (and occasionally sub-investment grade) companies to a select group of investors. Structured as bonds, notes or loans.	Investment grade/high yield	Fixed	Multiple investors Deal arranger	Poor for private companies	Low	Illiquid
Syndicated loan	Loans arranged by banks or other entities on behalf of a single borrower, offered to a group of lenders (a syndicate).	High yield	Fixed	Multiple investors Deal arranger	Poor for private companies	Low	Illiquid
Unitranche	A hybrid loan structure that combines senior debt and subordinated debt risk into one single senior loan with a blended interest rate, without the use of intermediaries such as banks.	High yield	Flexible	Single or small number of investors	Poor for private companies	Medium	Highly illiquid
Distressed debt	Investments in debt of entities in financial distress with the expectation of participation in the upside of the entity recovering.	High yield	Flexible	Single or small number of investors	Poor for private companies	Medium	Illiquid
Public debt/ Bonds	Debt instruments which are tradeable on an exchange. Issuers include government-related entities, banks, corporates and special purpose vehicles (SPVs) created to finance projects or asset pools.	Investment grade/high yield	Fixed	Multiple investors	Good for public companies	Low	Liquid
Corporate direct lending	Loans to conservatively managed mid-sized companies made on a bilateral basis without the use of intermediaries such as banks. Every deal has a unique negotiated structure.	Investment grade/high yield	Flexible	Single or small number of investors	Poor for private companies	Medium/ low	Illiquid
Mezzanine debt	A hybrid of debt and equity financing that is comprised of subordinated to senior debt.	High yield	Fixed	Single or small number of investors	Poor for private companies	Medium	Highly illiquid
Infrastructure debt	Typically long-term project-type debt investments used to finance development, upgrades or ongoing maintenance of infrastructure assets.	Investment grade	Fixed	Multiple investors	Poor for SPVs	Medium	Liquid
Real estate debt	Typically long-term project-type debt investments used to finance development, upgrades or ongoing maintenance of property assets.	Investment grade	Fixed	Multiple investors	Poor for SPVs	Medium	Liquid

Return profile

The asymmetric return profile of a typical debt investment is such that investors' focus is drawn to potential downside risks that may lead to a default. Investors should focus more attention on ESG issues which might be drivers of risk as opposed to sources of opportunity. Taking the same approach to ESG analysis as an equity investor may therefore not always be appropriate.

Credit risk profile

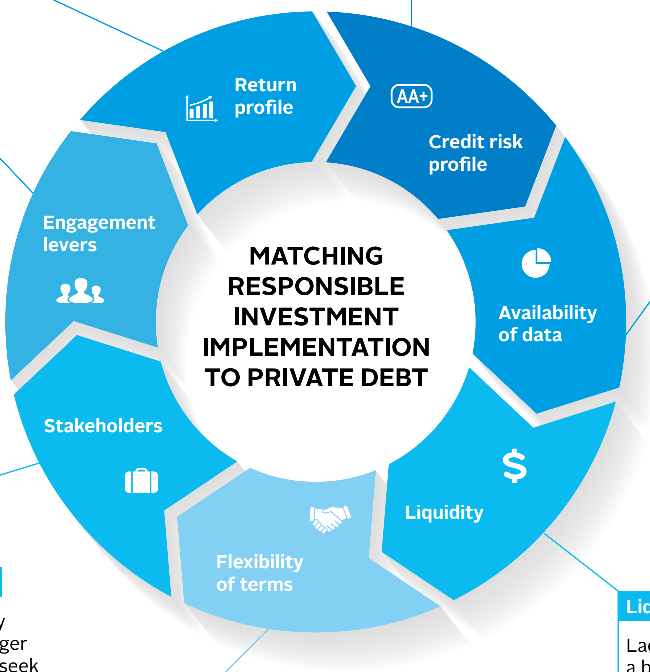
Organisations with weaker credit fundamentals will find it harder to absorb the impacts of ESG issues when they arise and may be more susceptible to single isolated ESG-related incidents than firms with stronger fundamentals.

Engagement levers

Opportunities for investors to engage borrowers are determined by the level of access the lender can get to senior management. This is typically governed by the concentration of investors involved in the deal. Direct loans made by a small number or just one lender allow them greater influence to determine the terms of the deal and engage the borrower on ESG issues – including, on some occasions, allowing for observer seats on the board.

Availability of data

The lack of publicly available data on private companies is both a challenge and an opportunity. Investors must use different techniques to analyse and integrate ESG information into investment decisions. While exclusion is less complex to implement, relative screening (i.e. best-in-class) is not practical owing to the lack of ESG benchmarks for private companies. ESG integration will often require detailed primary research.



Stakeholders

For deals involving a private equity sponsor, bank or third-party arranger and underwriter, the investor can seek ESG information from those third parties which may enhance its insight into the borrower's credit position. However, with more investors involved, their ESG-related requirements are likely to gravitate towards the lowest common denominator.

Flexibility of terms

Greater flexibility to negotiate terms allows investors to push for higher standards of reporting on ESG issues, adherence to specific ESG standards or targets, or variable interest rates relating to specific ESG outcomes.

Liquidity

Lack of liquidity in the market requires a buy-and-hold investment approach and research that should consider ESG factors for at least the tenor of the bond, to account for issues which may evolve over time.

A FRAMEWORK FOR RESPONSIBLE INVESTMENT IN PRIVATE DEBT

There are numerous ESG touchpoints at the various stages of the private debt investment process, as shown in Figure 10. This should not be viewed as a standardised checklist to suit every type of investor, but rather a menu of possible approaches to consider, depending on the investor's responsible investment policy, organisational structure, client needs and other considerations.

Figure 10: Typical private debt investment process, including ESG and engagement considerations

	Typical considerations for private debt investment	ESG considerations	Engagement activity
Pre-deal cycle	▪ Develop statement of investment principles ▪ Define investment universe – geography, sector, credit strength, deal size etc.	▪ Develop responsible investment/ESG policy ▪ Define ESG screening criteria ▪ Educate external agents on RI policy ▪ Define ESG impact or thematic requirements (specialist funds only)	Not applicable
Pre-transaction			
Phase I **Origination & Pre-assessment**	Sourcing & origination: ▪ Generate investment ideas ▪ Identify investment opportunities ▪ Engage agents to source deals Pre-assessment: ▪ Conduct high-level due diligence ▪ Identify any red flags for further consideration in due diligence process ▪ Take decision to proceed to due diligence phase	▪ Apply negative ESG screens ▪ Identify any ESG red flags for consideration in due diligence process ▪ Consult ESG team or independent advisory committee ▪ Consider jurisdictional ESG issues such as local governance, legal systems, ESG policy and regulation	▪ Engage senior management of prospective borrowers for disclosure of potential ESG risks
Phase II **Due diligence & Investment approval**	▪ Conduct credit analysis ▪ Conduct in-depth due diligence ▪ Appoint technical consultants ▪ Determine interest rate ▪ Write up investment memorandum ▪ Negotiate/finalise terms ▪ Take investment committee decision ▪ Transact	▪ Conduct ESG due diligence ▪ Conduct ESG technical assessment ▪ Integrate ESG summary in investment memorandums ▪ Educate investment committee on relevant ESG considerations ▪ Include ESG reporting requirements for borrowers in terms ▪ Determine ESG monitoring needs	▪ Request management changes relating to ESG (e.g. board independence) ▪ Arrange regular dialogue with borrower management ▪ Educate borrowers about investor ESG needs ▪ Define requests for ongoing monitoring of pertinent ESG criteria
Post-transaction			
Phase III **Investment holding period**	▪ Ensure on-going borrower reporting and monitoring ▪ Address developments and incidents that pose risks/potential defaults ▪ Provide technical assistance ▪ Undertake restructuring process (common in distressed debt)	▪ Carry out on-going ESG monitoring ▪ Support improvements that address ESG risks ▪ Measure ESG outcomes linked to investment (mostly impact funds) ▪ Identify potential positive impacts (mostly impact funds) ▪ Ensure manager ESG reporting to investors	▪ Include ESG agenda items in regular borrower meetings ▪ Manage ESG risks relating to potential defaults
Phase IV **Exit**	▪ Consider possible refinance options ▪ Close out process	▪ Undertake ESG impact assessment (impact funds) ▪ Facilitate manager ESG reporting to investors ▪ Consider internal close-out process including ESG lessons learned	▪ Consider close-out process with borrower, including ESG lessons learned

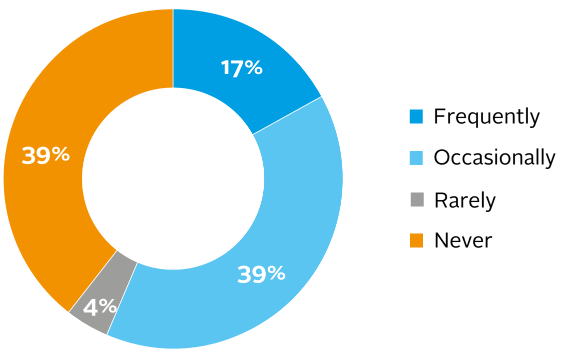
PHASE I: ORIGINATION AND PRE-ASSESSMENT

As investors identify potential private debt deals, they will engage with the borrower and consider whether the deal suits their investment approach, based on criteria such as loan size, EBITDA, industry and geography. In addition, they may also consider whether the borrower meets their ESG screening criteria. During this phase, they should be able to identify factors (ESG or otherwise) that may prove to be deal breakers, or which raise red flags for further consideration during the due diligence phase.

Negative screening/exclusions: Around half of the funds interviewed for this report have formal responsible investment policies that include negative screening criteria or guidelines. Others mentioned client-specific exclusions which are set out in side letters. Common exclusions relate to the production or distribution of controversial weapons, tobacco, alcohol and pornography, as well as other so-called 'sin stocks', which increasingly include the most carbon-intensive sectors such as coal, oil and gas[18]. Some funds base their screening practices on norms such as the UN Global Compact Principles, which relate to corporate sustainability[19].

While some screening criteria may be clearly defined, greater consideration is needed for grey areas where a company may be indirectly involved with an excluded sector – say as part of its supply chain or as a landlord. In these cases, the investor must take a view, typically based on the proportion of revenue derived from excluded activities relative to a pre-determined threshold.

Figure 11: Frequency with which fund managers have decided not to invest in a portfolio company due to ESG factors. Source: Preqin (2017) Private debt spotlight September 2017[20]



Positive screening, impact investing and the UN Sustainable Development Goals: The lack of consistent and comparable publicly reported ESG data on private companies means that positive screening based on relative corporate ESG assessments is rarely a realistic option for private debt investors. There are few ESG benchmarks that cover a sufficiently large universe of private companies from which to conduct objective positive screening.

Increasing numbers of investors want to target positive environmental or social investment outcomes, such as reduced environmental impacts, or contributing to the UN Sustainable Development Goals, alongside financial considerations. During the pre-assessment and due diligence phases, these investors should identify specific ESG themes and measures to assess environmental and/or social outcomes, as well as methods for measuring additionality (that is, that the outcome goes beyond that which would have occurred in the absence of the investment), and methods for reporting on impact to clients. (See section Thematic investing, impact investing & green loans for further discussion.)

PHASE II: DUE DILIGENCE & INVESTMENT APPROVAL

The pre-due diligence phase permits investors to quickly assess whether they should commit further resources to appraising a potential deal, based on an understanding of industry or sector risks. Once committed to the next investment phase, in-depth due diligence, to examine detailed company-specific risks, can begin.

DUE DILIGENCE

Private debt investors, as lenders rather than owners of companies, often have little or no direct influence over the strategic direction of a company, so the assessments made prior to investment are critical. Investors should aim to identify potentially credit-relevant ESG issues that may occur over the life of the investment. All the investors interviewed for this report mentioned considering ESG issues when conducting their due diligence.

Information for due diligence can come from a number of sources, including sell-side materials, legal and technical due diligence (for example environmental, health and safety assessments), private equity sponsor materials and the lender's primary research.

18 See Allianz exclusion criteria for coal

19 UN Global Compact asks companies to embrace, support and enact, within their sphere of influence, a set of core values in the areas of human rights, labour standards, the environment, and anti-corruption. These core values make up the Ten Principles of the UN Global Compact

20 Preqin (2017), Private debt spotlight, September 2017

Due diligence may be based on:

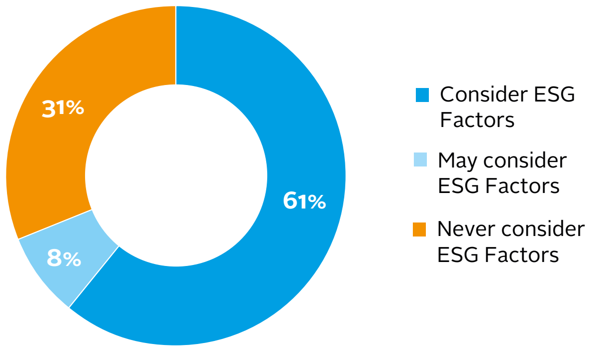
- Investor ESG questionnaires to be completed by borrowers (and, where relevant, private equity sponsors);
- Environmental impact assessments, compliance with industry standards, ISO standards etc.;
- Desk research or advice from technical consultants to explore flagged issues;
- Third-party data analysis, e.g. media feeds on controversies relating to ESG issues;
- Technical appraisals, which assess the need for specialist ESG research and/or ongoing monitoring of specific issues (e.g. compliance with environmental regulations); and
- PE sponsor or other lenders (where relevant), to assess whether they are aligned with the investor's views on ESG and that they have the competencies required to address ESG factors on an ongoing basis.

> "When you are looking at the private markets, you cannot apply a one-size-fits-all analysis of ESG on certain factors, because those factors just won't be available. But because you have this close working relationship with the borrower, and you are often talking over a period of many months, and any information you are sharing is private and does not have to be disclosed publicly, the company is free to discuss sensitive issues with you ... You are working almost in partnership on those transactions."
>
> M&G Investments

Investment decision

Investors should consider integrating relevant ESG factors alongside credit factors such as condition, cash flow and collateral. Many investors see ESG factors as an important element of the borrowers 'character' in credit terms. A 2017 survey by Preqin reported that 61% of investors surveyed currently consider ESG factors as part of their investment process. Investors often include a dedicated ESG summary in their investment committee memorandums to ensure this research is considered and discussed by the committee. Some memorandums include a traffic light or red-flag system to ensure that any major concerns are addressed before a decision to invest is made. In some cases, ESG professionals have the right to veto an investment on the grounds that it does not meet ESG screening criteria or another aspect of the investor's responsible investment policy.

Figure 12: Fund manager consideration of ESG factors in the deal-making process. Source: Preqin (2017) Private debt spotlight September 2017[21]



Transactions: ESG considerations in lending terms and documents

Depending on the type of private debt deal in which a lender is involved (i.e. whether investing in a syndicated or bilateral loan), the lender may be able to negotiate certain terms in legal documents. One advantage of private debt is the potential for flexible terms, such as bespoke repayment schedules and operational covenants[22]. In an ESG context, some investors request terms relating to high-level governance matters, such as the percentage of independent board members, or requests for regular reporting on, for example, adherence to environmental regulations or staff turnover rates.

21 Preqin (2017), Private debt spotlight, September 2017

22 AIMA – Alternative Credit Council (2018), Private credit explained

In connection with corporate direct lending transactions, or where the sponsor is not proactive in terms of ESG, an ESG clause can be a good starting point for addressing ESG factors, as it offers an opportunity to engage the parties on ESG from the inception of the transaction.

> "Our standard ESG clause requires the parties to recognise that we are committed to invest responsibly, adopt a progressive approach in terms of corporate responsibility, and use best efforts to answer an annual ESG questionnaire. Recently, we were very satisfied to see certain companies hire a CSR director a few months after the closing of the transaction."
>
> Tikehau Capital[23]

The consensus among interviewees was that they have the power to amend terms on direct lending, but not on syndicated deals where it would create too much complexity given the number of stakeholders involved. Investors will often find it easier to incorporate ESG terms into side letters than directly into contracts. In a 'covenant-lite' environment where the usual protective covenants typically found in more traditional loan facilities are lacking, investors may consider turning down deals where the borrower is not open to negotiating credit-risk mitigating requirements in lending terms. This is an area we expect to evolve but, in an increasingly competitive market, lenders may be reluctant to insist that borrowers undertake additional (ESG) reporting or impose other requirements.

> "We negotiate ESG reporting provisions, which are included (when possible) in the term sheet and subsequently in the loan agreements. Such provisions are generally in line with the sponsor's ESG requirements."
>
> LGT European Capital[24]

Ideally, dedicated responsible investment professionals, or 'ESG champions' in related investment roles, should support the deal team throughout the process by joining relevant investment committee meetings. Alternatively, they may choose to brief the deal team prior to such meetings, so that the deal team can maintain full ownership of the process. We explore ESG analysis and integration in the Integrating ESG into private debt investment decisions section.

> "If anything [ESG-related] has a material impact on the business, then we require [the borrower] to report that. If we find out subsequently they have not reported on something we considered to be material, then the ultimate sanction we have is to call a default under the documents."
>
> Permira

23 See Appendix section V for wording of the Tikehau Capital ESG clause.

24 LGT European Capital (2018), ESG Report 2018

PHASE III: INVESTMENT HOLDING PERIOD

On-going monitoring after a transaction has been completed is an essential part of any investment. During the due diligence phase, investors identify any material ESG issues that they believe should be monitored for the life of the investment and consider emerging issues on an ongoing basis. This typically involves monitoring for ESG incidents and identifying growing exposure to ESG risks, changes in management, etc.

> "If an event occurs that is deemed to have material ESG significance, we demand full details, explanation and advice of remedial and preventative action."
>
> M&G Investments[25]

In terms of levers to manage risk during the holding period, although lenders cannot impose any ownership rights over a borrower, they may still hold influence as a lender of capital. In addition, there may be options for investors to share expertise on ESG matters with borrowers, co-lenders and/or private equity sponsors in order to manage specific risk exposures. Companies preparing for an IPO often welcome investor insight on corporate governance and reporting. Larger stakeholders may be given an opportunity to take an observer seat on the board, which allows the investor further insights into the workings of the borrower, and to monitor ESG issues more closely.

PHASE IV: EXIT

Exits from private debt investments are typically driven by the refinancing of existing loans, a change-of-control event or the completion of loan terms. It is in a borrower's interest to maintain strong relationships with lenders, particularly when it is looking to refinance. This may provide investors with further opportunities to influence how a borrower addresses specific ESG issues.

In the case of refinancing because of business growth, lenders can rely on insights gleaned from the previous deal cycle and apply those to additional ESG due diligence or reporting requirements. The borrower will typically be open to more demanding ESG requirements in order to secure refinancing under mutually improved credit conditions.

> "If we want to make sure that all these [ESG] issues are considered in the investment decision, we have to make sure [information] is shared by everybody. We are trying to do this by making our ESG due diligence available to everybody upon exit."
>
> LBO France

25 Fiona Hagdrup, M&G, in the Local Government Chronicle accessed 10/09/2018

FURTHER GUIDANCE & ADVANCED PRACTICES

The following section explores different responsible investment approaches, emerging industry trends and thought leadership in more detail, including:

- Integrating ESG factors into private debt investment decisions;
- Engaging borrowers on ESG issues;
- Thematic investing, impact investing and green loans;
- Alignment between lenders, co-lenders and private equity sponsors about ESG issues;
- ESG reporting from managers to investors; and
- Operationalising responsible investment.

INTEGRATING ESG INTO PRIVATE DEBT INVESTMENT DECISIONS

Investors can integrate ESG factors into investment decisions and engage borrowers on ESG issues at various stages of the investment process, as shown in Figure 9. The more standardised ESG integration methodologies available to public markets investors – based on desk research or third-party data and analytics services – are generally not feasible for private market investors due to the lack of publicly available ESG data for private companies. This presents both a challenge and an opportunity for investors, given their ability to exploit imperfect market information and leverage relationships with borrowers.

WHICH ESG ISSUES TO CONSIDER?

Investors can consider ESG factors at various levels:

- Macro view – how do ESG factors, such as resource scarcity and climate change, affect economic growth?
- Sector view – how do ESG factors, such as shifting consumer tastes or regulatory changes, affect business at a sector or industry level?
- Micro view – how is exposure to, and management of, ESG factors linked to company financial performance?

As previously discussed, ESG integration should not be seen as a rigid framework or checklist of issues in isolation. Some ESG issues will be more material to companies in certain sectors than others, depending on whether they are focused on services, manufacturing, natural resources and so on.

There are a number of different frameworks which can help investment teams when considering which ESG issues to assess as part of their due diligence:

- The **Sustainability Accounting Standards Board** (SASB) Materiality Map[26] aims to identify the ESG issues that are most likely to be material for 79 different industries, and provides a useful starting point for investors to consider ESG factors for analysis;
- **Development finance institutions** (DFIs) are generally advanced in their assessment of ESG risks among investee companies, given their exposure to a wide variety of corporate and country risks, and legal and regulatory frameworks.
    - The International Finance Corporation (IFC) Environmental and Social Performance Standards define investee companies' responsibilities for managing environmental and social risks, and provide a useful framework for investors to consider issues such as land resettlement, biodiversity and indigenous people's rights[27]. While the Performance Standards were conceived with emerging market investments in mind, they are also applicable, in large part, to investments in developed markets.
    - The CDC Group ESG Toolkit provides a foundation and reference point upon which investors can develop their own proprietary ESG due diligence frameworks[28].
- Some DFIs, public entities and private investors produce ESG checklists. Examples of publicly available ESG checklists can be found in Appendix III.
- Real estate or infrastructure debt investors may wish to consider the GRESB assessments[29], which enable users to benchmark the ESG profile or performance of real assets and real asset funds on a global basis.

> "All the portfolio companies have employees so, by definition, there is a social risk element to all of these companies in terms of how they treat their employees and how they govern their business."
>
> Permira

26 SASB Materiality Map accessed 10/09/2018
27 The IFC Environmental and Social Performance Standards
28 CDC Group ESG Toolkit
29 GRESB Real Estate Debt Assessment

In addition to these frameworks, Figure 13 lists other examples of ESG issues raised by interviewees for this project. The list is comprised of a mix of values- or norms-based screening criteria and drivers of economic or financial risk and opportunity.

Again, we stress that ESG issues should not be seen as a checklist, but these examples should prompt investors to consider which issues might be most important to the companies to which they lend.

Figure 13: Selection of ESG factors mentioned in investor interviews, representing both norms-based factors and drivers of financial risk and return

Environmental	Social	Governance

■ Environmental management and audit practices
■ Pollution: air, ground, water, soil and groundwater impacts and liabilities
■ Links to thermal coal
■ Resilience to physical climate risks
	■ Employee health and safety
	■ Modern slavery
	■ Child labour practices
	■ Customer/product safety and integrity
	■ Personal debt
	■ Issues linked to health
	  ■ Vaping products
	  ■ High sugar content foods
		■ Close associates of senior management sitting on boards
		■ Supply chain risks
		■ Diversity
		■ Transparency
		■ Cyber-risk management
		■ Anti-competitive behaviour

> "Obviously, governance is immensely important in terms of private debt. We insist on the 'G' but, together with investment managers, we also look at the 'S' and the 'E'."
>
> EthiFinance

WHICH ENTITY TO CONSIDER?

Investors also need to consider which business entity their analysis should focus on – parent, subsidiary or project. Investors should assess a subsidiary's level of autonomy before determining whether analysis of the parent company alone is sufficient. If a subsidiary is operating under the policies of the parent, there may be no need to perform additional due diligence on the subsidiary. If the loan involves a specified allocation of proceeds, then additional analysis may be needed on that allocation or project.

HOW TO ANALYSE ESG

ESG research comprises analysing data collected from one or more of the following: desk research; third-party providers; technical experts; legal due diligence documents; co-investors (either lenders or private equity sponsors); ESG questionnaires; and meetings with the senior management of the borrower. While a lender is unlikely to commission a one-off ESG report, it is quite likely that a private equity sponsor (if involved) will have produced one that it may be prepared to share with the lender. Analysis of ESG factors

> "Inevitably, as sustainability becomes a core requirement for investors, there is a danger that a box-checking culture could develop. What is needed is a clear strategy to focus finite ESG engagement capacity on those areas where ESG risk is greatest, but also where the potential positive impact of marginal sustainable investment is highest."
>
> Allianz Global Investors[30]

30 Allianz Global Investors (2017) Infrastructure Debt and ESG: the importance of strategic prioritisation

should be aligned with the investment horizon, and the investor will need to determine whether issues such as climate change will affect an issuer in the short, medium or long term.

> "Our due diligence process on a company in northern France highlighted an environmental issue that would cost the business. Further due diligence on the capex required to upgrade an industrial site to meet environmental requirements (of €4m-6m just to be compliant) directly affected the credit analysis, so we chose not to invest."
>
> Idinvest Partners

For emerging market deals, development finance institution expertise on ESG can be invaluable to lenders, as the level of due diligence required is likely to be greater than for a deal carried out in more developed economies.

ESG integration in the context of private debt has specific characteristics. ESG integration for public markets practitioners generally involves integrating ESG factors into traditional valuation models (e.g. discounted cash flow models), which can be sensitive to incremental differences. Investment decisions in private markets tend to be more binary, as investors tend to consider whether or not they are comfortable with the overall risk.

> "When significant ESG issues arise in the due diligence perspective, it's a binary decision [to invest or not]. It's not something you can price in."
>
> Allianz Global Investors

> "[We] believe that, in the future, a company's ability to access capital will depend on its ESG performance."
>
> LGT European Capital

USING QUESTIONNAIRES TO GATHER ESG DATA

Investors face a significant ESG information gap due to the lack of public reporting obligations for private companies. Around half of the investors interviewed for this report have created ESG questionnaires to be completed by borrowers to overcome this challenge in an efficient manner. Questionnaires can be quantitative, qualitative, or a combination of the two. Investors interviewed for this report raised the importance of educating potential borrowers on their reasons for requesting ESG information, and to demonstrate a robust understanding of how ESG issues might affect their business model. Investors can act as a mirror to reflect corporate performance and, while most small businesses lack the resources to produce annual ESG reports, ESG questionnaires can be a relatively efficient way for investors to identify a borrower's important ESG characteristics.

> "Our ESG questionnaire is a real chance for [borrowers]. We have a positive view using both our analysis and a third-party report. We don't want to name and shame. We actually send them a summary of their annual report, for discussion."
>
> Lyxor Asset Management

Many investors noted how important it is to avoid burdening borrowers with unnecessary reporting requirements, and that surveys of around 10 questions are more likely to solicit constructive responses than those of 40 or 50 questions. At the same time, those investors commented that borrowers' preparedness to answer investor ESG inquiries has noticeably improved in recent years. Avoiding reporting fatigue by aligning with other lenders is another way for investors to support greater ESG transparency. Ultimately, investors may be able to benchmark borrowers (assuming the numbers allow for a meaningful benchmark) and even encourage competition between portfolio companies.

> "Today, we not only have better acceptance [of ESG] from companies, but there is also appetite for feedback, comparison and best practices. And this is where we can play an important role, because we have access to the data from the other companies in our portfolio. We formalised the output of our [ESG] survey across the entire portfolio on a number of key KPIs, so that an individual company can compare itself to companies of similar size."
>
> LGT European Capital

CONSIDERATIONS FOR THE SECONDARY PRIVATE DEBT MARKET

The secondary market for private debt is both nascent and, given the lack of liquidity in the private debt market, relatively small. Nonetheless, secondary market investors may still consider the ESG profile of borrowers in the same way as a primary debt investor would. The challenge for secondary investors will be the even more limited access to ESG information and management than is faced by primary lenders. Secondary deals will typically mean fewer opportunities for investor engagement with the borrower. Similarly, the capacity of an investor to conduct detailed due diligence is most likely less than for a primary deal, due to less access to company management, and must instead be partly reliant on the primary investor's due diligence. Aligning ESG expectations with the primary debt holder and/or sponsor can help to ensure that secondary transactions meet predefined minimum requirements.

CASE STUDY: A PRIVATE DEBT ESG QUESTIONNAIRE

LGT European Capital sets out its ESG scoring framework in an aggregated scorecard for portfolio companies. Thus far, the response rate to LGT's questionnaire has been 90%, showing the leverage that lenders have to demand ESG data from borrowers.

Figure 14: European private debt manager LGT's ESG scorecard. Source: LGT ESG Report 2018[31].

ESG KPIs

	ITEMS	SCORE	COMMENTARY
General	Existence of an ESG policy	43%	43% of the companies have an ESG policy. Two companies stated they are currently developing one.
	Tracking of ESG initiatives	37%	37% of the companies track their ESG initiatives with specific KPIs, sometimes featured in a dedicated annual report.
	Absence of litigation (in environmental, social and ethical affairs)	90%	Three companies dealt with ESG-related litigation in 2017 (one environmental, one product recall, one HR-related).
Environment	Existence of an environmental policy	57%	57% of the companies have an environmental policy, the primary focus of which is waste management.
	Estimation of CO2 footprint	23%	23% of the companies have assessed their carbon footprint at least once.
	Water or energy consumption	53%	53% of the companies track their consumption of water and energy (primarily electricity and fuel).
	Waste volumes, cost, and % recycled	37%	37% of the companies track their waste volumes. 27% of the companies monitor waste recycling.
Social	Job creation	90%	Net 2017 job creation throughout portfolio was 499, with 90% of companies having increased their headcount.
	Diversity – female headcount	34%	34% of the portfolio's headcount are female.
	Availability of training opportunities	90%	90% of the companies provide training opportunities to a significant portion of their employees.
	Company-wide profit sharing	50%	50% of the companies grant extra bonuses to their employees depending on financial performance.
Governance	Independent member(s) at Board	43%	43% of the companies have boards comprising at least one independent member.
	Board meetings per year	6	Board meetings are scheduled six times per year on average.
	Existence of a corporate code of ethics	53%	53% of the companies have a corporate code of ethics.
	Existence of other specific committees	47%	47% of the companies use specific committees (management, audit, remuneration, etc.) to assist the board.

> "The companies that answer our questions are pleased to do so and ask us to give feedback to improve their way of addressing [ESG matters]."
>
> La Banque Postale Asset Management

31 LGT European Capital (2018), ESG Report 2018

BORROWER REPORTING REQUIREMENTS FOR ESG ANALYSIS

As with investor reporting, there is no clear consensus on best practice reporting on ESG issues - how companies do this depends on a range of factors, such as their size, resources, expertise and relationship with their investors.

> "In our view, a poor approach to ESG is symptomatic of a more general unwillingness to embrace transparency."
>
> M&G Investments[32]

Some investors stipulate regular ESG reporting in the loan terms but, at a certain size, there is a general expectation that the borrower will publish some form of corporate ESG policy and reporting to address specific ESG issues.

> "The worst way of trying to impose reporting is asking for something they don't need. That does not encourage [borrowers] to respond. It is better to ask: 'Can you please share what you have?'"
>
> EthiFinance

ENGAGING BORROWERS ON ESG

As discussed, engagement is a useful tool for managing and monitoring ESG risks. Lenders can engage borrowers throughout the investment process, from initial pre-assessment through to the post-transaction phase. While lenders lack the access to management that shareholders enjoy, there can be intense exchanges between borrowers and lenders during the initial assessment and due diligence phases.

> "The direct, private relationship between loan provider and borrower, and the contractual nature of the loan, create relatively frequent contact between the parties that permits typically greater engagement than in the bond market."
>
> M&G Investments[33]

PRACTICAL CONSIDERATIONS

- Loans involving smaller numbers of investors will inevitably afford each one of those investors greater influence than those involved in a public debt issuance or leveraged loan.
- Often the best opportunity to engage is just before a transaction, when the loan is mission critical and the borrower is most attentive.
- As many smaller private companies lack dedicated investor relations or ESG personnel, lenders will need to seek out an ESG champion within the senior management team to maximise the effectiveness of their engagement.
- Strong working relationships and regular dialogue among borrowers, lenders, private equity sponsors and co-lenders is crucial to ensure alignment between all parties.

32 Fiona Hagdrup, M&G (2018), "What can loan managers do to manage ESG risks?" Local Government Chronicle

33 Fiona Hagdrup, M&G (2018), "What can loan managers do to manage ESG risks?" Local Government Chronicle

- Many investors consider themselves to be playing an educational role – explaining to borrowers why they are interested in ESG information and what they are looking for.
- Borrowers are typically receptive to engagements on ESG matters, and many appreciate the opportunity to demonstrate their commitment to and their management of ESG issues.
- Given the lack of formal private market ESG benchmarks, many borrowers appreciate the opportunity to benchmark themselves against peers in the lender's portfolio.

THEMATIC INVESTING, IMPACT INVESTING & GREEN LOANS

MOTIVATIONS FOR IMPACT OR OUTCOME-DRIVEN INVESTMENT

Policy makers around the world are reacting with increasing urgency to the most pressing sustainability issues, such as climate change. At the same time, many investors are actively targeting investments which generate positive environmental or social outcomes through good corporate practices, or through the products and services that investee companies offer. Private debt has the potential to provide a significant proportion of the capital these companies will need.

Impact investment has often been (rightly or wrongly) associated with compromised financial performance, but it is increasingly seen as an approach that does not necessarily lead to below-market returns, and can be compatible with investors' fiduciary duties. Indeed, certain investors target solutions to critical environmental and social issues specifically because of their potential to outperform traditional businesses over the medium and long term.

The main characteristics of private debt outlined above present both advantages and challenges as a means of allocating impact capital (see Figure 15).

Figure 15: The case for using private debt to gain exposure to thematic, impact or green investments

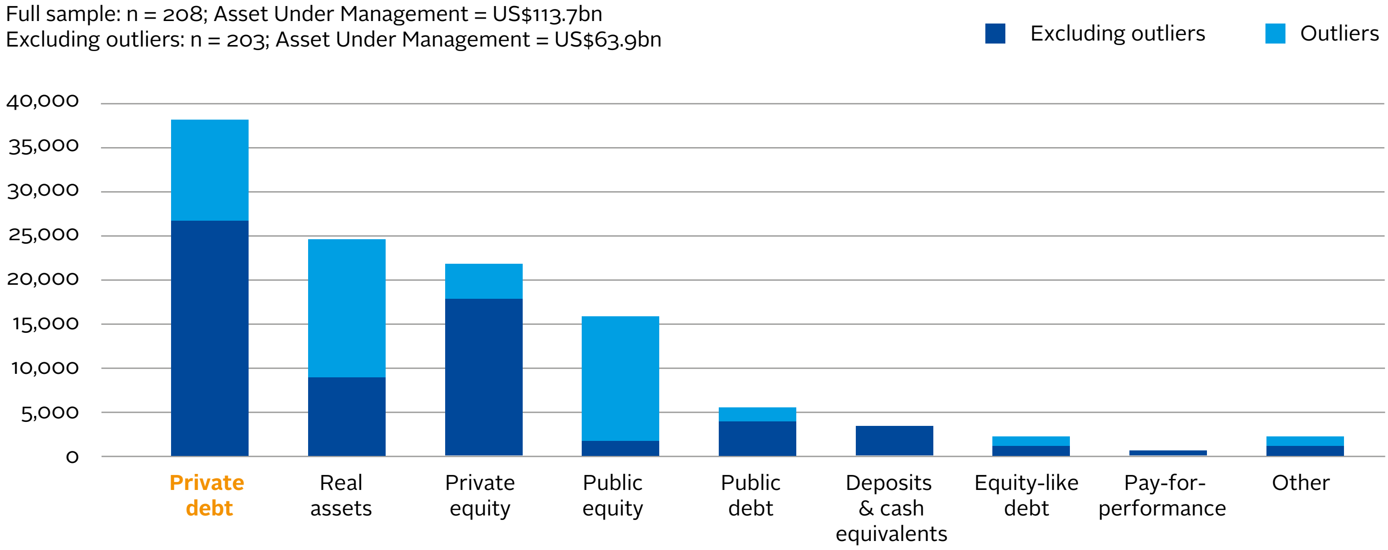
For	Against
▪ Debt instruments allow for specific allocation of proceeds to environmental or social outcomes. Companies that are not inherently green can still raise debt to fund green projects, such as energy efficiency retrofits for commercial real estate. ▪ A single or small number of investors can negotiate terms to stipulate borrower reporting on ESG or determine interest rates contingent on general ESG performance or specific ESG factors. ▪ Many of the solutions to ESG challenges will come from innovations by smaller, private companies. ▪ Real estate and infrastructure debt, which represent the bulk of assets allocated in private debt, have great potential for positive outcomes, given their links to economic development, energy generation and use, essential public services.	▪ With some investment strategies, debt investors are in a relatively weaker position from which to request specific impact reporting metrics from borrowers. ▪ Many private debt transactions involve small and medium-sized enterprises (SMEs), many of which are service-based companies that have relatively low potential for positive environmental outcomes. ▪ SMEs may struggle with the costs involved with measuring and reporting on impacts for investors. ▪ Relatively low upside opportunity when compared with private equity investors may deter those investors seeking to outperform by investing in growth sectors which address ESG risks.

> "Since loan agreements can often be bilateral, there is the ability to contractually bind the borrower as to its green loan obligations. If a [borrower] fails to use the proceeds for green purposes, this can cause an event of default or trigger in-built penalties until the borrower cures it."
>
> DLA Piper[34]

34 DLA Piper (2018) Shades of Green in Financing: A Discussion on Green Bonds and Green Loans

Figure 16: Investments which target positive environmental or social impact, by asset class. Source: The GIIN (2017) The Annual Impact Investor Survey[35]

Full sample: n = 208; Asset Under Management = US$113.7bn
Excluding outliers: n = 203; Asset Under Management = US$63.9bn



	Private debt	Real assets	Private equity	Public equity	Public debt	Deposits & cash equivalents	Equity-like debt	Pay-for-performance	Other
% Total	34%	22%	19%	14%	5%	3%	2%	0.2%	2%
% Excl. outliers	41%	14%	27%	3%	6%	5%	2%	0.3%	2%

GREEN LOANS

Green loans are defined as: "Any type of loan instrument made available exclusively to finance or re-finance, in whole or in part, new and/or existing eligible green projects[36]." Green bond issuance has grown exponentially since the European Investment Bank issued the world's first official green bond in 2007 and the green loan market holds equal promise as a large-scale source of capital for solutions to climate change and other sustainability challenges. As of July 2018, US$32bn of green loans had been issued globally[37]. The Green Loan Principles (GLP), developed by the Loan Market Association and largely based on the International Capital Market Association's Green Bond Principles, provide a high-level framework of market standards and guidelines for the green loan market[38]. They are designed to ensure consistency and integrity in four areas:

1. Use of loan proceeds;
2. Process for project evaluation and selection;
3. Management of proceeds; and
4. Reporting.

To ensure consistency and credibility to loans labelled as 'green', 'social' or 'sustainable', the GLP appendix includes an indicative list of categories of projects considered to be eligible for a green loan label, including renewable energy, pollution prevention and clean transportation.

POSITIVE INCENTIVE LOANS

Similarly to green loans, positive incentive loans (PILs) are associated with positive environmental or social impact. The key feature of a PIL is that a proportion of the financing cost is linked to the ESG performance of the borrower, as judged by independent ESG research providers.

> "It is vital that investors can clearly see what their money is doing to improve peoples' lives and the environment whilst providing stable financial returns,"
>
> M&G Investments[39]

35 The GIIN (2017) The Annual Impact Investor Survey
36 Loan Market Association (2018) Green Loan Principles
37 Environmental Finance (2018) The green and sustainability loan market: ready for take-off
38 Loan Market Association (2018) Green Loan Principles
39 Environmental Finance (2018) M&G launches private debt impact fund

EXAMPLES OF THEMATIC OR IMPACT INVESTMENTS IN PRIVATE DEBT

- French food company Danone recently signed a €2bn syndicated loan where the cost of capital is directly linked to specified goals based on sales from Certified B Corp subsidiaries and the combined ESG ratings from two independent research providers[40]. In this deal, a proportion of the cost of capital can either rise and fall from the base rate, depending on performance.
- UK-based M&G Investments manages a private debt fund that targets positive social and environmental impacts. In February 2017, M&G provided a long-term £85m loan to UK-based housing association One Housing. The loan is being used to increase the number of affordable properties developed by the company[41].
- A portfolio of three UK wind farms with a combined capacity of 151 megawatts reached financial close in 2017 after securing a £210m debt package. Developer Banks Renewables received £140 million of the total from Macquarie Infrastructure Debt Investment Solutions, which provided long-term liquidity comprising of both fixed rate and inflation-linked tranches[42].

> "Historically, we have had the belief that any company can be a very strong ESG company, whatever its environmental footprint. It's all about the trend, the effort and the progress. We never considered exclusions or sectors to be very relevant in a holistic ESG approach [...] We are not making an impact if we are only investing the sectors that are green."
>
> LGT European Capital

ALIGNMENT BETWEEN LENDERS, CO-LENDERS AND PRIVATE EQUITY SPONSORS ON ESG

> "We always try to have an engagement dialogue with other debt investors and with the [private equity] sponsor through regular meetings, not just the odd one-way email."
>
> SWEN Capital Partners

Aside from engaging borrowers, investors should also consider combining and streamlining efforts on ESG with other lenders and (where applicable) private equity sponsors. Private equity investors often hold the relevant ESG information a lender needs to complete a satisfactory due diligence process. A strong relationship and knowledge of the sponsor's own approach to responsible investment should help to build a lender's confidence further. The feasibility of such collaboration will depend on the respective private debt strategy. Hence, while participants in syndicated loans will be pressured to work towards the lowest common denominator regarding ESG due diligence, investors involved in unitranche or bilateral loans may see value in collaboration on ESG risks and will be able to determine their own thresholds.

With considerations about investor collaboration in mind, French private equity industry association France Invest has initiated a programme to identify best practices and issue recommendations (possibly including suggested clauses) for collaboration and dialogue on ESG between co-lenders and sponsors.

> "We tend to believe that, when you have got a private equity sponsor involved, the likelihood of [ESG] issues [materialising] is lower."
>
> LBO France

40 Bloomberg (2018) Weekly brief: Sustainable Finance. ESG brief April 18 2018

41 One Housing Living Better (2018) One Housing to build 1,450 homes following £85 million financing deal with M&G investments

42 AIMA - Alternative Credit Council (2017) Macquarie leads £210 million financing in triple UK wind deal

ASSESSING THE RESPONSIBLE INVESTMENT APPROACH OF PRIVATE EQUITY SPONSORS

Given the access that private equity sponsors have to company management, many of the private debt investors interviewed reported that they engage those sponsors with proprietary ESG questionnaires and/or review their publicly available PRI Transparency Reports to assess their commitment to responsible investment[43]. The focus for such investors is typically similar to that of a private equity LP: sponsor commitment to ESG considerations; their responsible investment policies; their internal resourcing of responsible investment; and examples of their responsible investment procedures in practice.

> "If you are dealing with a very large transaction with lots of potential lenders, you may have less influence. Often what is more important is your ESG views on the sponsor rather than the actual company you are lending to."
>
> M&G Investments

> "[Our approach is,] if the sponsor is a major player in ESG, we will a) evaluate the acquisition due diligence...on the equity side, and b) we will agree with them on how we are going to monitor ESG issues during the holding period."
>
> LBO France

Figure 17 shows an example from a lender of a scoring framework used to assess sponsor commitment to responsible investment. Furthermore, the Appendix of this report includes the PRI Private Debt Investor ESG Due Diligence Questionnaire. The questionnaire is based in part on the PRI Private Equity LP Due Diligence Questionnaire and is intended to encourage dialogue between investors and managers. The questions may also help to frame dialogue between lenders and sponsors[44].

Figure 17: Example of a manager rating system used by European fund-of-funds LGT European Capital to assess fund managers[45]

Rating	Description
1	Manager is genuinely committed to ESG, with institutional processes in place. Applies ESG criteria in investment decision-making, is an active owner and reports on ESG
2	Manager has taken steps to integrate ESG into its approach and investment process. Process is institutionalised, but manager may not follow through at all levels (e.g. reporting)
3	Manager demonstrates some commitment to ESG or has begun certain initiatives, but lacks institutionalised processes
4	Manager demonstrates little or no commitment to ESG

43 All PRI signatories are required to complete an annual Reporting & Assessment process for transparency and accountability purposes. The PRI publishes Transparency Reports which contain a sub-set of responses to the Reporting Framework, and encourages investors to share the results of their assessments, which include benchmarked scores.

44 PRI (2015) LP Due Diligence Questionnaire: and how to use it

45 LGT European Capital (2018) ESG Report 2018

ESG REPORTING: MANAGER TO INVESTOR

The private debt industry has yet to reach consensus on the best ways for managers to report on ESG to investors, and reporting activity seems to be lagging relative to other asset classes. This may be a reflection of a lack of demand from investors, but interviewees agreed that this trend is now turning. The PRI's report, *ESG monitoring, reporting and dialogue in private equity*[46], provides useful guidance on this aspect of responsible investment. It includes the following suggestions:

- Create a robust yet flexible reporting system that suits the needs of both LP and GP;
- At the manager or GP level, reporting should focus on responsible investment policy, the people responsible for delivering that policy, and the procedures used;
- At the portfolio level, some managers are starting to report on the ESG 'profile' of their holdings, although this may have to be done in aggregation rather than at the individual portfolio company level, due to legal agreements between lender and borrower;
- ESG reporting should focus on incidents and any other material changes to the ESG profile of an individual holding; and
- Managers are, increasingly, reporting ad hoc case studies of positive outcomes, which can provide investors with additional insight into how they manage certain ESG issues.

> "We tend to report to all our investors on a summary of our survey [of portfolio companies] every year, on some key KPIs, and both the response rate and performance. For this year, the response rate was in excess of 90%."
>
> LGT European Capital

> "You need to hear from a range of people [...] You also need to hear from the people who do the monitoring. The approach to work-out – how the manager treats distressed situations – is very important with private debt and very much has an ESG dimension: is it consistent with ESG principles, i.e. not fee-generative but really involving working with the companies to make sure sustainability and governance aspects are a high priority?"
>
> B Finance[47]

OPERATIONALISING RESPONSIBLE INVESTMENT

One of the first hurdles many investors face is how to operationalise responsible investment within their organisation: which staff members should take what responsibility for the various internal procedures, and how should the work be resourced? The PRI does not prescribe a single approach in this regard, but notes that investors typically formalise their responsible investment policies and procedures in a phased approach. There is, however, general consensus that best-practice responsible investment is fully integrated into the organisation and not treated as an add-on only to be used for marketing purposes. An integrated approach typically involves a centralised ESG function that can coordinate ESG champions across different teams, including compliance, research, portfolio management and marketing.

46 PRI (2018) ESG monitoring, reporting and dialogue in private equity
47 Bfinance (2016) ESG Under Scrutiny: Lessons from Manager Selection

> “We believe that, in the long term, there really will be a differentiation of a borrower’s capacity to access capital or cheaper capital, depending on its ESG performance.”
>
> LGT European Capital

Buy-in at the highest levels is essential, and it is also important to incentivise staff and educate them on emerging ESG topics where necessary. In terms of the actual responsible investment process, managers should ensure an ESG lead attends all deal flow meetings, investment committee meetings and major investment decision sign offs, and wields a veto over deals that do not meet predetermined ESG criteria. Many investors also now include a mandatory ESG section in investment memorandum templates and investment committee meetings.

SUMMARY OF KEY TAKEAWAYS

- The key concepts of responsible investment are complementary to private debt with its core focus on analysing and managing risk through relationships with investee entities.
- There appears to be significant responsible investment activity among private debt managers and a desire to further develop best practice in the industry.
- It seems that small business managers are willing to learn about the importance of ESG if investors are prepared to educate them, but this will not overcome the issue that small businesses will inevitably lack the resources to address all material ESG issues, meaning that investors will need to proactively address those issues.
- Among the challenges identified by interviewees, perhaps the greatest is the lack of objective, consistent and timely publicly available data on private companies. However, this also presents an opportunity for those with a good understanding of how ESG issues relate to borrower creditworthiness. It remains to be seen whether an industry-wide solution will emerge.
- Collaboration and information sharing between co-lenders and private equity sponsors will increase ESG transparency for borrowers.
- We anticipate increasing investor demand for clauses relating to ESG in legal documentation, but the willingness of small businesses to accept such clauses will depend on broader market dynamics, including interest rates and competition from other investors and banks.

APPENDICES

I. INVESTOR CASE STUDIES

Case studies relating to responsible investment in private debt can be found on the PRI website here.

Other relevant PRI case studies:

- Futuregrowth – Screening and engaging to mitigate ESG risks
- M&G – ESG engagement in private infrastructure debt
- Neuberger Berman – Engaging with non-investment grade issuers

II. EXAMPLES OF PRIVATE DEBT INVESTOR RI POLICIES

- AG2R Investisseur responsable
- Allianz Global Investors (2018) ESG Policy Framework
- ICG (2018) Policy and ESG checklist
- Idinvest (2018) Responsible Private Equity Policy
- LBO France (2017) ESG Policy
- Lyxor (2018) SRI policy
- SWEN (2018) Responsible investment Charter and policy

III. EXAMPLES OF INVESTOR ESG CHECKLISTS AND EXCLUSION LISTS

- CDC ESG toolkit for fund managers
- ICG ESG Checklist
- IFC exclusion list
- KFW exclusion criteria

IV. ESG CLAUSES FOR DEAL TERMS: TIKEHAU CAPITAL (FRANCE)

The three paragraphs below are clauses relating to ESG which may be inserted into a side agreement to supplement a contract between a lender and borrower. They were developed by French private debt manager Tikehau Capital.

REPRESENTATION

The Issuer has been informed of the commitments made by the Financial Investors, as signatories of the United Nations Principles of Responsible Investment (UN PRI) and having drawn up a charter of responsible investment, the need to take into account environmental, social and good governance criteria ("ESG" criteria) in their investments and the monitoring of their portfolio.

UNDERTAKINGS

The Issuer undertakes to make its reasonable endeavours for the Group to comply with Human Rights and international labour standards, and particularly in respect of child protection*. In addition, the Issuer undertakes, insofar as the financial resources and budget of the Group and the operating constraints to which the Group is subject, enables it to adopt a progressive approach in order for the Issuer and its subsidiaries to carry out their business under conditions which bring together economic interests and corporate responsibility.

REPORTING

The Issuer undertakes to provide annually performance indicators on the following environmental, social and good governance criteria. Such provision demonstrates a commitment to respect the principles of the United Nations Global Compact. We suggest to treat "Fight against corruption, money laundering and the financing of terrorism" with usual corruption, money laundering provisions and treat "Avoid or limit environmental damage" with usual environmental provisions.

V. PRIVATE DEBT INVESTOR ESG DUE DILIGENCE QUESTIONNAIRE

The Private Debt Investor ESG Due Diligence Questionnaire (DDQ) is designed for use by indirect investors (i.e. Limited Partners or asset owners) when assessing potential private debt managers. The intention is for those investors to integrate the following questions into their standard due diligence questionnaires to help them understand and evaluate a manager's approach to integrating material ESG factors into their investment practices and to understand where responsibility for doing so lies within the investment manager's organisation. Investors are encouraged to tailor the list to suit their objectives, and to incorporate it into commercial due diligence processes.

The DDQ acknowledges that what constitutes effective and relevant disclosure can be defined only through discussions between an investor and a manager, due to both the diverse nature of the private debt asset class and differing approaches to ESG management and disclosure among investors and managers.

POLICY & GOVERNANCE

1. What are your ESG-related policies and how do ESG factors influence your investment beliefs?

1.1 Please provide a copy of your policy that describes your approach to identifying and managing ESG factors within the investment and portfolio management processes?

1.2 What plans do you have, if any, to further develop management of ESG factors?

1.3 Do you commit to any international standards, industry (association) guidelines, reporting frameworks, or initiatives that promote responsible investment practices?

1.4 Do you make formal commitments relating to ESG integration and ESG restrictions in fund formation contracts, Limited Partnership Agreements or in side letters when requested by investors?

1.5 Does the investment manager annual employee performance review or remuneration metrics reflect any component for the inclusion of ESG?

1.6 Who is directly responsibility for setting the ESG incorporation strategy and framework for the fund/mandate?

1.7 What is your process and frequency of any formal review of responsible investment policies and practices?

PRE-INVESTMENT

2. How do you identify and manage material ESG-related risks?

2.1 How do you define the materiality of ESG factors? Please give two or three examples of ESG factors that you have identified as long-term material factors to investments in your most recent fund or mandate.

2.2 Describe your process for identifying and understanding: (i) potentially material ESG risks, including long-term risks and (ii) the time frame in which these come into play during due diligence. Please give an example of where you have identified ESG risks from your most recent fund or mandate.

2.3 Once identified, how might the identification of potentially material ESG risks impact the investment decision, for example validating the decision, reducing the amount invested or resulting in declining the investment? Please give an example from your most recent fund/previous role for new funds.

2.4 Describe your process of engagement with the (private) equity sponsor or co-lending parties on existing ESG integration processes. How do you ensure alignment in ESG strategy and negotiate commitments in transaction documentation?

2.5 How are ESG risks reported to, considered and documented by the ultimate decision making body, such as the Investment Committee?

2.6 Describe your approach to (and process for) understanding and managing ESG risks (e.g. carbon footprint of the portfolio, borrower's exposure to environmental or social regulatory risks etc.). How do you leverage ESG-related insights and best practices between assets within a portfolio?

2.6.1 Does the investment manager assess the exposure of its fund(s) to climate risk, and measure and monitor the carbon footprint of its investment portfolio?

2.7 During deal structuring, what is your approach to (and process for) integrating ESG-related considerations into lending terms and/or on-going monitoring of a borrower?

2.8 Please describe how: (i) oversight responsibilities, and (ii) implementation responsibilities for ESG integration are structured within your transactions. Please list the persons involved and describe their position within the organisation and how they are qualified for this role. Please also describe any external resources you may use.

2.9 Do you provide training, assistance and/or external resources to your deal team to help them understand and identify the relevance and importance of ESG factors in investment activities? If so, please describe what kind of training is provided.

POST-INVESTMENT

3. How do you contribute to a borrower's management of ESG-related risks and opportunities?

3.1 How do you assess that adequate ESG-related capability exists at the borrower level? How do you ensure that the management team for each borrower devotes sufficient resources to managing ESG factors that have been identified?

3.2 What monitoring processes do you have in place on a borrower's management of ESG factors? Is the oversight of ESG-related risk, including long-term risk, included on the agenda of regular meetings with the borrower's management?

3.3 What data do you capture on ESG performance? How do you define ESG performance targets?

3.4 Specify any initiative(s) on which you worked with the borrower's management or private equity sponsor to identify and instigate, and/or which you supported, the borrower to achieve a positive ESG outcome. Alternatively, can you provide examples of initiatives the borrower was already undertaking that you identified and/or supported as existing good practice?

3.5 Do you measure whether your approach to managing ESG considerations has affected the financial and/or ESG performance of your investments? If yes, please describe how you are able to determine these outcomes.

3.6 Do you exchange ESG insights with related stakeholders (e.g. co-lenders or private equity sponsors)? Give an example how collaboration led to an ESG initiative supported by the borrower's management?

3.7 What is your approach to incorporating ESG considerations into preparations for repayment or refinancing, and the post exit phase?

4. How can investors monitor and, where necessary, ensure that the fund or mandate is operating consistently with agreed-upon ESG-related policies and practices, including disclosure of ESG-related incidents?

4.1 Which channels do you use to communicate ESG-related information to investors? Can you provide samples of ESG-related disclosures from an earlier fund or mandate? If not, please indicate whether you would consider introducing ESG-related disclosures.

4.2 Is the management of ESG factors included on the agenda of the Limited Partners Advisory Committee, Annual General Meeting, and/or investor annual/quarterly updates?

4.3 Describe your approach to disclosing and following up on material ESG incidents to your investors.

CREDITS

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The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org