AIMA

ALTERNATIVE CREDIT COUNCIL

FINANCING THE ECONOMY 2021

ESG and Private Credit

in partnership with

ALLEN & OVERY

lendingforgrowth.org

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This PDF contains elements that are interactive.

Foreword

Welcome to the seventh edition of the Alternative Credit Council's (ACC) Financing the Economy research series, produced in partnership with Allen & Overy LLP. We're delighted to have the support of 57 leading private credit managers and investors managing an estimated $600bn of private credit assets in the development of this paper. We would like to convey our thanks to each of these firms for their contributions to this research.

The primary objective of this research is to provide investors and policymakers with data and insight on the market trends underpinning the development of private credit. As well as analysing how firms are deploying and raising capital, we have chosen to broaden the focus of this year's research to incorporate how Environmental, Social and Governance (ESG) considerations are shaping the private credit market.

ESG is now established as a priority for most investors. It is also central to policymakers' approaches to the regulation of financial services and how businesses of all types manage their operations. Our research shows that, for private credit managers, ESG is also increasingly 'business as usual', with the majority having already implemented changes to integrate ESG considerations across their strategies. Private credit managers are also a growing source of guidance and technical support to corporates on sustainability issues.

These changes are being positively received by investors, but our findings indicate that they also expect more to be done. The integration of ESG is currently far from uniform, particularly across core areas such as loan documentation, data collection and investor reporting. The absence of established practices in these areas is a significant obstacle for investors seeking to assess and benchmark how their allocations contribute towards their ESG goals. It also offers ammunition to those seeking to paint industry efforts as greenwashing.

Integrating ESG into their business models does not appear to have prevented private credit managers from continuing their growth and expansion. Our research estimates that the sector deployed almost $200bn of capital during 2020. This capital has helped private credit strengthen its importance for the middle market and supported its expansion into newer markets and strategies. This diversification is likely to augment the resilience private credit has demonstrated to investors during the past 18 months.

This research confirms that meeting investor ESG needs has now been added to the list of challenges as well as opportunities the sector must embrace to remain successful. Maintaining strong partnerships with borrowers and investors will be crucial. The findings we present in this paper show that ESG considerations are now a key focus within the industry.

Jiří Król
Global Head, Alternative Credit Council

Jake Mincemoyer
Partner, Allen & Overy

Stanimir Kostov
Partner, Allen & Overy

Executive summary

Private credit managers provided an estimated $196bn of fresh capital during 2020

This is a significant increase from the levels managers expected to deploy during last year's survey, in which they indicated a likely annual business volume of $113bn by the end of 2020. SMEs and mid-market companies continue to be at the core of the private credit market, with 74% of respondents describing their most common loan size as below $100m. A substantial part of the market is now targeting larger borrowers, with 26% of respondents describing their most common loan size as greater than $100m, up from 10% last year. Despite larger companies having access to various financing options, many are increasingly choosing the private route to capital, prizing the tailored and efficient financing solutions that private credit can offer.

A stable and growing part of investor portfolios

The performance of private credit during the last 12 months has provided investors with further evidence with which to assess the resilience of the asset class. Borrower default levels also remain relatively low, with 74% of firms reporting under 5% restructurings across their portfolios. We also see further evidence that the asset class continues to diversify, with a notable number of firms now active in Asia or providing speciality finance. Private credit firms also raised significant sums of capital, despite the uncertainty of the past year.

Integrating ESG into the investment process

Our data shows that ESG integration is an integral part of most private credit managers' lending strategies, with 74% noting that ESG is considered for all investments. While there has been widespread adoption of ESG in some form, the manner in which ESG has been integrated is by no means uniform across the sector. Key challenges for private credit managers are data availability, matching a consistent process to different lending strategies and markets, adherence to regulatory requirements and meeting diverse investor expectations.

Putting business on the track to sustainability

Private credit managers are playing a key role in driving sustainability changes among small and mid-sized companies. Private credit managers are a becoming a key source source of guidance and technical support on sustainability issues for many SMEs and mid-market businesses. Almost half of private credit managers surveyed see this as their biggest value-add on ESG issues, and nearly a third see their ability to influence ESG outcomes as their biggest strength.

The emergence of ESG-linked loans

A third of firms reported offering ESG-focused private credit products that incentivise businesses to become more sustainable, for example linking the interest rate to ESG-related criteria. Such products are likely to become more prevalent, with a further 28% of respondents planning to make loans with ESG-linked financial incentives in the future. While the materiality of how ESG performance is assessed continues to be debated within the industry, managers and investors interviewed for this research agreed that ESG-linked loan terms should not reward 'business as usual' and potential greenwashing and bluewashing are shared concerns.

A sustainable approach to ESG

Private credit managers have adapted and deepened their approach to ESG integration relatively quickly, but there is a consensus that methodologies, loan documentation and engagement practices will continue to evolve. While greater alignment between investors, private credit managers, borrowers and regulators will support this process, the industry's desire to innovate is likely to be the biggest driver of new solutions.

Research methodology

Financing the Economy 2021 is based on data from several sources. The Alternative Credit Council (ACC) and Allen & Overy LLP (A&O) conducted a survey of private credit managers and received responses from 57 private credit managers and investors. Collectively they manage an estimated $605.38bn in private credit investments, across a broad cross-section of jurisdictions and strategies.

The survey data was then explored by the ACC and A&O in a series of one-on-one interviews. Private credit managers were also invited to submit case studies of how their firms are contributing to the real economy and integrating ESG, which you can find throughout this paper.

The respondents to this survey are diverse in terms of geographical focus, range of private credit strategies covered and typical borrower size targeted. (see Figures 1 and 2). Most respondents typically provide loans of up to $100m, however a notable proportion of respondents provide loans larger than $100m (see Figure 3).

Figure 1: Where does your firm currently make private credit investments? (select all that apply)

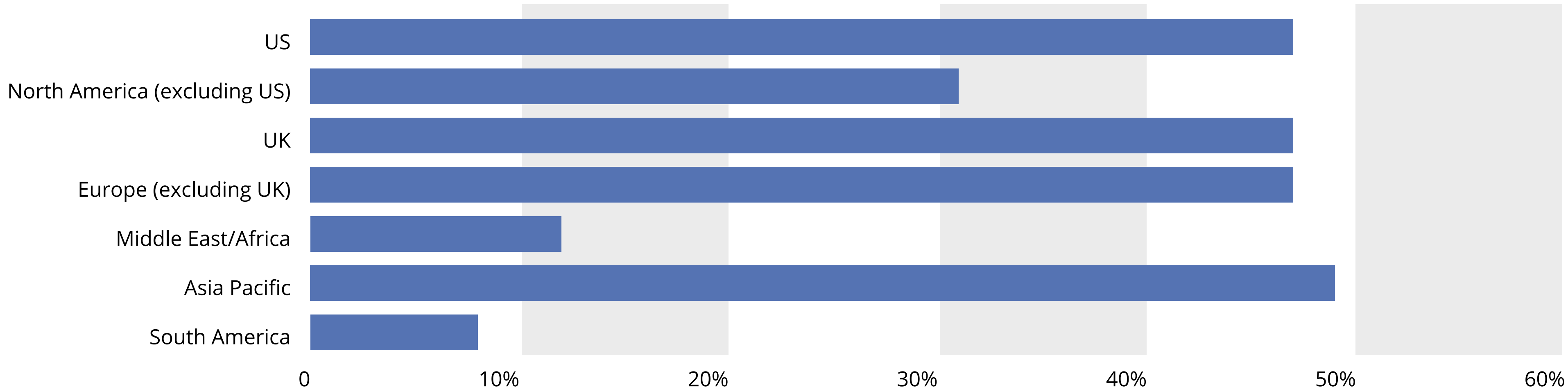


Figure 2. To which of the following private credit strategies (broadly defined as investments in loans, private bank debt, private debt securities and similar instruments, but excluding publicly traded bonds or more liquid fixed income strategies) are you currently deploying capital? (select all that apply)

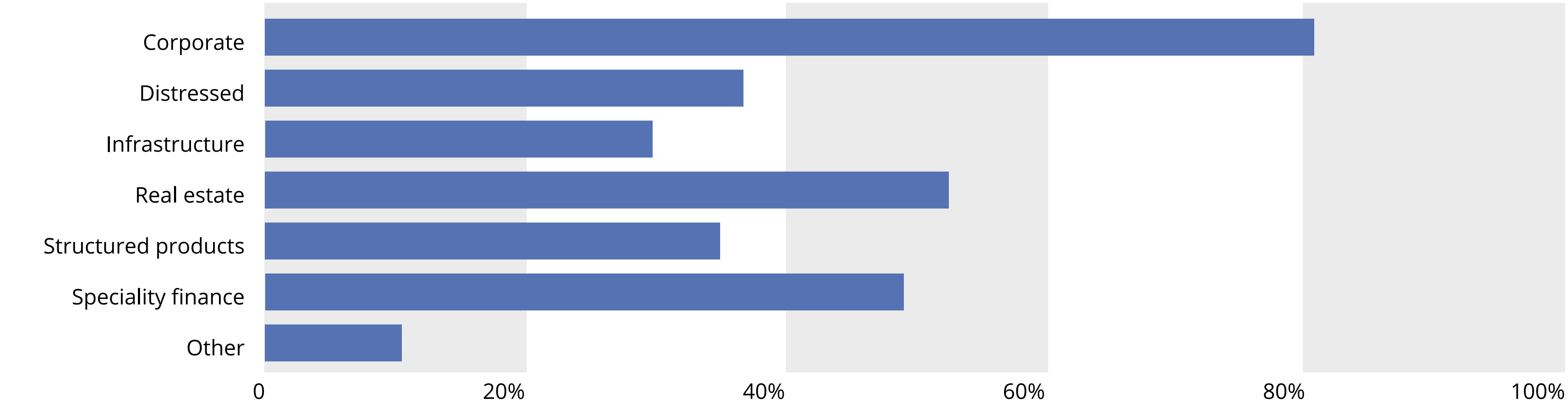
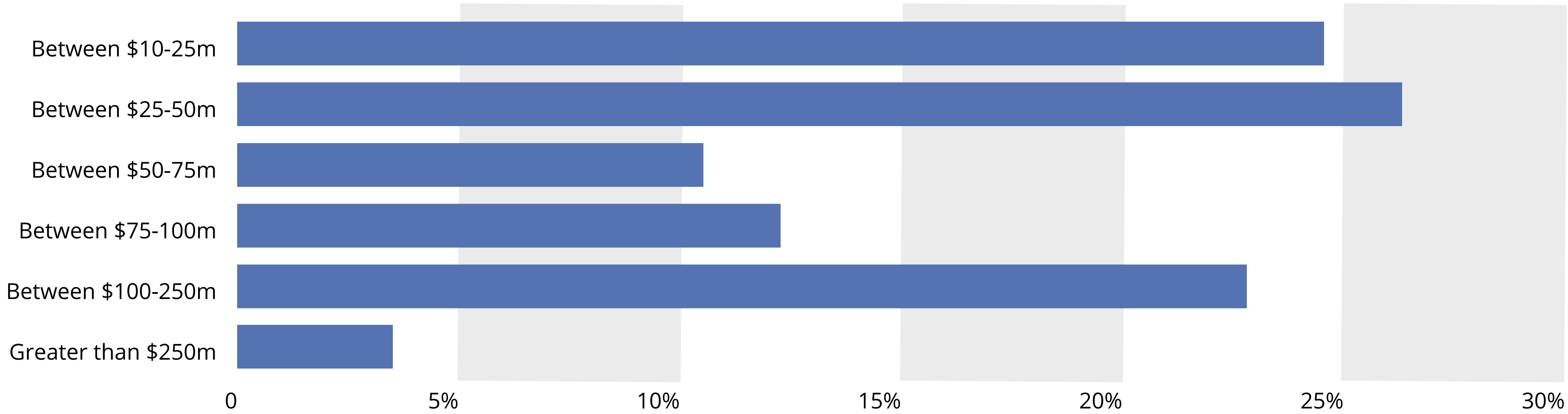


Figure 3. What is the most common loan size that you make within your private credit strategy?



Chapter 1 – Private credit demonstrates its value to investors and borrowers

This research series has sought to highlight the value of private credit to investors for several years. While the growth of the asset class has been undeniable, many investors took a more cautious view that the true strength and resilience of the asset class was still to be truly tested, given the relatively benign economic environment of the past decade.

The 2020 edition of this paper demonstrated how the industry continued to effectively deploy capital throughout the pandemic, and that private credit was a vital provider of capital support to businesses during this period.

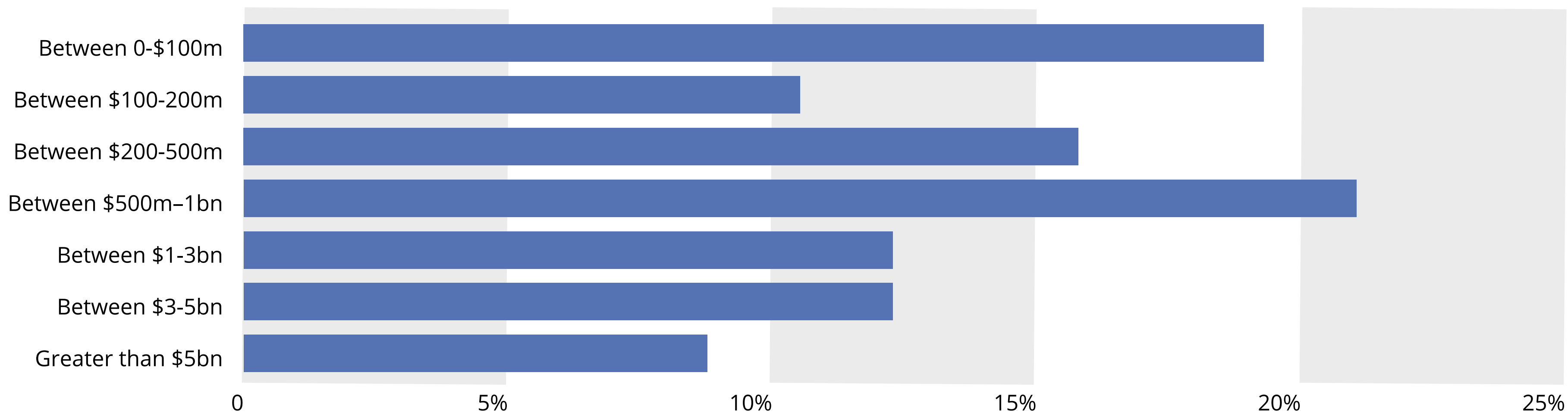
Two caveats to those conclusions were that the full impact of Covid-19 on the economy was still to be revealed, and there was significant uncertainty regarding the ongoing role of public health restrictions. While such caveats still apply in 2021, we are now able to draw on an additional twelve months of data to support this assessment.

This year's paper provides further evidence to support the view that the industry has performed well over the past 18 months.

Capital deployment

Managers interviewed for this research confirmed that deal activity quickly rebounded in late 2020 and early 2021. This is reflected most notably in respondents' annual business volume indicating that respondents, in aggregate, deployed approximately $106bn of capital in 2020 (Figure 4). The respondents manage combined private credit assets in excess of $605bn, or approximately 54% of global private credit assets.[1] Extrapolating the data from our sample size relative to the global market suggests that **private credit managers have deployed almost $200bn during 2020**. This is a significant increase from the levels managers expected to deploy during last year's survey, in which they indicated a likely annual business volume of $113bn by the end of 2020.[2]

Figure 4. What was your approximate annual business volume in 2020?



1 Preqin data estimates private credit assets under management totalled $1116.5bn at March 2021.
2 Financing the Economy 2020.

“Looking at the recent level of market activity you would think nothing had happened last year. There was an understandable decline in activity in Q2 and Q3 2020 as transactions were put on hold and Covid impacts assessed, with deal volume down 40 to 50%. But we saw record activity in Q4 2020 and Q1 2021 and expect that to continue throughout the year, driven by record levels of dry powder, organic growth and external M&A and consolidation opportunities, and increasing competition for deals.”

Joss Trout, Head of Investment Specialists Group, Tikehau Capital

A closer look at deal activity (Figure 3) shows that over 50% of respondents indicate a typical loan size of $25-100m, demonstrating that middle market corporate credit remains central to the asset class.

At the same time, interviewees noted that larger deals continue to become more common, with private credit managers financing deals that would previously have been taken up as broadly syndicated loans. **Larger companies with access to various financing options are increasingly choosing the private route to capital, prizing the tailored and efficient financing solutions that private credit can offer.** This speaks to the increased scale of some private credit managers and their ability to accommodate larger transactions, as well as the retrenchment of other lenders from this market. While mid-market loans continue to make up the majority of deal activity, the average deal size has steadily increased.

When it comes to sourcing deals, our data shows that the direct relationship with borrowers constitutes the most common channel of credit opportunity (Figure 5). The ability to source and originate high quality deals remains a key differentiating factor for private credit firms. As businesses adjust to changes in customer behaviour as a result of Covid-19, demand for capital remains significant. Lenders with the skills and expertise to support borrowers in sectors which require more significant restructuring, such as leisure and travel, are in high demand.

Another key sourcing channel is the relationship with private equity sponsors. While our data indicates private equity is the second most common channel for respondents to this survey, it is likely to be responsible for the majority of capital invested. The strong relationship between private credit managers and equity sponsors continues to be mutually beneficial for both parties. In this context, interviewees have emphasised that add-on transactions and returning sponsored borrowers have constituted a particularly strong component of their deal activity over the last twelve months.

"With a weak syndication market, we ended up financing bigger deals than we would typically. Those deals that would have typically gone into the syndication market didn't and we therefore were able to take advantage of the fact that sponsors still want to get those deals financed, and we were able to provide that capital. The median borrower for our business used to have an EBITDA of about €40 million, however, last year this increased to about €75 million as a result of the growth in large-cap deals."

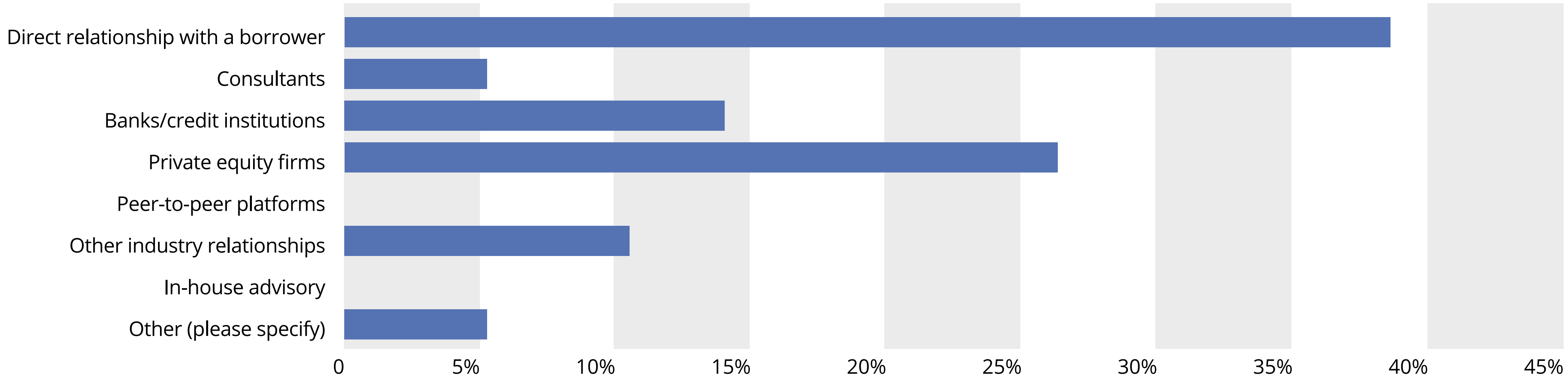
Andrew McCullagh, Managing Director, Hayfin Capital Management

"Sophisticated companies typically have access to many alternatives, so why might they choose a private solution, even if it is not the lowest cost option? It could be because private lenders are offering more flexibility. Maybe they have a differentiated view on, for example, a capital structure that's denominated in multiple currencies, or maybe a private lender is willing to provide capacity for a company to make acquisitions by offering a delayed draw term loan. Liquid markets may not offer such customised terms.

Additionally, there is a relationship aspect to consider. We will often be a lender to many different companies within a sponsor's portfolio. Over time, sponsors learn how you deal with both good times and moments of adversity, so we believe they feel more comfortable to call us if they need more capital for any given reason."

Eric Muller, Portfolio Manager & Partner, Oak Hill Advisors

Figure 5. What is the most common channel of sourcing potential credit opportunities?



"It has been a record year for private credit on multiple fronts, such as deployment, fundraising, deal activity and buy and build related M&A, all at the sort of levels which we have not seen for more than a decade. There are several drivers behind this. Firstly, the long term shift from public to private markets has accelerated throughout the pandemic, creating structural changes to these markets, with many investors increasing allocations to alternatives, recognising the attractive risk return profile and lower volatility of the asset class. Secondly, absolute deal numbers have been driven by high public market valuations. We continue to see a bifurcated market between those assets in defensive sectors attracting the best terms, and those with a Covid hole in earnings which are struggling to raise capital, albeit it now seems credit investors are tiptoeing back in to consumer and cyclicals. And finally, the competitive environment has changed, with banks continuing to retrench post-pandemic, allowing credit funds to increase market share."

Chris Fowler, Managing Director, CVC Credit

CASE STUDY

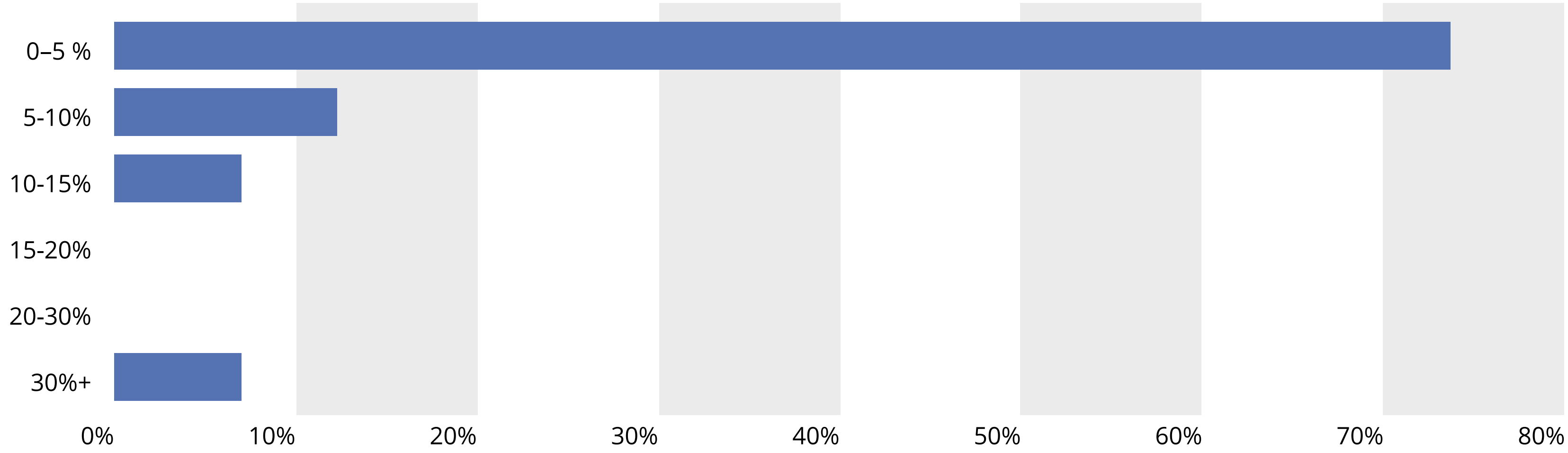
Hayfin provides €410m unitranche loan to German TV home shopping player

Having been a lender to HSE24 for a number of years, when it was a repeat syndicate loan issuer, Hayfin provided the German TV home shopping player with a €410m unitranche loan (as well as a PIK bridge) to refinance existing debt and fund a dividend when the sponsor, Providence, transferred the asset into a new vehicle.

Hayfin's long-term lending relationship with HSE24 is managed by its team in Frankfurt and is a product of the firm's commitment to maintaining an extensive European footprint and being local to the markets in which it lends. This led to extremely strong institutional knowledge of the asset, sector, management team and the sponsor, allowing Hayfin to structure a comprehensive financing solution in a short timeframe for a bespoke transaction when Providence opted to move the asset into a new vehicle.

Hayfin is one of the select few European direct lenders with the firepower to lead-arrange, underwrite and retain such a large facility, offering Providence the convenience of dealing with its lender on a bilateral basis. HSE24's strong, protected and very cash-generative business model is highly attractive and provides investors with strong credit backing.

Figure 6. In 2020, what proportion of your portfolio experienced defaults, or required restructurings?



The relatively abundant availability of capital means there has been strong pressure on terms across both sponsored and non-sponsored borrowers. Despite this market dynamic, interviewees stated that fears of diluted terms have not been realised to the same extent as seen in other credit markets. This is particularly applicable in the Asia Pacific region, which some interviewees have described as much more of a 'lenders' market' compared to elsewhere in the world.

Our survey data also suggests there is a reasonable amount of stability around defaults or restructurings in the private credit market. **The majority of respondents indicate that none or less than 5% of their portfolio experienced defaults or restructurings (see Figure 6).**

While there are pockets of more substantial restructuring (with some reporting that this applied to more than 30% of their portfolio), this is primarily where firms have made an active decision to pursue special situations, rescue finance or distressed opportunities. The dispersion of responses within our data is also likely to reflect how exposure to sectors with greater public health restrictions, and the relative seniority of the lender in the capital structure, differs across the market.

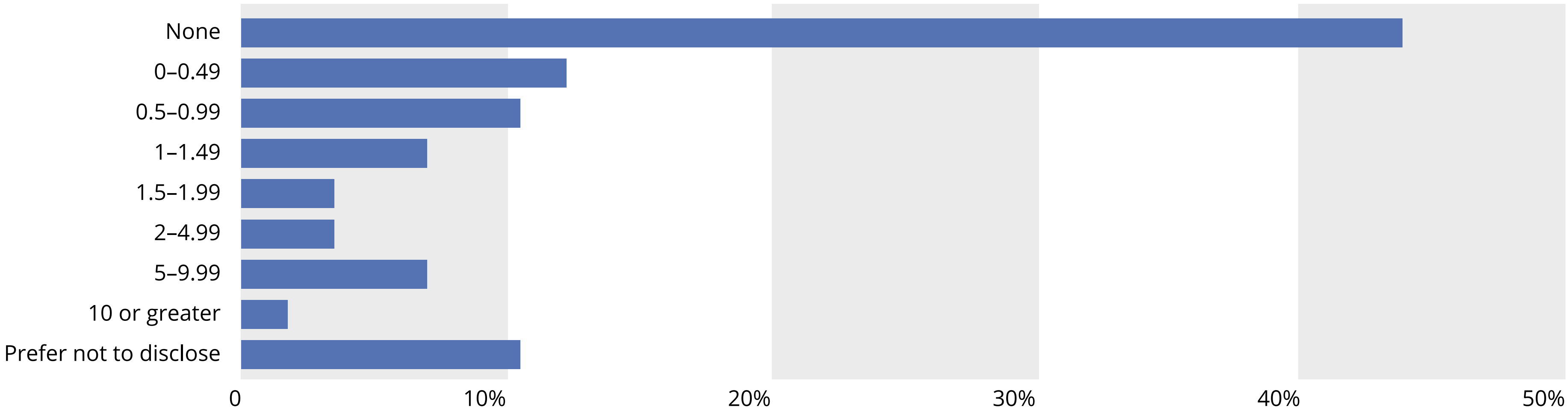
We also find that leverage levels remain in line with the findings of our previous research, both in absolute and relative terms (Figure 7). The market appears to be broadly split between firms that do not deploy financial leverage and those that do, and there is also a dispersion among the users of leverage across a relatively wide range. While most funds that use leverage deploy less than five units of debt per unit of equity, there is a small but material group of managers that report leverage in excess of these numbers. This is, again, consistent with our previous findings which showed that, although most fund managers report leverage below 2x debt/equity (including those who do not deploy leverage), there are some hybrid strategies that tend to make greater use of portfolio financing. We also find that it is increasingly common for private credit firms to offer both levered and unlevered sleeves within their funds to better align their strategies with investor preferences.

"In the last 12 months, we were looking to see how the marks in the private credit space were going to behave relative to public credit. We have by and large seen a recovery, however, I still have a few questions about how this market is conducting valuations relative to the public marks as there has been an interesting lag relative to public credit. In the regulatory capital space, for example, the banks themselves mark the portfolios. While there have been absolutely no losses within the portfolios that we are invested in, they have not recovered to where they were pre-Covid.

Some of the managers involved in the space don't have a great answer for us about why that is, so I think that there may need to be a third party mark because banks have their own incentives around where to mark those pools that may not be reflective of the underlying economics of the reg cap structure and the outlook for the potential credits inside those portfolios. For the entire private credit space I think valuation is incredibly interesting, and this dynamic is likely to play a significant role looking ahead."

Ashley Baum, Director, Head of Special Opportunities,
Teacher Retirement System of Texas

Figure 7. How much financial leverage (borrowing against portfolio assets) does your most levered private credit fund employ (unit of debt per unit of equity)?



Levels of leverage in the financial sector are also monitored closely by policymakers, given its potential to amplify and transmit the impact of market downturns more widely. It is important to note that leverage allows managers to invest more effectively to increase returns delivered to allocators. While information on leverage levels can be a useful data point, such information needs to be considered alongside other factors such as the role of leverage in the investment strategy, the terms of financing, how this relates to the investment fund structure and the investment mandate. Our research suggests that any potential risks arising from the use of leverage are likely to be relatively modest.

Leverage levels appear lower in absolute terms compared to many other investment strategies and traditional lenders, while our interviews highlighted how the financing terms are also aligned with the liquidity profile of the underlying investment strategy.

Capital raising

Investors interviewed for this research confirm that private credit is a stable and growing part of their overall capital allocation. As investors have been able to navigate the changed economic landscape with more certainty and have grown comfortable with virtual due diligence processes, interviewees reported that allocations from new investors have returned to pre-pandemic levels. In this context, interviewees emphasised the need for yield as a primary factor driving private credit allocation. It is unsurprising that the rise of private credit is likely to come at the expense of traditional asset classes, such as public markets fixed income, which have been increasingly less able to match investors' return requirements.

In addition, high satisfaction levels with the performance of the asset class have supported further allocations.[3] Underlining this point is the level of capital raised for private credit in 2020 exceeding that of 2019, despite the impact of Covid-19 throughout the past year (Figure 8).

In the first half of 2020, managers saw investor reluctance to conduct virtual due diligence on new managers, instead focusing on reallocating to existing managers and preferring larger managers to smaller players. Figure 8 also shows a reduction in the number of funds raising capital, which serves as further evidence for this trend.

Figure 8: Aggregate capital raised by private credit managers 2019-2021[4]

Year	Number of funds	Aggregate capital raised (bn)
2021 (as of 5 Nov)	173	$150.75
2020	252	$165.29
2019	249	$142.33

> **"What seems to be driving demand for private credit is a need for yield and a concern that in the public markets – be that bonds, public credit or equity – the returns are not there. That is the bigger pull than the idea of private credit having passed a test. Today we see more of the yield seekers than those fundamentally reassessing private credit."**

Stuart Fiertz, Co-Founder and President, Cheyne Capital

3 See **ACC Private Credit Investor Intentions** and **Preqin Private Debt Report 2021**
4 Preqin Pro.

Long-term drivers of growth:

Our research confirms that key features of private credit remain at the fore of the asset class's success during the past twelve months. In particular:

Bilateral relationships: Private credit firms generally establish direct and collaborative relationships with companies in their portfolio, as businesses tend to engage with the same individuals throughout the due diligence process and lifecycle of the loan.

A flexible approach: Core features of a credit agreement, such as repayment terms or covenants, will typically be structured to match the unique needs of the borrower. Private credit lenders are better equipped to handle periods of uncertainty which may arise throughout the lifecycle of the loan. This was particularly relevant during Covid-19 and enabled managers to negotiate terms to preserve capital and prevent defaults.

Long-term investment horizon: Private credit assets are generally not intended to be traded and will be held to maturity by the original lender, creating a natural alignment of interest between the stakeholders involved in the financing.

Expertise and ability to deploy in speed and size: Private credit managers hold unique sector specific expertise enabling them to better assess risks and opportunities as well as mispricing. Throughout periods of disruption, this expertise is vital to making investment decisions quickly and in size, recognising underlying values of businesses.

Conclusion

Private credit managers have continued to meet their investors' expectations during the past twelve months across the following areas:

Capital deployment: Deal volume continued to surge and middle market loans dominated the activity. A notable rise in large-scale deals has led to a growth in average private credit deal size.

Portfolio and risk management: Default and restructuring levels remain low across the sector as a whole and many firms are actively targeting stressed borrowers for new investments.

Capital raising: Investors continue to allocate capital to private credit funds. The return profile of the sector continues to be attractive compared with traditional fixed income assets.

While these findings certainly paint a positive picture, it is important to note that the aggregate picture is not reflective of every private credit manager, particularly those with strategies focused on geographies and sectors which have been more severely affected by Covid-19. Nevertheless, our survey has shown that there are good reasons to remain confident in the future growth and performance of the asset class.

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CASE STUDY

AIG Investments provides €140m to European real estate developer and asset manager

AIG Investments provided a total of €140m in financing over the past two years to a European-based real estate developer and asset manager. Through two private placement issuances, the company was able to diversify its funding sources and access fixed-rate, long-term financing, a key feature of the private placement market. The company was able to efficiently match their long-term real estate assets with long-term debt by locking in 12-year financing at a fixed rate. This incremental financing will support the company's growth strategy, including further geographic diversification in Europe.

CASE STUDY

Project 2G: Tor Investment Management provides funding to an electric vehicle business in Australia.

Tor provided an AUD 110 million two-year senior secured loan to TrueGreen Mobility Limited, an Australian electric vehicle business, for the refinancing of existing debt, capex, and working capital. TrueGreen is a leading manufacturer and supplier of zero emission buses and next generation hydrogen buses in Australia with a strong pipeline for government supply in the state of NSW.
The company also has a developing business for EV commercial vehicles to be supplied to major corporates in Australia.

Chapter 2 – Integrating ESG into the investment process

A structural shift in the attitudes of investors and regulators towards ESG considerations in the financial sector has taken place over the past few years. However, there was little evidence of convergence in approaches or how ESG considerations should be integrated into the investment process.

The prominence of ESG in public discourse has grown significantly. ESG matters are now considered a business imperative and viewed as central to investors' expectations and the global policy agenda. Our interviews confirm the recent increase in the salience of ESG integration in the market, and the growing role of ESG considerations in capital allocation decisions, with most seeing this as a permanent feature of the market. **Our interviews indicate that ESG integration is an integral part of the vast majority of private credit managers' lending strategies.** With 74% of respondents noting that ESG is considered for all their investments (Figure 9).

Figure 9. Are ESG considerations currently an integral part of your lending strategy?

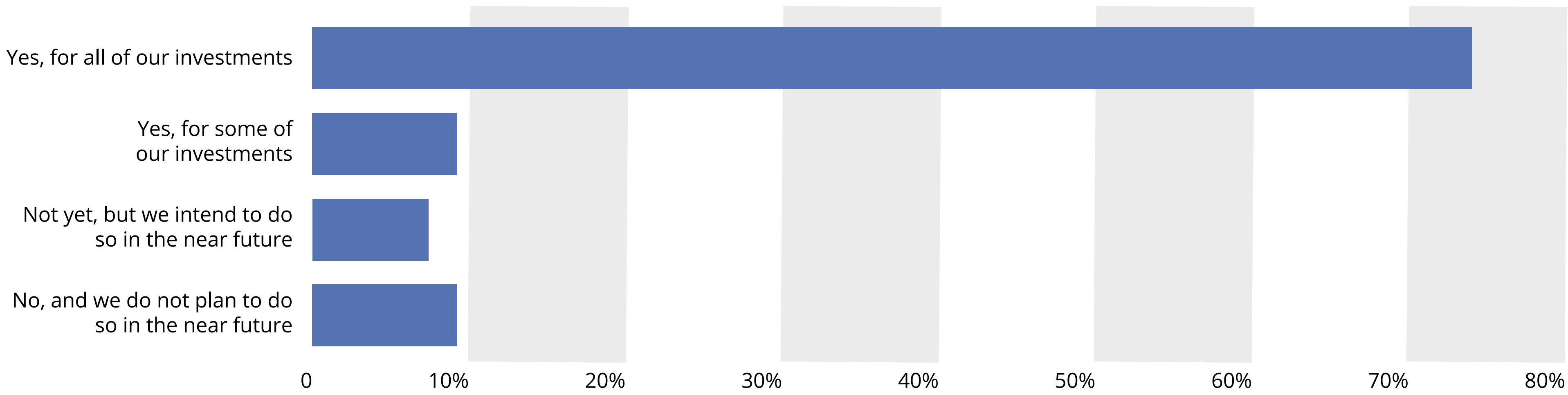
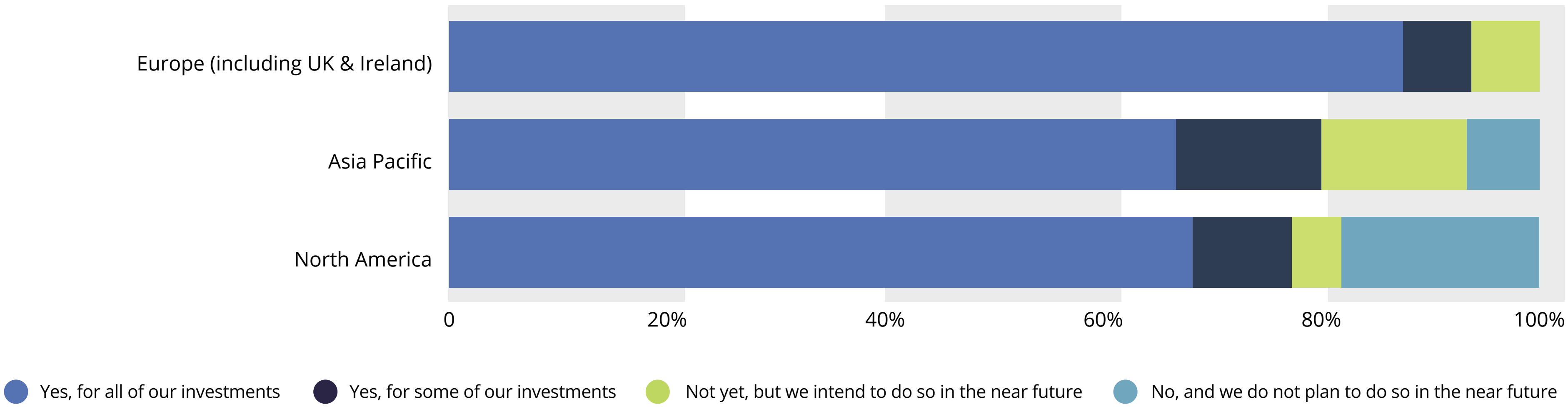


Figure 10. Are ESG considerations currently an integral part of your lending strategy?



"Would you go to a doctor who hasn't read the latest medical journals? Investors who are ignoring ESG in their process are relying on an antiquated approach to portfolio management. We should consider critical data that is now readily available."

Brian Towers, Managing Director, Head of Product, AIG First Principles

When it comes to ESG, it is often assumed that the regulatory focus in the European markets has accelerated the integration of ESG by European managers – especially when compared to non-European firms. However, our data indicates that, although there are some differences, North American and European managers are not worlds apart. Most participants across both markets are integrating ESG, albeit with 88% of European based managers integrating ESG across all of their investments, compared to 68% of North American managers. Additionally, while 18% of North American managers stated that they do not plan to integrate ESG, no European managers selected this option (Figure 10).

While these findings reflect a global adoption of ESG in some form, as outlined in the next section, the manner in which ESG has been integrated is by no means uniform.

"ESG has basically become a fully integrated process, but it hasn't always been that way. It's only in the last 24 months that we've come to the conclusion that we're not going to be able to compete for capital without a fully integrated approach.

So when we conduct due diligence on a potential borrower, ESG is part of it, ESG is part of the investment committee memo and ESG is part of the approval process. We also routinely decline to pursue opportunities because they're not going to work from an ESG perspective. So ESG is very much more than the flavour of the month, it is the way of the future, and we're building the business around it."

James Sweeney, Chief Operating Officer, Tor Investment Management

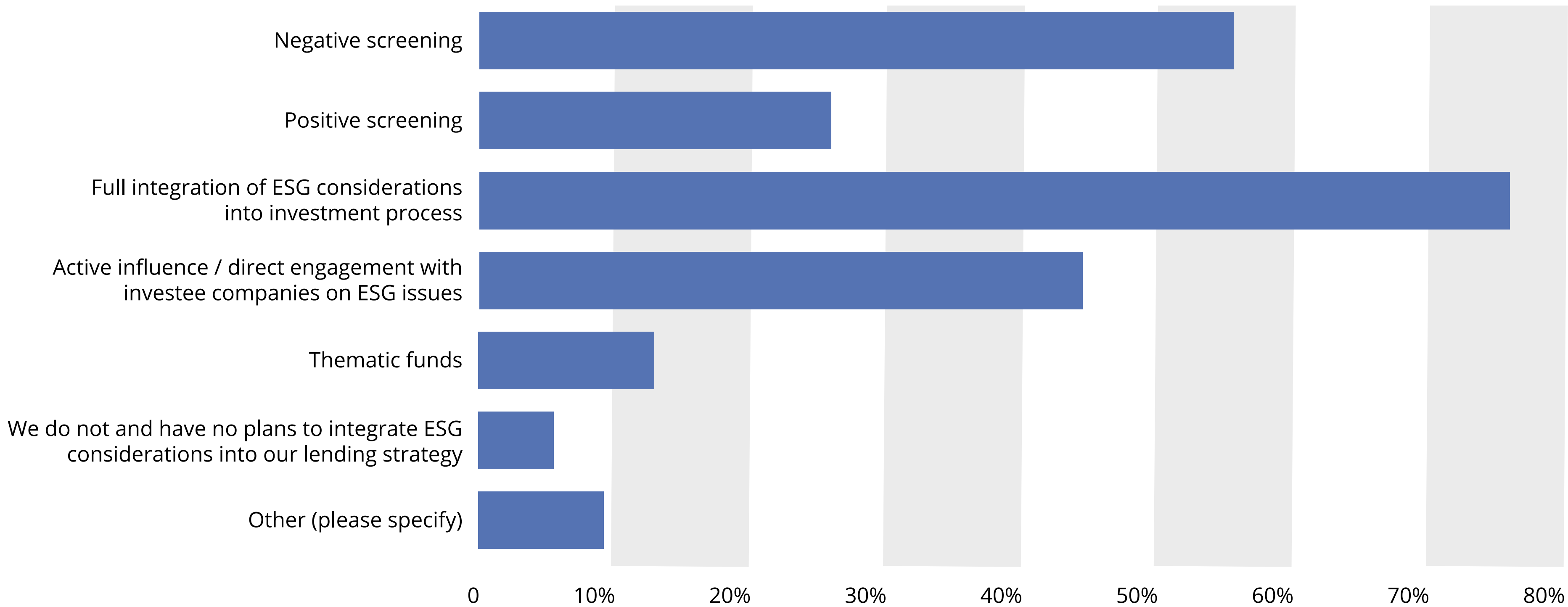
ESG in practice

In line with the rest of the financial markets, private credit managers generally view ESG as a lens through which investors can identify potential investment risks and opportunities, rather than determining a discreet set of categories to encompass under the ESG or responsible investment umbrella.

Our interviews indicate that **the majority of managers have adopted a risk-based approach to ESG, and believe that the integration of ESG factors into investment due diligence can provide an additional layer of risk protection and help identify exposures that may be financially material.** Investors in private credit are typically more concerned with capital preservation and income generation as opposed to value creation and, therefore, a risk-based approach to ESG appears to be compatible with the asset class. Identifying and managing exposure to ESG risks is largely considered a material part of credit risk analysis. While some managers may choose to go beyond looking at ESG as downside protection by actively selecting investments to further ESG objectives, the market tends to consider ESG as a risk rather than an opportunity.

While managers largely converge around this risk-based interpretation of ESG, how ESG risks are treated in practice differs significantly. As per Figure 11, full integration of ESG attracts the majority of responses, but other approaches such as negative screening or direct engagement with borrowers are also commonly used.

Figure 11. How do you (or plan to) integrate ESG considerations into your lending strategy? (select all that apply)



As part of a risk-based approach to ESG, private credit managers consider a mixture of global factors alongside industry specific considerations. Global factors often include climate change (flooding, drought) and regulatory risks (carbon tax, emissions restrictions). Industry specific risks can include labour standards, staff turnover, waste management and energy efficiency practices, inadequate governance structures, data protection and privacy or corruption and bribery. Some of these ESG risk mitigation practices will impact return on investment. For instance, managers often seek to invest in companies with good governance structures to ensure the robustness of the business and its ability to provide returns.

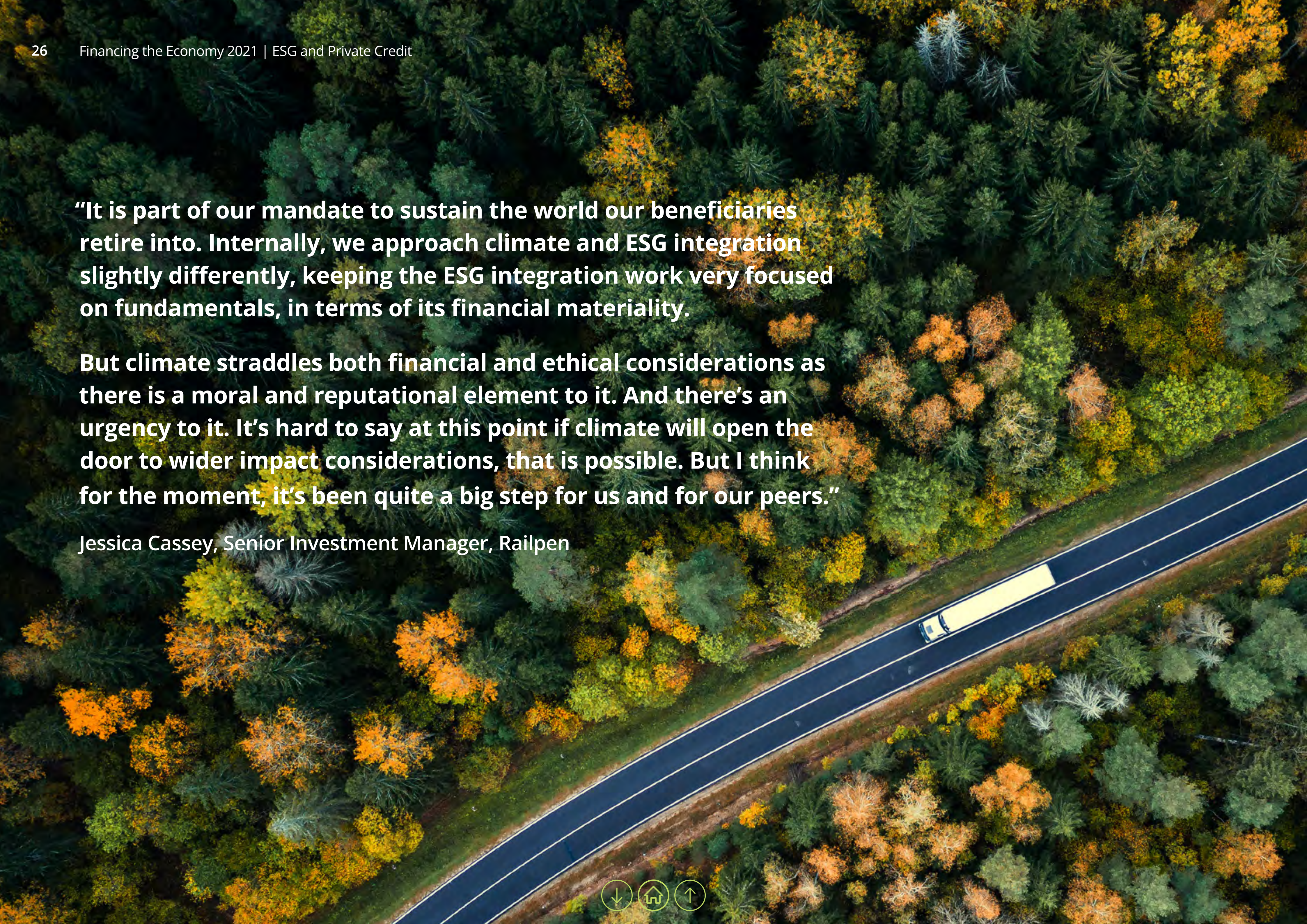
Some interviewees predicted that the current focus on ESG as a risk measure will eventually be expanded, as asset owners become more open to considering factors beyond the scope of financial materiality. Per Figure 11, 44% of respondents to this survey stated that they actively seek to influence their portfolio companies on ESG issues. Additionally, a substantive percentage (13%) of respondents are raising thematic ESG funds based on their conviction that investors will increasingly seek asset managers who can provide more developed ESG-linked investment strategies.

What is a thematic ESG fund?

Themed investing allows investors to address ESG issues by investing in companies actively addressing or contributing to providing solutions to such issues. Common areas of focus include climate change and renewable energy, waste and water management, sustainable agriculture, health products, diversity & inclusion and inclusive finance.

"We're seeing more and more asset managers starting to embrace the mindset that thoughtful contemplation of ESG considerations and ESG risks actually can feed into the investment thesis and help identify stronger, long-term return potential going forward. I believe that layering on this ESG expertise as another lens through which to understand this kind of long-term potential for companies and how well they are positioned, is going to be an edge for investors who have that skill set."

Brianna Barrett, Head of Sustainable Investing in the Americas, BlackRock Alternative Investors



"It is part of our mandate to sustain the world our beneficiaries retire into. Internally, we approach climate and ESG integration slightly differently, keeping the ESG integration work very focused on fundamentals, in terms of its financial materiality.

But climate straddles both financial and ethical considerations as there is a moral and reputational element to it. And there's an urgency to it. It's hard to say at this point if climate will open the door to wider impact considerations, that is possible. But I think for the moment, it's been quite a big step for us and for our peers."

Jessica Cassey, Senior Investment Manager, Railpen

Focus on climate change

The impact of an investment on climate change is central to almost all ESG approaches, with climate risk the dominant element of ESG analysis. It is the primary consideration for investors and policymakers, and increasingly important to the general public. Private credit managers have responded accordingly, and their investment approaches increasingly include climate considerations as standard, whereas other ESG factors are often less prominent or included only at the request of the investor or in relation to local considerations.

This shows that both asset owners and managers in the alternative investment space are taking climate change seriously and this is reflected in their investment approach.

Interviews with asset owners and allocators in the context of this research reinforce the view of a 'climate first' approach to ESG. While other ESG considerations, such as diversity or impact on local communities, are seen as important, the commitment of many investors to slowing climate change has elevated climate risk to be the primary factor. Given the potential severity of climate change on the environment, almost all businesses are likely to be affected by climate change in some form. This is particularly relevant to private credit managers as investors in illiquid assets with longer maturities, and our research indicates that climate change is now seen as a key financial risk rather than a values-based concern.

"I have never seen this level of mobilisation of different stakeholders to act on the same issue with a shared goal. Organisations focused on tackling climate change share a vision to limit warming to 1.5 degrees by 2050, which enables each organisation to assess its specific role in that vision. What we are seeing now is that as various stakeholders sense a tipping point, the inevitability of action on climate change compels more aggressive approaches."

Adam Heltzer, Managing Director and Global Head of ESG, Ares Management

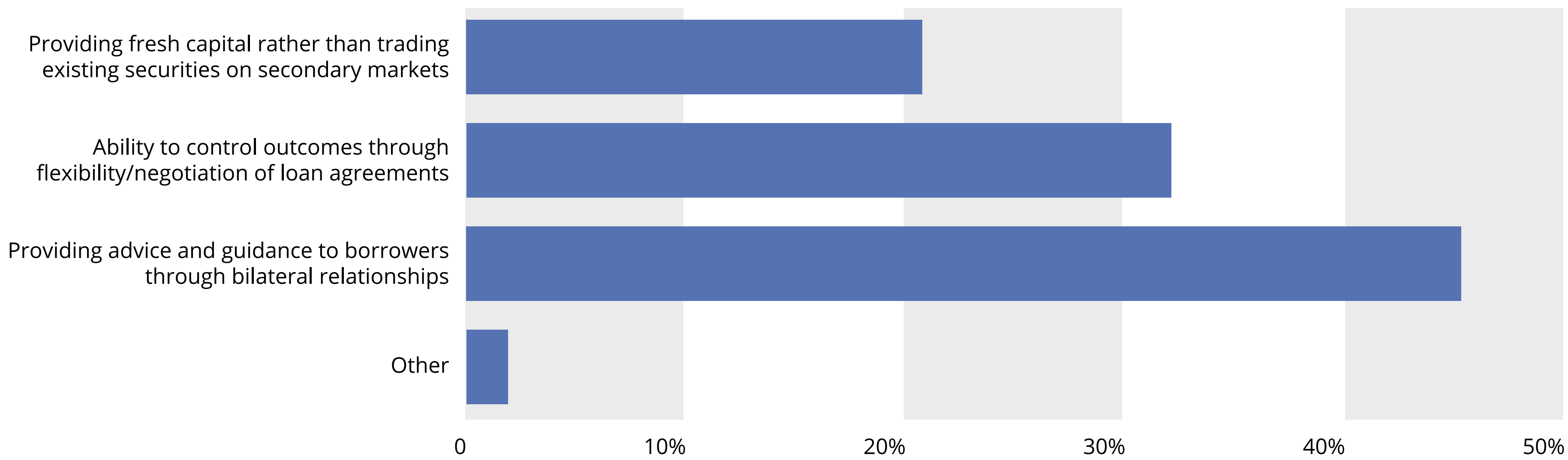
Ahead of the game or long way to go?

Although there is evidence that private credit managers do consider common approaches, such as those provided by the Sustainability Accounting Standards Board (SASB) which delineates a subset of ESG issues most relevant to financial performance in 77 industries, many firms have developed their own approach to particular industries, strategies or product lines. Adopting bespoke and industry specific ESG assessments not only heightens the materiality of managers' overall risk analysis, but it eases data gathering as businesses are only asked to provide data most relevant to their industry.

The depth of expertise and direct bilateral relationships that characterise private credit strategies is also seen as a key distinguishing factor when it comes to ESG integration. Private credit managers are well placed to replicate their existing bespoke investment approach to include their integration of ESG risks. Several of the firms we spoke to believed that their sectoral expertise, ability to deal with complexity and a rigorous approach to due diligence would help them to identify complex ESG risks. **These fundamental features of private credit offer investors greater potential to meaningfully affect ESG outcomes.** Many private credit managers expect this key strength to increasingly come to the fore with respect to ESG integration over coming years.

As indicated in Figure 12, 45% of respondents see private credit managers' ability to provide ESG advice and guidance to borrowers as the main 'value add' offered by the asset class. This finding is supported by most interview participants, who emphasised the educational role many lenders are increasingly fulfilling for borrowers, particularly in those sectors which traditionally have little experience with sustainability or ESG.

Figure 12. What do you consider to be the biggest value add of private credit with respect to ESG?



The perception of the strengths of the asset class tends to differ depending on the comparator. When comparing private credit with private equity, most recognise the impact of credit providers can be limited. However, the ability to control outcomes by virtue of the manager's position as the majority or sole lender to the business in many cases distinguishes private credit managers with respect to ESG in relation to other credit investments. In public or broadly syndicated markets, where investors either exercise substantially less influence or where coordination problems exist, influencing the behaviour of portfolio companies is harder to achieve. Private credit managers typically face reduced agency problems and may offer a more direct means for investors to put their ESG commitments into practice.

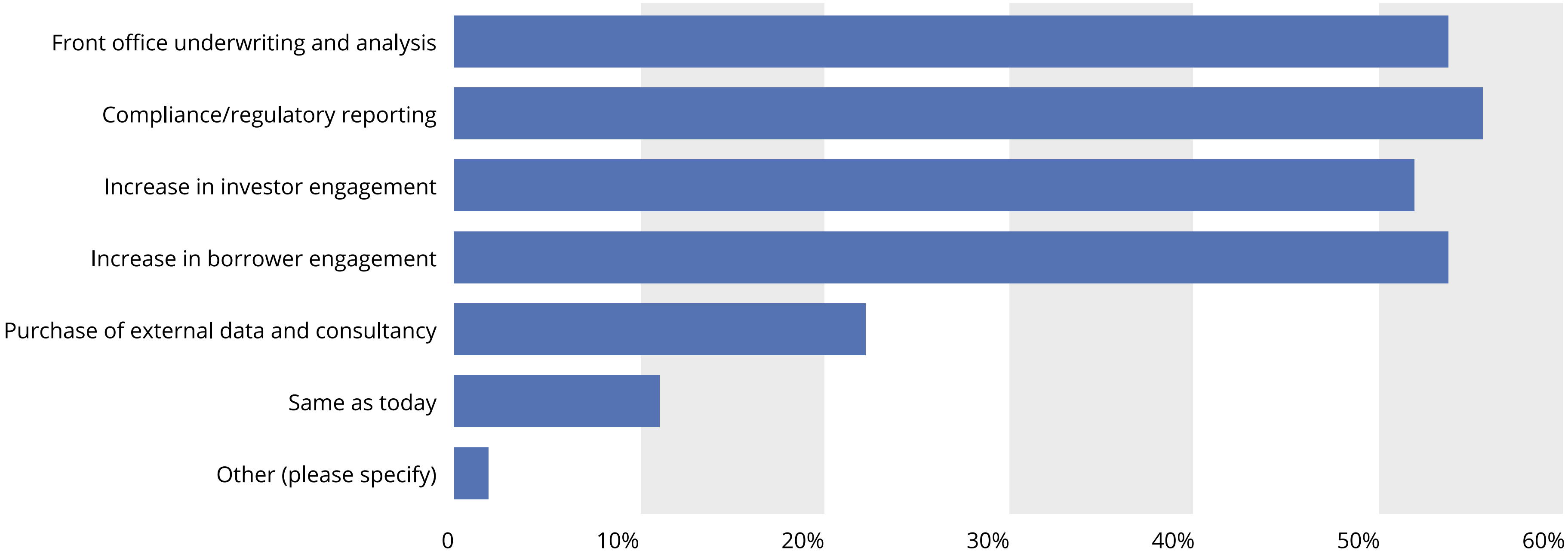
Applying a tailored approach to ESG integration can also set private credit apart from other markets where investors are currently seeing more standardisation. Striking the right balance between this approach and consistency with approaches adopted elsewhere is likely to be a persistent question for the industry over the coming years. This may be particularly apparent when it comes to measuring the comparability of investment practices, loan and portfolio level reporting, as well as with respect to materiality.

While our research indicates that practices in the private credit market are more developed than many currently assume, the industry is likely to face continued challenges with respect to consistency with the broader market and concerns over perceived greenwashing. Our data offers a more optimistic view that the integration of ESG by private credit managers is substantive, while also acknowledging that this remains an iterative process.

Developing and implementing ESG policies and practices requires significant investment and our research indicates that private credit firms are building capacity across their businesses (Figure 13). From front office underwriting to compliance and engagement with borrowers and investors, managers are putting significant capital towards addressing remaining challenges within their businesses and improving their approach to ESG.

Private credit managers interviewed for this research noted that they have accelerated their efforts in response to the increased focus on ESG by investors, regulators and the public. This research will now consider the challenges they face in relation to data gathering and borrower engagement.

Figure 13. Where do you expect your firm to dedicate additional resources to ESG over the next three years? (select all that apply)



Conclusion

ESG integration is being implemented across the sector, yet there are a variety of approaches being developed across different strategies and product lines.

Universal, not uniform: Most private credit managers are integrating ESG into their lending process. However, there is no consistent approach towards ESG integration across the asset class. While some variation across specific strategies is to be expected, the depth of integration and sophistication of approach is still maturing.

Building for the future: While some firms have made significant investments towards integrating ESG into their lending process, many are still finding the right approach for their business. The practices we see today are likely to be relatively different and more sophisticated in the future, as the industry continues to invest heavily in its ESG capabilities across all business lines and activities.

"In surveying many of our invested managers, including those who incorporate private credit within their investment process, a big takeaway from our review of ESG practices is how dispersed the efforts are across organisations. Generally, it is not one team or one individual who is doing the ESG work. The integration of ESG into the investment process is usually much broader, even if there might be a team to supplement that work. It is key to equip the investment professionals with the right tools and knowledge to be able to make the best investment decisions they can whilst taking into account ESG, rather than assigning ESG responsibility to one individual within the organisation."

Lauren Gellhaus, Head of ESG, Teacher Retirement System of Texas

CASE STUDY

Oak Hill Advisors leads $500 million preferred equity commitment to corporate climate and energy advisor.

Oak Hill Advisors ("OHA") led a $500 million preferred equity commitment to Bluesource, an experienced and diversified corporate climate and energy advisor providing environmental services and products in North America.

This financing partnership will fund Bluesource's acquisition of commercial hardwood timberlands in the U.S. and Canada, with the goal of establishing a sustainable forestry strategy by harvesting new tree growth and generating carbon credits. In order to generate carbon credits, the project must produce real, permanent and verifiable reductions in GHG emissions.

Issuing carbon credits involves placing long-term conservation easements on forests, ensuring they will not be harvested in excess of new growth for at least 30-100 years. OHA believes this strategy will lead to long-term environmental benefits even beyond carbon reductions, such as habitat rejuvenation, soil retention and water management. OHA is excited to establish this partnership and has high conviction in Bluesource's management team and capabilities to execute on its strategy.

Chapter 3 – ESG Data

ESG analysis requires managers to collect data on the factors relevant to a borrower's given industry. When it comes to data collection, our survey findings show a fragmented picture (Figure 14). Most respondents adopt standard ESG data collection procedures, either across all investment strategies (24%) or across all private credit strategies (30%), with a notable proportion of respondents using differentiated approaches across strategies (24%) or not gathering data consistently (11%).

Information to inform due diligence typically comes from several sources. For example, legal and technical due diligence (environmental or health and safety assessments), private equity sponsor materials, the lender's primary research or using third-party data sources. Our data (Figure 15) indicates that most private credit managers gather data from borrowers using common templates (59%) and structured discussions (56%) with borrowers. However, consultants and public information are still important sources of information. Both Figures 14 and 15 show that only a small minority of respondents do not gather ESG data.

Figure 14. Is ESG data gathered in a standard way across your firm?

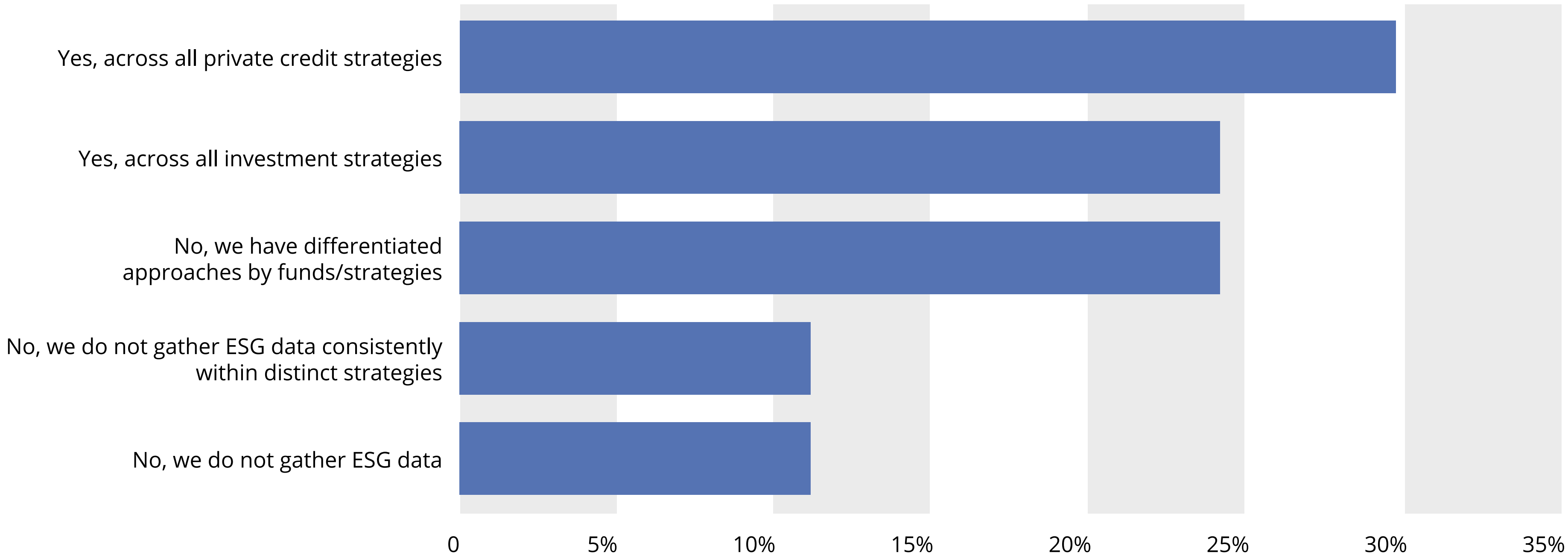
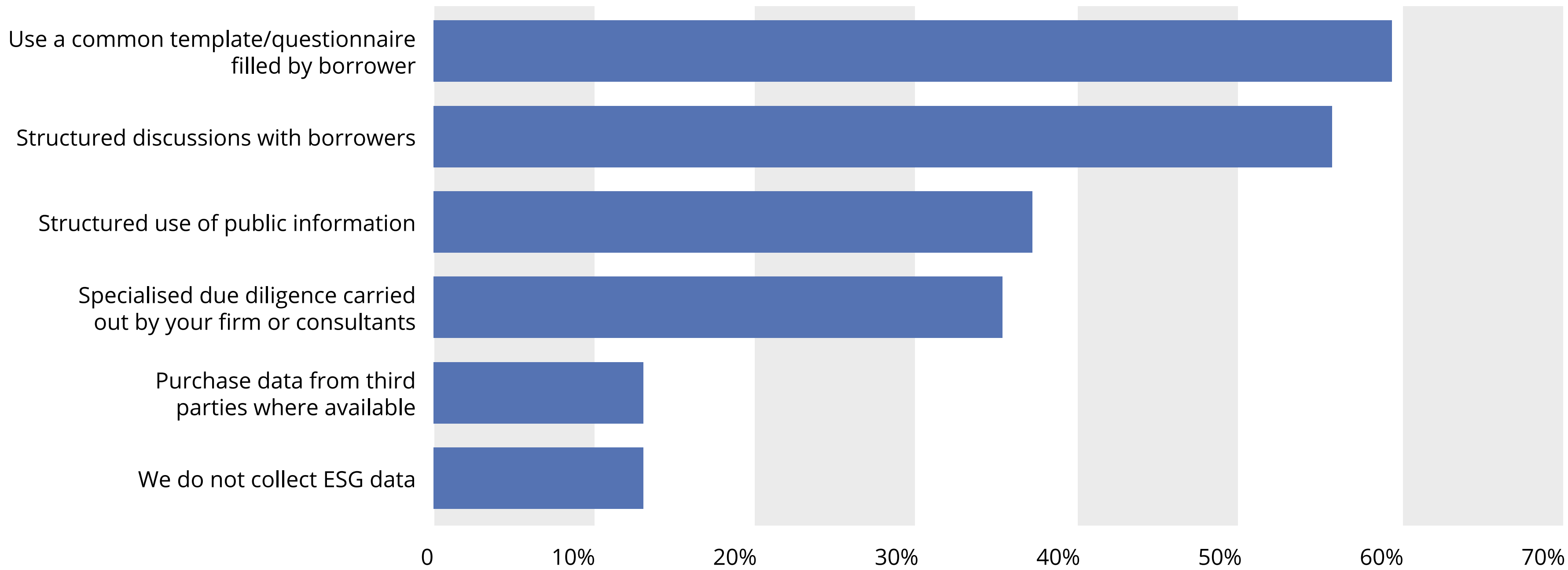


Figure 15. How do you gather ESG relevant data on borrowers? (select all that apply)



While approaching borrowers directly is the most common approach, there are significant challenges with respect to the materiality, availability, quality and consistency of ESG data that can be collated. Many borrowers have not experienced the same focus on ESG as financial markets. Building the knowledge and capacity required to measure and consistently report ESG data is a considerable investment for private businesses and implementing an appropriate process will take time.

Private credit continues to primarily operate in the mid-market and SME space where such challenges can be more acute. There is an increased need to engage with borrowers on ESG considerations and to apply a proportionate approach to ESG data collection. Smaller businesses have less capacity to measure and provide metrics on carbon emissions or other data points.

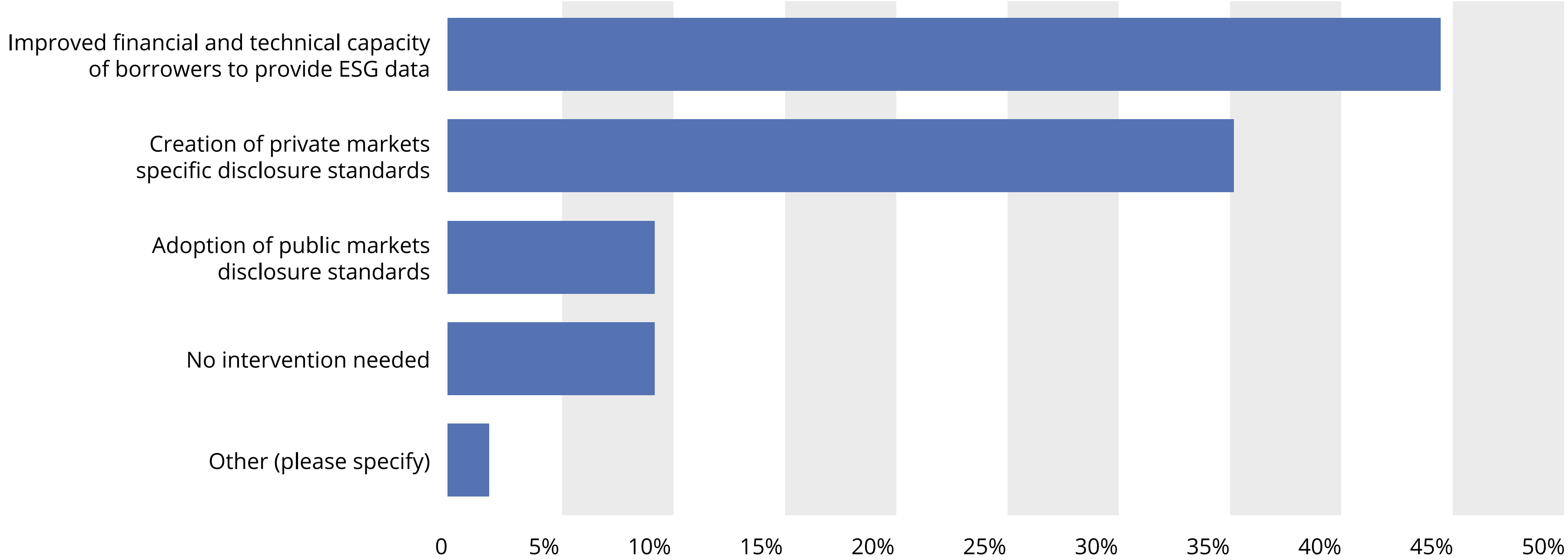
In a competitive market, some interviewees noted that managers will need to balance including additional ESG-focused reporting requirements against securing a deal.

Despite these pressures, the majority of firms interviewed for this research felt that the demands of allocators and regulators to provide portfolio level ESG data, would see a trend towards more, not less, data.

Another relevant factor is the limited capacity of third-party ESG rating agencies and data providers to support private credit managers. Only 13% of respondents rely on ESG service providers when gathering data (Figure 15). While both established and newer data providers attempt to penetrate private markets, external ESG ratings or data analysis are currently less developed in private markets. Interviewees underlined this point, noting that the added costs were not commensurate with the quality of information and ratings delivered. There is also a fundamental question about whether the greater application of ratings within private credit would represent a step forward. Many private credit managers believe this would create an agency problem for asset owners and reduce the healthy pressure on their own due diligence processes. Others see the incorporation of external expertise and a degree of independence as a potentially useful development.

Most managers are still evaluating the usefulness of the ESG rating space. The market is still developing and with limited coverage of many businesses private credit managers target. Whether rating providers eventually provide a viable solution for the sector is likely to remain an open question for the next few years.

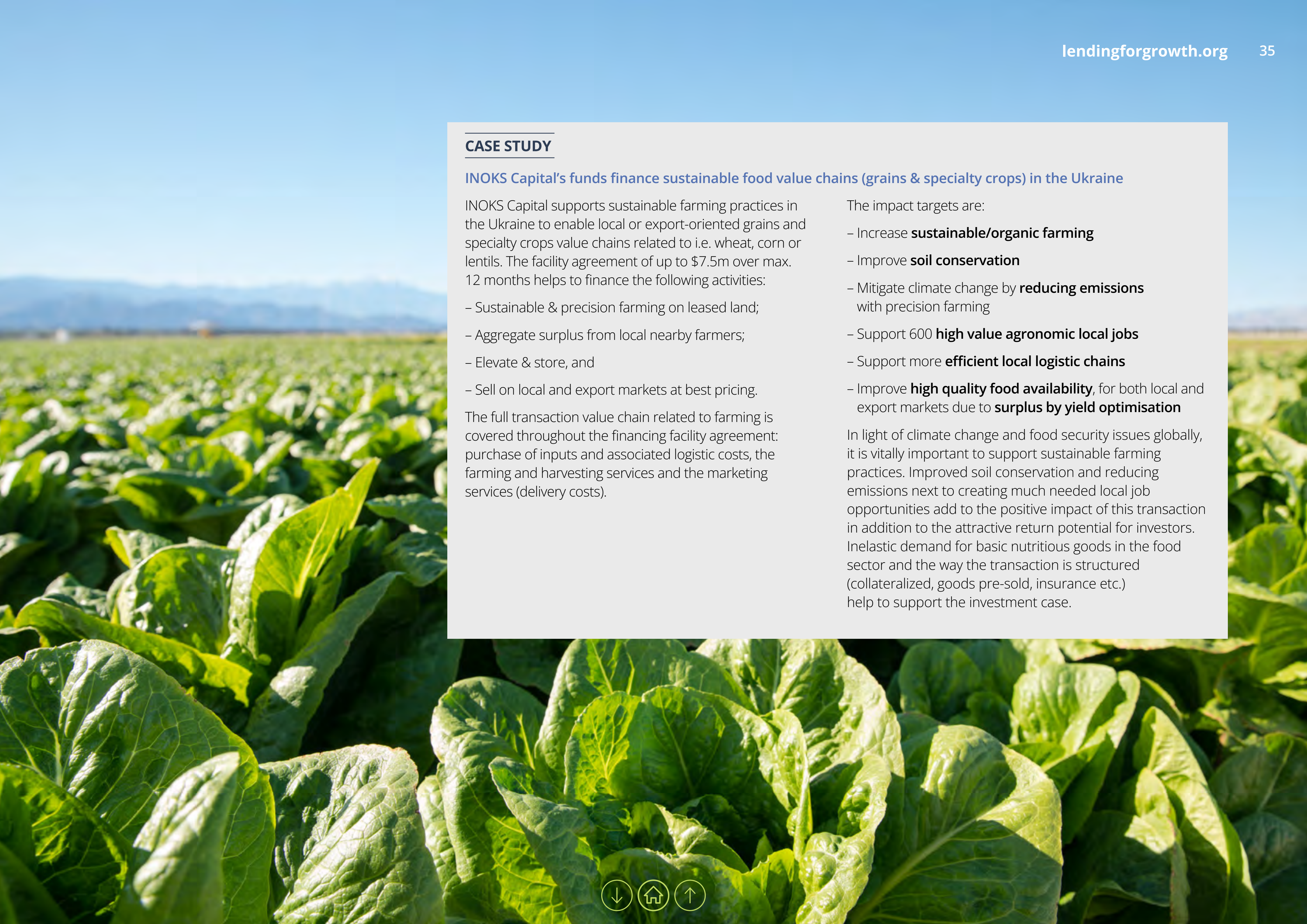
Figure 16. What would contribute the most to the generation of better ESG data quality from issuers/borrowers?



If rating agencies are not the solution, how can the private credit industry obtain high quality and consistent ESG data? As per Figure 16, respondents believe that improved financial and technical capacity on the part of the borrower to make disclosures, and the creation of private market standards would be beneficial.

It is also important to consider the role of the sponsor in facilitating data provision. While many managers interviewed for this research noted the positive impact of some private equity sponsors in providing technical assistance and formalising ESG practices, the private equity industry is also developing its own approaches and dealing with challenges in relation to ESG. Some sponsors may not be willing to provide what is seen as proprietary and commercially useful ESG information. Further, with lenders seeking bespoke ESG disclosures, sponsors may not want to deploy the resources required to meet tailored requests. Additionally, some sponsors are hesitant to invite follow-up engagement following the disclosure of ESG data, seeking to avoid multiple data requests. Finally, as private equity sponsors are themselves expected to disclose ESG data to investors, they may prefer their portfolio companies to prioritise their own reporting requests over those of the lender. At the same time, some sponsors do welcome the lender's focus on ESG as a way to support their own engagement with borrowers or to improve their own ESG methodologies. We are starting to see a number of private market initiatives take place to resolve some of these issues and can expect significant progress in the near future.

Our research also shows that managers view market specific disclosure standards as a key means of improving data quality. While some industry groups have previously developed sector specific templates, adoption of these standards is currently patchy. More recent efforts have seen allocators and asset managers agree both data standards and a consistent approach to implementation and benchmarks. Notable examples include the work of the Institutional Limited Partners Association on ESG assessment frameworks and due diligence questionnaires endorsed by both LPs and GPs. Additionally, CDC Group has launched an 'ESG toolkit' for fund managers, which provides practical guidance for responsible investors in emerging markets.



CASE STUDY

INOKS Capital's funds finance sustainable food value chains (grains & specialty crops) in the Ukraine

INOKS Capital supports sustainable farming practices in the Ukraine to enable local or export-oriented grains and specialty crops value chains related to i.e. wheat, corn or lentils. The facility agreement of up to $7.5m over max. 12 months helps to finance the following activities:

– Sustainable & precision farming on leased land;

– Aggregate surplus from local nearby farmers;

– Elevate & store, and

– Sell on local and export markets at best pricing.

The full transaction value chain related to farming is covered throughout the financing facility agreement: purchase of inputs and associated logistic costs, the farming and harvesting services and the marketing services (delivery costs).

The impact targets are:

– Increase **sustainable/organic farming**

– Improve **soil conservation**

– Mitigate climate change by **reducing emissions** with precision farming

– Support 600 **high value agronomic local jobs**

– Support more **efficient local logistic chains**

– Improve **high quality food availability**, for both local and export markets due to **surplus by yield optimisation**

In light of climate change and food security issues globally, it is vitally important to support sustainable farming practices. Improved soil conservation and reducing emissions next to creating much needed local job opportunities add to the positive impact of this transaction in addition to the attractive return potential for investors. Inelastic demand for basic nutritious goods in the food sector and the way the transaction is structured (collateralized, goods pre-sold, insurance etc.) help to support the investment case.

Conclusion

In conclusion, there is no silver bullet to solving ESG data issues, and a multi-pronged approach across all key stakeholders is required. Specifically:

Investors shaping the market: When balancing considerations of competitiveness against increasing pressure from allocators and regulators to provide portfolio level ESG data, the trend is firmly towards more, not less, data.

Bottom up approach: Borrowers must seek to improve their internal capacity to meet ESG expectations as finance providers, including private credit, increasingly incorporate ESG analysis into their investment decisions.

Collaboration: Private equity and credit managers need to continue to provide support to borrowers in raising technical capacity by leveraging internal expertise and the bilateral relationship with portfolio companies. Collaboration between the equity and credit side on gathering and sharing data could dramatically improve the current situation. Convergence around common disclosure requirements may support these efforts, but coordination issues are likely to persist in the short-term.

"First, you've got to have a good relationship and try and get data out of borrowers themselves. Second, it is key to go through the sponsors since, in the same way that we're under pressure from our investors to do more, the PE sector is under pressure from their investors as well and that's why I think being joined at the hip with PE houses on this is really important.

Ultimately, they are the owners and should theoretically want the same data we want. Our investors are the same people and they should be asking for the same information."

Nathan Brown, Chief Operating Officer, Arcmont Asset Management

"It would seem to me that the answer to this has to be engagement. It is engagement by us with service providers and more importantly, it is engagement with our borrowers, bearing in mind that we do not own the companies that we interact with – we lend them money, so our influences is, by definition, less significant. Equity is permanent capital, whereas debt is short term capital and there is massive competition for it.

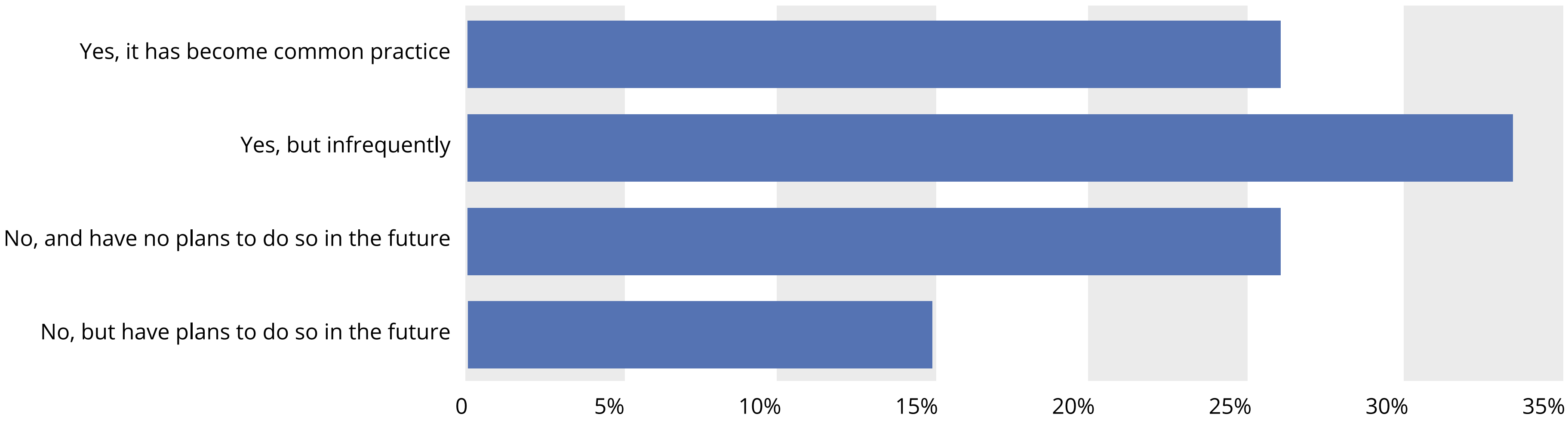
So, if we are asking borrowers for too much, there are plenty of other capital providers available as many deals are oversubscribed. However, what is happening now is that every lender is asking these borrowers similar questions, so it is not just OHA asking for climate data, for example. It is increasingly clear that every lender is in the same boat and asking these same questions."

Declan Tiernan, Co-Head of Europe & Partner, Oak Hill Advisors

Chapter 4 – ESG through the life of the loan

While ESG factors are part of the due diligence process, the picture is less clear when it comes to ongoing engagement after the provision of the loan. Private credit investors as lenders, not owners, often have little direct control over the strategic direction of a borrower outside the terms of the loan. This is reflected in our research which shows that the level of ESG engagement throughout the life of the loan varies significantly across the sector (Figure 17). 26% of respondents have adopted ESG engagement as common practice, while 26% of managers indicate no plans to engage borrowers on ESG matters in the future. 33% of respondents are engaging borrowers infrequently, with a further 15% currently developing plans to engage more regularly on ESG.

Figure 17. Do you engage with borrowers to improve their ESG performance throughout the life of the loan?



"Borrowers are very eager to be supportive of the ESG ratchet mechanisms we have introduced. It may be that some companies are only considering economic benefits associated with the discounts on loans if they meet the minimum ESG KPIs.

However, I genuinely think that in the vast majority of the cases, it is because most companies understand the importance of ESG. On the investor side, we've equally had no investors say that we are effectively subsidising businesses by offering them coupon discounts. This is because it is clear that adherence to enhanced ESG measures drives incremental economic value at the enterprise level, well beyond the coupon discount that is offered.

These businesses become more valuable both by retaining and attracting better staff and running more efficient businesses. In summary, the benefits of this mechanism far outweigh the reduced cost of debt from a lender's perspective."

Anthony Robertson, CIO – Strategic Value Credit, Cheyne Capital

Views on the ability of managers to engage with borrowers on ESG, and indeed the value in doing so, differ across the sector. Some expressed a concern that managers with more robust engagement requirements risk losing deals to competitors who offer borrowers less onerous routes to investment. Additionally, some interview participants noted that any value created by encouraging borrowers to make ESG related changes to their business would primarily benefit equity owners and their investors.

From a borrower's perspective, making business changes according to ESG criteria might require significant investment. If business owners are not convinced of the long-term value proposition of integrating ESG, then ESG engagement will act as a competitive disadvantage for managers who require it.

However, our research reveals that this view is not universally shared. Where borrowers are themselves convinced that alignment with ESG considerations provides value, engaging with them throughout the life of the loan can act as a competitive advantage. Moreover, stronger businesses will continue to grow and may present an attractive opportunity for future financing. Indeed, some managers have noted that equity sponsors who themselves are experiencing a move towards ESG integration will value an engaged lender as a counterparty. In addition, companies oriented towards growth will naturally be considering ESG factors as part of how their business is run, and it is rare to find a company performing well on all metrics except ESG.

Opportunities for managers to engage borrowers are also determined by the level of access the lender can get to senior management. Direct loans made by a single lender or small number of lenders allows greater influence to determine the terms of the deal and engage the borrower on ESG issues. As noted in Chapter 2, this relatively high level of agency is a key strength of private credit when compared to many public market investment strategies.

Those supporting the case for engagement have expressed a preference for enshrining engagement terms in the loan covenants governing the relationship with the borrower. This is particularly relevant when it comes to reporting requirements. The more direct the relationship with the borrower, the greater the flexibility to negotiate terms which meet investors' expectations on reporting or adherence to specific ESG standards or targets.

The use and adoption of ESG covenants is equally fragmented. 15% of respondents have adopted ESG covenants as common practice, while 31% do so infrequently. 20% have no plans to incorporate ESG covenants. Our data suggests a distinction between European and North American managers. 38% of European respondents incorporate ESG covenants consistently, compared to only 5% of North American managers. The use and adoption of ESG covenants is equally fragmented (Figure 18).

"By virtue of the transition that will happen over the next 10 years, ESG will no longer be enough to satisfy investor demands, it will become a basic part of due diligence and standard business operating procedure rather than a separation on your offer. Impact will then become about investors wanting managers to go further with affecting outcomes, which may be environmental outcomes, like carbon emissions and temperature gauges of portfolios first and foremost.

While this is going to happen faster in the liquid markets, considering such outcomes as part of private credit deals is a great way to start showing that private credit managers are on this spectrum too. In this regard, the great story for private markets is the increased ability to affect outcomes through a narrower scope of investments, more involvement in the deal and less competing stakeholders."

Matt Christensen, Managing Director, Global Head Sustainable & Impact Investing, Allianz Global Investors

"Since August 2020, we have invested more than €1bn across 23 sustainability-linked loans mostly arranged by us via our direct lending and corporate lending funds. The first thing to say is that we believe that ESG margin ratchets have the potential to become a standard feature of deals if market participants manage to go beyond greenwashing and business as usual.

If we support companies in tackling sustainability issues relevant to them, that will help create value for them and for our investors as the risk return profile improves. You have some investments where, as lenders, you might not see the full benefit of ESG initiatives during the life of the loan. However, we typically support our portfolio companies over many years, re-investing multiple times, so we will ultimately benefit from it.

We look to create strong relationships with the management teams we work with and often when we're the incumbent lender we are selected to provide the refinancing, even in competitive processes. In that sense, we take a long-term, partnership approach. This also benefits the equity sponsors who like that we can bring something concrete to the table and are not only here to fill a communication requirement for our investors.

We want to act in a positive way over a long period of time."

Laure Villepelet, Head of ESG/CSR, Tikehau Capital

Figure 18. Do you add ESG-related covenants or conditions to your lending agreements?

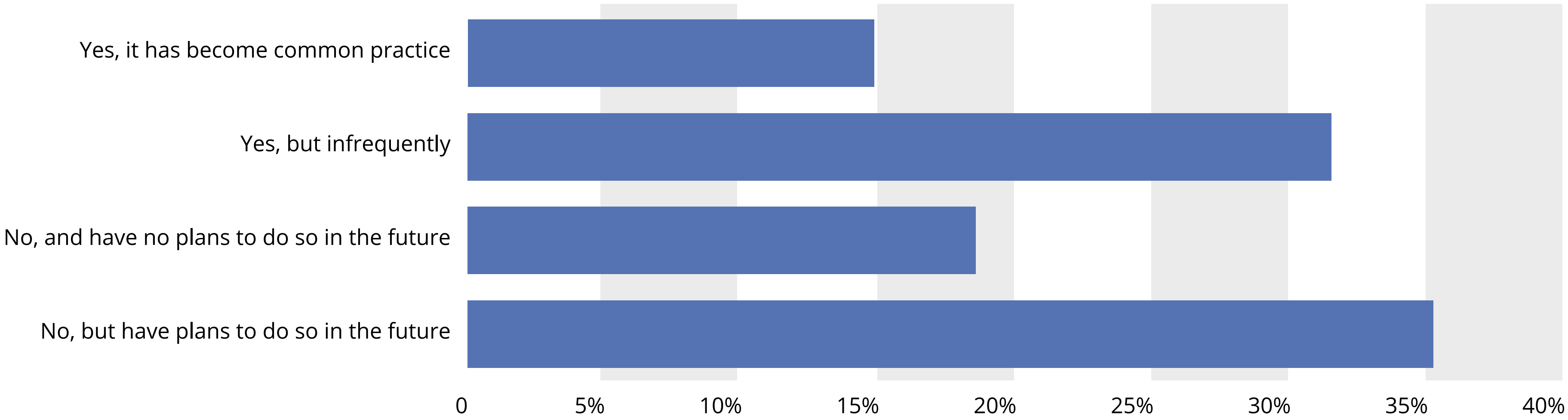
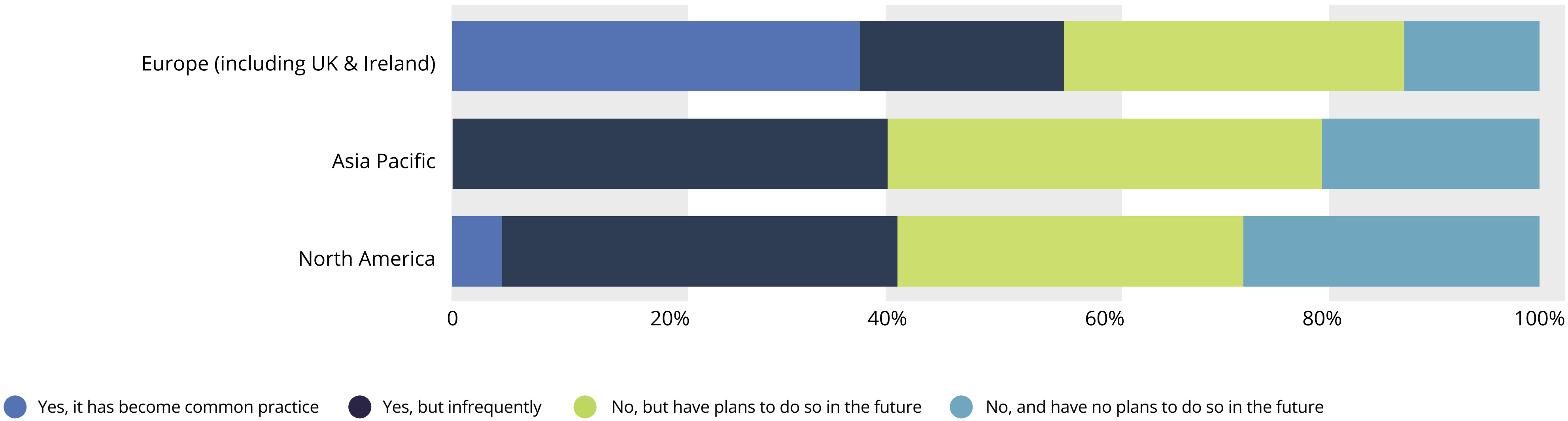


Figure 19. Do you add ESG-related covenants or conditions to your lending agreements?



While the data in Figures 18 and 19 refer to ESG covenants of all types, Figure 20 tackles an important subset – covenants which tie ESG performance to lending terms, most notably through margin ratchets.

According to our survey, loans with ESG margin ratchets are still relatively niche, with fewer than 10% of respondents tying ESG performance to lending terms and 40% of respondents indicating no plans to do so in the future. Our data shows that 28% of respondents are planning to adopt ESG-linked lending terms and a further 23% are already doing so on an infrequent basis, suggesting this is a growing market trend.

Proponents of ESG margin ratchets argue that they incentivise borrowers to make ESG-focused changes to the company and strengthen the lender-borrower relationship. As ESG-focused changes often require material investment on the part of the borrower, such incentives will be welcomed by business owners and equity sponsors. ESG-linked loans can also be described as another example of private credit having a different risk appetite to traditional lenders and developing products tailored to the needs of their customers.

One lender interviewed for this research noted that 60% of their lending between 2020 and early 2021 has incorporated ESG performance linked lending terms, while another has integrated ESG ratchets into all loan agreements since spring 2021. Those who have embraced this approach stated that investors have responded positively to this trend. The lower return associated with such products is relatively minor when compared to the potential upside of retaining a reoccurring lending relationship with the borrowers in question, and demonstrating the ability to meaningfully affect outcomes. Notably, a geographical breakdown of Figure 20 shows that European and North American managers are broadly in line when it comes to the adoption of this product (Figure 21).

What is an ESG ratchet?

An ESG ratchet is a trigger that decreases the margin on a loan by a pre-set amount. Both the level of interest rate reduction and the ESG criteria borrowers are required to meet in order to trigger a reduction.

CASE STUDY

CVC Credit provides funding to UK-based online used book marketplace

CVC Credit provided a first lien loan to fund the acquisition of World of Books ("WoB") by Livingbridge, as well as an acquisition facility to support growth. CVC Credit is offering an ESG-criteria linked margin ratchet on the loan such that the company will be granted a margin reduction if it obtains third party ESG accreditation. Founded in 2008, WoB is a UK-based online re-commerce business primarily focussed on the global resale of used books. The business sells its books in over 180 countries via its own website as well as through c.30 other global online market places, including eBay and Amazon, and utilises proprietary algorithms to assist the sorting of books to identify those which are of resaleable condition, and for which there is anticipated demand at a profitable price point. WoB, which is a certified B Corporation, helps to divert approximately 825 tonnes of media from landfill p.a., and also helps to save 37k tonnes of new paper p.a. The company also focuses its efforts on climate action as it reduced its owned carbon footprint by 30 percent per book sold in 2020 and pledged to be carbon neutral by 2022.

"There are a lot of companies that are asking what ESG is and how to do it effectively. The good news is that, compared to five years ago, there is much greater interest among management teams and business owners in leading ESG efforts within their companies as they better understand its value and importance.

My message to our portfolio companies is: this is where the world is going and you would rather start now than be a latecomer. Ares can offer many ways to help, including resources and experience to enable our portfolio companies to get started or accelerate their ESG progress, leaning in more heavily on issues that we – and most investors – prioritise. This can span building a holistic sustainability agenda, as well as more thematic efforts in areas like DE&I and climate change.

However, it's also important for companies to have something that really speaks to their firm, their culture, their purpose and their values.

Getting started can come with growing pains, but we find that most companies already have some activity in this space, in some cases quite substantially, and want to get better as they now understand that to thrive in the long-term they need to make this a core part of their strategy."

Adam Heltzer, Managing Director and Global Head of ESG, Ares Management

Figure 20. Do you tie a borrower's ESG performance to its lending terms (interest rate, repayment schedule, etc)?

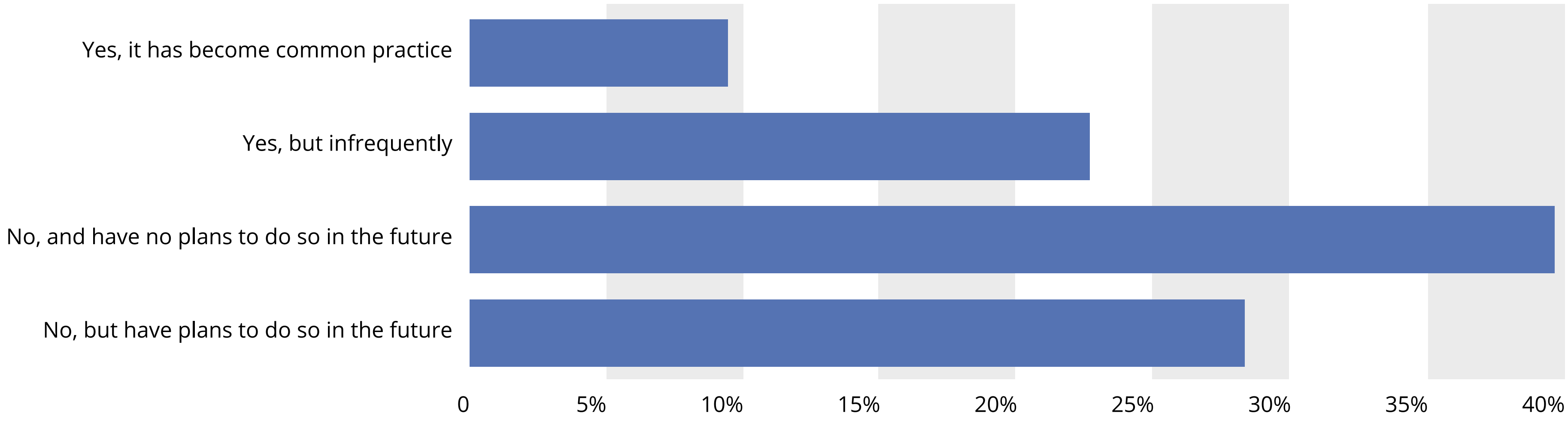
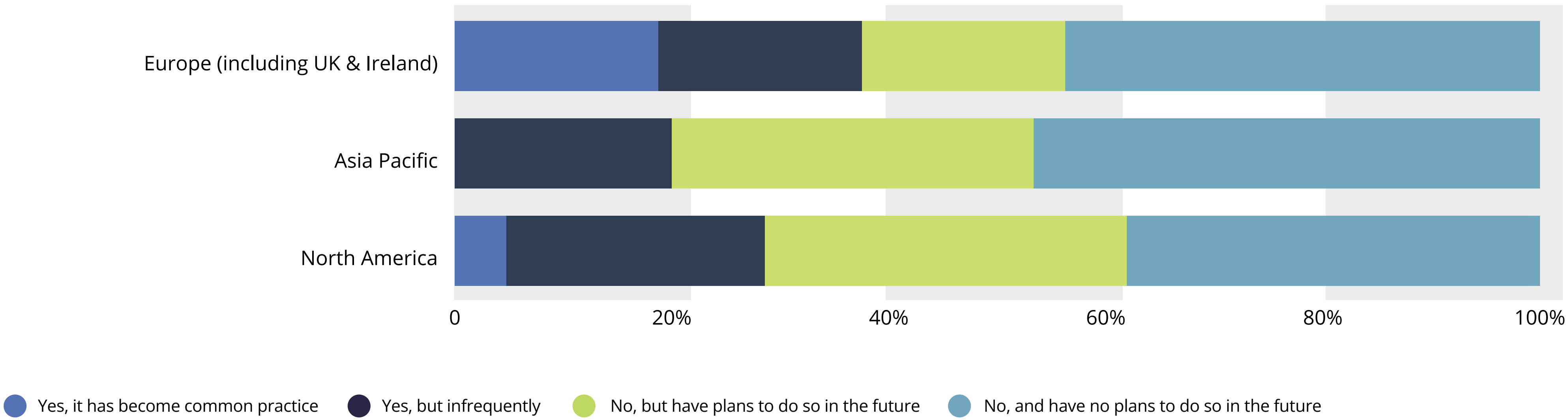


Figure 21. Do you tie a borrower's ESG performance to its lending terms (interest rate, repayment schedule, etc)?



What remains less clear is the robustness and materiality of how ESG performance is being assessed. Some interview respondents expressed concern over labelling loans as ESG products when the underlying categories of measuring progress are weak or do not significantly contribute to the improvement of the business. While there is no uniform standard to which ESG products are currently being held, managers and investors interviewed for this research agreed that ESG-linked loan terms should not reward 'business as usual' and that potential greenwashing and bluewashing are shared concerns.

Some argue that the fundamental reasoning of ESG products which deploy financial incentives to the borrower is incompatible with the fiduciary duty which managers are legally obliged to uphold. Sacrificing returns, for any reason, is not in line with the investor's best interests. From an allocator perspective, investment decisions are often ringfenced by financial materiality and, to some, ESG-linked loans are not able to meet the threshold of financial relevance. Managers who deploy ESG-linked incentives generally respond to such challenges by citing improvement in credit quality that is associated with borrowers meeting meaningful and well-designed ESG targets, and such improvements are seen as fully justifying the financial costs of the incentives from a fiduciary perspective.

Conclusion

Our research has highlighted that, unlike ESG integration more broadly, ESG engagement with the objective of affecting outcomes and ESG products cannot be considered common practice within the private credit industry. However, managers continue to seek solutions to better incentivise borrowers. Key takeaways include:

The case for engagement: This needs to balance competing incentives across all stakeholders and practice remains disparate across the market. However, sponsors and borrowers who themselves see the benefit in ESG integration value the support of private credit managers.

ESG-linked loans and products: A growing part of the market which is used to incentivise borrowers to disclose ESG data and improve the sustainability of their business. Uncertainties pertaining to appropriate KPIs and ratchet levels mean there is little standardisation across the market, but this may become more prominent as practices mature.

CASE STUDY

Tikehau Capital provides ESG-linked loan to European IT services company

In August 2021, Tikehau Capital served as sole arranger on a €180m financing for Prodware SA, one of its long-lasting relationships. The financing was split into a €140m unitranche to refinance the existing debt and a €40m committed Acquisition Capex Facility to support the growth strategy.

Founded in 1989, Prodware is a European leader in IT services, helping small and midcap companies to embrace innovation processes and drive their digital transformation in order to enhance their overall competitiveness. Prodware's main activities consist in (i) providing consulting services to clients regarding their digital strategy, (ii) providing SaaS and IaaS (Infrastructure as a Service) cloud solutions that are customized for technical and service requirements and (iii) developing and integrating software based on Microsoft Dynamics ERP and Microsoft Dynamics CRM, which can be adjusted by customers as per their functional and technical needs. The Company also provides tailored-made solutions as per clients' requirements.

Through an ESG ratchet, Tikehau Capital ambition is to assist Prodware in strengthening its sustainability roadmap considering key topics such as innovation and human capital.

Tikehau Capital's favorable view of the business is supported by Prodware's ability to understand the challenges of a specific sector to adapt business IT solutions and provide packaged solutions, from consulting, to SaaS, integration and maintenance.

CASE STUDY

Ares Management Corporation lends £1bn of available debt facilities to RSK Group in largest sustainability linked private credit financing to date

Founded in 1989, RSK Group ("RSK") is the U.K.'s largest privately-owned multi-disciplinary environmental business. Led by Founder and Chief Executive Officer Dr. Alan Ryder, RSK is a fully integrated, environmental, engineering and technical services group currently comprised of over 100 businesses and employing more than 7,000 specialists. The company has an established presence in more than 40 countries around the world. RSK supports its global client base across diversified sectors, from energy to water, to conduct business in a sustainable, safe and environmentally responsible manner through comprehensive, solutions-led services.

In the third quarter of 2021, Ares' European Direct Lending team announced it had structured as sole lender £1 billion of available debt facilities for RSK, marking the largest private credit-backed sustainability linked financing to date. The facilities will be used to refinance RSK's existing credit lines as well as to support its continued organic and inorganic growth plans.

The new debt facilities include an annual margin review based on the achievement of sustainability targets, which are broadly focused on carbon intensity reduction and continual improvement to health and safety management and ethics. These targets are aligned to RSK's Corporate Responsibility and Sustainability Route Map, which forms the basis of its sustainability strategy, based on RSK's sustainability pillars and the United Nation's Sustainable Development Goals. RSK anticipates interest savings in excess of £500,000 per year and has committed to donate a minimum of 50% of this margin benefit toward sustainability-related initiatives or charitable causes.

Chapter 5 – Creating the right framework

Investor and regulators continue to play significant roles in driving the integration of ESG by private credit managers. Both investors and regulators are evolving their thinking on ESG requirements, and managers have to navigate a changing policy environment alongside shifting investor expectations.

Investors

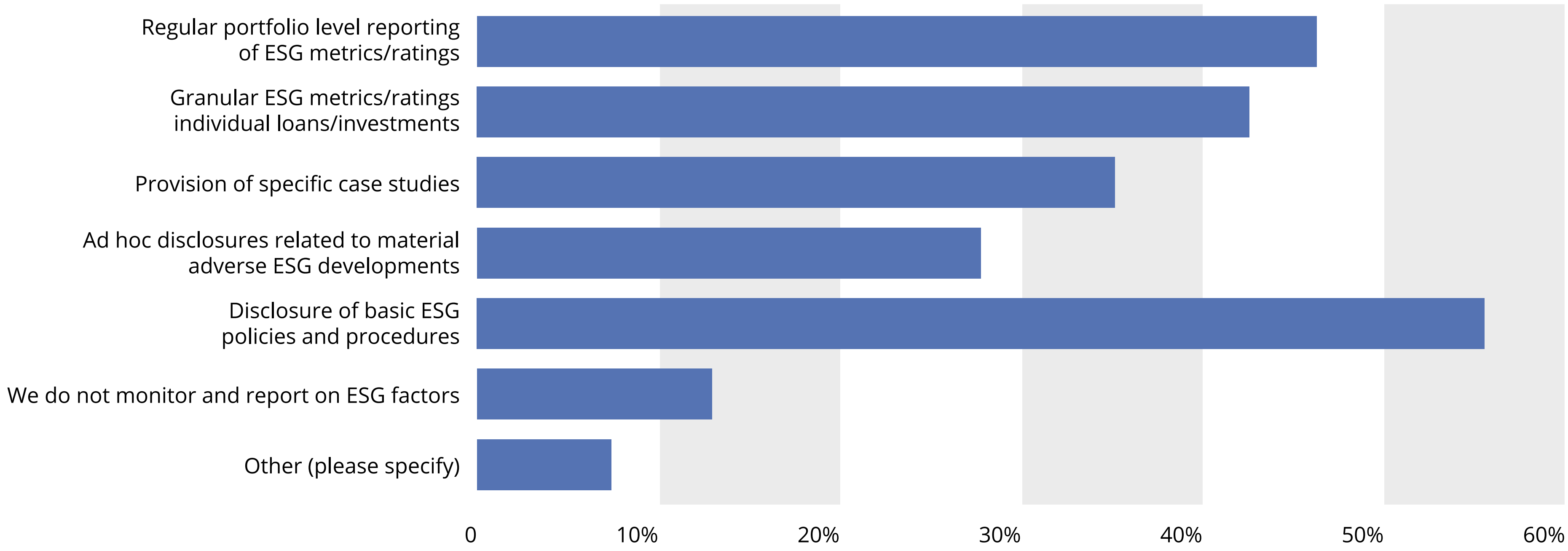
Awareness of ESG risks and their potential impact on managers' underlying portfolios has been a growing area of focus for asset owners. As noted in Chapter 1, the approach to ESG has previously focused on downside protection and financial materiality. In this context, investors are seeking increased levels of disclosure and reporting requirements, both during the manager selection process and on an ongoing basis.

Figure 22 shows how the reporting of ESG factors differs across the sector. The disclosure of basic ESG policies by most respondents complemented a mixed picture across other means of reporting, such as regular portfolio level reporting, granular ESG metrics and provision of case studies.13% of respondents do not monitor and report on ESG factors.

"When it comes to investors, the spectrum is very wide. Some investors don't ask for anything at all and others impose onerous requirements. In this context it is also important to note that sustainability related expertise does not come cheap and is valued highly, so sustainability is absolutely increasing the cost base for both managers and investors."

Thierry Adant, Chief Investment Officer, Newmarket Capital

Figure 22. What best describes how you monitor and report on ESG factors to your investors? (select all that apply)



"It still feels like ESG integration is in its very early infancy and it has become very clear that there is no real best practice that exists today. Therefore, it takes a lot of original thought and authorship to really consider what ESG needs to look like for your firm. Looking ahead, I would imagine that in three years' time it will look substantially more sophisticated if we are able to get more access to data, and more borrowers see ESG as an integrated part of their corporate strategic objectives."

Kerry Hugh-Jones, Co-Managing Partner - Strategic Value Credit, Cheyne Capital

Interviews with managers confirmed that investor ESG reporting requirements vary considerably. While some allocators, particularly those based in Europe, have placed significant emphasis on ESG, market practice is still evolving as investors are themselves integrating new processes. While the volume of ESG reporting requirements continues to increase, this has not yet been accompanied by more specificity or consistent expectations of what lenders can provide.

This is partly a consequence of investors balancing the expectations of their beneficiaries and regulatory requirements relating to ESG. Each of these creates different demands and expectations which have added operational burdens to asset managers' reporting processes. The approaches adopted by private credit managers to date may also not easily fit within the frameworks investors have established for their own purposes, particularly with respect to benchmarking and assessing materiality.

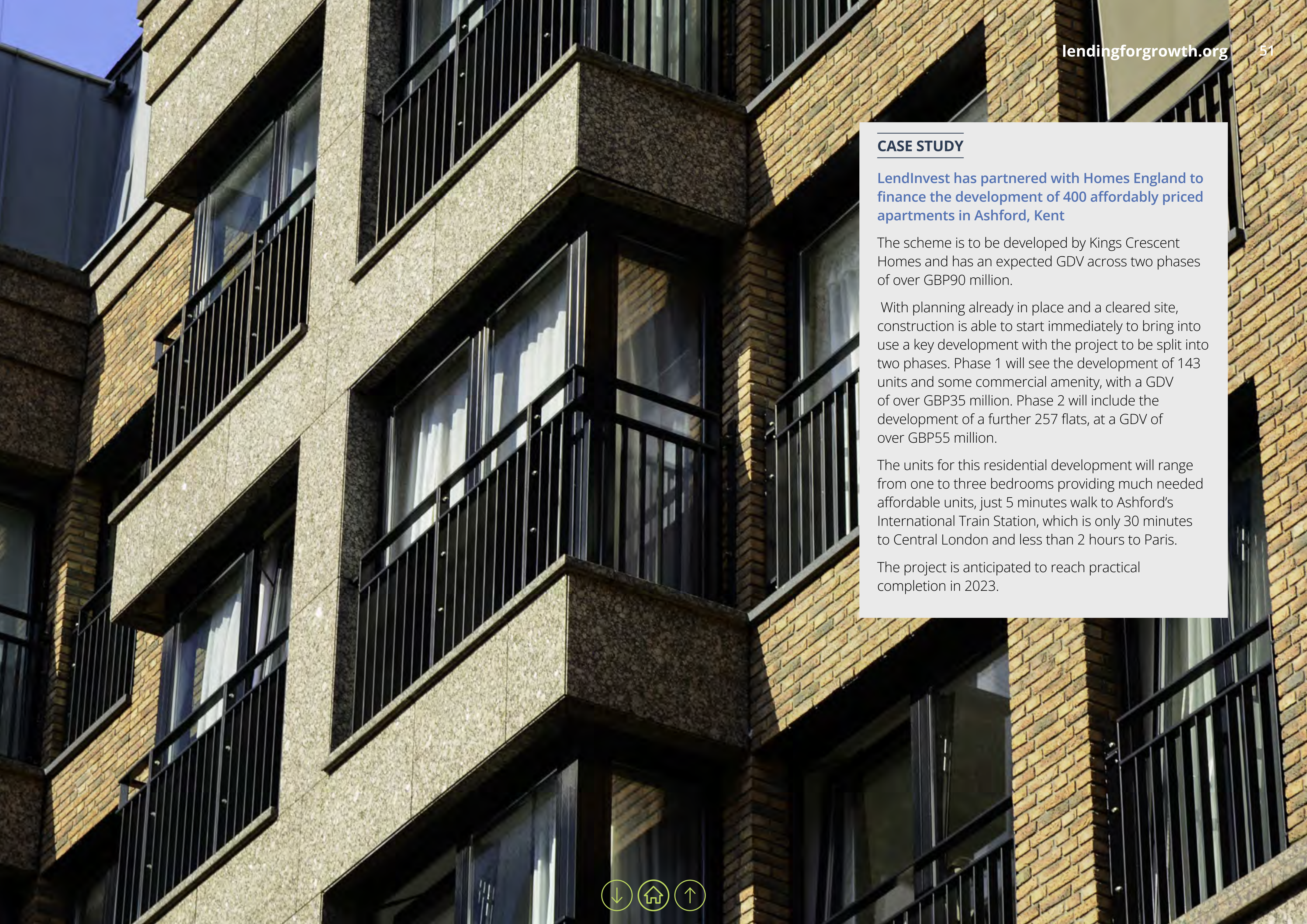
Notably, one investor interviewed for this research expressed the view that 'private credit managers' levels of disclosure are nowhere near where they need to be'. Additionally, another investor outlined that some managers have simply 'dressed up' existing processes under a new ESG label without making meaningful changes to how they select, monitor and engage with borrowers or manage their business internally. Investors are still in the process of ramping up internal capacities and few have the resources to act as consultants to managers in their ESG adoption.

Industry organisations such as the Alternative Credit Council can play an important role in encouraging the adoption of common reporting standards. Given the challenges associated with data gathering from borrowers (see Chapter 3), increased specificity and harmonisation of reporting requirements are likely to be necessary to address these broader issues.

"In terms of collecting ESG data, when you're investing in multiple sectors, and multiple countries, every portfolio company has a unique ESG success story. The challenge can often be to aggregate or communicate these individual stories across our portfolio in a way that investors and third parties can understand.

At ADM Capital, we've dedicated significant effort into making sure we can communicate both portfolio wide empirical ESG data, as well as individual private company level ESG stories to investors so that they appreciate what's happening with their money. ADM Capital's commitments to ESG due diligence and reporting goes back for over a decade."

Alexander Shaik, Partner and General Counsel, Asia Pacific Private Credit, ADM Capital



CASE STUDY

LendInvest has partnered with Homes England to finance the development of 400 affordably priced apartments in Ashford, Kent

The scheme is to be developed by Kings Crescent Homes and has an expected GDV across two phases of over GBP90 million.

With planning already in place and a cleared site, construction is able to start immediately to bring into use a key development with the project to be split into two phases. Phase 1 will see the development of 143 units and some commercial amenity, with a GDV of over GBP35 million. Phase 2 will include the development of a further 257 flats, at a GDV of over GBP55 million.

The units for this residential development will range from one to three bedrooms providing much needed affordable units, just 5 minutes walk to Ashford's International Train Station, which is only 30 minutes to Central London and less than 2 hours to Paris.

The project is anticipated to reach practical completion in 2023.

Regulators

Regulators have increasingly focused their attention on ESG in financial markets, particularly when it comes to sustainability focused disclosures. UNPRI's regulatory database currently encompasses 650 policy tools and over 300 policy revisions which support, encourage or require investors to consider all long-term value drivers, including ESG factors, with the most new or revised policy instruments having been introduced in 2020.[5]

This surge has been felt most prominently in the European Union where, in 2018, the European Commission launched the "Sustainable Finance Action Plan", which outlines actions that provide much of the conceptual framework for sustainable finance regulation in Europe. This regulatory reform trend was further strengthened in 2020, with the announcement of the EU's "Green Deal".

Key legislation governing the European framework includes:

1. **Taxonomy Regulation:** EU Regulation on the establishment of a framework to facilitate sustainable investment;
2. **Sustainable Finance Disclosures Regulation (SFDR):** EU Regulation on sustainability-related disclosures for the financial services sector; and
3. **Non-Financial Reporting Directive (NFRD):** Directive on disclosure of non-financial and diversity information by certain large undertakings and groups. A successor to the NFRD, the Corporate Sustainability Reporting Directive, is currently proceeding through the legislative process.

The UK has expressed its intentions to match the ambition of the EU's Action Plan. Its policy programme includes disclosure and other requirements aligned with the Task Force on Climate Financial Risk recommendations, a UK green taxonomy, support for industry fora to share best practice in relation to climate risk issues, and support for international initiatives to address nature-based financial risk.

In the US, the regulatory approach to ESG is also evolving, with the current administration expected to take a different approach to its predecessor. In March 2021 the US Department of Labor announced it would not enforce its rule preventing certain employee benefit plans from pursuing "non-financial objectives," including ESG objectives, if doing so puts returns or participants at risk. While the US Securities and Exchange Commission (SEC) has not yet adopted ESG-specific guidelines and instead only requires that disclosure of ESG risks be made if they are "material", a recent SEC consultation on corporate ESG disclosures shows that 75% of respondents support the introduction of mandatory rules around climate.[6]

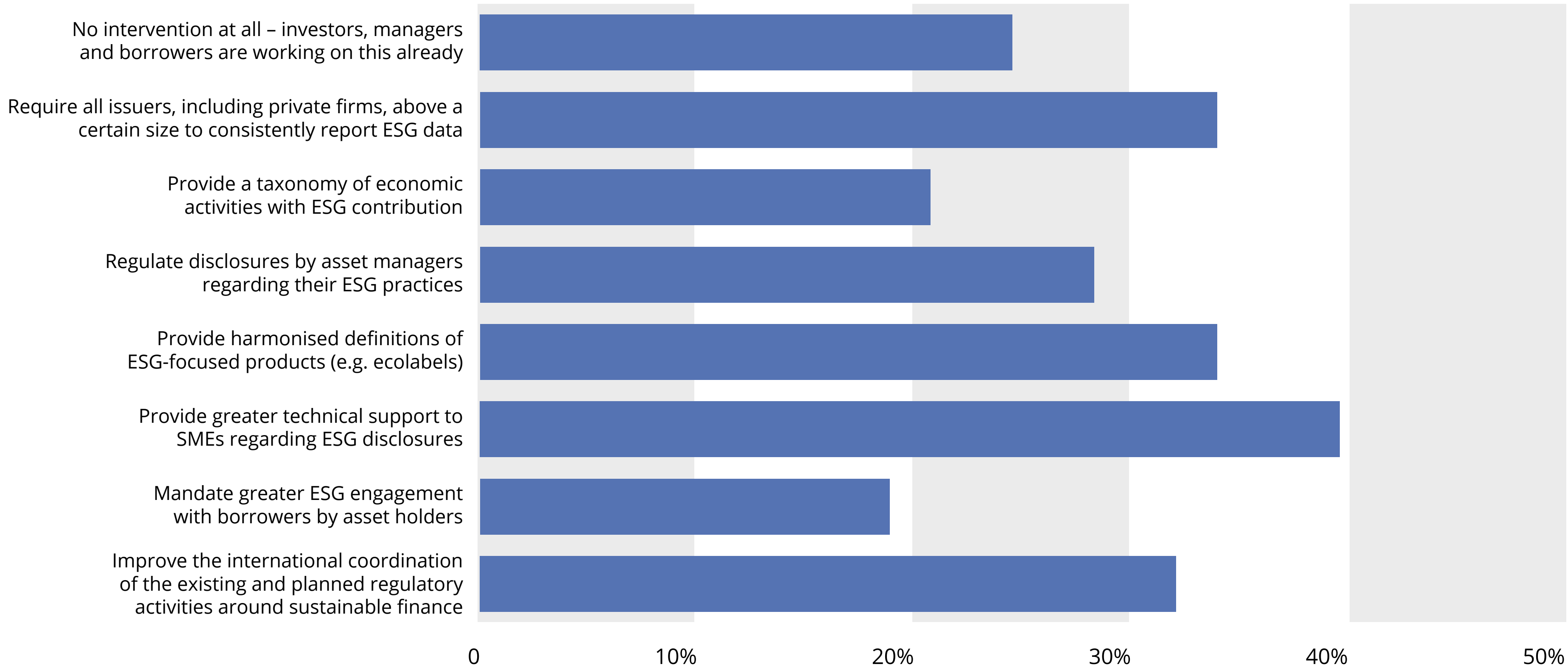
In October 2021, the Biden Administration published 'A roadmap to build a climate-resilient economy' via Executive Order, further confirming the recognition of climate change as a serious and systemic risk to the US economy and financial system. The report sets out a roadmap for measuring, disclosing, managing and mitigating climate-related financial risk across the economy, including the Federal Government, while also catalysing public and private investment to seize the opportunity of a net-zero, clean energy future.[7]

In recognition of the fragmented regulatory environment, efforts are underway to develop global standards. The Board of the International Organization of Securities Commissions has established a Sustainable Finance Taskforce, which aims to address the urgent need to improve the consistency, comparability and reliability of sustainability reporting for investors. Additionally, the International Financial Reporting Standards Foundation (IFRS) is increasing its efforts to develop a common set of global sustainability standards to help meet investor needs and set a sound baseline for jurisdictions to consider when setting or implementing their sustainability-related disclosure requirements. To accomplish this objective, the IFRS is seeking to establish an International Sustainability Standards Board to sit alongside the International Accounting Standards Board. Such efforts will take time to come to fruition and success will depend on a consultative approach with the asset management industry and other stakeholders.

When asked to consider what regulatory initiatives would support better ESG practice in the asset management sector (Figure 23), a slight majority of respondents favour greater technical support to SMEs regarding SME disclosures. Respondents also favoured consistent ESG reporting requirements for all issuers above a certain size, harmonised definitions of ESG focused products and international coordination of the existing and planned regulatory activities around sustainable finance.

5 UNPRI regulation data base.
6 See https://www.responsible-investor.com/articles/sec-consultation-sees-three-quarters-back-mandatory-climate-disclosure-rules-chair-reveals.
7 See U.S. Climate-Related Financial Risk Executive Order 14030.

Figure 23. What regulatory or government initiatives would you like to see to support better adherence to ESG by the asset management sector? (select all that apply)



A key point to note is the significant focus regulators have placed on financial services in relation to ESG. While some may argue the role of financial services in funding other industries warrants this focus, managers have noted that the lack of commensurate ESG requirements across the economy has hindered their ability to meet expectations.

This could be addressed through similar obligations on corporates and greater technical support for them to meet them. Absent such measures, private credit managers will face a disproportionate burden supporting such businesses and the economy overall will face capacity constraints when incorporating more sustainable practices.

Conclusion

The approach of both policymakers and investors towards ESG continues to evolve. This is affecting managers' ability to effectively implement and communicate ESG policies. Specifically:

Investors: More specific, proportionate and harmonised disclosure requirements would be welcome by private credit managers to reduce the operational burden they currently face.

Regulators: Should focus on improving consistency of rapidly developing ESG standards and consider how to improve the capacity of smaller businesses to understand, develop and implement sustainability-oriented practices.

Conclusion

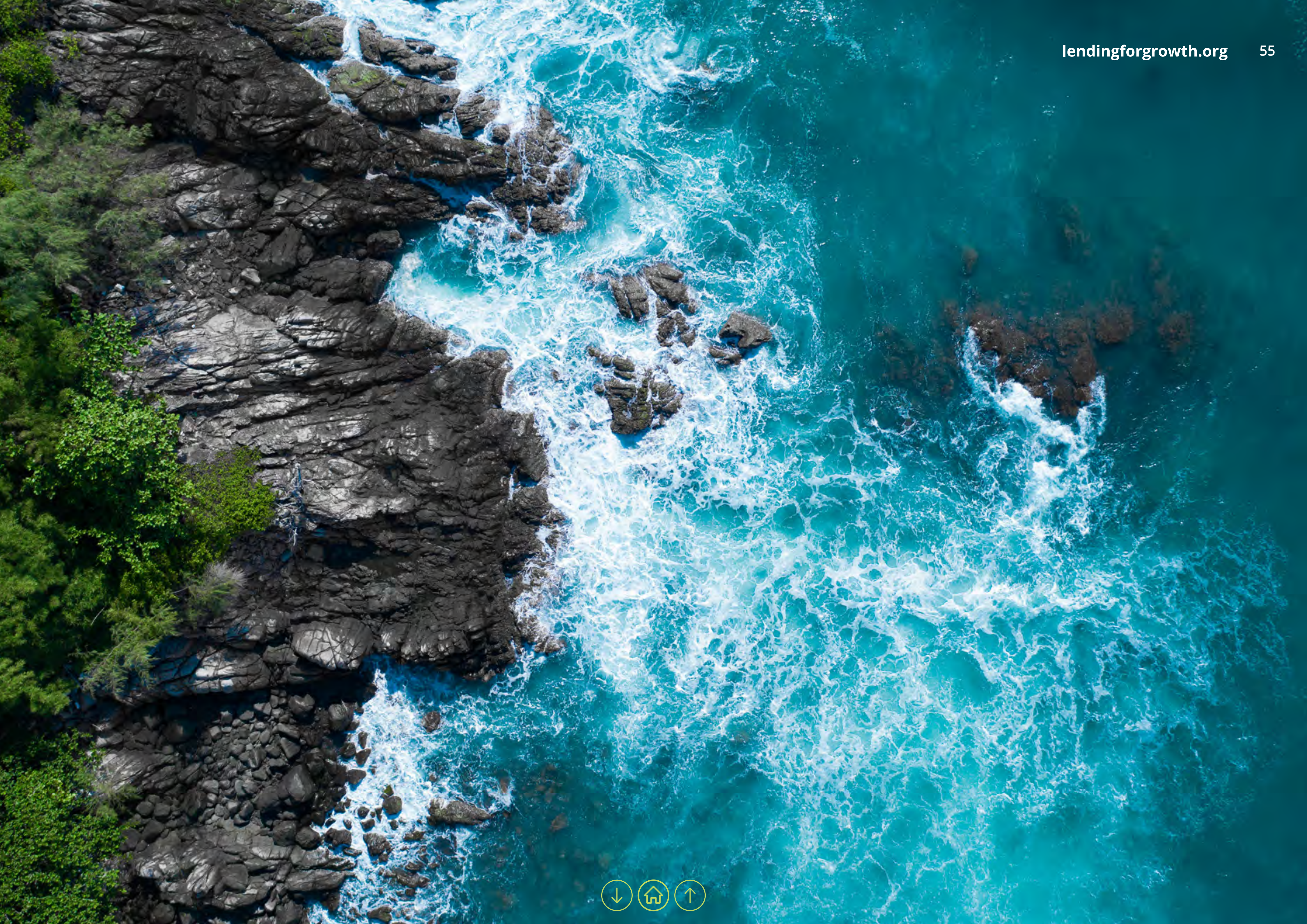
Our research demonstrates that private credit continues to develop as an asset class. Deal volumes remain healthy and mid-market lending remains the most prominent part of the sector. This activity continues to be complemented by diversification into newer strategies and markets, notably the growth of larger deals. At an aggregate level, performance remains healthy, with strong capital raising and low levels of borrower defaults or restructuring. Nonetheless, some geographies and sectors are likely to show much higher defaults or face greater headwinds.

We also find that ESG considerations are having a profound impact on the way private credit managers run their business. Most private credit managers are integrating ESG into their lending process. While some variation across different lending strategies is to be expected, there is little consistency towards ESG integration across the asset class. This suggests that the depth of integration and sophistication of approach is still maturing, and the sector will see further innovation until market practices become more established.

Data availability remains a key challenge for private credit managers. Despite this, there is a consensus that the market trend is firmly towards more, not less, data and pressure from investors and policymakers to provide more information will continue. Providing borrowers with technical support on sustainability is a key means by which private credit managers are seeking to differentiate themselves with investors and address data gaps. Private market initiatives where investors and both equity and debt managers agree common approaches to data gathering and dissemination are on the rise, and the Alternative Credit Council actively participates in these endeavours.

The development of ESG-linked loan products is also seen by some managers as a key means to incentivise borrowers to disclose ESG data and improve the sustainability of their business. Such products are only offered by a minority of firms at present but are expected to become a bigger part of the market. Appropriate KPIs and interest rate ratchet levels for such products are developed on a firm-by-firm basis, although greater adoption of such products may see more standardisation.

There are many competing drivers of change in the market, with investors, policymakers, private credit managers and borrowers all increasing their focus on ESG and sustainability. Greater cooperation and alignment between these stakeholders will be key in decreasing the operational burdens private credit managers currently face, while increasing transparency and understanding of different ESG approaches.



About ACC

The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. It currently represents 200 members that manage over US$450bn of private credit assets.

The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council.

ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business.

The ACC's core objectives are to provide guidance on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.

About AIMA

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than US$2 trillion in hedge fund and private credit assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry.

AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 200 members that manage US$450 billion of private credit assets globally.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

About Allen & Overy

At a time of significant market change in the legal industry, Allen & Overy is determined to continue leading the market as we have done throughout our 86-year history. The firm will do this by ensuring we always challenge ourselves to bring new and original ways of thinking to the complex legal challenges our clients face.

We cover the full spectrum of alternative investment, upstream and downstream and across all asset classes, from the structuring and establishment of managers and their funds, to the investments that they carry out. We have dedicated teams across our network of 44 offices in 31 countries, providing almost complete geographic coverage for our Alternative Investment Manager clients. We act for all types of funds, managers and investors, including global, industry leading managers, younger managers and start-ups/spin-offs, sovereign wealth funds, pension funds and insurance companies, and have deep sector expertise in each of the key asset classes: private equity, real estate, infrastructure, distressed and credit.

We help design and implement some of the most complex and innovative cross-border alternative investment structures, and the deals (domestic and international) that are done via those structures, whether leveraged finance, fund finance, CLOs, structured finance and securitisation, and corporate transactions. In addition our regulatory, compliance, employment and tax teams support our clients' transactional and operational requirements.