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Integrating ESG risks in private debt

Strong case for including non-financial information in investment decisions

Key Takeaways

- ESG is not yet prevalent within private debt investing despite the potential long-term benefits of incorporating ESG risks
- Managing ESG considerations is necessary in private debt investing as a natural way to preserve the downside protection of portfolio returns. ESG quantifies risks that can't be measured by traditional financial metrics.
- Incorporating ESG risks necessitates smart due diligence, post-investment reporting and monitoring to foster improvements, and the willingness to decline a deal or divest if a portfolio company breaches core ESG values.

Most institutional investors and fund managers have started to embed environmental, social and governance (ESG) measures into their asset selection processes. These measures apply primarily to quoted securities, where there are substantial numbers of funds dedicated to ESG equity and bond investing.

However, ESG is less prevalent within private debt investing, despite the potential long-term benefits of incorporating ESG risks. This apparent oversight is curious since many private debt investors are in the rare position of being able to secure regular and direct access to their investee companies active owners (Private Equity - PE's) and therefore have more scope to influence ESG initiatives.

In addition, the long-term nature of many private debt investments allows for a deeper relationship than most shareholders and bondholders have with issuing companies.

It's surely time for the integration of private debt assets and ESG.

The ESG explosion

ESG-aware investing existed before the financial crisis of 2008-2009 but was barely a blip on most investors' radar. In the decade since the alarming wobble in the West's financial system, investor interest in ESG has multiplied.

The initial focus was on ethical and sustainable investments, and this has expanded to many areas of business and social life. Today, ESG topics range from

MV|Credit

Frederic Nadal
CEO and President of the ESG Committee

Helene Barikmo
Member of the Deal Team and ESG committee.

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Regulation and legal edicts have followed in the wake of this growing social awareness, and investment firms today are faced with more stringent and systematic rules.

The UN Principles for Responsible Investing (UNPRI) is the best-known ESG standard, but many regions and countries have their own versions of UNPRI which differ according to local culture and norms.

In short, there is an unstoppable wave washing over the investment industry and its clients, including private debt investors.

The need for ESG in private debt assets

Why are ESG considerations necessary in private asset investment?

The simple answer is for the same reason that ESG is being integrated into mainstream asset classes. That is, managing ESG risks is a natural way to reduce risk and add return to a portfolio. Responsible ESG investing seeks to quantify risks that can't be measured by traditional financial metrics.

These include the risk that government regulation will force a company to rectify its poor (even if profitable) environmental practices, the risk of controversies such as lawsuits and financial penalties, and the risk to workers of unsafe working conditions (which, in turn, is a risk to the company).

"Most investors now accept that managing ESG risks is a key contributor to downside protection and the preservation of capital," says Frederic Nadal, chief executive of MV Credit, an affiliate of Natixis Investment Managers.

Applying ESG to private debt assets

Selecting ESG-compliant portfolio companies is a multi-layered process.

MV Credit invests, for instance, in private debt transactions where the PE relationships typically already have established ESG policies. MV Credit validates prospective portfolio companies' ESG compliance and risk considerations alongside general financial credit due diligence using external sources.

Due diligence prior to investment ensures that ESG considerations for each investment decision comply with MV Credit's and UNPRI core values. A summary of this due diligence is included in the investment recommendation presented to the management board.

"Post-investment reporting and monitoring is also important to foster improvements in the portfolio companies' ESG standards," says Helene Barikmo, member of MV Credits Deal Team and ESG committee. The deal team provides a regular review of the risks highlighted during the due diligence stage and takes any issues that arise to the board. If these issues result in the breach of ESG values and investment policies, divestment becomes an option.

Environmental	Social	Governance
Climate change	Demographics	Business integrity
Biodiversity	Human rights	Shareholder rights
Energy resource and management	Employee relations	Incentive structure
Environment	Health & Safety Diversity	Audit practices
Biocapacity and ecosystem quality	Diversity	Board independence and expertise
Air pollution	Customer relations	Fiduciary duty
Water scarcity and pollution	Product responsibility	Transparency / accountability

What to ask?

The quality of the due diligence process depends on the quality of the questions put to the prospective portfolio companies. Well-crafted and relevant questions to companies about their ESG practices are more likely to elicit information that can genuinely inform the investment decision.

A good line of questioning on policies relating to **environment** is likely to include questions such as:

- Has the target company faced any major environmental issues or litigations?
- If so, what improvements were made and was there any regulatory action such as enforcement, prosecution, fines?
- How is the management of environmental issues organised? Has the company appointed someone to handle environmental issues on a day-to-day basis?
- Could the company's operations directly or indirectly affect cultural heritage or impact biodiversity?

Questions on **social** issues might include:

- What is done to ensure the fair and ethical treatment of the workforce?
- Does the target company have an anti-slavery policy and a policy on modern-day slavery? How is this monitored?
- Does the company monitor incidents and accidents? If so, provide a breakdown of statistics for the last three years, including near misses, number of lost days, frequency rates etc.
- Is the company active in countries where corruption is prevalent? Are competitors suspected of actively using bribery in the company's markets?

Meanwhile, key questions on **governance** are, among others:

- Is there a remuneration committee? Does this committee engage with the board?
- Does the company have a whistle-blowing policy? Is it independently managed, and is it anonymous? Is it available at all times of the year? Has it ever been used?

- Does the company have defined cybersecurity and data protection practices? Have these been independently challenged?
- Are ESG processes and systems audited either internally or externally on a regular basis and are the results reported to the board?

Learning to say no

Unless an investment firm is prepared to actually decline a deal based on ESG considerations, then even the best-crafted ESG policy can have little impact. Nadal says: "In recent times, MV Credit has turned down a number of transactions involving companies which represented good credits, but posed ESG risks."

Take the example of a subscription-based BtoB service company for which MV Credit was asked to provide the debt in a private equity deal. During the diligence process, it became clear that the company frequently received double payments from customers that were not automatically returned and were added to the P&L after three years. Despite assurances from the company that the system to alert customers of a balance due to them would be improved, MV Credit elected not to proceed with the investment on ESG grounds.

In another example, MV Credit was invited to participate in a loan to finance the acquisition of a care home for the elderly. The investment committee decided that adding debt to a care home business might force the homes to make spending cuts, which would consequently detract from the quality of care. Again, the investment was turned down on ESG grounds.

ESG starts at home

An investment firm cannot reasonably claim to be able to measure and manage ESG risks, unless it first does so within its own business.

MV Credit is a signatory to the UNPRI. These principles include incorporating ESG analysis into investment decisions, being an active owner, seeking ESG disclosures from investee companies and reporting on its ESG activities and progress.

"Proactive day-to-day incorporation of ESG into all aspects of operations has been a major focus of MV Credit's development in recent times," says Barikmo. Initiatives have included expanding team diversity and a close focus on business integrity to manage its carbon footprint and recycling targets.

As part of the creation of a detailed ESG roadmap, MV Credit is in the process of refining communication on the ESG status of its portfolio companies. Other ongoing projects include ensuring regular ESG reporting from borrowers and developing an ESG monitoring scoring methodology.

Conclusion

ESG is desirable both from a moral and ethical viewpoint, and also from a risk-return standpoint. Management of ESG risk has been shown in many academic and asset management practitioner studies to reduce losses, particularly in longer-term investments.

There is no reason why it should not be applied to private debt investing, just as it is to investing in listed securities. Nadal adds: "It is up to asset managers and their clients to act in the best interests of themselves and society at large by incorporating ESG into private asset transactions."

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