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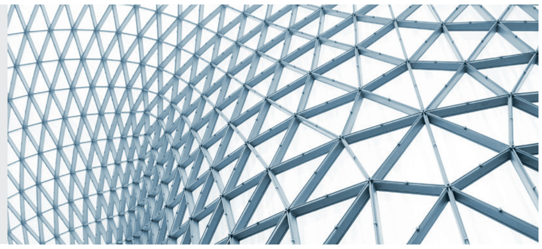

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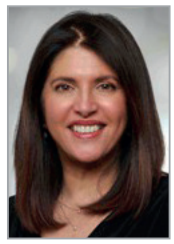
Private debt has unique opportunity to drive the ESG agenda

Lender-friendly environment combined with investor focus on sustainability provide a unique opportunity

Key Takeaways:

- The current lender-friendly landscape gives private debt providers the opportunity to champion ESG leaders in the private equity industry. Debt providers can encourage positive screening and greater allocations to portfolio companies which focus on enhanced ESG performance relative to their peers.
- ESG-linked subscription lines are becoming an important part of private fund financing, as borrowers seek to create ESG-linked KPIs in the expectation that good ESG performance will result in margin decreases on their borrowings.
- The shift to ESG-compliant investing should not only take place at portfolio company level. Private market participants must practice what they preach, acting at the corporate level too.



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Since the Covid-19 pandemic emerged in early 2020, traditional providers of financing have further retrenched and private credit is fast becoming the go-to debt provider for the private equity industry. As a result, deals are being transacted on more lender-friendly terms as regards to pricing, legal documentation and so on, compared with the pre-pandemic environment.

At the same time, the pandemic has reinforced investors' convictions on ESG issues, spurring them to seek more rapid and deeper ESG integration in their portfolios.

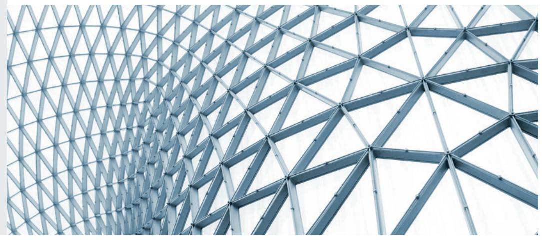
These shifts in market dynamics present the private debt industry with a golden opportunity to help shape the future of businesses across the board. Private debt firms are now in a strong position to action change among portfolio companies and the private equity firms with which they partner. Private market participants, as an industry, must take advantage of this enhanced positioning to help drive one of the key priorities of investors today: ESG integration.

Championing ESG leaders

ESG considerations are becoming a fundamental aspect of investment decision-making and a key component of risk management. In 2021, ESG investing is just "good business", enhancing performance by side-stepping allocations to companies and sectors where regulation, environmental factors and social issues could impact negatively on the business model.

The practice of "blacklists" and negative exclusions, where particular sectors, issuers and themes are excluded from portfolios, has been prevalent in the private fund industry for years. However, for some firms and investors, this bare minimum approach has only represented the start for their ESG activities. The private debt industry has the opportunity to go further and drive wider and more long-lasting change.

The current lender-friendly landscape gives private debt providers the opportunity to champion ESG leaders in the private equity industry. Debt providers can encourage more advanced ESG activities such as positive screening and greater allocations to portfolio companies which focus on enhanced ESG performance relative to their peers.



Relationship with sponsors is evolving

There is now ample opportunity for the private debt industry and its investors to seek formal undertakings from sponsors on ESG targets and information rights.

In general, private equity sponsors are willing to co-operate, given that they are being urged by their own investors, the LPs, to enhance ESG activities and reporting.

Increasing popularity of ESG-linked loans

Change is coming thick and fast. Take the example of the €2.3bn ESG-linked subscription credit facility in June 2020. The facility was the biggest ESG-linked facility seen so far and was backed by a powerful group of leading financial institutions.

The margin on the facility adjusts depending on the fund's ESG performance. The underlying portfolio companies are assessed according to a number of ESG measures: gender equality on their boards; their efforts towards renewable energy transition; the effectiveness of their sustainability governance platform. Notably, the facility aims to enhance the "S" and "G" components of ESG, which tend to receive less attention than the environmental aspects.

ESG-linked subscription lines are becoming an important part of private fund financing, as borrowers seek to create ESG-linked KPIs in the expectation that good ESG performance will result in margin decreases on their borrowings. MV Credit is planning to introduce ESG KPIs for its portfolio companies, in a similar way that the fund finance industry has done in its structuring of facilities. Most transactions last year were for equity funds, but private debt managers will undoubtedly move into the space in the near future.

Private debt/equity must walk the talk

The shift to ESG-compliant investing should not take only place take place at portfolio company level. Private market participants must practice what they preach, acting at the corporate level too. This is why MV Credit recently committed to becoming carbon neutral, reflecting a desire to be a more sustainable organisation through better environmental performance and more sustainable growth. Hopefully, other firms in the private equity and debt space will follow a similar path, enhancing the credibility of the sector as a whole.

Amid the terrible human impact of the pandemic, one of the positive consequences is it has provided the impetus to change business models so ESG considerations rise up the list of priorities. There has, for example, been a marked decrease in business travel, with meetings now routinely conducted via video calls.

Fundraising, a fundamental aspect of the private equity and debt world, has also adapted and LPs have become used to the new world of committing money to strategies without an office-based meeting and a handshake.

This is not the end of business travel of course. Meetings between sponsors, debt providers and LPs will return to our daily environment. But some of the changes that have been made will persist, delivering positive impact to communities.

Let's grab the chance to promote a sustainable future

The conversation around ESG has moved from box-ticking to the forefront of investment decision-making, and the Covid-19 crisis has only accelerated this move.

With the effects of the pandemic likely to persist for some time, the private debt market will remain skewed towards lenders who push for preferential terms, but also towards firms who are ready to demonstrate much higher levels of ESG implementation.

It is time for us as an industry to look beyond our own investment needs and harness the lender-friendly environment to promote a more sustainable and responsible agenda across the business world.

Written in March 2021

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