EXPERT Q&A

ESG is dominating debate across all fields of investment, including private debt. Partners Group's Andrew Bellis and Christopher Bone explain that different forms of lending need different approaches, and that dialogue with companies is key

Sustainable investing: Credit where credit's due

At first sight, private debt investment managers may appear to lack the leverage needed to play a determining role in a company's ESG policies, yet investors are facing a flurry of claims from managers boasting of their ESG credentials. Can debt funds really play a role in the drive to sustainability, particularly in today's competitive credit markets? Andrew Bellis, head of liquid loans at Partners Group, and Christopher Bone, the firm's head of private debt Europe, discuss the challenges and opportunities for both investment managers and their investors.

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Q How much is ESG an issue among debt investors and is it developing as fast as in private equity investment?

Andrew Bellis: It is hugely topical, but there are variations depending on who you are speaking to, where that investor is based and what type of fund they are looking at. In my recent investor calls, it has probably been the subject we have spent the longest time on, but a lot of debt investors are struggling with how to look at it. They want to factor ESG into their investment decisions, but it's often not clear how to do it in the debt world and it is quite different from the equity world. I would note it's particularly important for Europe-based investors right now.

Christopher Bone: It has definitely come up the agenda in the last 12 months, with the EU's Sustainable Finance Disclosure Regulation really adding to the impetus. When we are speaking to investors in Europe, the Nordic countries are typically very focused on this topic, but it is becoming equally important in the UK and across the EU.

Q How can an investment manager go about assessing ESG and is there

a difference in approach between syndicated loans and direct lending?

CB: At Partners Group, we have an overarching approach that is not just for debt, but also our private equity, infrastructure and real estate businesses. For me on the direct lending side, where we are negotiating documentation ourselves, we can split it into three areas.

First, you have the screening for ESG issues and that is exclusionary – not lending to certain subsectors. Tobacco and coal are obvious ones, but it goes wider.

The second level is the reporting that we require from our portfolio companies. On the direct lending side, we can achieve more granularity on reporting. We get monthly accounts and, as part of the information undertakings, we can prescribe exactly what we want to see, including specific KPIs. Depending on the industry, those KPIs might be the percentage of recycled material used in production, or the percentage of energy from green sources a company uses, or the percentage of women on their board. We select KPIs that are material and relevant to a business and that have potential to deliver positive stakeholder impact and then hard-wire them into the documentation.

The third level is ESG ratchets, which are designed to incentivise companies to improve their ESG performance on relevant, pre-defined KPIs. There are questions about whether these rachets work for all types of lending, but on the direct lending side we find them a relevant way to put our agenda on the table. In the last few months, we've done three ESG-linked unitranches with ESG margin ratchets. These ratchets mean certain ESG KPIs are included in the covenants and every quarter they are tested. If a portfolio company doesn't hit those criteria, then the margin goes up by 5bps or 7.5bps, for example, and vice versa.

A 5bps change may not seem significant. However, somebody at the company will be responsible for meeting those KPIs and if you've got a £100 million ($141 million; €116 million) loan, and it is at 5bps, that is quite a bit of money they are responsible for. It is also important to select KPIs that are material to a company and that contribute to reducing risk, providing additional incentive for both the manager and the portfolio company.

AB: The approach on the syndicated loans side is based on the same philosophy. We also use screening, but there is a nuance to it in terms of our internal screening versus what fund, and in particular CLO, documentation permits. In the CLO market, the documentation often contains language about exclusions, but it can be fairly broad. For example, it might say no investment in a company that operated casinos, but that exclusion is based on no more than a certain proportion, typically 50 percent, of the business's revenue being from casino operations.

That is why we have our own internal criteria; we think it is much more robust. We've also developed a scoring system for ESG. Every company we look at, we assign an ESG score to and can then factor that, and any other ESG concerns, into our investment decision. We are now providing reporting to our investors which will include aggregated ESG scores and give our investors more information on ESG performance.

On ratchets, we have concerns about how effective they are on the syndicated loans side and how they are being used. We think some of the criteria on ESG ratchets are not really ESG-related and more what the company should

Q What are the future trends in ESG and what are the next likely developments?

CB: There are a lot of managers that are looking at ESG and wondering how to approach it. Everyone is looking for some sort of standardisation or benchmarking. How do you judge one manager against another? How do you judge returns in this context? Who decides what the KPIs are and who will test whether they are being met? It's a bit of a wild west right now.

AB: We are in the early stages of this, and it will continue to evolve. We will continue to enhance our approach and be on the forefront of this topic, given how important it is. The thing that is interesting for the future is, so far, this has been a very European-focused topic. But things are changing in the US and, as that continues, we believe there will be more a global approach.

be doing in the normal course of running its business; it does at times feel like greenwashing.

It is more appropriate to have a ratchet in a business that operates in an area with more ESG risk and then actively encourage positive change, for example, rather than just putting vaguely linked ESG ratchets into every loan.

Also, the advantage that Chris has on the direct lending side is that he can drive the terms. On the syndicated loans side – particularly now there is a risk-on appetite – it's really hard to do that. So, while ratchets are a positive development, we are not sure they are yet being used in the right way all of the time. Industry organisations such as LSTA are working on developing frameworks that may help provide more direction in this area in the future.

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> **CHRISTOPHER BONE**

Q How then, on the syndicated loans side, can you exercise influence over a company's ESG approach?

AB: Syndicated lending has a different dynamic; it relies on a market-based approach. When we developed our scoring system, we had to ask companies a lot of questions related to their ESG practices, which was new for many of them. Today, it is not just us doing this, so there is more engagement. We've been ahead of the game, but it is important that other market participants think about this too.

Down the line, companies that are reluctant to provide information or don't act in the right way, may well be penalised with a higher cost of debt, because many market participants are unwilling to lend.

Q On the direct lending side, how easy is it to get a dialogue with borrowers on ESG factors?

CB: First, there's the borrower base that you are already lending to. That can be a very different conversation depending on where that borrower is. If it's in the UK and you say, 'I want to discuss one of your specific ESG policies and I want to speak to someone at the company responsible for ESG' they will probably say that is fine and you will get the information and contact.

If you go along to an equivalent in the US and ask the same question, you may well get a different response. Companies are differently prepared for those conversations and that is partly a geographical phenomenon.

With a new investment being made today, it is very different. When we are competing for a financing, we now try to include ESG in the term sheets and say we want to talk about reporting and commitments. A company may be willing to engage on that straight away, or they may want the core financing terms agreed first and be willing to talk about ESG later. But, during the past year, we have gotten notably better traction on this topic from sponsors.

Q How can investors be sure about the credentials of funds that claim to be ESG? Is there a risk of some ESG claims being unclear?

CB: Looking at the ESG credentials of a fund does not mean much unless you also know how the manager approaches ESG. An investor should lift up the bonnet. Ask how long the manager has been integrating ESG into its investment process; ask for its latest UN Principles for Responsible Investment scoring; ask for examples. I don't think you should put too much credence on a particular fund. I am a sceptic about that.

AB: Labels can be very misleading in both funds and in CLOs. We think labelling something as 'ESG compliant' is just dangerous. It's not clear what you are compliant with, and one person's compliance is different to someone else's. Of course, the terms of the fund or the CLO are important, but the manager, and their process, is much more important. ■