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The Growth of ESG in Private Debt Markets: Current Challenges, Proposed Next Steps, and ELFA's ESG in Private Debt Survey

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Executive Summary

- ESG integration in private credit is accelerating rapidly, and requires an approach that is distinctly different from the way ESG analysis is applied to publicly listed equity and fixed-income investments.
- In this Insights report, we summarise the regulatory and market drivers behind this trend, the current processes and related underlying deal documentation, and some of the ESG integration issues facing lenders and borrowers in the private credit market.
- Approaches to ESG in private credit are quickly evolving, with lenders adopting a variety of innovations to encourage better disclosure and more sustainable practices. However, whilst much progress has been made in this area, as a relatively young asset class, inefficiencies remain.
- The Private Debt Committee's ESG workstream is seeking to address these issues, working with the ESG Committee which has introduced several initiatives to improve leveraged finance market practice by standardising ESG engagement and disclosure across the market, including by way of our ESG Fact Sheets.
- The development of these resources falls within our mission to promote better disclosure and greater transparency in reporting so that borrowers will understand what is required of them and lenders can engage effectively with borrowers to obtain material information necessary to their investment analysis and management going forward.
- To further this mission, we are launching our ESG in Private Debt Survey for investors, and we intend to follow this report with the results of the survey and our suggested next steps to support the growth of ESG in the private debt market.

Introduction

The private debt market is undergoing a seismic shift in approach to consideration of environmental, social, and governance (ESG) factors and sustainability. However, the process for integrating ESG in private credit is very different from the way ESG analysis is applied in the publicly listed equity and fixed-income markets due to, among other things, the distinct deal processes and counterparties involved.

Further, the typical private credit borrower is usually a smaller company than those issuing public equity or fixed-income instruments like high yield bonds or leveraged loans. Whilst private equity owners and debt arrangers are encouraging management at these companies to track and quantify ESG efforts and related data, and lenders are asking for more information about these topics, private debt borrowers are – in general – coming to the process with fewer resources than larger firms.

Finally, as many of the companies in the private credit market are sponsor-owned, private equity sponsors play a critical role in influencing ESG practices, given the control they have over the company and its board of directors. For this reason, engagement with a company's sponsor is a key complement to discussions with the company itself.

In this Insights report, we highlight the key market and regulatory factors driving the growth of ESG in the private debt market, identify the challenges presented by the current approach to ESG in the typical deal process, and make preliminary suggestions to support greater efficiency and streamlining of ESG engagement.

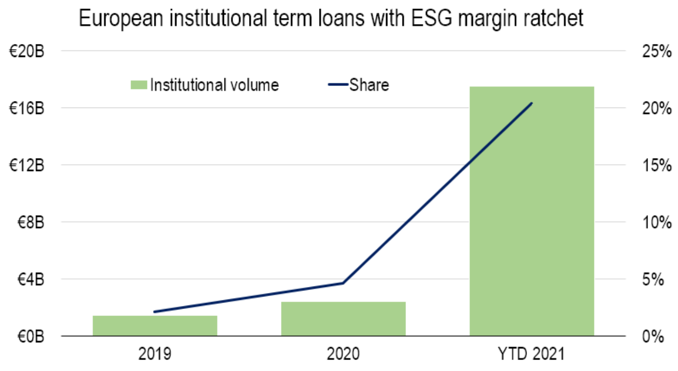
We also launch our ESG in Private Debt Survey, which seeks to broaden our outreach on the topic to private debt investors both inside and outside of our organisation in order to guide our next steps to support the growth of ESG integration in private credit.

Key drivers of the growth of ESG in the private debt market

The European private debt market has experienced a period of rapid evolution in how ESG is incorporated into deal documentation during 2021. Whilst comprehensive data is not available for this market, this development follows a similar trend in the broadly syndicated loan and high yield bond market.

Data from LCD[1] show that institutional term loans incorporating ESG provisions into the margin ratchet clause reached €17.5 billion in the year to 20 September 2021, amounting to approximately 20% of the market – a stunning growth compared to the less than 5% figure in FY20.[2]

Growth in using ESG Margin Rachets in European Broadly Syndicated Loan Market



Data through Sept. 20, 2021.
Source: LCD, an offering of S&P Global Market Intelligence

The trend of loans incorporating ESG contractual provisions based on sustainability performance targets (SPTs), and the broader increase in ESG integration in the private credit market, reflects a mix of profound market and regulatory forces, which we explore in this section.

Borrowers and arranging banks structuring ESG loans benefit from favourable market conditions

The combination of the sheer volume of liquidity on offer, economic benefit, the relative ease of structuring and a booming demand for ESG products are strong drivers for private equity sponsors to structure sustainability-linked loans. If the SPTs are met, borrowers can save between 0.05% and 0.20% on the cost of borrowing (compared to a greenmium ranging around 0.03% for traditional corporate green and sustainable bonds).[3]

Further, CFOs are increasingly being encouraged to better track and quantify their company's ESG efforts, as this can allow them to secure better interest rates on financing and this may attract a wider pool of investors interested in sustainable investments.

However, so long as the demand for ESG products is higher than the supply, borrowers will have the upper hand in negotiating terms and may, as a result, avoid including provisions that investors would like to see, including requirements for third-party oversight.[4]

The increase in deal activity for ESG-linked financings has also resulted in the creation of new roles, like sustainability coordinator and ESG agent.[5]

Stakeholder demand and a view on future value support the push for ESG

In a changing business environment, pressure on companies to focus on ESG issues (e.g.: climate change, diversity and inclusivity, and sound governance) continues to mount. Researchers, business groups, regulators and NGOs have variously warned of the risks—or emphasized the opportunities—that such issues present to company performance.

Albeit difficult to quantify, companies are subject to myriad external and internal influences such as current and prospective consumers, employees, communities, industry peers, groups and associations – all potentially influencing companies' sustainability roadmaps.

In a survey from February 2020, McKinsey noted that 83% of C-suite leaders and investment professionals say they expect that ESG programs will contribute more to shareholder value in five years than today.[6] This is supported by research demonstrating that strong performance on ESG issues can improve top-line growth, reduce costs, minimise regulatory and legal interventions, improve employee productivity, and focus investments and capital expenditures.

Regulatory scrutiny of ESG is a key driver of the increased focus on ESG in the private debt market

This comes at a time when leveraged loan investors, arranger banks, sponsors and an increasing number of corporate borrowers are subject to an ever-greater mix of initiatives by regulators.

In Europe, the EU Finance Package consists of multiple regulatory texts including the Non-Financial Reporting Directive 2014/95/EU ("NFRD", in force since 2018 and applicable to companies) and the Sustainable Finance Disclosure Regulation (EU) 2019/2088 ("SFDR", partially in force since 10 March 2021 and applicable to investors). The proposal for a Corporate Sustainability Reporting Directive (CSRD) adopted in April 2021 will likely expand the ESG disclosures to larger private companies.

NFDR requires public-interest companies with more than 500 employers in the EU (listed companies, banks, insurance companies, and other public-interest entities) to include non-financial statements in their annual reports or in a separate filing from 2018 onwards. These must include information such as environmental protection, social responsibility and treatment of employees, respect for human rights, anti-corruption and bribery, and diversity on company boards.

[1] Leveraged Commentary & Data (LCD), an offering of S&P Global Market Intelligence.
[2] Ibid.
[3] Credit Agricole Greenmium tracker dated 27 August 2021.
[4] https://www.reuters.com/business/sustainable-business/private-equity-vows-help-world-lenders-want-proof-2021-06-09/
[5] See, e.g., the ELFA and LMA Best Practice Guide to Sustainability-Linked Leveraged Loans and the LMA's Glossary of Terms.
[6] https://www.mckinsey.com/business-functions/sustainability/our-insights/the-esg-premium-new-perspectives-on-value-and-performance

The CSRD expands the scope of NFRD to all listed companies as well as to private companies meeting at least two out of three criteria (greater than 250 employees and/or more than €40 million turnover and/or more than €20 million total assets).

CSRD further clarifies the obligation to report according to the double materiality perspective: i.e., companies should report (i) information necessary to understand how sustainability matters affect them, and (ii) information necessary to understand the impact they have on people and the environment.

SFDR introduces a range of new obligations for asset managers to be more transparent on their investments and especially for ESG funds. Funds which promote environmental or social characteristics ("Article 8 funds"), or which have a sustainable investment objective ("Article 9 funds") will be expected to report on their sustainability performance with a certain set of metrics.

These are being finalised and may look similar to the 18 criteria of the Principal adverse sustainability impacts statement in Annex 1 of ESMA Final Report on draft Regulatory Technical Standards (dated February 2021). Such criteria include greenhouse gas emissions (scope 1, 2 and scope 3 from 2023 onwards), gender pay gap and board diversity.

As such, credit investors with ESG funds will increasingly request information on such metrics from borrowers. Moreover, Article 9 funds with an environmental impact will also need to report on their alignment with the EU Taxonomy, and credit investors will increasingly request detailed disclosures on their borrowers' sustainable products, services, and capital expenditures.

Alternative funds are expected to have the lowest percentage of Article 8 funds and Article 9 funds. As a result, SFDR creates a more favourable backdrop for ESG with additional transparency obligations to be passed on to investee companies by lenders seeking to deploy ESG strategies.[7]

A nascent class of impact private debt funds seek both financial and non-financial objectives

Direct and corporate lenders have more control over structure and negotiation of the loan documentation and hence are able to introduce ESG ratchet mechanisms. Further, a new type of impact private debt fund has emerged over recent months[8], suggesting that lenders want to have a say on sustainability-linked loan features both to reduce the risks of greenwashing and also to increase positive impact.

The typical private debt deal process and resulting challenges to ESG integration

ESG data is typically absent from initial due diligence packages

The deal process in private debt usually follows a typical format: a financing opportunity is introduced through either a debt advisory or private equity firm supported by a teaser or Information Memorandum providing the prospective financing party with an initial overview of the business, the market it operates in and its financials. Subject to deal dynamics, this might initially be followed by a management presentation and vendor due diligence material on financial and commercial aspects.

Whilst financial due diligence (FDD) commercial due diligence (CDD) is quite standard at this stage, any specific ESG-related due diligence (ESG DD) often only becomes available through the buy-side due diligence process if specifically mandated. That is, ESG DD has yet to make it into the standard package supplied as part of the investment process.

So far, ESG DD is more likely to be made available where targets are asset-heavy such as in producing industries such as packaging. However, even in this case such material would typically focus mainly on environmental considerations and is, in general, somewhat thin on the "S" and "G" aspects of the business.

A lot of otherwise useful information can generally be found in legal due diligence materials and it is worth noting that throughout the diligence process prospective lenders should always be able to address any ESG-related concerns with any of the stakeholders, be it the advisor, management, diligence providers or the private equity owners themselves.

Different aspects of ESG might also best be taken up with different audiences – for example, governance issues are probably best placed with the future owners of a business, trying to understand their strategy and organisational set-up looking forward, especially where there are clear areas of improvement (for instance when looking at first time buy-outs of smaller founder-led businesses that lack the typical infrastructure of larger, seasoned corporates).

[7] Barclays SFDR tracker, September 2021
[8] See, e.g., Eiffel Impact Debt (€750 million), Tikehau Impact Lending (€400 million target) and Amundi Senior Impact Debt IV (€650 million).

Lenders mine ESG data through engagement; third-party data providers are less helpful in private debt

An increasing albeit still very limited number of private companies publish a sustainability report with references to different standards such as GRI or SASB.

As a result, ESG integration in the private debt market is a highly tailored, uniquely bespoke process, and requires proactive engagement and bottom-up analysis. Information will be less comparable case-by-case as the investment team will focus their attention on risks specific to a particular asset and information that is made available as part of each diligence process.

Further, many asset managers have started incorporating ESG questionnaires, presented either as a set standard template across the board or a standard template tailored to certain industries to accommodate for potentially differing sector dynamics.

Such an approach does help with standardisation – indeed, the ELFA has published 11 ESG Fact Sheets designed to streamline the ESG engagement process, available on our website.

However, the utility of ESG questionnaires will be driven by the availability of ESG data from corporates, especially for companies at the smaller end of the spectrum, still varies substantially – some are able to provide a full suite of key performance data points whilst others might not (yet) record a single ESG item.

Third-party data, which is frequently sought out by the more liquid fixed income and equity strategies, continues to be scarce and often of lesser use in the private debt space given the largely private nature of respective issuers and their securities and the resulting lack of comparability.

Increased regulatory pressure over recent years, however, has helped advance efforts in that respect, starting with the very top of the food chain – in this case, institutional investors across the globe, who through imposing new standards for disclosure slowly but surely help raise the standards of investing.

Data collection, engagement and monitoring present unique challenges for private debt investors

Whilst progress has been made recently with regards to improving ESG integration across the private debt market, as a relatively young asset class there are still a number o inefficiencies which remain. We believe that collaboration across the market, including by way of a number of ELFA initiatives, will help the market to achieve an end goal of improving and homogenising approaches to ESG processes.

Firstly, as previously highlighted at the diligence stage of initial transactions, there is a lack of consistency in whether or not ESG DD is included in the initial screening process of investments. Whilst increasingly there is a focus on ESG early in a deal life cycle, this lack of standardisation at the outset can be an obstacle to lenders in what are often fast paced transactions. Lenders are increasingly asked to demonstrate that they have considered relevant and targeted ESG-related diligence for new deals.

To the extent market participants tailor initial diligence out the outset to market recognised risks – using, for example, ELFA's industry-level ESG Fact Sheets – lenders will be better placed to respond with granularity to an increasing volume of ESG related queries received from their investors.

Similarly, access to the appropriate data points to assess outcomes at the borrower level is also the primary challenge facing market participants in conducting ongoing ESG analysis post-investment. In view of the diverse portfolios existing within private credit, and additionally given the often-smaller scale of companies, the data sets available to lenders are limited. As discussed above, ESG data providers tend to focus on servicing larger liquid markets where data availability is much improved versus private markets.

Whilst conversations are ongoing, and are increasingly relevant in the face of regulatory tailwinds, ELFA has proactively developed solutions by engaging with the investor community to distil expectations around data collection and reporting.

Additionally, through ongoing sharing and collaboration by ELFA members, best practices in terms of ESG questionnaires, reporting templates, and more generally around approaches to ESG across private debt portfolios continue to be discussed.

Supported by ongoing engagement by members and market participants, ELFA has created a forum for discussion and debate that can help pave the way for increasing consistency across private debt markets.

ELFA's ESG in Private Debt Survey aims to guide next steps in supporting the growth of ESG in private credit

As discussed, private debt presents unique challenges for good ESG integration for both lenders and borrowers. On the lender side, when compared to private equity, private debt frequently has higher deal volume, shorter diligence windows, less access to management and data, and fewer high-quality ESG tools to analyse investments. Further, as regulatory pressure to report on non-financial data rapidly increases, the infrastructure to help especially the smaller, less ESG-mature borrowers to understand the importance of disclosure and to collect the required information is lagging behind.

We strongly believe that more coordination will drive better efficiency. We have contributed significantly to synchronise efforts in the leveraged finance market with a wide range of ESG resources available on our website. We are looking to repeat this process through engagement with private debt market participants, including investors, debt advisory firms, private equity firms, and professional trade associations, on the challenges of ESG integration described in this Insights report.

As part of this effort, ELFA is launching the ESG in Private Debt Survey to gather information from investors on this topic.

Click here to take the survey.

We will make the results of the survey available to the public in a follow-up to this Insights report, and intend to use the information to raise awareness of some of the issues facing private debt lenders and borrowers, and how we can best support market participants.

About ELFA:
ELFA is a professional trade association comprised of European leveraged finance investors from over 45 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit ELFA's website: www.elfainvestors.com.

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