European Leveraged Finance Association

PRESS RELEASE

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ESG-related due diligence lacking in private credit market – European Leverage Finance Association report finds

- **ELFA report finds ESG data is typically absent from initial due diligence packages unless specifically mandated by investors**
- **ESG integration in private credit requires different approach to that applied to publicly listed equity and fixed income investments**
- **ELFA seeking to address issues and improve ESG practices in private credit**

In its latest Insights Report – The Growth of ESG in Private Debt Markets - the European Leveraged Finance Association (ELFA) highlights inefficiencies in the private credit market in relation to ESG due diligence. The report notes that ESG due diligence has yet to make it into standard packages as part of the investment process and that while there is a need for information to be tailored, the opportunity exists to standardise approaches to ESG processes across the market to improve engagement.

Challenges with typical deal process and ESG data collection
The report outlines that although financial due diligence and commercial due diligence is quite standard in the initial stages of the private credit deal process, ESG-related due diligence often only becomes available through the buy-side due diligence process if specifically mandated. ELFA notes that some exceptions exist, particularly where borrowers are in asset-heavy industries, however in these cases materials are likely to focus mainly on environmental concerns as a standalone, with information typically thin on social and governance issues.

Lack of access to appropriate data points is highlighted as a key challenge when considering ongoing ESG analysis post-investment. The diverse portfolios that exist within private credit and the often-smaller scale of companies means that third party ESG data sets are limited. As a result, ESG integration in private debt is a highly tailored, uniquely bespoke process that requires proactive engagement and bottom-up analysis.

The report also highlights the critical role of private equity sponsors in influencing ESG practices, given the control they have over a company and its board of directors, and that for certain areas such as governance issues, the future owners of the company are the most appropriate parties to engage with. Engagement with a company's sponsor and future owners can therefore be a key complement to discussions with the company itself and adds extra layers of interaction and analysis.

Sabrina Fox, Chief Executive Officer, European Leveraged Finance Association (ELFA) comments, "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 of inefficiencies that remain. The lack of standardisation at the outset of a deal can be an obstacle to lenders in what are often fast paced transactions. The varying nature of data available at the corporate level within privately owned companies and lack of third-party data can make the realities of securing relevant ESG information particularly challenging in the private credit market. ELFA's ESG Fact Sheets, which outline key ESG data points on a sector-level basis, can help market participants standardize diligence to support effective and efficient engagement."

Market dynamics can favour borrowers
Borrowers and arranging banks structuring ESG loans have benefited from favourable market conditions. The combination of the sheer volume of liquidity on offer, economic benefit through lower costs of borrowing, the relative ease of structuring and a booming demand for ESG products are strong drivers for private equity sponsors to structure sustainability-linked loans. The report highlights that as long as demand for ESG products is higher than supply, borrowers will have the upper hand in negotiating terms, which may as a result avoid including certain protective provisions that investors would like to see.

Pressure on companies to focus on ESG issues is, however, rising across multiple stakeholder groups. The report notes that regulatory scrutiny is a key driver of the increased focus on ESG in the private credit market as leveraged loan investors, arranger banks, sponsors and an increasing number of corporate borrowers are all subject to an ever-greater mix of initiatives from regulators. Regulatory texts within the EU Finance Package such as the Sustainable Finance Disclosure Regulations (SFDR) and the proposed Corporate Sustainability Reporting Directive (CSRD) mean that investors and private companies will be obliged to report on sustainability and non-financial performance.

Sabrina Fox adds: “The European private debt market has experienced a period of rapid evolution in how ESG is incorporated into deal documentation and with the increasing scrutiny of regulators the pace of this is only increasing. There is an urgent need to address the issues highlighted in our report in order to ensure that the ongoing growth of ESG integration in private credit is sustainable and that the market is efficient and resilient. With this in mind, we will be undertaking a number of initiatives to promote greater collaboration with market participants in order to achieve an end goal of improving and homogenising approaches to ESG across the market.”

The ELFA Private Debt Committee’s ESG workstream is seeking to address the issues highlighted in the report. The organisation has this week launched an ESG in Private Debt Survey, seeking to broaden its outreach on the topic and guide initiatives in supporting the growth of ESG integration in private credit.

ELFA has already introduced several initiatives to improve market practice and standardise ESG engagement and disclosure across the leveraged finance market, including with its ESG Fact Sheets. Many asset managers are now incorporating the ESG Fact Sheets in their due diligence process, either as a standard template or tailored to certain industries to accommodate for differing sector dynamics. Further, borrowers across asset classes are using the ESG Fact Sheets as a guide to ESG data collection and disclosure.

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About ELFA
ELFA is a trade association comprised of European leveraged finance investors from 50 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 the ELFA website: www.elfainvestors.com.