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ESG in Private Credit – Key Takeaways from ELFA & KBRA Event

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Inside this issue...

Enhancing data through active engagement
The importance of training and education
Regulation – Progress but not perfection
Incorporating ELFA's ESG Fact Sheets and other industry initiatives

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ESG in Private Credit – Key Takeaways from ELFA & KBRA Event

Executive Summary

1. Despite progress and awareness regarding ESG in the private debt market, there is still a need for improved dialogue and engagement between investors and borrowers. More dialogue and engagement will ensure better ESG data from borrowers going forward.
2. Navigating ESG disclosure can be very challenging, and the data is still in the early stages of evolution. Therefore, the investment process should be data-informed rather than data-driven and will often require active engagement to better interpret the information. However, market participants should not allow the desire for perfect ESG data and disclosure to get in the way of progress.
3. Though there are certainly trends within sectors, ESG issues can often be specific to each borrower thus highlighting the need for engagement on a case-by-case basis.
4. Private credit investors can influence borrower behaviour as they are in direct dialogue with the companies they invest in and therefore can support and encourage more sustainable business practices and related disclosure.

Introduction

ELFA and KBRA co-hosted an event "ESG in Private Credit" with experts across the sector discussing the following topics:

- How firms integrate ESG into their investment process
- How to enhance and access ESG data in the private debt market
- The evolution of ESG regulation

Speakers highlighted that while ESG data helps investors monitor risk and opportunities across their portfolio, the investment process should be data-informed rather than data-driven. This requires active engagement with the borrower disclosing the information. Enhanced engagement and better dialogue between investor and borrower allow for a more meaningful analysis of the data received.

Enhancing data through active engagement

Private credit investors have the benefit of a direct relationship with borrowers, which can be used to drive ESG adoption and disclosure.

There is a unique problem in private markets, which firms are finding difficult to overcome, and that's the fact that an effective solution requires a bottom-up approach, based on data creation, employment of the right methodology, a data aggregation, management and reporting system, with clear alignment to regulatory and investor standards. Data can help lenders to monitor ESG-related risks across the portfolio. However, focusing solely on the data may obscure the nuances of what each company is doing to manage ESG risks and capitalize on ESG opportunities.

Active engagement and ESG-related education efforts with the borrower helps to improve the analytical process. Hosting workshops with portfolio companies and specialist data providers to undertake training on carbon reporting is an example of engagement that supports companies to better integrate ESG.

Companies that establish a dialogue with lenders concurrently with the creation of KPIs have the benefit of customising these with key stakeholders in mind.

The importance of training and education

During the pre-investment stage of the deal, panellists noted the importance of a focus on education so that the deal team understands any relevant risks, including in respect of ESG-related regulation and along the supply chain. Through this increased awareness and more clearly defined ESG risks, deal teams can then be more thoughtful around considering relevant ESG risks during the investment process.

Noting the sometimes fast-paced nature of transaction, post-investment there is often a more practical opportunity for engagement and detailed monitoring of the investment. For example, for the most part it's after a deal is completed that ESG KPIs can be set for margin ratchets as there is a greater visibility on material ESG factors and ESG data availability.

Regulation – Progress but not perfection

Regulations such as the Sustainable Finance Disclosure Regulation (SFDR) and the Corporate Sustainability Reporting Directive (CSRD) in the EU are helping to improve transparency within the market.

However, panellists at the workshop noted that while regulation is a positive step, it will take time for borrowers to adjust to the new requirements. Market participants should not allow the desire for perfect ESG data and disclosure to get in the way of progress.

Incorporating ELFA's ESG Fact Sheets and other industry initiatives

By improving collaboration across the industry, borrowers are guided to disclose and engage on ESG as it becomes clear that this will result in better access to capital. Resources such as the ELFA's ESG Fact Sheets are designed to educate the market and serve as tools for engagement.

The ESG Fact Sheets can be a useful starting point for discussion on ESG factors, and facilitate engagement amongst market participants, including borrowers, the buy-side, the sell-side and third-party data providers.

Each ESG Fact Sheet highlights key topics for the sector they represent under the three ESG pillars, along with related policies, processes controls and Key Performance Indicators that could be relevant to investment decisions. These resources help align market expectations and streamline the disclosure process for borrowers navigating their ESG journey.

The ESG Integrated Disclosure Project (ESG IDP) was also noted by panellists as another helpful disclosure tool for the market. The ESG IDP is an industry initiative in the private credit and syndicated loan markets to promote greater harmonisation and consistency of disclosure of key ESG indicators by borrowers.[1] As previously announced, ELFA recognises commonality with the approach taken by the ESG IDP template and welcomes the opportunity to provide support, feedback, and resources to the initiative to harmonise industry efforts and accelerate ESG integration across all markets.[2]

Conclusion

There are many ways for lenders and borrowers to engage on ESG topics through the life cycle of a deal. Some of the lessons learned about ESG integration during the event are that dialogue and active engagement with the borrower through workshops that help support companies on their ESG journey are key. Both the regulator and the regulated will be adjusting to a new system, thus the data disclosed may not be perfect initially.

While there are commonalities in ESG for borrowers, there are also borrower specific nuances that need to be considered on a case-by-case basis. Avoiding any tendency to oversimplify the issue and instead understanding the complexity of ESG is an essential first step for any market participants in leveraged finance.

[1] https://www.esgidp.org/
[2] https://elfainvestors.com/news/elfa-to-support-the-launch-of-the-esg-idp-template/

About ELFA:
ELFA is a professional trade association comprised of European leveraged finance investors from over 60 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.

About KBRA:
KBRA is a global full-service rating agency with a mission to set a standard of excellence and integrity. Established in 2010, KBRA remains dedicated to the restoration of trust in credit ratings by creating new standards for assessing risk and by offering timely and transparent ratings. KBRA provides market participants with an alternative solution by delivering in-depth research across various sectors within the United States and European markets.

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