# Why ESG Matters (Last of a Series)

THE LEAD | May 18, 2022

We noted last week how various asset classes incorporate aspects of environmental, social and governance elements in their risk analysis of a business or manager. We wrap up our special series by examining how private credit integrates ESG into its various strategies.

Credit managers are typically not involved in the direct management of businesses they finance. An exception is impact investing. According to a recent Private Debt Investor article, private debt represents 34% of all impact investing AUM, with real assets and private equity at 22% and 19%, respectively. Noteworthy areas include healthcare, renewables, and housing.

Similarly sustainability-linked loans (SLLs) compel borrowers to reach given ESG goals. SLLs are a small but growing category within the overall $732 billion (per BloombergNEF) sustainable debt market. That suggests momentum for investors to seek green private debt alternatives as well.

Nevertheless negative screening is a powerful tool for lenders. The European Leveraged Finance Association (ELFA) reported 90% of managers surveyed had “passed on, reduced or sold out of a credit investment entirely due to ESG reasons at least once.”

As lender checklists become more sophisticated, demands on borrowers will grow. Larger companies, particularly broadly syndicated loan issuers, can be incentivized with spread discounts for meeting certain ESG targets. Middle market businesses don’t always have the capability to track their carbon footprints, for example. But doing so will carry cost benefits the same way that better credit ratings do.

Using ESG criteria at the beginning of borrower due diligence is critical to establishing baselines against which to measure future performance. These classifications generally fall into three categories: macro, micro and values-based. Direct lenders tend to focus on the latter two, with specific frameworks established to find red flags, then monitor closely after the deal closes.

Key to successful ESG integration in private debt is the close relationship lenders have with both the private equity owner and the borrower. The tighter the circle of credit providers, the more likely key issues will be communicated. As one global investment manager noted, “You are working almost in partnership on those transactions.”

A sector-specific approach is also critical to getting the most transparent, ESG-credible results. Defensive service industries, particularly those with low capex, fewer plants and minimal production waste, are likely to yield smaller carbon footprints and less pollution risk.

ESG should not be viewed as principles outside the asset universe being imposed on investors. Rather it’s a natural evolution of historic developments combined with the reality of a shrinking interconnected planet.

What matters, after all, is not the definition or categorization of these principles, but the effort itself to create alignment, modified as necessary over time, with your firm’s moral and ethical standards and the investment choices you make.