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Global Private Equity- Spotlight on the Industry: the Rise of Environmental, Social, and Governance Factors in Private Credit

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Global Private Equity - Spotlight on the Industry

Over the past 24 months, private debt funds, their investors, sponsors, and portfolio companies that tap into such debt, have accelerated the importance given to sustainable investment and best business practices.

The heightened focus on environmental, social, and governance (ESG) factors across the general debt and equity markets has been well publicised. Whilst there has been less written on the private debt market, which is often seen as opaque, this does not mean that this market is taking its sustainability responsibilities any less seriously. Private debt funds have recognised the importance placed on ESG by their investors and targets, and are increasingly following the trend set across all asset classes.

Previously, ESG in private debt was linked to the public equity and fixed income markets in terms of what was contemplated from a documentation perspective, and was rarely seen. Now, ESG elements feature in the majority of deals in the middle market. The fundamental reason behind this is that it has become more important for investors to build ESG factors into their investment thesis because of the general desire for financing to flow to businesses that are more sustainability-conscious.

ESG IN THE PRIVATE DEBT MARKET

With more focus on ESG across asset classes, it is of little surprise that the private debt space has fallen into line. Whether it be through general reporting requirements or economic incentives, ESG provisions based on sustainability performance targets reflect the strong regulatory and market forces at play.

Investors are therefore increasingly needing to identify and evaluate ESG risks as part of their underwriting and due diligence processes.

Various metrics demonstrate that businesses with an ESG focus have shown resilience.

It is fair to say that market conditions, buoyant with liquidity, have recently been favourable for borrowers and their sponsors. In addition, many investments now come with sustainability-linked terms, plus there is often an economic incentive for companies willing to measure and quantify their ESG efforts. As a result, private equity houses and their portfolio companies are increasingly seeking to take advantage of the favourable terms being offered.

Equally, lenders in the private debt space have an increased desire to lend into companies that can demonstrate a commitment to ESG progression, as their own investors and limited partners are focusing more on ESG and require enhanced reporting. This ties in with heightened regulatory oversight, which will, in part, drive companies to increase their reporting generally, and potentially specifically under the proposal for a Corporate Sustainability Reporting Directive. As regulation on borrowers increases, investors will seek to request more information from them

Various metrics demonstrate that businesses with an ESG focus have shown resilience throughout COVID-19 and are outperforming other businesses year on year. It is not always the obvious businesses that have an ESG focus. A deep dive into a company's credentials often shows that they do pursue sustainability campaigns, even if their business model doesn't immediately suggest them as being a leader in ESG.

This is not to say that the asset class doesn't face significant challenges when using ESG as a metric for investment. For example, due to the way private debt transactions are underwritten and diligenced, lender education and diligence processes are relatively light on ESG specifics and such targeted diligence is rarely commissioned. A number of specific sectors may require certain environmental reports, but these aren't generally common. This gap at the diligence stage hinders private debt's ability to create more uniform reporting requirements and can be at odds with investors who require asset managers to demonstrate that they have considered certain ESG-related diligence on investments.

ESG PROVISIONS IN PRIVATE DEBT DOCUMENTS

The incorporation of ESG-related provisions into loan agreements is intended to incentivise companies to improve the performance of certain areas of the business. These are often judged against criteria that may be set at the time of closing or developed post-closing. The biggest incentive is an economic one, where the introduction of an "ESG margin ratchet" is now commonplace in private debt deals spanning the mid-market. Where borrowers hit certain metrics, a small reduction in the margin (around five to 10 basis points) is available; a tiered approach, with multiple indicators, may potentially result in better reductions.

Agreeing on what the key performance indicators are is sometimes the hardest part of the process, with most companies having to rely on fairly generic metrics, mainly focused on the "G" of ESG. The social aspect often focusses on equality and diversity, and may include certification as to positions on modern slavery, human rights issues, and labour standards.

Other criteria include actively requiring the company's employees to participate in local community projects or internal training. Some credits will allow for internal confirmation as to levels of success, whilst others will require third party verification.

ESG elements feature in the majority of deals in the middle market.

Commentators argue that for the ratchet to have teeth and act as a real incentive for borrowers to improve on ESG, it needs to work both ways. One example is a small increase in pricing kicking in where metrics are not met. At the same time, however, private debt funds are still willing to offer one-way economic incentives as a driver for companies to make substantive change.

In addition to economics, some investors that are taking a proactive approach to ESG include other requirements in the documentation, such as an obligation to complete ESG questionnaires on an annual basis. This is required regardless of whether or not there is a default or event of default outstanding and can be a prerequisite of an investor's credit approval process.

Given the lack of conformity as to reporting requirements and the contents of such reports, it is not surprising that such provisions have not made their way into loan documents as regularly as the ratchet.

LOOKING FORWARD

Whilst not as visible as other asset classes, it is clear that private credit is integral to the development of ESG and sustainability-linked loans. A heightened focus on the part of both investors and borrowers had led to a huge volume of loans containing one or more ESG-linked aspects. Greater attention from investors as to where they deploy capital has made borrowers acutely aware of ESG issues and how they can improve their contributions to society and the environment. Private debt investors are increasingly working with borrowers and sponsors to set ESG criteria or improve reporting standards to enable the investor to track improvement and progress year on year.

As the asset class (and ticket size for a transaction) continues to grow, it seems likely that credit funds and their investors will have a significant say in how ESG factors will feature in loan documentation in the future.

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