Direct lending:

uncovering the private nature of ESG

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Integrating environmental, social or governance (ESG) factors into direct lending can be more challenging than in other asset classes. But in this relatively illiquid market, there is a growing acknowledgement that lending to companies with good or improving ESG practices is an important way to mitigate overall risk.

ESG and private debt: from the niche to the mainstream

We are increasingly seeing demand from prospects and existing clients for our direct-lending capability to systematically integrate ESG factors into the investment process. Due to long lock-in periods, we believe that direct lending particularly lends itself to ESG integration. This is because confirmative information about ESG behaviours has the potential to mitigate risk, which can help protect against the downside. The absence of a true secondary market makes it all the more important for private lenders to factor in ESG characteristics.

The ESG data maze

Investors initially struggled to formalise ESG considerations and requirements into their approach, which meant a broad array of different assessment methods developed. Since those early days these have somewhat converged and some common frameworks for quantification and qualification have started to emerge.

However, this largely applies to securities – usually equities or bonds – issued by large, publicly listed companies. These firms face fairly standardised requirements to disclose certain data, including key performance measures. Regulatory requirements facilitate the availability of relevant information and make potential investments more comparable.

Given the lack of shared and standardised ESG data for private and smaller companies, ESG integration methodologies are generally not as readily available for private-market investors. This means that private lenders often have to do their own fundamental, bottom-up ESG research on borrowers.

Nowadays, so-called ESG data providers use disclosed information to come up with ESG ratings on large companies. However, they have some commonly known caveats and pitfalls which include market-cap, disclosure and geography biases, or a lack of timeliness and materiality. Nonetheless, we think that information from these sources can provide a useful starting point. The problem is that the data simply does not exist for private debt.

Despite the lack of meaningful ESG ratings in direct lending, integrating ESG is possible and remains a core responsibility – particularly when investors are signatories to the UN's Principle for Responsible Investment (PRI). One of the PRI's six basic principles calls for the incorporation of ESG issues into investment analysis and decision-making processes. To that effect, the PRI recently published yardsticks that outline a proposed minimum level of ESG integration in private debt.[1]

The private dimension of ESG

In private debt – the clue is in the name – information continues to be largely private, given that the securities are not designed for liquidity or the secondary market but are invested in with a general intent to be held until maturity (often for seven years or more).

The availability of ESG data tends to be discretionary and is driven by the mandates handed out to diligence providers by current or prospective equity owners. Unlike financial and commercial analysis, specific diligence on ESG matters has not yet become part of the standard package readily supplied to future lenders. The most useful information can generally be found in legal diligence material, but this is still far from comprehensive.

It is therefore largely in the hands of lenders to ask the right questions and request relevant information from borrowers. Proactively seeking this out is paramount, as associated risks can expose a business just as severely and swiftly as pure financial drivers.

Taking stock: evidence that ESG affects returns

We have undertaken research which shows that good ESG practices are correlated with positive financial outcomes. In equity markets, we have proved that companies with poor social and governance scores tend to underperform their peers,[2] while in fixed income we have demonstrated a correlation between ESG scores and corporate[3] and sovereign[4] credit-default swap spreads.

[1] See: https://www.unpri.org/private-debt/private-debt-and-ri-guidance-and-advanced-practices/4061.article
[2] 'ESG investing: a social uprising', published by Federated Hermes in November 2018.
[3] 'Pricing ESG risks in credit markets: reinforcing our conviction', published by Federated Hermes in October 2018.
[4] 'Pricing ESG risk in sovereign credit', published by Federated Hermes in July 2019.

We can see that ESG factors affect many asset classes. The reason for this is simple: negative ESG behaviours affect the firm as a whole, and therefore all of the securities it issues. Conversely, more sustainable companies tend to deliver higher risk-adjusted returns and exhibit less cash-flow volatility and a lower cost of capital.

Integration challenges

Given the competitive European private-debt landscape, it can be a challenge to add yet another set of diligence requirements. Some stakeholders perceive the due-diligence process to already be a heavily loaded exercise, and ESG-related inquiries are easily pushed down the priority list. But overlooking the effects of ESG dynamics results in an insufficiently holistic analysis which does not capture the entire risk spectrum.

When looking back at major cases of corporate distress in the context of a generally sound market environment, it is notable how rarely firms simply fall victim to a sluggish economy. Instead, businesses oftentimes seem to have been affected by idiosyncratic issues like fraud, reputational repercussions of mismanagement and debt-funded spending sprees. While these could be interpreted as seemingly unexpected twists of fortune, instead they are often a function of bad governance.

When it comes to ESG, the challenges for prospective debt investors are manifold. No two businesses are the same and the E, S and G factors may not be equally relevant. Potential lenders need to determine which questions will best allow them to assess risks, then ensure they have the opportunity to place them and receive comprehensive answers.

This is often easier said than done, given that time is precious and the opportunity to make ESG-related inquiries can be very limited. However, it is worth noting that an issuer's reluctance to engage tends to be characteristic of a more general attitude towards transparency and cooperation.

Paying particular attention to a borrower's envisaged equity owner is critical, as the interests of stakeholders will be more aligned if the sponsor is not merely paying lip service to ESG integration. In any case, ESG analysis within direct lending – particularly for smaller firms – is bespoke, requires effort and ought to be anything but a box-ticking exercise. Instead, we see it as a risk-mitigation exercise.

Another universal challenge (or opportunity) across asset classes is the fact that investors tend to interpret ESG information differently. Some might see a risk when others do not, or consider a risk significant when others readily dismiss it as negligible.

When a risk is identified as substantial, the question is whether it can be remedied or mitigated – and if the potential owner and management are prepared to take the necessary steps. Alternatively, investors might have to walk away from an opportunity. The less quantifiable a risk is – and ESG risks may not always be measurable – the more difficult this can be as others may not even be able to relate to the concern.

The challenge of making judgement calls on such limited – or at times inconclusive – information should not be underestimated. When in doubt, erring on the side of caution has proved successful in the past.

Lenders should undoubtedly keep pushing for more (and enhanced) ESG disclosures. But so long as requirements between investors remain disparate, demanding higher standards will continue to put a lender at a disadvantage when competing with peers.

Meanwhile, the institutional market offers much-needed support in the push for a more level playing field. Limited partners are equally under pressure to pursue more sustainable investment strategies and are increasingly relaying this to their asset managers. This can be seen not only in the debt markets, but more importantly also across the equity universe.

Our approach: ESG analysis in the private-debt space

At the international business of Federated Hermes, we incorporate meaningful ESG analysis into private debt investing using a three-pillared approach:

Integration

We conduct an ESG assessment of each investment opportunity. Notably, we do not use scorecards or fixed-template questionnaires. Instead, we analyse the industry and business model in detail and tailor our questions accordingly. In our ESG assessment, we apply a rating from one (very low ESG risk) to five (very high risk). E, S and G factors are then weighted by relative materiality, resulting in an overall rating.

Using this final score, we evaluate whether the ESG risks are acceptable and if we want to partake in the loan. Diligently doing this before providing financing is particularly important in illiquid private debt, given that it is difficult to exit a loan before it reaches maturity or is refinanced.

Once a loan is made, we monitor the firm's ESG ratings regularly and, where necessary and feasible, engage with the borrower directly.

Exclusions

Generally, we do not lend to companies that operate in industries where we believe ESG-related risks outweigh the rewards (and in the worst case could lead to reputational repercussions).

Examples of these include gambling, tobacco, distilled alcohol, adult entertainment, weapons and munitions, fur trade and animal-tested products, genetically modified organisms, destructive fishery practices and businesses damaging primary or tropical habitats. Other industries like energy, chemicals and manufacturing are subject to enhanced due diligence.

Engagement

A key component of effectively integrating ESG considerations into direct lending is stewardship, or the process of actively engaging with borrowers. Usually considered a tool for public-equity and fixed-income investors, engagement is also important in direct lending.

Should an ESG issue arise during the life of a loan, we seek to actively engage with the sponsor and management team in order to remedy it. We collaborate with our in-house engagement professionals, EOS at Federated Hermes, to ensure that our engagement is outcomes-focused and impactful.

Mitigating ESG risks has been shown to increase the enterprise value of a company and thus benefit investors first and foremost, as is our fiduciary duty. However, we also believe it is in the interest of other stakeholders and society as a whole.

Genuinely green?

Today, it is a struggle to find anyone who has not enthusiastically committed to ESG integration. Nonetheless, for the vast majority this remains a marketing exercise. Industry bodies are aware of this and the European Leveraged Finance Association together with the Principles for Responsible Investment (PRI) is working on drafting so-called ESG Factsheets "to create more consistency and efficiency in ESG disclosure and engagement between investors and the companies to which they lend".[5]

But there is also a sense that ESG factors are increasingly seen as a vital driver of financial returns. Indeed, new products in the market may reduce funding costs for borrowers that manage to comply with certain ESG criteria. In December 2019, a European-sponsored syndicated-loan transaction was the first to include a term-loan spread that increases or decreases depending on ESG behaviours.[6]

Delivering holistic returns

Integrating ESG within private debt is likely to remain a challenge in the short to medium term, given the lack of structural drivers – such as regulatory requirements and an institutionalised approach – that enforce heightened disclosures.

However, outcomes are measured not just by origination but by the sustained performance of borrowers and the repayment of facilities at par value. Because of this, ESG integration should continue to offer rewards. Indeed, the advent of ESG-related margins seems to be a natural development.

At the international business of Federated Hermes, we believe that companies with superior ESG practices are less risky, and therefore favourable targets for private lenders. Limiting and remedying these risks can improve a company's profitability and reduce its cash-flow volatility, which supports our aim to preserve capital while capturing yield.

Incorporating ESG factors also means that investors are remunerated for the actual risk they are taking on. As one of the first investment houses to conduct authentic, genuine ESG integration, we are convinced that our approach is the most effective way to develop a holistic understanding of risk – something that is ultimately in the best interest of all stakeholders.

[5] For more information about the European Leveraged Finance Association's (ELFA's) ESG factsheets, see: https://elfainvestors.com/ESG-Fact-Sheet.
[6] "Jeanologia completes first sponsor-backed ESG-linked term loan," published by S&P Global in December 2019.

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