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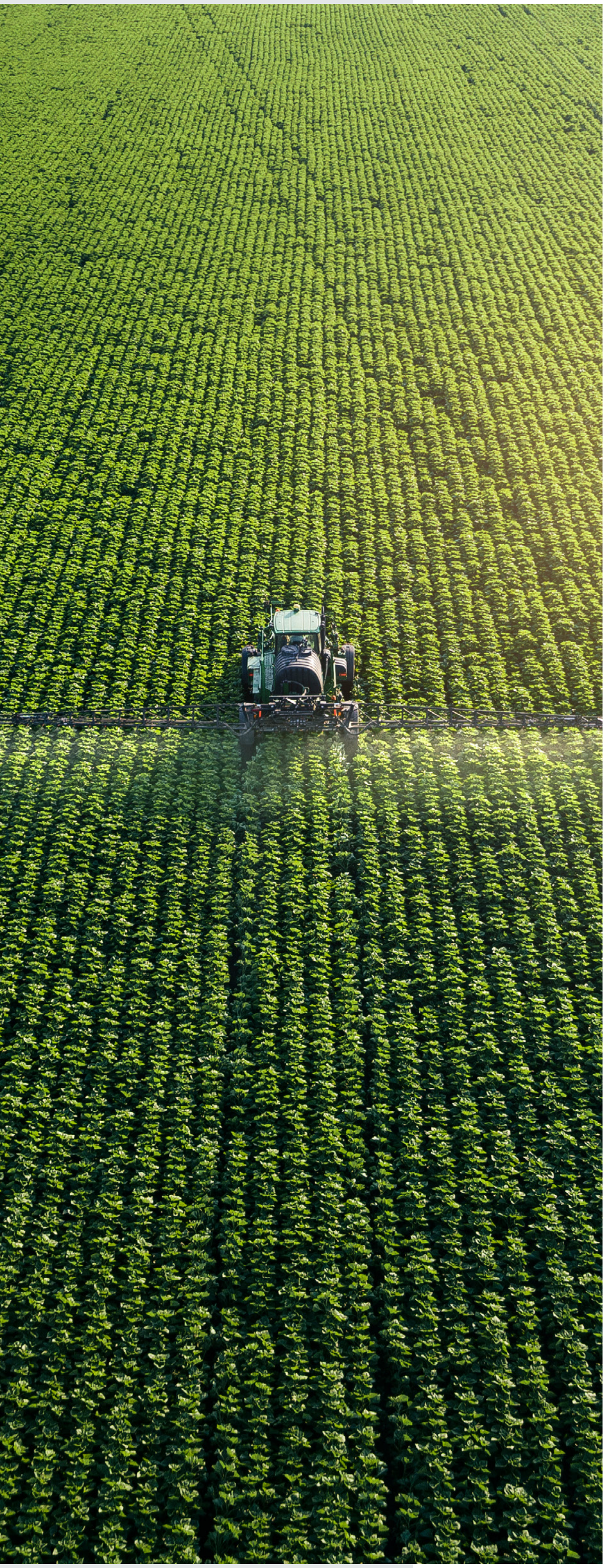

PRIVATE CREDIT

How Innovations in Private Credit Are Driving ESG Progress

INSIGHTS

Aaron Gillespie
Managing Director,
Global Private Finance

Sustainability-linked loans are among the new ways lenders are providing incentives for middle market companies to strengthen their ESG practices.

Approaches to ESG in private credit have become increasingly sophisticated, with lenders adopting a variety of innovations to encourage better and more sustainable practices. But there is still progress to be made, and investors, sponsors and lenders will play an integral role.

Private Credit Demands a Unique Approach to ESG

For a number of reasons, private credit requires an approach that is distinctly different from the way ESG analysis is applied with publicly listed equity and fixed-income investments. Even though every borrower must be evaluated on a case-by-case basis, certain broad considerations must be kept in mind. First, **private credit is an illiquid asset class**, with a typical life cycle of three to five years. In contrast to the broadly syndicated markets, there is little or no ability to trade in and out of loans or to sell out of deals. Additionally, unlike equity investors, debtholders do not own shares of the company or sit on company boards. As a result, **debtholders cannot directly change company behavior or decision-making.** These factors greatly increase the importance of conducting ESG due diligence up front and getting it right.

The attributes of the middle market companies that private credit investors loan to must also be considered. At Barings, we define the middle market as companies with earnings before interest, taxes, depreciation, and amortization (EBITDA) in the range of $20 million to $75 million. These mid-sized companies are often at an earlier stage of their development than large, publicly traded companies are. **While many of these middle market companies are committed to addressing ESG issues, they generally do not have the same resources as larger firms.** With staffs of anywhere from 50 to 500 people, for example, many of these companies do not have teams that are fully dedicated to ESG and sustainability—and often do not produce the substantial quarterly ESG and sustainability reports that many large companies now distribute. Additionally, they may also be earlier in their progress toward the detailed, specific procedures for implementing ESG principles that many larger firms already have in place.

Finally, it is important to remember that many of the middle market companies in the private credit market are sponsor-owned. **Private equity (PE) sponsors play a critical role in influencing ESG practices**, given the control they have over the company and its board of directors. For this reason, it is important for lenders to ensure that their views on ESG align not only with a company's management team, but also with its sponsor. Indeed, working with the sponsors on ESG due diligence can help the lenders more effectively identify and evaluate all the opportunities and risks that arise from a company's business practices.

ESG Approaches Are Continuously Evolving

Some of the earliest approaches to sustainable investing, across many asset classes, focused on negative screening. In some cases, this included blanket exclusions on investments in companies that offer controversial products, like alcohol, tobacco and firearms. With the increasing focus on environmental impacts, more investment strategies today are also excluding companies in the fossil fuel business. While negative screening remains appropriate in some instances, a broader range of approaches has emerged as investors, asset managers and companies are finding sophisticated ways to support environmental and social goals, as well as enhanced corporate governance.

Engagement, in particular, has been an important next step in this evolution. Rather than simply excluding companies from consideration because they operate in certain sectors, investors and asset managers are gravitating toward a more hands-on approach—such as by communicating their priorities and, in some cases, offering incentives to companies that enhance their ESG practices. In our view, this can be a more effective way to achieve beneficial results both for companies and society. Simply put, the carrot often works better than the stick. The additional benefit of using incentives to change corporate behavior is that all stakeholders—managers, employees, customers and investors—become committed to the improvements.

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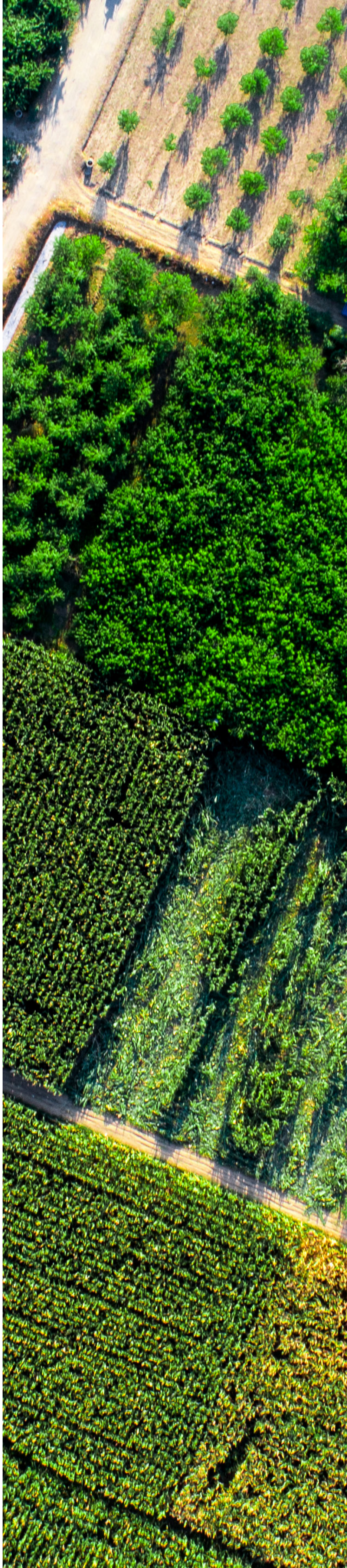
SUSTAINABILITY-LINKED LOANS

In private credit, ESG-forward or sustainability-linked loans are an innovative approach that demonstrate the power of engagement, as they can positively incentivize companies to enhance their ESG practices. In essence, lenders can customize loan agreements with specific ESG or sustainability provisions. If a company meets a certain number of these criteria, it can get a reduction in its borrowing costs. While sustainability-linked margin ratchets offer material incentives for borrowers to potentially lower their interest payments, the magnitude of that reduction—typically on the order of 5 to 10 basis points (bps)—does not have a significant impact on investors. That is an impact that ESG-minded investors may be willing to accept, given that this asset class typically offers yields in the 6–8% range, with the exact yield depending on a variety of factors, including the seniority in the capital structure of the type of debt that was issued.



Barings' Approach to ESG

At Barings, long before ESG rose to prominence, we carefully examined what each company's impact on the environment was, how it treated employees, customers, and its community, and whether it had the proper safeguards to ensure that the company was well-managed and responsive to the interests of its equity investors and debtholders. We have always believed that careful consideration of environmental, social and governance issues represents good, solid credit underwriting.

As the procedures for implementing ESG principles have become more detailed and specific in recent years, our teams have helped lead the way. In 2015, for instance, we began to formally integrate ESG considerations into our investment process by flagging ESG-related risks and opportunities in our memos with our deal terms. We also began applying ESG scores to each of our borrowers and tracking their progress on ESG. Since 2015, we have published an annual ESG report to enable all of our stakeholders to regularly review our progress on these matters.

THREE KEYS TO BARINGS' APPROACH TO ESG WITH PRIVATE CREDIT

As we consider where the industry has come from and where it's going, we believe there are three important attributes that distinguish our approach to ESG in private credit.

1. **Robust ESG analysis at the initial credit underwriting stage.** We carefully evaluate ESG risk factors when considering whether to lend to a middle market company. This involves evaluating companies on a case-by-case basis to determine if there are certain ESG risks that could materially impact an investment over the course of its lifecycle—either directly or indirectly through litigation, regulation or reputational damage. If a company raises issues for us, or if they are not fully committed to improving their ESG practices, we may decline to invest. Again, because of the buy-and-hold nature of this asset class, it is vital that a high degree of selectivity be applied upfront.

   Following are examples of opportunities we ***did not*** proceed with because of an environmental, a social or a governance concern.

   - A **disposal service provider** that had continuing environmental issues with its disposal methods
   - A **software-testing provider** that receives a portion of its revenue from aerospace and defense companies linked to controversial weapons systems
   - A **corporate administration services provider** that had experienced material regulatory and internal control breaches and not yet made significant enhancements in its governance practices

   In our view, evaluating companies' ESG practices requires looking beyond their starting point and considering, too, the direction of travel. There are occasions when we believe we can proceed with an underwriting, for instance, if a company has demonstrated a willingness to make progress, even if its ESG practices are not yet optimal.

2. **Protecting our investments and encouraging positive change.** We are increasingly using innovative ways to influence ESG practices through the terms and conditions, and ultimately the pricing, of debt structures. As an example of this, we may include parameters in loan agreement terms that establish restrictions on what companies can do. These restrictions might put guardrails around what markets companies can sell into or the types of acquisitions they can make. Taking these precautions helps ensure that the business we invest in today will not look materially different in the future when it comes to ESG-related risks.

   In addition to such protections, we have begun to use our influence in an effort to focus middle market companies on ESG issues. **In 2020, we structured and closed the first ever ESG-linked unitranche transaction in the global middle market.** This was achieved by including provisions in the loan documentation that allowed for the portfolio company to reduce its effective interest rate on the loan if it met certain criteria such as lowering emissions to a set target, hiring a sustainability officer and increasing its environmental reporting. While this type of loan was the first of its kind in the private credit market, it is now something we are in the process of rolling out across our global businesses. While Europe and Australia have been at the forefront of embracing ESG, we are gaining traction with this new approach in the United States and across Asia-Pacific.

   Following are examples of recent opportunities where we included sustainability-linked criteria in the loan documentation to help incentivize companies to improve their ESG practices.

   - A **waste and recycling service provider**, which primarily targets the food and beverage market, made improvements toward their ESG behavior as a result of sustainability-linked criteria items such as establishing waste tonnage diversion goals, hiring a Corporate Social Responsibility (CSR) manager, and creating an annual CSR report for investors.
   - A **sustainability and operating costs management company**—which provides services to their customers to help reduce their environmental footprint, sources green energy from renewable sources, and provides ESG consulting services to reduce the environmental impact of real estate portfolios—accepted loan terms which included criteria to incentivize further positive ESG outcomes.

   As part of this effort, we have worked with an outside legal expert to create guidelines that our deal teams can leverage to come up with appropriate provisions to include in the documentation of new transactions. The provisions can cover a range of topics, including:

   - Board and senior management focus on broad ESG and sustainability topics
   - Goals for board diversity
   - Standards for addressing pay-gap issues
   - Targets for reduced carbon-emission levels

   As companies look to enhance their ESG practices, these guidelines enable our deal teams to identify for the PE sponsor and the borrower what issues are most important and ways to make improvements in these areas over time.

3. **Transparency and reporting.** We want to ensure that our approach to ESG integration and engagement is fruitful, and in fact, driving the intended results. As we continue to make efforts to encourage the middle market to focus on ESG topics, one outcome we hope to achieve is improved quantity and quality of information with a better ability to track progress. Similarly, our private credit team at Barings has been tracking ESG considerations within investment opportunities since 2015 and provides an annual ESG report to communicate our approach and the results of our efforts both internally and externally. We know that there continue to be many opportunities for growth and improvement, and as such, believe the transparency created through reporting opens up engagement opportunities with our partners and stakeholders that help all of us improve.

A Change That Is Here to Stay, Benefitting Everyone

Throughout our firm's history, we have always believed that a critical component of good underwriting is evaluating companies' governance practices, as well as their impact on the environment and society. Now these issues have crystalized across the investment landscape as ESG. While ESG now seems to be at the forefront of every investment conversation, we do not think it is simply a fad that will be replaced by another a few years down the road. ESG-focused investing is here to stay.

As we move toward more sustainable business practices and investments, the benefits for companies, investors and society will be considerable. While the middle market may lag the developments that occur with large, publicly held companies, significant progress in this market has already been made. The adoption of ESG in private credit will undoubtedly continue to evolve, and Barings will remain at the forefront of that progress.

For more on this topic, please listen to this episode of Barings' Streaming Income podcast, with author, and Global Private Finance Group Managing Director, Aaron Gillespie.*

*Full Podcast URL: https://www.barings.com/perspectives/viewpoints/esg-innovations-in-private-credit

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**As of June 30, 2022*

21-1746291