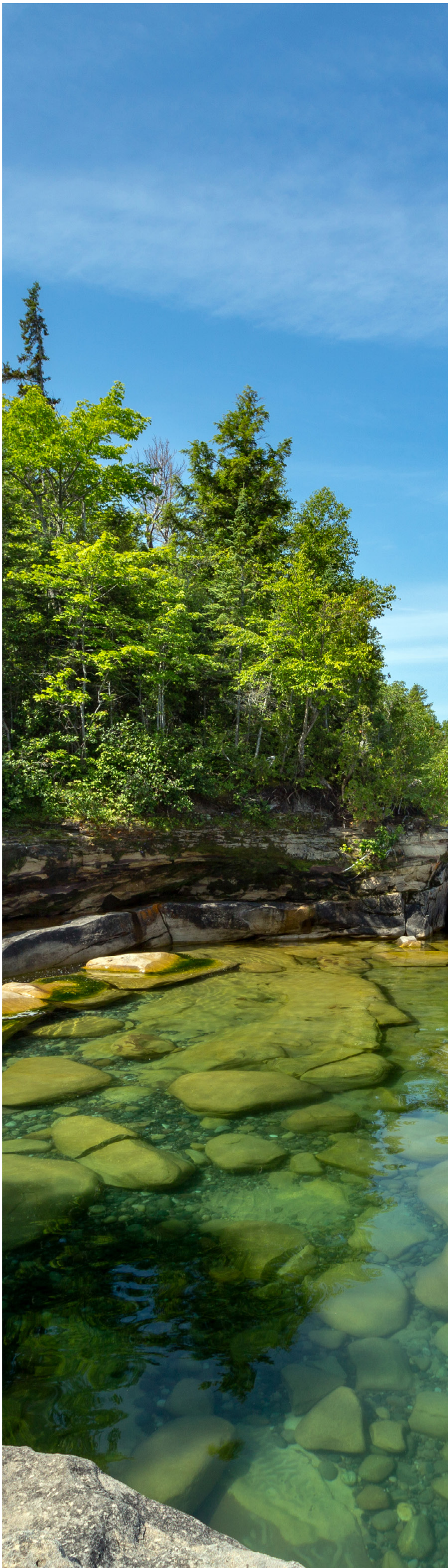
BARINGS

Global Private Finance

SUSTAINABILITY REPORT

2023



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Our Global Private Finance Offering

WHO WE ARE

Barings Global Private Finance (GPF) is an industry leader in private debt, with over 30 years of institutional experience in the asset class. As one of the most active lenders to North American and European middle market private equity-owned companies, and with nearly 15 years of experience in the developed Asia Pacific region, we offer investors a truly global, fully integrated private debt platform[1].

Our mandate is to provide debt financing solutions to traditional middle market companies. These companies generally have between $10 million–$100 million of cash flow or earnings. We provide solutions up and down the capital structure, including first lien senior secured and second lien loans, unsecured debt, preferred equity and, to a much lesser extent, equity co-investments.

Most of the loans we provide are to private equity-owned businesses. In our experience, sponsor-backed transactions provide better risk/return profiles over time and through cycles. These investments are directly originated and negotiated with the sponsors and management teams, which means we can complete a deep level of due diligence prior to investment.

These direct relationships are critical and are maintained throughout the life of an investment, enabling us to engage on key risks and opportunities—including on environmental, social and governance (ESG) issues—at any point during the life cycle of the deal.

1. Pitchbook (2022 Annual U.S. PE Middle Market Report league table), Debtwire (2022 FY European Direct Lender Rankings). As of 2022.

A FOCUS ON ENGAGEMENT

As it relates to ESG, our investment approach to private debt has been built upon a commitment to active stewardship of the entities in which we invest, in an effort to minimize risk and maximize returns for our clients. While we are not the owners, nor do we control the boards of our borrowers, we utilize our direct relationships and capital to help minimize ESG risks and unlock opportunities. From an investment standpoint, this means we generally support engagement over exclusion as it allows us to consider a more fullsome investment universe[2].

Once a potential investment has been identified, we undergo an initial review to assess the sustainability of the investment through preliminary diligence materials and, when able, we actively engage with the business and its owners to understand key ESG risks and opportunities (where financially material) to improve investment analysis and financial performance. We use our access to key stakeholders in the transaction to influence change from the inside and potentially improve a company's ESG profile over time. Ultimately, we believe true stewardship involves helping businesses along the path to improvement, as well as interacting with leaders in the field.

Nonetheless, as buy-and-hold investors, we are aware that each loan represents a long-term commitment. As a result, we are highly selective in our investment process. The GPF team flags sectors/exposures during the initial opportunity review where there may be potentially higher ESG risks/sensitivities. While every opportunity is considered on a case-by-case basis, the level of revenue and EBITDA derived from a potentially higher ESG risk sector or region may be an investment consideration.

Our approach to borrower selection is defined by remaining committed to investing in companies that meet our underwriting standards, including the prevalence of appropriate mitigants to key credit and ESG risks. We believe our process and the standards to which we hold ourselves mark us out as an outlier in the private debt space.

BARINGS' GLOBAL PRIVATE FINANCE HIGHLIGHTS

$39+ billion

invested across the globe

30

years of institutional experience

Investing across

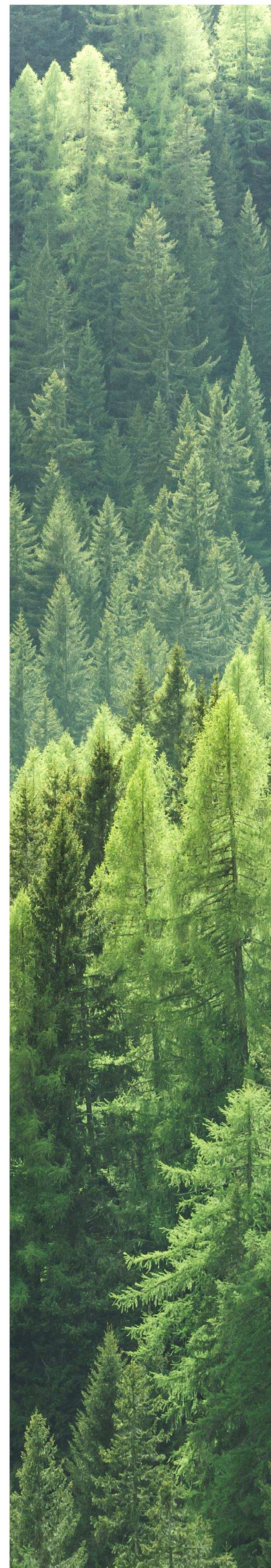
16 countries

and nine currencies

14

ESG margin ratchet loans issued across Europe and North America since 2020

2. We will not directly invest in companies that violate international conventions on cluster munitions, anti-personnel mines and chemical and biological weapons. We will not knowingly hold securities issued by companies that are materially involved in the production, stockpiling and use of these weapons at the time of investment.



Where We've Come From

ESG & Global Private Finance

As a global investment partner with expertise spanning a broad range of asset classes and capabilities, Barings recognizes each asset class has unique features. Each underlying investment team is therefore empowered to address the integration of ESG factors in a way that reflects the nuances of their asset class and investment strategy.

In GPF, there are several factors we are cognizant of as we strive to enhance analysis of ESG issues through our investment decisions and, ultimately, the allocation of investor capital.

OPPORTUNITIES

Investments in private debt tend to be buy-and-hold. This longer-term perspective facilitates stronger relationships with private equity sponsors and management teams. We find sitting in the room with management or picking up the phone provides a rich and personal dynamic for discussing ESG issues—especially in comparison to engagement mechanisms seen in other asset classes, such as proxy voting in listed equities.

We are the lead or co-lead in the vast majority of our investments[3], holding most, if not all, of the debt in the company's capital structure[4]. With this meaningful position, we are well placed to proactively collaborate with private equity sponsors to help develop ESG integration strategies within businesses.

CHALLENGES

Private businesses are subject to different sets of regulatory requirements compared with their public counterparts. As some regulations are less stringent, these companies often do not have established systems and processes for internal data-gathering.

This issue is particularly prominent in the middle-market, where companies may still be in their scaling phase and lack resources to devote to data collection. As a result, data related to areas as divergent as carbon emissions and supply chains can be scant, or simply non-existent.

As a provider of capital to private companies, our view is our influence should encompass pushing for increased data gathering and transparency. However, this can take years to come to fruition.

In recent years, we have aimed to incentivize borrowers through offering favorable loan terms to those demonstrating a genuine effort to and progress in improving their ESG profile. This effort led to the development and implementation of our first ESG margin ratchet in 2020. More detail is available here: Our ESG Margin Ratchet: A Deep Dive.

3. Barings internal analysis. As of March 31, 2023.
4. Barings internal analysis. As of March 31, 2023.

PRIVATE EQUITY & ESG

In recent years we have witnessed growing interest in the formalization of ESG from private equity firms. Partly driven by investor demand, these firms have increasingly worked to integrate ESG concerns into their investment approach.

This is beneficial from our perspective, as it means that the private equity sponsors we collaborate with are now more likely to be aligned on progressing the incorporation of ESG data into decision making.

However, the private equity landscape is changing at varying speeds, with different firms exhibiting different levels of interest in ESG due to differences in their LP base, their heritage and their investment philosophy.

Against this backdrop, our preference for providing loans to middle-market borrowers requires a closer look.

MIDDLE-MARKET PRIVATE FINANCE DEALS & ESG

ADVANTAGES

- Generally, we're more likely to be the sole or largest lender to middle-market borrowers, which means we can exert greater influence. This is beneficial for all the areas over which we want to exert influence, including ESG.
- Even when we're not the sole lender we may still be able to command significant influence, given our substantial capital commitment and long-standing relationships with leading private equity clients in the middle-market.

DISADVANTAGES

- While larger private equity firms may have more established ESG integration because of their scale and larger and broader LP base, medium-sized firms tend to be earlier in their adoption of ESG integration.
- Reporting can be more resource-intensive and costly for middle-market businesses when compared to larger borrowers, making it more difficult to quantify ESG metrics.

Regional Variations

The dynamics of ESG in the realm of private finance are not uniform. Significant cultural and regulatory differences exist between regions, markets and industries. As one of the few global players in the private finance space, we have a rare vantage point from which to illustrate these differences to our partners.

NORTH AMERICA

Generally a small club market, in which more than one party (usually less than five) provides debt capital to a borrower.

Generally less-developed interest in ESG from private equity firms.

Key pieces of regulation include the SEC's climate-related disclosure rules, which are expected to come into effect in 2024. This is in addition to varying regulation emerging at state level.

EUROPE

Generally, a bilateral market, in which a single lender provides debt capital to a borrower.

Well-developed interest in ESG, within a short timeframe from private equity firms.

Key pieces of regulation include the European Union's Sustainable Finance Disclosure Regulation (SFDR), Taxonomy and the Corporate Sustainability Reporting Directive.

APAC

Generally a small club market, although APAC is a large and diverse region. Our APAC operations focus on more developed markets, such as Australia and New Zealand.

Currently a middle ground in terms of ESG interest from private equity firms—instances of less developed and more developed engagement exist.

Regulation varies widely across the region, with no landmark, unifying disclosure rules yet in place.

BILATERAL VS. CLUB MARKETS

In the context of a bilateral market such as Europe, we are likely to be the sole lender to a middle-market borrower. This is preferable in terms of ESG influence, as the absence of other lenders grants us outsized influence and gives us the best chance of implementing meaningful ESG Key Performance Indicators (KPIs) in return for favorable loan terms.

In a club market, we're unlikely to be the sole lender to a middle-market borrower. The presence of other parties means their preferences must be considered if a loan is to be agreed upon. This can result in lenders that are less attuned to ESG issues resisting the integration of our ESG process.

This is one reason why, even if we can't be the sole lender, we strive to be the largest or significant lender. As the largest investing party, we can exert the greatest influence possible, meaning we can do our utmost to galvanize others to adhere to ESG best practice. We are the largest investor in roughly 70% of our GPF deals[5].

5. Barings internal analysis. As of March 31, 2023.

OUR COMMITTEE STRUCTURE

SUSTAINABILITY COMMITTEE

Responsible for oversight of the firm's sustainability strategy, our ESG integration and stewardship programs, and our sustainability policies and commitments.

CENTRALIZED RESOURCES

Responsible for firm-level sustainability strategy, ESG policies and governance, partnerships, Barings Social Impact, and supporting investment teams with ESG integration, research, and analytics and reporting.

Comprises 11 professionals

INVESTMENT TEAM EMBEDDED RESOURCES

Our ESG leads embedded within each investment team support the broader investment teams to understand and identify material ESG opportunities and risks.

Comprises 25 professionals

OPERATIONAL EMBEDDED RESOURCES

Dedicated resources across the firm's operational functions, such as Legal, Compliance, Marketing and Communications, support the implementation and delivery of our sustainability strategy.

Our committees within GPF are structured to both embed ESG into our investment process and ensure the cross-regional consistency of our approach, despite potential regional differences.

While initial scrutiny of prospective borrowers is taking place, our Global Private Finance ESG Advisory Group functions as an accessible, in-business resource for investment teams across different regions. Once a potential investment has been identified, investment teams are able to contact this group to discuss the ESG profiles of possible borrowers. While this does not occur on every investment, it is encouraged in cases where the ESG profile of the borrower is more nuanced. This ongoing dialogue actively contributes to our investment decisions. The global perspective of our Global Private Finance ESG Advisory Group also ensures our investment approach and due diligence processes are consistent from region to region.

Members of the Global Private Finance ESG Advisory Group attend meetings of our Investment Committee, which is structured as separate European, North American and APAC committees. The existence of specific regional committees enables committee members to develop a deeper understanding of the varying regulatory and cultural landscapes of these regions, which includes ESG factors. However, three senior members of our team sit on all three Investment Committees, balancing this sensitivity to regional nuance with a cohesive global approach.

Where We Are

ESG in the Life Cycle of a Deal

PRE-INVESTMENT

1. **Initial Screening**
   Initial screen of borrowers is conducted by investment teams, with the Global Private Finance ESG Advisory Group providing input where necessary. Although we favor engagement with borrowers, companies in certain sectors or with higher risk exposure, ESG or otherwise, are filtered out at this early stage.
2. **Due Diligence**
   The deal team presents the borrower with a set of ESG-based questions. Their responses, in conjunction with research into the business and/or ESG-based due diligence, are included in Investment Committee memos.
3. **Pre-Deal ESG Scoring**
   We use our proprietary, industry-based ESG scoring methodology to assess the prospective borrower, making use of industry weighting methods and other information gathered regarding the business in question. These scores are included in Investment Committee memos.
4. **ESG Margin Ratchet Offer**
   In many cases, we will offer the prospective borrower an ESG margin ratchet as part of the terms of their financing. If the borrower agrees, this tool will be incorporated into the credit agreement documenting the transaction. While we encourage the implementation of the ESG margin ratchet, we also respect that borrowers may decide against its inclusion.

INVESTMENT

5. **ESG Margin Ratchet Implementation**
   If the borrower has agreed to its inclusion, the ESG margin ratchet is implemented. KPIs and related discounts are often agreed during this phase but may also be determined after the financing closes. The appointment of an ESG consultant is encouraged at this stage, with the goal of conducting broader assessments, data collection and borrower engagement. Learn more about the practical implementation of the ESG margin ratchet with our case studies.

POST-INVESTMENT

6. **Ongoing ESG Scoring**
   ESG scores are reassessed and validated or updated each quarter, and ESG engagements are tracked.
7. **Annual ESG Questionnaire**
   Although it is not mandatory, we encourage the annual completion of our ESG questionnaire, which is designed to enable the ongoing tracking of ESG developments and progress.
8. **ESG Margin Ratchet Verification**
   The KPIs agreed as part of the ESG margin ratchet, and whether the borrower is on track to meet them, are considered and reported on at least annually.

A sample of the questions asked as part of our initial due diligence process:

ENVIRONMENTAL

1. **Carbon Footprint**
    - Do you measure and disclose your carbon footprint or other greenhouse gas emissions? If so, what are your most recent carbon emissions figures (metric tons of Scope 1 and 2 emissions per year)?
    - Have you set targets or made commitments to reduce emissions?
2. **Waste Management**
    - Do you have any waste management initiatives in place (e.g. recycling, reducing wastage)? If so, please provide details.

SOCIAL

1. **Social Incidents**
    - Have you had any material incidents, complaints or enforcement actions over the past five years that have been associated with employees or key stakeholders, such as customers or suppliers? If so, please provide details.
2. **Human and Labor Rights**
    - Do you have policies/processes to prevent human rights or child/forced labor incidents?
3. **Gender & Racial Equality**
    - What is the level of gender and racial diversity of the board? Do you publish gender pay gap information? If so, please provide it.

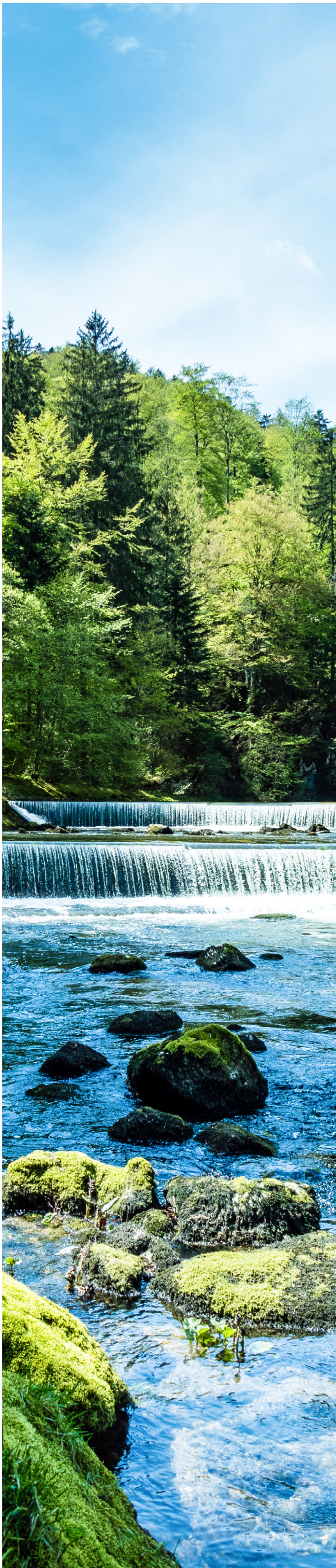
GOVERNANCE

1. **ESG Responsibility**
    - Do you have a board member (or designated person) responsible for the company's ESG strategy? If so, what experience or training do they have?
2. **Materiality Assessment**
    - Have you conducted a materiality assessment? If so, please provide a copy.
    - If a materiality assessment has been conducted, what ESG targets or broader strategy has been set based on its conclusions?

Our ESG Margin Ratchet: A Deep Dive

WHY MARGIN RATCHETS?

1. As previously explored, in the role of lender to private businesses, it can be more challenging to exert direct influence over borrowers. The use of margin ratchets offers a tangible means of incentivizing ESG alignment where there are multiple stakeholders and factors at play.
2. We are pragmatic when it comes to ESG. By offering a distinct financial incentive for progress in ESG integration, we believe we are offering borrowers an approach that appeals to both commercial interests and sustainability concerns, which benefit the long-term financial performance of the business.
3. Our use of margin ratchets involves the agreement of bespoke KPIs and terms for each individual borrower. This allows us to optimize engagement from management teams and PE sponsors, and ensures progress made toward the ESG targets is meaningful to the company in the context of its industry, sector and heritage.



CUSTOMIZATION VS. STANDARDIZATION

Since the implementation of our first ESG margin ratchet in August 2020, we have encouraged the creation of customized KPIs for each borrower.

This approach is built upon a recognition of the inherent individuality of any business, especially in relation to the ever-evolving field of ESG.

Some businesses may exhibit strengths in one area of ESG but weaknesses in another. Certain ESG factors are also undeniably of greater materiality to specific sectors and industries.

With regards to ESG integration, some borrowers may be further along the road, yet their pace may be slowing. Others may be historically less developed but implementing change at a rapid rate. Our approach allows us to tailor our KPIs to the unique circumstances of each borrower.

Despite these strengths, the decision to customize rather than standardize KPIs contributes to limitations in reporting. In the absence of KPIs that are consistent across a large number of borrowers, producing reporting that tangibly quantifies the collective performance of borrowers is challenging.

OUR DIRECTION OF TRAVEL

ESG margin ratchets remain a relatively new device in our pursuit of greater ESG integration and influence within our private debt funds. As ESG practices become more entrenched across the broader realm of private markets, we anticipate a growing role for this tool.

Today, 13 of the 104 investments in our European portfolio incorporate active ESG margin ratchets with formally set KPIs. There are an additional 33 investments in our European portfolio with a principle to agree the ESG margin ratchet KPIs. As our existing loan book matures and grows, we hope to incorporate the margin ratchet approach into a greater proportion of holdings, since some of our existing loans were negotiated prior to the launch of our ESG margin ratchet.

But even with this intent in mind, the complexities of collaborating with a diverse range of borrowers and private equity firms across various geographies will also have an impact. There have inevitably been scenarios where the use of a margin ratchet was not fully supported by the other parties in a deal, which meant the approach could not be implemented. We expect this to continue to be the case until the initiative becomes more common across the middle market.

Our overall direction of travel is to support an expanding role for the ratchet in our investment process. The proportion of loans we have granted that incorporate this tool has increased each quarter since Q1 2020, and as of Q4 2022, 82% of borrowers in Europe agreed to ESG ratchets on new platform investments made during 2022[6]. We hope ESG's expanding significance in this space will serve to align more lenders and borrowers with our perspective in the future.

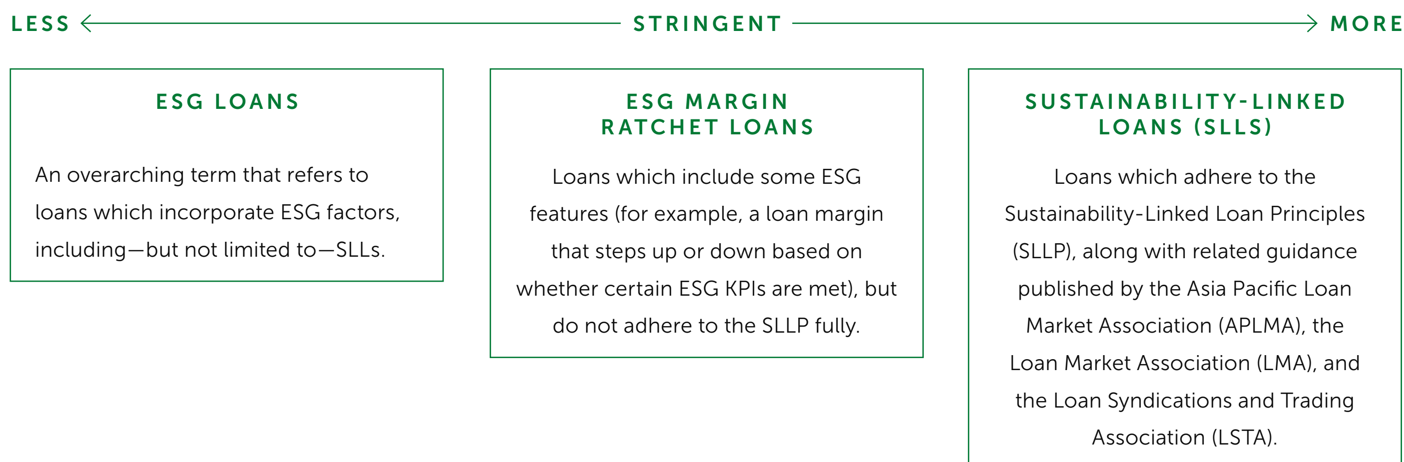
6. Barings internal analysis. As of March 31, 2023.

What's in a Name?

WHY MARGIN RATCHETS?

Terms such as 'ESG-linked loans', 'ESG loans' and 'sustainability-linked loans' are often applied interchangeably, without any distinction made between the features that characterize these different loan products.

However, different criteria must be met for these descriptors to be used accurately and applying these terms with precision and consistency is crucial. As a provider of loans in the private market, we believe it is our responsibility to understand and communicate these nuances to our borrowers, sponsor clients, and investors.



THE SUSTAINABILITY-LINKED LOAN PRINCIPLES (SLLP)

The SLLP are a set of voluntary principles that provide the market with recommended guidelines for the fundamental characteristics of SLLs, while still allowing flexibility for products to continue to develop. To be classified, marketed or referred to as an SLL, a loan must exhibit alignment with the following five core components:

1. Selection of Key Performance Indicators (KPIs)
2. Calibration of Specific Performance Targets (SPTs)
3. Loan characteristics
4. Reporting
5. Verification

The SLLP set out detailed criteria and best practice for adhering to these five core components, with the aim of preserving the integrity and credibility of the SLL designation.

OUR PERSPECTIVE

The continuing evolution of ESG in our private debt operations is demonstrated in the way we categorize our loans.

At present, our position is that loans we issue with ESG features are ESG margin ratchet loans—loans incorporating some ESG features, without exhibiting the level of compliance with the SLLP necessary to be considered SLLs.

However, as industry-wide acknowledgement and understanding of greenwashing grows and regulations become more detailed and prescriptive, we recognize the stamp of credibility the SLL certification represents, and the reassurance it can provide to our borrowers. Although our approach in this area continues to develop, we're transitioning toward greater alignment with the SLLP, with the goal of increasing the proportion of the loans we issue that can be classified as SLLs.

For the reasons we outlined in the Regional Variations section, this process is not uniform and varies based on a range of unique regional factors. Currently, our shift towards SLL classification for loans is more developed in Europe than in North America and APAC.

CASE STUDY

ESG Margin Ratchet Loan in Action: IT Services Company

BORROWER PROFILE

The borrower is an IT services company with over 6,000 customers across three European countries. The business supports SMEs with limited internal IT capacities by providing tailored IT solutions. Its clients are diverse, ranging from start-ups and freelancers to medium-sized and large companies.

HOW THE KPIs WERE DETERMINED

To enable objectivity and draw upon specialist expertise, we outsourced responsibility in this area to a third-party ESG consultant. This consultancy firm conducted desk research, analyzed data provided by the company's representatives and held discussions with its management, with the goal of building a thorough understanding of the borrower business and its ESG profile.

The ESG consultant aimed to comply with the SLLP. The SLLP stipulate three criteria which must be met if KPIs are to be considered sufficient for the loan to achieve SLL certification:

1. Relevance: KPIs should relate to the core operations of the borrower's business, which are of high strategic significance to the borrower.
2. Measurability: KPIs should be quantifiable on a consistent methodological basis.
3. Benchmarking: Clear benchmarks to assess performance against should be established. However, due to the nature of the ESG consultant's involvement, which was limited to assessing the materiality and baselines of proposed KPIs, benchmarking was not performed.

The consultancy firm conducted a materiality assessment to determine a series of key material themes for the company to focus on, within which a set of relevant and measurable KPIs could be devised. Based on the extent to which the business complied with these KPIs, a discount could be offered on the rate of interest stipulated for their loan.

KPIs

Key Material Themes			KPIs Suggested by the ESG Consultant				
Selected Themes	**Relevance**	**Unit of measurement**	**2022**	**2023**	**2024**	**2025**	**2026**
Energy Use	The energy consumption of data centers and company sites drives Scope 2 and 3 emissions.	% of renewable energy consumed and/or produced	39%	44%	50%	55%	60%
Vehicle Emissions	Vehicle emissions account for the majority of the Scope 1 emissions produced by the IT industry.	% of the vehicles in the fleet that are electric	17%	18%	22%	26%	30%
Resource Efficiency and Waste Management	Material circularity is highly relevant, due to the distribution of hardware by the company.	% of supplied hardware that has been refurbished			Milestone to measure % refurbished		
Employee Engagement and Wellbeing	Employee engagement is crucial to success in a service-oriented business model	Average number of training hours per employee, per year	6.0	10.3	14.5	18.8	23.0
Diversity, Equity and Inclusion	Improving diversity in a male-dominated industry is critical to the company's social impact.	% of the Board of Directors (BoD) that is female	0%	0%	0%	16%	16%
Data Protection and Cyber Security	The company's commercial leverage is highly dependent on data security guarantees.	Increase coverage of revenue streams under the ISO 27001 certification	42%	42%	65%	75%	90%

CASE STUDY

Our ESG Margin Ratchet Loan in Action: Health Care Services

BORROWER PROFILE

The borrower is is a health care services company based in England that primarily offers educational and residential services. The business operates residential homes and special schools across England and Wales.

HOW THE KPIs WERE DETERMINED

The company's approach approach differed from the IT services company example in that they chose to devise a series of KPIs themselves. A third-party ESG consultant was subsequently engaged to review these KPIs and assess their alignment with two of the core components of the SLLP: Selection of KPIs and Calibration of SPTs. Once these targets had been finalized, discounts on the rate of interest that must be paid on the loan could be determined, based on the extent to which the borrower met these targets.

SELECTION OF KPIs

The ESG consultant would ultimately conclude that KPI 1 and 4 ('Gender pay gap' and 'Staff turnover') were strong, while KPI 2 and 3 ('Quality ratings of care homes' and 'GHG emission intensity per staff') were adequate, based on an assessment of their materiality, relevance and scope of applicability.

CALIBRATION OF SPTs

The ESG consultant considers the SPTs to be aligned with the company's ESG reports. It considers SPT 1, SPT 2.1, SPT 2.2 and SPT 3 to be moderately ambitious and SPT 4 to be ambitious, based on historical and peer performance.

KPIs & SPTs

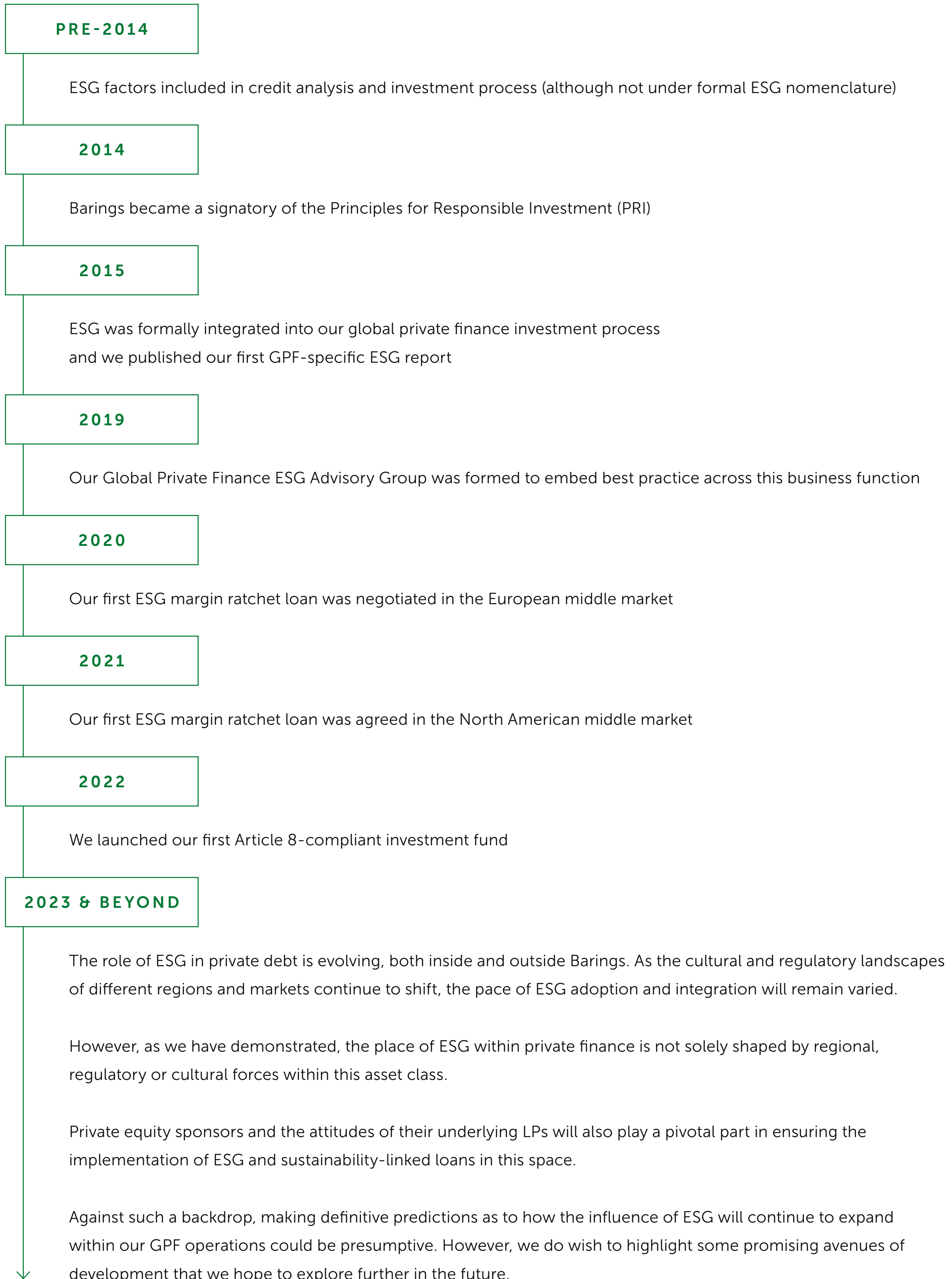
KPI	Baseline	Strength of KPI	SPT	Ambition of SPT
Gender Pay Gap (%)	2022	Strong	SPT 1: Reduce the gender pay gap to 1.5% by 2023, and maintain this rate annually until 2027.	Moderately ambitious
Quality Ratings of Care Homes (%)	2022	Adequate	SPT 2.1: Achieve a '"Good" rating for 90% of all care homes by 2023 and maintain the rate annually until 2027.	Moderately ambitious
			SPT 2.2: Reduce the percentage of care homes rated as "Inadequate" to 1.95% by 2023 and maintain the rate annually until 2027.	Moderately ambitious
GHG Emission Intensity Per Staff (kgCO_2e/staff)	2022	Adequate	SPT 3: Reduce GHG emissions per staff by 5% annually from 2023 to 2027.	Moderately ambitious
Staff Turnover (%)	2022	Strong	SPT 4: Reduce staff turnover to <30% by 2023, 2024, 2025, <29% by 2026 and <28% by 2027.	Ambitious

KPIs & SPTs CONTEXTUALIZED AGAINST HISTORICAL PERFORMANCE

KPI	2020	2021	2022 (Baseline)	SPTs (2023–2027)
Gender pay gap (%)	-5.30%	1.10%	1.10%	SPT 1: Reduce the gender pay gap to 1.5% by 2023 and maintain the rate annually until 2027.
Quality Ratings of Care Homes (%)	91%	90.1%	90.6%	SPT 2.1: Achieve a "Good" rating for 90% of all care homes by 2023 and maintain the rate annually until 2027.
	0.10%	0.20%	1.95%	SPT 2.2: Reduce the percentage of care homes rated as "Inadequate" to 1.95% by 2023 and maintain the rate annually until 2027.
GHG Emission Intensity Per Staff (kgCO_2e/staff)	1,310	1,178	1,257	SPT 3: Reduce GHG emissions per staff by 5% annually from 2023 to 2027.
Staff Turnover (%)	31%	35%	35%	SPT 4: Reduce staff turnover to <30% by 2023, 2024, 2025, <29% by 2026 and <28% by 2027.

Where We're Going

Visions of the Future



PRE-2014

ESG factors included in credit analysis and investment process (although not under formal ESG nomenclature)

2014

Barings became a signatory of the Principles for Responsible Investment (PRI)

2015

ESG was formally integrated into our global private finance investment process and we published our first GPF-specific ESG report

2019

Our Global Private Finance ESG Advisory Group was formed to embed best practice across this business function

2020

Our first ESG margin ratchet loan was negotiated in the European middle market

2021

Our first ESG margin ratchet loan was agreed in the North American middle market

2022

We launched our first Article 8-compliant investment fund

2023 & BEYOND

The role of ESG in private debt is evolving, both inside and outside Barings. As the cultural and regulatory landscapes of different regions and markets continue to shift, the pace of ESG adoption and integration will remain varied.

However, as we have demonstrated, the place of ESG within private finance is not solely shaped by regional, regulatory or cultural forces within this asset class.

Private equity sponsors and the attitudes of their underlying LPs will also play a pivotal part in ensuring the implementation of ESG and sustainability-linked loans in this space.

Against such a backdrop, making definitive predictions as to how the influence of ESG will continue to expand within our GPF operations could be presumptive. However, we do wish to highlight some promising avenues of development that we hope to explore further in the future.

POTENTIAL AVENUES

POLISHING THE RATCHET

As discussed earlier, a tension exists between our desires for customization and standardization in the application of our ESG margin ratchet. While customizing the KPIs for each borrower enables more relevant targets, it also acts as a stumbling block to data gathering and reporting.

DATA OPTIMIZATIONS

Even without altering the KPIs we implement, the incorporation of ratchets in a rising number of private finance deals means we are amassing a growing body of data on our borrowers, which can be used to define more precise and effective KPIs in the future.

One key change in this area is the introduction of annual questionnaires, for the purpose of collecting ESG data from our borrowers. Data is already being systematically collected in this way in Europe, and we are working towards making this process more globally consistent.

Our Portfolio Solutions and Analytics team is also currently working with a leading third-party provider with the goal of adopting an improved estimation framework. In time, this may be integrated into our GPF operations.

THE NEXT GENERATION OF FUNDS

Our view is that the integration of ESG into investment processes is simply good practice, and ultimately leads to our portfolio companies improving their business models, policies and practices.

Nonetheless, we are conscious of a shifting regulatory landscape, encompassing policies that include the EU's SFDR and the SEC's forthcoming climate-related disclosure regulations. Compliance with these regulations helps our investors benefit from a common language and framework from which to make investment decisions.

To offer our clients and partners the ability to invest in global private finance via the structures most appropriate to their needs, we aim to focus further on data collection and disclosures to enable us to deliver on our client's ESG preferences.

The Next Generation of Funds: A Deep Dive

THE REGULATORY LANDSCAPE

A regulatory framework at the forefront of our consideration is the SFDR, which has two levels. Level 1 came into effect in March 2021 and required firms to evidence sustainability activities at an entity level and introduced three new product disclosure categories. Level 2, which came into effect in January 2023, strengthened the pre and post-contractual disclosure requirements for funds which either promote ESG characteristics or have a sustainable investment objective.

The SFDR's disclosure categories are discussed below:

LEAST ← SUSTAINABLE → MOST

ARTICLE 6	ARTICLE 8	ARTICLE 9
This serves as the default categorization. It pertains to mainstream funds that do not promote a tilt toward investing in assets with positive environmental and/or social profiles, and do not have a defined sustainability objective.	*This pertains to funds that promote environmental and social characteristics. This may involve the screening for and exclusion of certain assets, such as those linked to fossil fuels. Article 8 funds lack a defined sustainability objective, but sustainability concerns nonetheless inform their investment process.*	*This pertains to funds with a defined sustainability objective or which track a climate benchmark. While ESG is incorporated into the investment processes of both Article 8 and 9 funds, the criteria for Article 9 funds are more stringent. Article 8 and 9 funds are often referred to as 'light and dark green' funds, respectively.*

OUR PERSPECTIVE

Our current North American and European Private Loan Fund offerings aim to achieve Article 8 compliance. Of significance, our North American Private Loan Fund 3 will be the first Article 8-compliant North American fund that we've launched as part of our GPF business.

Broadening our focus beyond a single region, our Global Private Loan Funds 4 and 5 will also aim to earn this classification. Our ultimate goal is that, moving forward, all our flagship investment vehicles will be Article 8-compliant.

OUR PROCESS

To achieve this goal, we have taken action to optimize our internal practices. All our investment professionals, and thus portfolios, integrate ESG considerations into our investment process. We have formalized our approach through establishing a series of binding criteria within the fund of Article 8 documents. These new criteria more tangibly draw these funds into compliance with the terms of Article 8 accounts.

Our compliance has also been evidenced by more clearly defining our goals regarding the ESG margin ratchet. This tool is now available for application in all the European private finance loans we offer, and our target is that 50% of these loans will have the ESG margin ratchet built into their documentation. However, we recognize that borrowers may choose not to implement the ratchet.

We are also working to increase the proportion of the North American private finance loans we issue that have the ratchet built into their documentation. However, we recognize that this target may take longer to achieve because of the club nature of the market and regulatory headwinds. Less widespread interest in ESG integration among private equity firms may result in slower adoption of the margin ratchet approach in this market.

Despite this, our ambitions extend beyond the current state of play, especially as ESG integration continues at a rapid pace in other areas of capital markets. Our view is that continued interest from investors, competitors and some regulators will draw an increasing number of businesses down the path of ESG integration, ultimately resulting in an uptick in the use of our ESG margin ratchet and growing alignment with our overall approach as a firm.

Conclusion

A new wave of regulation, growing interest in ESG from private equity firms and the development of new methods of quantifying ESG integration are all shaping the ways in which business is conducted in the world of private finance, and beyond. Against this backdrop, the challenge for our GPF team is not to navigate the trends of the present but to look further, identifying areas of development that are yet to be adequately explored.

In making the transition to Article 8 compliance for our flagship funds, integrating our ESG margin ratchet into a growing number of loans, and using our proprietary ESG scoring system to analyze prospective borrowers, we believe a solid foundation for continued development has been established. As we move forward, initiatives such as enhancing our reporting capabilities and expanding the role of social concerns in our investment process offer promise.

While our overall ESG approach and commitment to progress is clear, our positioning is not set in stone. Our processes, tools and infrastructure remain iterative. Potential paths forward have been outlined but we intend to remain responsive to any regulatory, cultural or technological developments that may present unforeseen opportunities or challenges. We intend to invite our investment partners to provide feedback and to prompt further discussion.

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