

# ESG DUE DILIGENCE IN PRIVATE DEBT DEAL MAKING

## SIGNATORY TYPE

Investment Manager

## OPERATING MARKET

US

## AUM

US\$4.3 billion

## AUTHORS

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Churchill Asset Management provides senior and unitranche debt financing to middle market companies, and currently manages \$6.4 billion in committed capital. Churchill is an affiliate of Nuveen, the asset management division of TIAA. TIAA was an early signatory to the PRI. Demand from institutional investors is driving rapid growth across private debt segments, and the increasingly competitive landscape is adding another layer of complexity when sourcing and closing deals. We believe that addressing material ESG risk and opportunity factors in the investment decision-making process helps to reduce investment risk, may enhance long-term value, and ensures that investor capital is used effectively and ethically.

We partner with long-term oriented companies and operators with strong ESG practices. Our commitment and approach to responsible investing is detailed in our Sustainability Policy and reflects industry best practices for integrating ESG factors throughout the investment lifecycle. This case study, however, focuses on our approach to ESG incorporation during the pre-investment phase of a transaction.

## DUE DILIGENCE

The integration of ESG factors begins with our deal teams analysing materiality and applying exclusions, supported by the Nuveen private markets sustainability team. During the due diligence phase, we evaluate the ESG-related risks that could damage a company's operations and reputation, while also thoroughly analysing the operating history to minimise ESG-related defaults and losses.

We developed an ESG checklist to identify ESG-related issues and risks from a company, sector and geography

perspective. The checklist consists of a standard set of environmental, social and governance questions for all investments, regardless of sector, plus an exclusions list and a screen for country-level geographic risks. The checklist is customised to our credit box, and embeds ESG materiality guidance from widely-used industry sources, including the International Finance Corporation (IFC) Environmental and Social Performance Standards, the CDC ESG Toolkit, and the Sustainability Accounting Standards Board (SASB) Materiality Map, thereby streamlining the ESG screening process.

Aggregating information about sector materiality and performance standards into our checklist allows us to easily prioritise or weight certain ESG issues based on the sector. Investment teams spend more time on these issues during the due diligence phase and are required to provide commentary rather than merely tick relevant boxes. Where available, third-party materials (such as from the equity sponsor or a consulting firm) are used by the investment teams to bolster due diligence.

## INVESTMENT DECISION

Our investment teams apply a set of criteria against each opportunity to determine suitability, based on the results of the ESG checklist. The ESG checklist is designed to be a document that is discussed at the investment committee, and analysis is included in every investment approval memo. Each investment decision is thoroughly discussed and needs to be unanimously approved by our investment committee before an investment is made. While we are more sensitive to certain ESG issues when making a credit decision, such as those on our exclusions list, we tend to take a case-by-case approach based on materiality versus a binary one when considering ESG factors.

## ALIGNMENT WITH THE UN SUSTAINABLE DEVELOPMENT GOALS

In addition to screening for ESG risks, we also consider the sustainability impact of our investments by assessing their relevance to the Sustainable Development Goals. For each investment, the closing memo includes an SDG checklist that identifies whether and how the investment aligns with one or more of the sustainable development themes. This helps us to better understand our potential sustainability impact at the individual deal and portfolio level, as well as communicate shared sustainability objectives with our partners and stakeholders. Through our investments, we identified that we primarily contribute to SDG 3: Health and well-being.

## PRACTICAL CONSIDERATION OF ESG FACTORS DURING THE PRE-INVESTMENT PHASE

Integrating ESG factors during the pre-investment phase raises awareness of potential risks and opportunities that can affect investment performance. Indeed, ESG factors have played an important role in our investment decision-making process, helping us to identify and mitigate ESG risks early in the lifecycle of an investment. ESG issues are raised to the investment committee during our initial screening meeting, so that we can screen investments before spending time on due diligence. The examples below highlight how our approach has played out in practice.

### MANAGING MATERIAL ENVIRONMENTAL ISSUES

ESG due diligence also helps us to uncover material issues that should be monitored throughout the lifetime of an investment. For example, through our ESG due diligence process, we discovered that a company we were considering had minor environmental issues in the past involving the handling of highly combustible chemical compounds. Even though hazards remained, the company had taken steps to curb any future issues and reduced potential chemical exposure to below Occupational Safety and Health Administration thresholds. As a result, we deemed the company worth of investment. However, awareness of this ESG risk means that we will monitor it closely, report on the status at our quarterly portfolio reviews, and work with the sponsor and company to address any potential future issues.

### SCREENING BUSINESS MODEL FOR EXCLUSIONARY ISSUES

Using ESG screens during the due diligence phase also helps us to ensure that Churchill is investing ethically and excluding companies that are not aligned with our core values and standards. For example, in the case of a manufacturing company we were considering, we discovered that a portion of its revenues were tied to materials that could be used in the production of cluster bombs or nuclear weapons. Given the confidential nature of this portion of the company's revenues, the management team was unable to disclose the product's end use. We were therefore unable to determine if the business conflicted with the governance and social responsibility criteria in our ESG policy and exclusions list. As a result, we opted to not invest in the deal. Our practice of screening companies based on an ESG exclusions list is done on a case-by-case basis, as opposed to using a revenue threshold.

### EVALUATING AND MANAGING GOVERNANCE ISSUES

Thorough ESG due diligence helps us to identify environmental liability, legal liability or reputational risk that we may determine to be unacceptable. For example, in researching an investment opportunity, we discovered that a senior executive at the company had been involved with securities fraud and his securities license was revoked. While the infraction took place while the executive was employed at a different company, we considered this to be a significant governance concern and, as a result, we did not feel comfortable lending to the company. We communicated the reason for declining the investment to the sponsor, as is common practice.

**Risks and other important considerations**

This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. The information provided does not take into account the specific objectives or circumstances of any particular investor, or suggest any specific course of action. Investment decisions should be made based on an investor's objectives and circumstances and in consultation with his or her advisors.

Investing involves risk; principal loss is possible. There is no guarantee an investment's objectives will be achieved. An investment which includes only holdings deemed consistent with applicable Environmental Social Governance (ESG) guidelines may result in available investments that are more limited than those that do not apply such guidelines. ESG criteria risk is the risk that because the criteria excludes securities of certain issuers for nonfinancial reasons, an investment may forgo some market opportunities available to those that don't use these criteria.

Churchill Asset Management is a registered investment advisor and majority-owned, indirect subsidiary of Teachers Insurance and Annuity Association of America.

Middle market loan investments are subject to credit risk and potentially limited liquidity, as well as interest rate risk, currency risk, prepayment and extension risk, and inflation risk.