EXPERT Q&A

Private debt has historically lagged other asset classes when it comes to responsible investment, but it is catching up fast, says Allison Spector, director of sustainability at Nuveen

A coming of age

Q How has the concept of responsible investment evolved within private credit?

For a long time, the focus was on negative screening. Over time, some private debt players – in Europe and then in the US – started to adopt environmental, social and governance practices focused on qualitative due diligence in order to manage downside risk. What has arguably had the most impact on private credit is actually the deepening of ESG integration among private equity sponsors, with whom lenders such as Churchill Asset Management, Nuveen's private capital affiliate, partner. The result has been a more data-driven, quantitative approach to ESG in private credit that focuses duly on managing ESG risks as well as opportunities.

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Q Where does private debt stand now in ESG in relation to other asset classes?

I think it is still trailing ESG integration in other asset classes, for example listed equities and private equity, but perhaps not by far. The main difference with listed equities is the availability of ESG data and therefore the ability to benchmark ESG performance across a portfolio. We have some ability to leverage public corporate data – for example, if we are selecting a private credit issued by a public organisation as is common in Nuveen's private placements strategy – but otherwise coverage of private companies is moderate at best. Meanwhile, the main difference with private equity is the lender's level of influence over ESG outcomes. Increasingly we are seeing lenders engage companies on material ESG issues, but this has not always been the case.

Q Has private debt behaved responsibly through the covid crisis?

The first instinct, obviously, was to understand the financial and operational impact of the pandemic on portfolio companies. However, that very quickly moved to considering ESG principles, and most significantly the health and safety of employees and the need to prevent the spread of the virus. From our perspective, having a strong focus on ESG gives us better lines of communication with these companies, beyond the financials, which has translated into a better ability to monitor performance and to help businesses manage through the crisis.

Q How does this approach inform origination and credit selection?

We integrate ESG principles across 100 percent of our private credit assets under management – $63 billion across private placements, senior loans, mezzanine debt, and real estate debt as of the end of September – because we believe ESG integration can reduce investment risk and may enhance investment performance. We do this by using a proprietary ESG ratings tool that leverages MSCI's ESG ratings methodology, which is traditionally used in public markets. By adapting and customising ESG research tools for private markets, we enable every single one of our credit analysts to effectively develop and apply ESG expertise throughout the investment process.

The process starts with origination. We implement a screen for high-risk business activities that may conflict with Nuveen's responsible investing policy, such as exposure to coal, tobacco or munitions. Then, during due diligence, analysts input a range of information about each investment opportunity – including the sector, location and size of the business – to determine ESG materiality, or level of risk exposure, across 37 different ESG issues.

Each company is then assessed on the maturity of its risk management practices for material issues and benchmarked against its peers. A high level of exposure on a material issue, for example, requires very robust risk management practices if it is to score well. Each credit receives an ESG rating for 10 separate themes and an overall ESG rating. All that feeds into the investment committee memo for consideration in credit decisions.

Q What are the biggest challenges with implementing a responsible investment approach in private debt?

Like other asset classes, data availability and quality is a significant challenge. Public corporations are required to disclose certain data around ESG performance but in private markets, and specifically private credit, you don't get that same access to information. Often portfolio companies may not even collect data in the first place or, if they do, it may be poor quality. We are starting to see that change, however, with greater pressure from private equity sponsors as well as private credit players like Nuveen and Churchill. Indeed, we are building our own ESG mid-market dataset through the collection of ESG data points across all our portfolio companies. That allows us to benchmark ESG performance, which is another challenge in private markets. Even if you have data in an absolute sense, you don't really know if it is good or bad until you have a meaningful reference point.

Q Climate change is a very high profile issue. How do you manage that risk?

We have hard-coded climate change vulnerability as a material issue for every single investment, which is a departure from the MSCI methodology. Managing climate change risk is a priority for Nuveen and Churchill, so we want to ensure adequate data across the entire portfolio. Each investment is assessed for exposure to both physical climate hazards (typically based on location), as well as transition risk (typically based on carbon intensity).

Classifying 100 percent of Nuveen's private credit assets under management on these two components of climate risk exposure helps us understand how it will perform in a changing climate and low-carbon economy.

Q Does ESG inform loan documentation?

To date, our focus on ESG within private debt has prioritised the pre-investment phase. We do not put specific ESG requirements or covenants in our deal documentation beyond disclosure and reporting expectations, which includes material ESG events. We do, however, focus on partnering with credible private equity sponsors which do just that. That is not to say that we don't care about ESG post-investment. We absolutely do. We use our proprietary ESG tool to monitor and benchmark performance. Credit analysts update ESG ratings on an annual basis, at the same time as they update credit ratings. If we find any significant issues, we use that as a lever to start a conversation.

Q We have talked about ESG as a risk mitigator, but what about as an opportunity?

Absolutely. Obviously, climate change poses risks to investment portfolios – risks that may not have been priced in yet – hence the prioritisation of screening for climate change vulnerability across all investments. But at the same time, climate change undoubtedly opens up opportunities. Those opportunities range from renewable energy generation to resource efficiency. For example, Nuveen's private placements strategy has a significant focus on C-PACE (commercial property assessed clean energy) – the financing of energy efficiency upgrades in commercial buildings. Those improvements can result in significant cost savings for landlords and tenants while having a positive impact on the environment.

On the social side, meanwhile, through Churchill, we are invested in a lot of healthcare services companies which serve large populations in multiple locations. While covid may have seen a slowdown in patient-facing companies, such as physician practice management, ultimately we see that demand as being inelastic, and healthcare continues to be an exciting sector.

Q How is impact investment evolving in private debt?

Private debt constitutes a large share of total impact investment assets under management, but has tended to focus on a narrow set of sectors, most notably financial services and microfinance. We think there is phenomenal opportunity to expand the role of commercial private debt in impact investing across sectors and impact objectives, but we have not seen the same uptick in market activity among private credit players as we have seen among mainstream private equity in recent years (Nuveen recently launched its first third-party private equity impact strategy).

> *"Having a strong focus on ESG has given us better lines of communication with our portfolio, beyond the financials"*

This may be the case because impact investing is often perceived to be more 'additional' through active ownership strategies like private equity, where managers can more directly point to their value-add. The same level of engagement may not exist within private credit strategies, but that doesn't mean they are necessarily any less 'impactful'. Impact investments in public fixed-income strategies, such as green bonds, demonstrate the potential for deep impact without active ownership in the traditional sense (Nuveen currently manages over $5 billion in impact investing assets under management in public fixed income). Where private credit could learn from green bonds is in the area of impact measurement and reporting – improving disclosure requirements and transparency around how impact is managed and what impact has been achieved. Like ESG, the growth of impact investing in private credit depends a lot on the availability and quality of impact data from private companies.

Q Will we reach a point where we do not differentiate responsible investors?

I think that consideration of material ESG factors and impact externalities, both positive and negative, will become standard practice. It already is at Nuveen. Collecting and using this data to inform investment due diligence and underwriting will become the norm for the private credit investment process, particularly as the data continues to improve. What will ultimately differentiate responsible investment and impact investment *strategies* is the way in which this data is used to optimise for specific ESG or impact objectives, while maintaining investment portfolio risk-return targets. ■