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December 2022/January 2023 • privatedebtinvestor.com

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EXPERT Q&A

A detailed assessment of ESG performance is required for effective due diligence – a harmonised approach needs to be adopted, says Churchill Asset Management's Mickey Weatherston

ESG data takes centre stage

Over the past few years, the private credit industry has realised that a thorough assessment of a borrower's ESG exposure is critical to effective underwriting. Moreover, LPs are putting pressure on private credit lenders to supply data on the ESG performance of portfolio companies, most notably around carbon emissions.

Mickey Weatherston, head of sustainability and ESG integration at Churchill Asset Management, an investment specialist arm of Nuveen, reflects on some key ESG trends facing the asset class. He tells us a more harmonised approach to ESG reporting is needed to allow the industry to move forward.

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Q How do you integrate ESG factors during pre-investment due diligence?

We consider ESG factors from the moment an opportunity comes across our origination team's desk. ESG issues are front and centre for every deal we review and underwrite. They are as important as any of the other credit metrics we use in our underwriting process. We start by screening a potential investment against our firmwide exclusion policy – if a company participates in an industry or sells a product or service that appears on our exclusion policy, we decline the deal at that very first stage.

If an opportunity passes this initial screen, we run our materiality assessment on the business. The materiality assessment helps us identify broader ESG issues. It also helps us narrow down the questions we will focus on during the management assessment we complete for every company. Environmental topics might not have been considered by our underwriting teams four years ago, but now that there is a push towards a low-carbon economy, it is critical that we consider how businesses are affected by transitional risks, as well as physical climate risks.

The assessment uses a proprietary rating tool that Churchill developed in partnership with Nuveen's responsible investment team. It assigns a risk exposure score to sector-specific ESG issues for every portfolio company we review. It also looks for alignment to the UN Principles for Responsible Investment (PRI), the UN Sustainable Development Goals (SDGs), and it helps us identify if there's a potential violation of the UN Global Compact, or the OECD Guidelines for Multinational

Enterprises. If something is flagged as a violation, we'll immediately decline the deal.

Q In terms of reporting and disclosing ESG performance, do you see a need to harmonise different approaches?

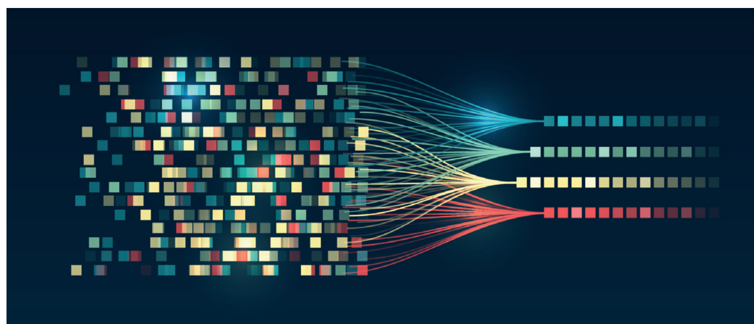
It is very important, especially on the private credit side, where we rely on the sponsor to provide as much information as possible. The breadth and quality of the ESG data we receive on a potential opportunity increases our chances of identifying material ESG risks and opportunities. This then maximises the quality of due diligence and underwriting we can perform for our investors.

Right now, a large number of industry groups and data vendors are coming to the market trying to help portfolio companies track what are deemed the most important issues and metrics. However, one of the data collection efforts needs to win out and become the most prominent, so we can all start applying the same framework. As a lending partner to the private equity community, we recognise that having to complete multiple different ESG questionnaires from lenders creates inefficiencies for PE firms.

Fortunately, the industry is moving towards harmonisation. We partnered with the UN PRI and other signatories to help develop the Private Credit-Private Equity ESG Factor Map, which promotes information sharing during pre-investment due diligence. We are also supporting the Loan Syndications and Trading Association (LSTA) in its partnership with the Alternative Credit Council (ACC) and PRI on their ESG Integrated Disclosure Project, which is pushing for consistent disclosures across the credit market.

If all market participants work from a standardised data set, which maps to some of the key industry frameworks like the Sustainable Finance Disclosure Regulation's (SFDR) Principal Adverse Impact indicators or the LSTA's ESG Data Harmonization Project, we can more effectively implement ESG integration internally.

The ideal is to work from the same large data set as other market participants. We can then bring the data in-house, use it in our proprietary rating tool, and factor it into our due diligence process.



Q Which types of ESG data are key priorities for your investors?

Carbon emissions data are top of mind for all our investors. The types of data being requested become more granular by the day. I just received a 120-itemised ESG questionnaire from an investor, and two-thirds of the questions were on environmental factors, with a great deal of information on carbon emissions requested.

Right now, European LPs are leading the charge. This is due in large part to regulatory requirements under the SFDR, as well as end investors placing a high priority on a transition to a lower carbon economy. Oftentimes, the investor has already made a net-zero commitment, so it needs to compile data across all its funds and investments. A lot of investors are asking for information on the carbon intensity of their funds, including Scope 1, 2 and 3 emissions data.

"ESG issues are front and centre for every deal we review and underwrite"

Q How do you ensure you are aligned with PE sponsors on ESG?

This is where the power of Churchill's platform plays a really important role in our ESG integration process. Along with being a lending partner and equity co-investor to the private equity community, we're also an LP in more than 250 private equity funds and sit on over 200 advisory boards.

This gives us a deeper understanding of the practices of the sponsors we partner with. We can align on ESG

risks and opportunities in ways that we otherwise might not have identified had we not been an important investor to the sponsor.

In addition to that, the number of third-party ESG due diligence reports we receive from sponsors is rapidly increasing. The data harmonisation efforts are also leading to greater collaboration with our sponsors on ESG due diligence, and on portfolio monitoring. We re-rate our portfolio annually, based on a quarterly portfolio review, to identify any material issue risks that might have arisen since we first rated the company. Partnerships with sponsors are very important to us. The harmonisation of data and the power of being an LP with top-tier sponsors has been a great advantage.

Q Given that asset owners are increasingly looking for data on carbon emissions, how do you estimate the carbon emissions of the companies you lend to?

Very few private middle market companies have been able to calculate their Scope 1 and 2 emissions and almost none their Scope 3 emissions – they generally do not have the expertise or resources to do so. We felt that the next best thing was to model emissions for all the portfolio companies we lend to.

We are working with Persefoni, a top-tier climate disclosure and carbon management solution, to compile data points and draw on data from public companies that have disclosed emissions data. We can use these datasets as proxy data to model the emissions of private middle market companies that operate in similar subsectors.

As we partner with more PE sponsors on emissions reduction plans, and as investors request better emissions data, we hope that middle market companies will improve their capacity to calculate their true carbon footprint. But our current feeling is that modelling is still the best way to provide our investors with a reference data point on carbon emissions. I've been very impressed with the quality of the data we've been able to generate.

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Q Sustainability-linked loans (SLLs) have attracted a lot of attention recently, especially in Europe. Can these be a game changer for private credit in promoting sustainability?

The US is probably at least a couple of years behind Europe, but the potential benefits of SLLs are obvious. These loans enable lenders to partner with a sponsor and a portfolio company to identify the key ESG priorities. Then they encourage the company to focus on making changes in its business practices to address the issues. If a company is properly incentivised to tackle the challenges – for instance, lowering emissions or reducing waste – then the odds are that the issues will be addressed more quickly than they would otherwise have been.

It's probably the next frontier for ESG investing in private markets – for now, we're taking a cautious approach. We'd like to see the US market for SLLs evolve and mature a little bit more. It's taken a few years for the European market to develop – we need to see the US also put some controls in place to ensure that lenders do not get caught up in greenwashing claims.

Q What are the key challenges in ensuring SLLs are effective?

The common feedback we hear on the first wave of SLLs in the US market is that they still have a lot to deliver. There is no real penalty if the company does not achieve its goals. I think to be credible, there has to be a penalty for not achieving goals, in the same way companies get a price reduction for hitting their target. And both the penalty and incentive need to be meaningful – at least 15 basis points.

Also, it's important that the criteria and KPIs used to determine whether the borrower gets a discount are determined through a partnership approach. The lender needs to have a seat at the table. If the borrower or sponsor just says: 'here is the goal, give us a discount if we meet it', that will carry less credibility.

Ideally, there should be interim targets to track progress, and KPIs should be audited by a third party. Data transparency is critical. There's going to be a greater regulatory focus on ensuring these products are working effectively and adhere to the metrics that they claim that they are tracking. ■