Hamilton Lane

The Intersection of Private Credit and ESG

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The past year may have elevated Environmental, Social and Governance (ESG) into the mainstream, but the truth is that ESG is not a new theme in the world of investing.

LPs and GPs alike are placing greater emphasis on the importance of ESG considerations to their investment strategies and decision making. While the focus spans the whole of the private markets industry, notably it is rising in importance in one particular area: Private credit. For credit-focused GPs, ESG is quickly becoming a key area of diligence when evaluating investments and, for companies, it is paving the way for greater capital markets access. Here, we explore the increasing role that ESG is playing in private credit.

How are private credit GPs approaching ESG today?

ESG is largely an investment filtering exercise for many private credit managers. GPs recognize that ESG issues matter, especially to their LPs, and therefore have incorporated filters in their diligence processes to ensure they are identifying risks and backing responsible companies. In terms of credentialing, there are multiple ways for credit GPs to demonstrate their adherence to responsible principles, such as becoming a signatory to the Principles for Responsible Investment (PRI) or implementing ESG standards such as those set by the Sustainability Accounting Standards Board.

Is implementing ESG in private credit easy?

By and large, private credit managers have been more focused on identifying already-responsible companies for investment versus identifying companies that have room to become more ESG-friendly. This is not to say that private credit is falling short — in fact, the industry is paying close attention and taking ESG quite seriously. But integrating ESG considerations isn't without its challenges.

For starters, lenders depend on company-level information to assess ESG risks. Not all companies, particularly private companies, track ESG KPIs (key performance indicators), and this dynamic is further complicated by the fact that there exist various standards for tracking ESG impact. Evaluation is case-by-case and it is not always straightforward. As an example, a healthcare company that makes disposable patient products creates heavy waste on one hand, but reduces patient infections, reduces hospital re-admissions, and saves lives on the other. Is that company an ESG friend or foe? It's not always so black and white.

Many private credit managers have implemented some type of proprietary scoring system in determining ESG-level risks and it is increasingly common to see an ESG analysis page in a GP's Investment Committee report. Arguably, deal teams are more focused on debating the merits and considerations of a company's ESG profile, similar to other credit risks, than they have been

historically. Some managers have gone as far as to develop detailed frameworks — such as sector-specific ones that identify the sustainability issues that are most relevant to that sector's financial performance — while others take a more ad-hoc approach.

How can LPs assess whether a credit GP is approaching ESG appropriately?

There are three basic criteria that LPs might consider here. The first is organizational: LPs can seek to understand organizational dynamics such as whether the GP is a signatory to the PRI, or whether the GP has a formal ESG policy in place, along with the appropriate resources to ensure compliance. The second criterion relates to investment decision-making: Best-in-class GPs are likely to provide their professionals with formal training and have a defined due diligence process for evaluating ESG risks. Some GPs may be a step more advanced in creating company-level strategic plans. The third criterion relates to monitoring and reporting:

> GPs that are taking ESG seriously are not just screening out bad ESG actors, they are defining KPIs, measuring them periodically, and reporting back to their LPs.

How do GPs 'win' in an ESG-minded investment environment?

Scale and access to deal flow are key. The larger a GP's deal funnel, the more selective a manager can be, especially in a world where absolute return is not the only measure of success. LPs do not want managers chasing yield at the expense of, say, environmental impact. But by the same token, they also don't want managers sacrificing performance simply for the sake of an ESG-friendly company. Striking that happy balance means having sufficient options from which to choose.

What does the future hold for ESG incorporation within private credit?

The future of ESG incorporation in the context of private credit is still being written; however, what's clear even today is that private credit plays a pivotal role in accelerating positive change around the globe. With the industry having migrated from an ESG consciousness phase to one of ESG implementation, we believe private credit is positively changing the capital markets paradigm by elevating the standard required to qualify for capital. Arguably, companies that conduct themselves in accordance with higher environmental, social and governance standards may have the potential for greater access to capital (and quite possibly at better rates) in the future. As a result, companies may experience market pressure to evolve.

This type of systemic change is already underway. A recent announcement highlighted that a large global GP received the largest ESG-linked credit facility in the United States, exclusively tied to board diversity. The margin on the facility is linked to achieving 30% ethnically diverse directors on the board of companies controlled by the GP within two years of taking ownership. This is just one example of where private credit may focus ESG implementation in the future.

While ESG implementation within the private credit space has seen meaningful progress, as ESG standards and tracking improve, the asset class will have the opportunity to traverse new frontiers. Those who can demonstrate a true commitment to furthering ESG and delivering measurable impact stand to go far, as investors will increasingly reward those managers' good ESG behavior.