The Investment Podcast

M&G Investments

Episode 6: Sustainability in private credit – can the two go hand in hand?
25 June 2021

Catherine Ross [00:00:33] Hello and welcome to the Investment Podcast. I'm Catherine Ross, Head of Private Credit at M&G and I'm joined by Fiona Hagdrup, a Fund Manager in private credit with a keen interest in ESG to talk about sustainability in private credit investment. Sustainable investing from a value standpoint is now, of course, a major focus across the investment spectrum. Commentators across the industry have spoken of the paradigm shift in investing that they believe we're going through, with the swing to sustainability being profound, urgent and irreversible. Now, this has been most obviously implemented in public markets, given the nature of the investment relationship and the levels of disclosure demanded and deliverable there. But another important investment trend is, of course, the appetite from investors for access to private market opportunities, where there's arguably greater potential for influence in promoting sustainable practices, but where there may be less in the way of disclosure requirements and challenges in providing tangible evidence and data that prove the sustainability of business operations. Are these two investments aims compatible with one another? That's what I'll be exploring with Fiona in this podcast. So, let's start there. Is an allocation to private credit coherent with a desire to increase sustainability in investment, in your view?

Fiona Hagdrup [00:01:46] Yes, it is. We've definitely reached a tipping point. ESG risk factors and sustainability are at the top of the list of considerations and demands from all stakeholders in a company these days, including in the private world. The importance of ESG integration, the enhancing of traditional credit analysis such that it can reveal hidden vulnerabilities or strengths that might not have been captured otherwise by looking through an ESG lens, that's well understood by lenders to private companies. They're sometimes called non-financial attributes, ESG risk factors, but we don't really consider them non-financial at all when a company's credit quality is so directly linked to its valuation, which itself is a reflection of market faith in sustainability of its earnings. If that faith isn't founded on confidence in care being taken over long-term issues, whether it's climate change or employee welfare, inclusivity, then there's potentially a huge financial impact. So, this means encouraging private companies to broaden their disclosures, including the targets that they set themselves, and to report on their progress in meeting them. Also, asking them to enumerate the ESG risks and opportunities as they see them over the short, medium and long term. Crucially, who owns those risks? Who takes accountability for them in the business? It is better to demonstrate their mitigation and their management to investors. That is part of the ordinary course of lending business these days and is the foundation for sustainable investing.

Catherine [00:03:44] So ESG integration is a core component of credit analysis across both public and private markets, at the very least it is an aspiration both from that connection to business performance, but also prompted by clients and other expectations. In the private debt world, what does that integration really look like in practice? How far have we come in reality?

Fiona [00:04:02] ESG integration is a given nowadays. It has gone from being a nice to have to a must-have. Cath, do you remember when we began proactive ESG integration in private credit back in 2013? We had certain institutional clients encouraging us back then, but we also had a lot of head-scratching. Even if some of the private equity sponsors who own a lot of our companies were relatively advanced in ESG, sometimes it felt like we were the only ones making a noise about it in private debt. And so, just as now, we leaned on a wider M&G ESG methodology and approach in other markets, we got ourselves some good training and involvement from sustainability colleagues and equity colleagues, including those that are running impact funds, to get going with explicit ESG risk assessment. It was about taking it from the subconscious within the general credit process to the conscious and then organising it and showing it to clients, which was really the start of our use of the SASB Materiality Map for risk identification, too. And now look! We're seven years on, we're well versed in risk assessment across E,S and G pillars, we're still finding that SASB framework useful, but we've now adapted it for internal systems and processes. We've embellished it with our own investment expertise and experience, and we've just launched an ESG company scoring system across the firm, including private companies. We have a very strong engagement program where we are well plumbed into sustainability themes and debates. We've significantly expanded resources and we're part of the lively market dialogue through trade bodies like the LMA and other important institutions more generally like the CDP. We are also moving forward with some of the third-party data providers to encourage them to expand private world coverage. So, I'd say the momentum in ESG these days in the private world is just as remarkable and palpable as in public markets and now on the investing side, we're ready to step it up another gear.

Catherine [00:06:34] So looking at the best public market practices that have been a key driver in the progress that we've made in the private markets to date, given the broad spectrum that is private assets, it is arguably going to be difficult to generalise about how this will all play out in private credit overall. But if we were to look specifically at the loan market, how is an avowedly sustainable or ESG loan investing approach different?

Fiona [00:06:58] Investing with an explicit ESG objective alongside a financial target, so with an ESG tilt to the strategy or a best-in-class filter, yes, it is nascent for private credit, but it's quickly developing. But I think it's for investors looking to be, as we are as asset owners, part of pushing the market forward. It's important to have access to companies, sufficient resources to do the engagement, the lobbying and the risk assessment in-house, to do it both qualitatively and quantitatively. For all that third party data providers are doing more in our space, private credit is still woefully underserved by them. More importantly, their methodologies, as we know, can be very different, very subjective, not always fresh. So, we're using the confidence of the wider firm's investment experience, married with our own experience and market knowledge, the track record of ESG integration that we have in the private markets, and the tools, the quantitative tools to rank and monitor ESG risk and investment. We think we know what good looks like and we know how to ask companies with serious intent for better. For clients for whom everything they do requires a sustainable bias and for those that understand the nature of the private loan market where it is today, then we think they can join us at the frontier and be part of the advancement of where private credit can reasonably be expected to move to. That said, it still takes a leap of faith and that's why a regular and careful ESG integrated mainstream strategy will continue too.

Catherine [00:08:58] It is an interesting phrase you used there, a leap of faith. It's clear that sustainable lending practices are nascent, as you've said, in private credit, albeit developing apace. But is that leap of faith that you mentioned for investors, something that they can be confident to make, do you think, given how much is still changing?

Fiona [00:09:15] Well, in the public equity markets, the logic of a link between sustainability and a company's valuation is well understood and is proven by academic and industry research. But, yes, in fixed income, in debt, we're talking about investments with maturities, about dated risk exposure and in loans specifically, potentially pretty short exposure at individual instrument level of two to four years. So that's why I say that. Also in private credit, there isn't a long track record or proof of the return effect over cycles of a best-in-class approach versus regular way ESG integrated or otherwise. So, I think for an investor to value a sustainable loan allocation right now, there does need to be an explicit equating in their minds of the drive to move things forward, as we intend to do anyway, as asset owner, as I say, to approach what long term sustainability means in the public world – so an equating of that aspiration with economic return expectations. All that said, it certainly sounds logical in a very asymmetric asset class like loans that doing all that you can to bolster downside protection yet more by investing in investment class companies and issuing transition sectors or questionable long term business models could create attractive, risk-adjusted returns over a cycle. We've certainly had 20 plus years of demonstrating that credit conservatism and careful selection has been a market-beating strategy. For a multi-asset manager, a relationship with a company can, through its life cycle, go from a very small direct lending club loan through a buy and build growth phase that sees a company become a large-cap, private equity-owned entity that might also issue public bonds and might ultimately list on the stock exchange. So as an asset manager and owner, we might feature at every stage along the way with that company even ultimately investing in that public equity. So, the mindset is always for the long term, which is important in planning a sustainability strategy. On the investor side too, no one is tactically allocating to private debt or loans. It is a long term strategic multi-year decision. I think these things transcend the short-term nature of the individual instruments and make long term sustainability of relevance. Also, via a robust ESG risk assessment methodology, we think that it comes together.

Catherine [00:12:24] So we've talked quite a bit about integration within private assets. Taking it a step further, what about specific ESG instruments? Do they appear in private credit? Do they matter, do you think?

Fiona [00:12:36] Yes and yes. For one thing, they're emblematic of the acceptance by the issuer community of the need to disclose and provide data on their progress and sustainability. Their arrival in the private credit space is the end of the era when that measurement was not required. So descriptive, vague qualitative statements of intent, they don't cut it anymore. So, at their best, through these instruments, companies are telling stakeholders that they get that. I'm mainly talking here about sustainability linked loans and bonds. I think these are instruments that are set to define the action in sub-investment grade corporate land because they allow flexibility in their use of proceeds. I'm not saying that we won't also see a rise in the so-called use of proceeds, instruments, green and social loans. We will, and we are in an arena that lends itself to startups, for example, cleantech solution companies. But, in the main in Europe, most companies probably won't have the volume of green or social projects to justify a specific financing. They would they'd rather formalise their efforts to reduce carbon intensity or improve management, diversification, employee diversification by embedding their targets, their KPIs into general corporate purposes financing. So, we see the engine of growth and momentum being with regular way companies being better and showing their plan for this via an agreement to be measured on KPIs.

Catherine [00:14:32] We've seen a lot of comments recently from regulators about the dangers of a greenwashing, the focus they're going to have on it on businesses and on insuring managers are delivering on what they say they say that can do here credibly. Is there a greenwashing risk in sustainability-linked loans?

Fiona [00:14:50] I think we have to be particularly careful with loans because they have a two-way pricing ratchet. So not only is there a financial penalty if a KPI is missed like bonds, but in loans, there's also a financial incentive if a KPI is exceeded. So, the lender community must be assertive at the start to ensure that hurdles set by a company are meaningful and that the sustainability linked feature doesn't become a financial engineering tool. Sustainability linked issuance is already half of this year's loan issuance overall in Europe. It is a big part, it is getting on for 20 percent of the U.S. loan market, too. So, these risks notwithstanding, I think that sustainability linked instruments are important in illustrating commitment to ESG. But, yes, they have to be so much more than value signaling. Commitments made by companies have to be credible, materially stretching, relevant, and the progress measurements should be independently reviewed to have authenticity. I think second opinions are a crucial part of the use of the proceeds world, of the green bonds world and we think something similar should take place on sustainability linked loans.

Catherine [00:16:17] How are our clients responding to all of this? You mentioned before about the early adopters that we saw here back in our loan funds back in 2013: institutional investors who'd set their stall out, supported by a strong regulatory imperative perhaps too, looking initially for evidence around integration, which has transitioned into sustainability as an avowed strategy. How would you characterise the client landscape now and how can asset managers respond to it?

Fiona [00:16:41] Increasingly assertive of a responsible investment strategy, screening out is part of it often but more important is the holding to account of the manager and the setting of expectations for demonstration and for discussion of how we're valuing what is good and how we're backing it with their capital as well as our own. Also, it is about how we're part of the solution for driving change in those companies that have good intent but who may be in transition. I think we will show it to clients in three ways. We have the tools which permit that all important quantification. What's exciting, and recent and a step change is that we're able now to prove and quantify some of the purely qualitative assessments we were making and to synthesize relevant ESG risk factors into a scoring system for every company. That isn't a private credit thing stand alone, that is an M&G thing. Across the board, whether public, private, debt or equity issuer, we can weigh up risk and mitigants via a robust, consistent methodology across the firm. ESG assessment isn't something you can outsource, like you might with credit ratings. As I said earlier, it's very subjective, you can see that in the correlation between third party scores being very low. For another thing, you have to have real analysts involved in iterative discussions with companies on key topics and frequently over time. These scores are far more live, more vibrant, than credit ratings and there needs to be consistency and comparability and a context for the metrics. I think targets are another way in which we're quantifying progress, that we are showing to clients. So, we want to show the state of the underlying company target setting over different time periods, over the near term, the next three to five years, the medium term, 10 years or so and the long term. By doing that, we can break up the challenges ahead and provide some measurement milestones. In climate reporting, for example, we're endeavoring to show the picture right now on GHG emissions disclosure, but also to show the percentage of companies that have Paris aligned science-based targets now and how that's changing over time. I'll freely admit that a lot of the private company-specific data is based on estimates, estimates derived from an in-house model that is looking at the size of the company, the number of employees in that sector, etc. Even that allows a starting point, some context and crucially, a base from which we can initiate engagement and encourage a company to hook up with CDP to initiate an ordered disclosure program. Then there's engagement itself. That's really the third important way that we prove a sustainability agenda to clients, by showing the systematic engagement that's going on, the objectives we have for companies, the progress we've made, the follow-ups we plan and the investment decisions that have ensued. We're fortunate in private credit that we have a close nexus with our companies, that goes with the territory. We might not be shareholders with a vote, but we are relationship lending and we know management. Engagement is a core part of a sustainable strategy. It includes the company owners, too, because private equity with an ESG agenda gets things done across a whole portfolio. So, whether it's bilaterally or engaging via industry groups, we can't do anything all on our own, then there's a leverage effect in nudging forward the owner community too. Also, by engagement, I mean structured meetings with an objective, i.e. the PRI definition of a meaningful dialogue with a company

Catherine [00:21:24] We've touched on this already a little bit. But how might regulation come into play in pushing this forward, do you think, in the private sphere?

Fiona [00:21:32] Yes, regulation is mushrooming. The most significant near-term change in regulation is the stick that we're about to be given which is the improved disclosure that's going to come from the expansion of the Corporate Sustainability Reporting Directive. The NFRD is going to be expanded and will include private companies. That's going to quadruple the affected corporates, improve disclosure and improve relative comparison enormously.

Catherine [00:22:16] So to wrap this up and bring this together, how would you describe your approach to sustainable lending in those funds that you run with that explicit objective?

Fiona [00:22:25] Well, we have to start somewhere and it's somewhat crude for now. We hope that sophistication will come as reporting, disclosure and benchmarking all develop too. With a sustainable loan strategy today, what we have really is an amalgamation of a tilting approach of favouring those companies via their weighting in the portfolio that are in absolute terms best in class or in relative terms to their asset class peers, i.e., for their size and maturity. Remember that a lot of these companies haven't been companies for terribly long, but for the size and maturity, they're leading the way. That married with an explicit screening out of worst in class or the laggards. But we have to leave room in this asset class of relatively young, fast-developing companies for those with a positive trajectory and with a big potential for positive change. So, as I say, optimization will maximize the ESG score by overweighting the strong, high scoring companies, will leave some scope to recognise improvement and encourage it via engagement. But, yes, we set a tolerance threshold for entry into a portfolio to exclude laggards or exclude those not yet at base camp, but leave room to invest and monitor others and ideally hasten their advance via engagement. Engagement has to be a core part of the approach. Then, aside from the active decisions and management, there are a series of negative exclusions, whether that's some specific sectors on ethical grounds, human rights grounds, or it's screening out sectors that we consider not to have a sustainable future and this includes norms-based screens, of course, too.

Catherine [00:24:43] What does the future look like in this space do you think Fi?

Fiona [00:24:45] For loans specifically, what we lack is a sustainability benchmark. A class, against which we can judge a loan portfolio on ESG grounds. That will change and we aim to be part of that change, just like we were when the loan market brought in a new index in the early 2000s. But for now, the assessment has to be absolute on the part of a manager, and that means that the approach then has to be founded on a robust overseeing assessment. So, employing the high standards of the best public companies to assess the status of private ones while acknowledging that they're in their revolution. That's it in a nutshell. We cut them some slack for their youth or for their more limited resources, but we still assess them with a framework that knows what good looks like in absolute terms. I think that's only possible for large scale pan asset class international asset managers.

Catherine [00:25:53] Thanks so much for sharing your insights. It's a really important topic and one that is most definitely evolving. As ever, we're keen to continue the conversation with clients and consultants on this so please do get in touch. Thank you for listening.

Disclaimer (bold). Disclaimer. **DELETE ROW above containing logo if the disclaimer falls on first page.** Delete table altogether if it is not needed.