

# SUSTAINABILITY IN PRIVATE DEBT INVESTING



**CREDIT WHERE CREDIT IS DUE**



**BNP PARIBAS**  
**ASSET MANAGEMENT**

The asset manager  
for a changing  
world



## WHY PRIVATE DEBT?

Since the global financial crisis of 2008, interest rates have remained at historically low levels providing investors (in many cases) with negatively real yielding assets that cause attrition of portfolio value over time. With the onset of Covid-19 in Q1 2020 further monetary and fiscal stimulus has been required that have pushed interest rates even lower and led to greater uncertainty and thus volatility within listed markets. For larger institutional investors such as insurance companies and large Defined Benefit (DB) pension funds, where scale and long-term time horizons allow, private credit has become an increasing focus, as long-term bank lending has decreased due to rising regulatory pressure. Estimated to top \$1 trillion in size in 2020<sup>1</sup> the private credit universe is diverse, encompassing investment grade senior private debt such as infrastructure debt and commercial real estate debt through to sub-investment grade corporate lending e.g. SME lending.

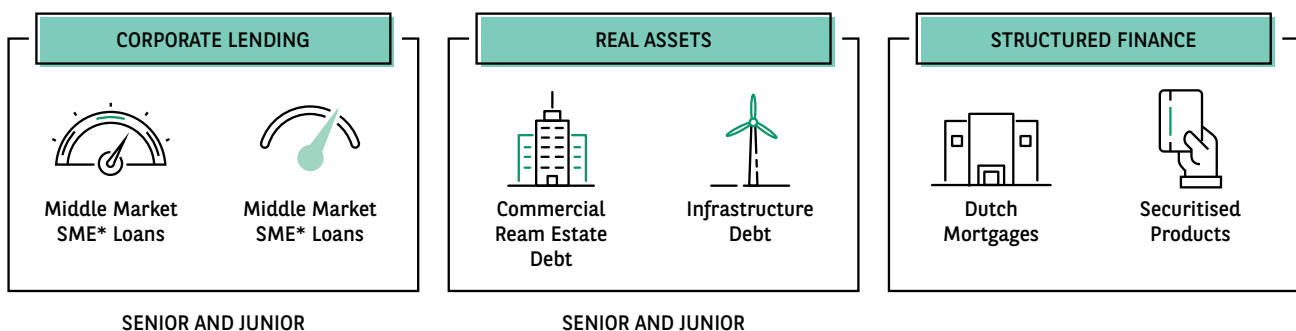
Senior investment grade private debt can be used as a substitute for traditional liability matching assets demonstrating typically lower default rates and higher

recovery rates than equivalently rated listed corporate credit. Many are backed by stable and consistent long-term contractual cash-flows which are marked to model on a monthly or quarterly basis. As they are illiquid and non-listed they tend to demonstrate low volatility despite offering enhanced returns through the harvesting of the illiquidity premia associated with them. This trend toward private credit is now gaining further momentum as innovative diversified private credit solutions have been developed that enable efficient allocation to private credit by smaller institutional investors and segments of the market, such as Defined Contribution (DC) pension schemes.

BNP Paribas Asset Management (BNPP AM) has broad global expertise in originating and managing private credit transactions for institutional investors. A benefit of partnering with BNPP AM in this area is access to a unique dual origination engine that incorporates the expertise of underlying investment teams in addition to the origination engine of the wider A+ rated BNP Paribas Group<sup>2</sup>.

## TYPICAL DIVERSIFIED PRIVATE CREDIT ASSETS

The diversification benefits of private credit stem from their characteristics relative to publicly available credit, the breadth of underlying asset classes available, optionality across the capital spectrum (e.g. fixed versus floating rate, senior or mezzanine transactions) and the geographical (and currency) exposures that can be achieved through investing in global portfolios. The infographic below highlights some of the key asset classes that can be used to form diversified private credit portfolios.



1. How Private Equity Credit Soared to Fuel Private Equity Boom, Kelsey Butler, Bloomberg Businessweek, 22 Sept 2019, accessed 25th March 2020

2. Source: Standard & Poor's - 5 April 2019

## SUSTAINABILITY COMES OF AGE

Coupled with the search for income another key feature of the institutional market has been the rise and evolution of 'sustainable' investing. From its origins as ethical investing, sustainable investing today seeks to embed environmental, social and governance (ESG) considerations into investment decisions fostering more active ownership. Initially focused on negative screening, investors and asset managers have increasingly sought to embed ESG factors within investment processes as it has been proven to add long-term value to investment portfolios. Academic research (Friede, Busch & Bassen, 2015<sup>3</sup>) has long told us that incorporating an evaluation of ESG risk into traditional investments is positively correlated with performance, and that this relationship is stronger the longer an asset is held.

The United Nations Principles for Responsible Investment (UN PRI) were launched in 2006, with BNPP AM among its founding signatories. One objective was to provide an evolving framework for asset owners and asset managers to consider the role of ESG within investment portfolios. The growth of ESG investing can be attributed to the following themes:

- Sufficient empirical data now exists to support the assertion that incorporating ESG risks into financial decision-making processes adds value in the long-term as evidenced by the growth of academic literature supporting the thesis.
- Social media brings into sharp focus key themes such as income inequality that are critical to the inter-generational functionality of the global economy. The issue of inclusive growth has led institutional investors to recognise their social responsibility in considering human rights, labour rights, inequality, working conditions, modern slavery and child labour. In recent years impact investing has come to the fore where investors actively seek investments that have a positive impact on society and the real economy.
- International efforts have increased to address climate change. International agreements such as the COP21 Paris accord, aim to limit the rise in global temperatures to two degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius. This is forcing institutional investors to consider climate-related financial risks within both portfolio construction and reporting/disclosure.

- Climate change is leading to an energy transition from fossil fuels to renewables. Exclusionary principles such as coal and oil have been applied by institutional investors with technological improvements (and regulatory/political focus) creating attractive opportunities across the value chain of renewable energy projects. Increased regulation of these areas is leading to a paradigm shift.
- Other environmental themes include pollution (air, sea, water), deforestation, waste management, resource depletion and biodiversity.
- Governance, since the global financial crisis, has been recognised as systemically important to the global economy. Within fixed income and equity markets issues such as board diversity, executive pay, taxation and bribery and corruption are being challenged. Increasingly governance has also been prioritised by regulators in order to stimulate active ownership and engagement by investors to promote a fairer and more representative/inclusive economy.

Historically, ESG investing was mainly implemented in equity investments but in recent years has expanded to incorporate fixed income markets too. Some areas of private markets such as private equity have adopted ESG practises as they are in an even stronger position than public equity owners to influence the long-term ESG practises of underlying businesses to benefit from the themes and trends highlighted above. So far ESG factors have been less widely adopted by private credit managers. This is in some ways surprising, given the recognition that private debt holders are in many ways in a stronger position to influence the behaviours of companies (or projects) to which they lend than bondholders of publicly traded companies. Less surprising, though, when you consider the challenges to incorporating ESG. More on that later.

The rise of ESG considerations within private credit are also inevitable when one considers the current economic environment and the impact of the themes listed above on underlying asset classes. Within infrastructure for example, OECD<sup>4</sup> nations are increasingly restricted in their ability to meet the burgeoning social, transport and energy infrastructure that is required to sustain economic activity levels. Consequently, the role of private capital through public-private partnerships is becoming ever more critical.

3. Gunnar Friede, Timo Busch & Alexander Bassen (2015) ESG and financial performance: aggregated evidence from more than 2000 empirical studies, *Journal of Sustainable Finance & Investment*, 5:4, 210-233, DOI: 10.1080/20430795.2015.1118917

4. The Organisation for Economic Co-operation and Development

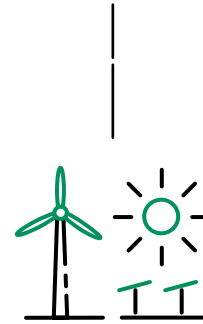
Examples of this have been seen in the US and Europe with sustainable financing of infrastructure projects by both banks (who continue to lend to the sector) and private capital. Such government led projects inevitably occur under competitive tender with ESG benefits of individual projects forming a larger proportion of the assessment of bids, encompassing both societal and environmental considerations, in addition to alignment with sovereign commitments to global initiatives like climate change.

## BNP PARIBAS AND SUSTAINABLE INVESTING

The BNP Paribas Group has been lending to the real economy in the UK for over 150-years. The Group's corporate and social responsibility strategy is aligned with the UN Sustainable Development Goals (the SDGs, launched in 2015) and has four key pillars; the economy, the community, the environment and our people. Activity and operations are governed by the UN Global Compact, ten principles that cover human rights, labour rights, the environment and anti-corruption. In addition BNP Paribas has implemented exclusions that prohibit or limit activity in sensitive sectors. Prohibited sectors where restrictions apply include controversial weapons, coal, tobacco and asbestos. Limited sectors include palm oil, wood pulp, nuclear, mining, unconventional oil and gas and agriculture.

At BNP Paribas there are also numerous examples of how the Group's strategic direction, aligned to the UN Sustainable Development Goals, is having a positive impact on society, such as the funding of renewables, green bonds, social impact bonds and innovation within social housing. In the latter instance, the Group has been actively providing credit facilities to UK housing associations as sustainability-linked-loans (SLLs) where the interest rate is linked to the housing association achieving certain Social Key Performance Indicators (Social KPIs). While supporting the community through the delivery of much needed new homes the SLL is linked to the housing association's ability to find employment for its residents through training programmes.

BNPP Asset Management (BNPP AM) too can demonstrate a long-term commitment to sustainability since 2002 when it joined the institutional investors group on climate



## THE RISE OF ESG CONSIDERATIONS WITHIN PRIVATE CREDIT ARE INEVITABLE

change (IIGCC) and launched its first socially responsible investment (SRI) fund. Since that time, BNPP AM was a founding signatory to the UN PRI in 2006, implemented the UN Global Compact Principles and sector policies of the BNP Paribas Group in 2012, signed the Montreal Carbon pledge to align portfolios with the Paris agreement in 2015 and launched an extensive Global Sustainability Strategy in 2019. This strategy has identified key themes that BNPP AM wishes to prioritise through ESG integrated investment processes and product innovation, namely energy transition, environmental sustainability and equality and inclusive growth.

BNPP AM's sustainability activities are co-ordinated by the Sustainability Centre, which is comprised of 25 ESG experts with a diverse range of industry backgrounds including consulting, advocacy and policy, intergovernmental organisations, non-governmental organisations, investments, sell-side analysis, buy-side analysis and climate change. The Sustainability Centre is responsible for verifying each investment team at BNPP AM to ensure that ESG risks are embedded into their respective investment processes. During 2019 and early 2020, this verification covered all the processes within the Group including equities, fixed income, multi-asset and private debt and real assets.

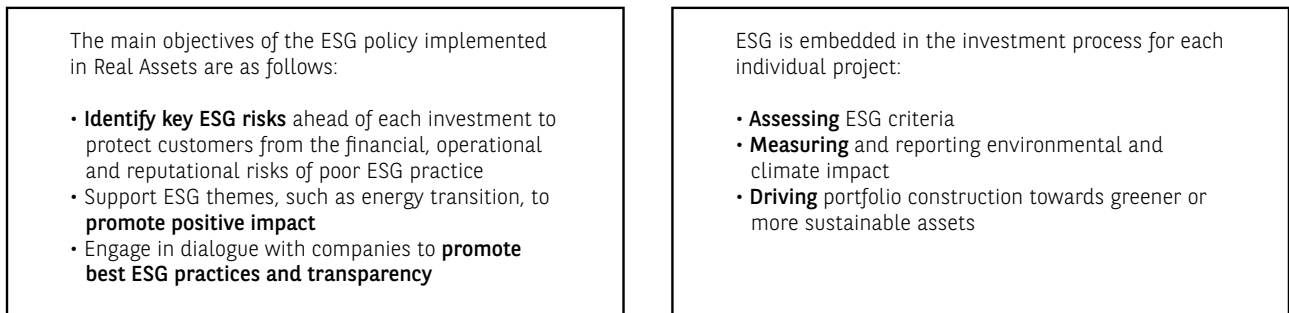
## SUSTAINABLE INVESTING AND PRIVATE CREDIT

*'Nothing in life that's worth anything is easy' – Barack Obama*

As highlighted, across the industry, ESG risks have increasingly been embraced within listed markets but the take up within private markets and in particular, private debt is not as widespread. Why is it not yet standard? Part of the challenge derives from what is appealing about the assets themselves, namely that the underlying asset classes are idiosyncratic in nature. This diversification makes it difficult to apply a standardised process. Assessing infrastructure assets or commercial real estate assets is

quite distinct from assessing corporate lending to small and medium enterprises (SMEs). With respect to SMEs for example, loan sizes tend to be smaller, CSR policies tend to be absent, board diversity may be irrelevant and data is often unavailable. This means customised ESG processes need to be applied within private credit and real assets to ensure a meaningful management of ESG risks. However, as with the UN PRI's guidance of 2019, a framework can be developed that is relevant to private credit. Using real assets as an example, the principle objectives of the ESG policy are shown below.

### Real Assets - a shared framework, with specialist components



The approach aims to identify the issues related to sustainable development, to determine the risks and opportunities that could impact the value of a project and to support sustainable and value creating growth



## A PRACTICAL EXAMPLE - INFRASTRUCTURE DEBT

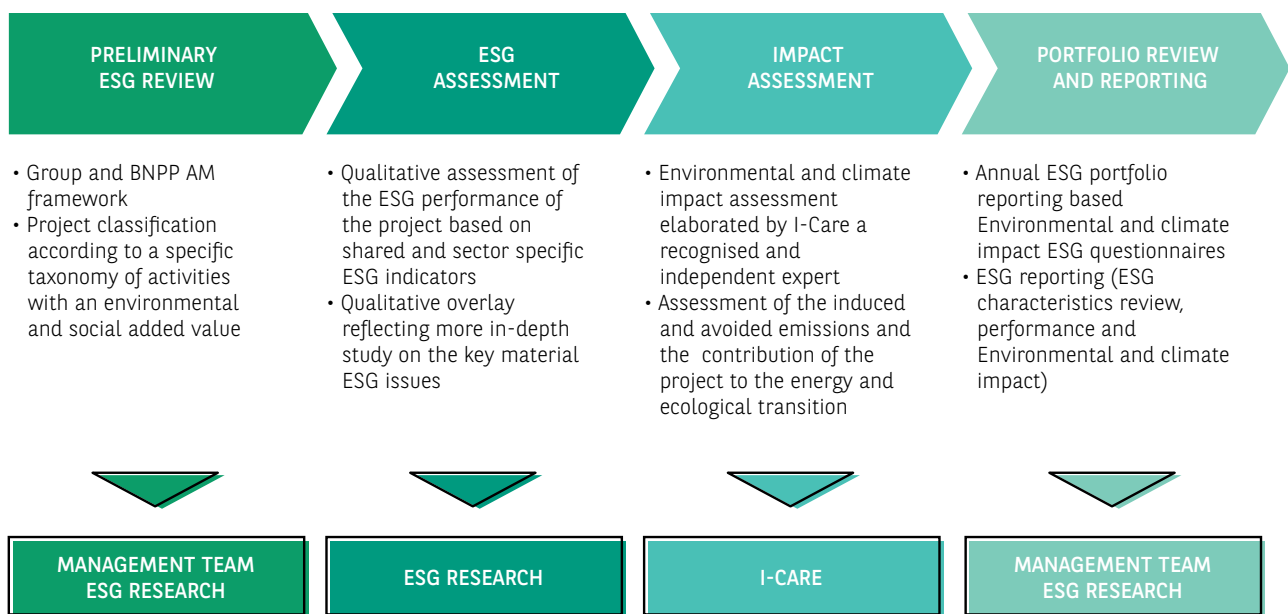
When BNPP AM launched its Private Debt and Real Assets platform, there were no ESG standards to speak of relevant to private credit. Consequently, methodologies using proprietary tools were developed to identify the key risks associated with each asset class, promote ESG practises and transparency and support the key themes that underpin our overall strategy.

Looking at our Infrastructure Debt strategy, integration of sustainability factors is embedded in every step of the investment process. The research methodology is proprietary and developed through close co-operation between the BNPP AM Sustainability Centre, a leader in ESG research, and the Infrastructure Debt team, specialist in assessing infrastructure projects. This positive collegiate and collaborative approach has allowed for the design of a tailored methodology developed to measure the environmental and climate impact of the assets financed, aligning with and complementing the Investment Team's specific investment criteria.

The first step in assessing ESG risks within infrastructure debt involves a preliminary review of the project's sponsor. They are checked against BNPP AM's Responsible Business Conduct Policy to make sure that they are not in violation of the UN Global Compact principles or any of BNPP AM's sector policies. This serves as an assessment of the project's compliance with our overall CSR policy and the sponsor's

compliance with our business conduct expectations. In some instances, portfolios can be skewed toward those sectors that conform with BNPP AM's ambition to promote the energy transition, environmental sustainability and equality and inclusive growth. Examples include waste management, water management, renewable energy, energy efficiency, green buildings, social infrastructure, clean transport and information technology/communication projects.

Once it has been established that a project and its associated sponsor are in compliance with our overall CSR policies, the Sustainability Centre conducts a qualitative analysis (having developed tailored taxonomies) of the transaction leading to an ESG score. These qualitative assessments are based around factors such as climate change, biodiversity, air pollution and a project's impact on local communities. Ultimately, once a transaction reaches the credit committee, the ESG team are able to enforce a veto right preventing transactions from being sanctioned if the overall ESG profile of the transaction is inconsistent with our sustainability beliefs. In recent years, credible independent data providers have worked with BNPP AM to provide scalable climate impact data on emissions linked to construction of projects and their ongoing operation and maintenance. These service providers align each transaction to the two-degree climate change aspirations and provide an additional quantitative assessment of each transaction.



Typically, private debt holders would argue that the equity-owners of individual projects are in a better position to manage and monitor ESG risks. However, engagement with project sponsors at the next stage of the process allows for the verification of key ESG assumptions, engagement on business practises but more importantly (with respect to primary greenfield transactions particularly) the drafting of key covenants, triggers and waivers that are to be embedded in the terms of the loan. One of the attractions of private credit is precisely this, that investors in primary private credit are able to set their own terms to manage the credit risk in order to ensure compliance with key financial metrics. This level of control may include, for example, a provision to block dividends to the equity holders in the event that key financial metrics are breached. In addition, this level of control allows debt-holders to set financial indicators at levels above the level of project default to enable a technical default to require remediation by the equity sponsor. This is one reason why the default rates are typically lower for infrastructure debt than equivalently

rated listed counterparts. It is also possible to incorporate social and operational KPIs at this point in the process, further aligning transactions with BNPP AM's overall ESG policy.

Once a transaction has been structured and reviewed by the credit committee the transaction is sanctioned and the asset enters the portfolio. Both the infrastructure debt team and the Sustainability Centre will continue to monitor both the financial metrics and the ESG characteristics of the transaction to manage the credit risk on an ongoing basis and ensure continued compliance with ESG policy. Ultimately, what is appealing is the control investors have over private credit that makes it appealing and is one reason why covenant light transactions are not sought across BNPP AM's private debt and real assets division. This is particularly pertinent given the market turmoil due of the Covid-19 pandemic. The ability to remediate or restructure transactions give investors the greatest downside protection.

## A CONTRASTING EXAMPLE – UK SME LOANS

The UN PRI have designated SME lending as a form of impact investing due to its stimulative effect on the real economy and direct impact on employment prospects. In the UK there are 5.9 million<sup>5</sup> SMEs, up by 200,000 from 2018. Defined by number of employees (i.e. with < 250 employees) SMEs account for 60% of employment within the UK with 8,000 large firms accounting for the remaining 40%. Within this market segment bank lending has retrenched in recent years as the number of bank branches has fallen rapidly along with the size of teams able to conduct the necessary credit analysis. It has been replaced by direct lending to mid-market companies from institutional investors and private credit funds. Equally at the micro end of the market fintech (<9 employees) solutions have emerged (such as Funding Circle) offering loans on average <£200k.

At BNPP AM we believe there is a market segment that exists above fintech and below typical mid-market lending to mid and large enterprises that is conducted by direct lenders and banks. This under-addressed segment of the market is defined as companies with turnover <£50m p.a.

meaning genuine UK SMEs with a direct impact on the real economy. This positive impact of 'inclusive finance' is diversified both by industry but also by region with 80%<sup>6</sup> of the loans originated supporting businesses in regions outside the London area.

To achieve efficiency, given the smaller loan sizes for these business enterprises, we have digitised and automated the credit process, working with origination partners to ensure coverage across the UK. The loans that are issued to SMEs are fixed rate, amortising, un-secured loans that are designed to complement bank lending products that are typically securitised. This necessitates a thorough analysis of each company's balance sheet, cash-flows and business projections. The default profile of the SME universe has been modelled using BIGDATA technology so the team have a profile of the probability of default that can be utilised as a benchmark when pricing and issuing loans. Because of this some industries are excluded (e.g. restaurants, hotels) due to the cyclicity in the underlying businesses and the higher probability of defaults associated with them. Equally,

5. House of Commons Briefing Paper Number 06152 – 'Business Statistics' – December 2019.

6. Source: BNP Paribas Alternative Finance Team, February 2020



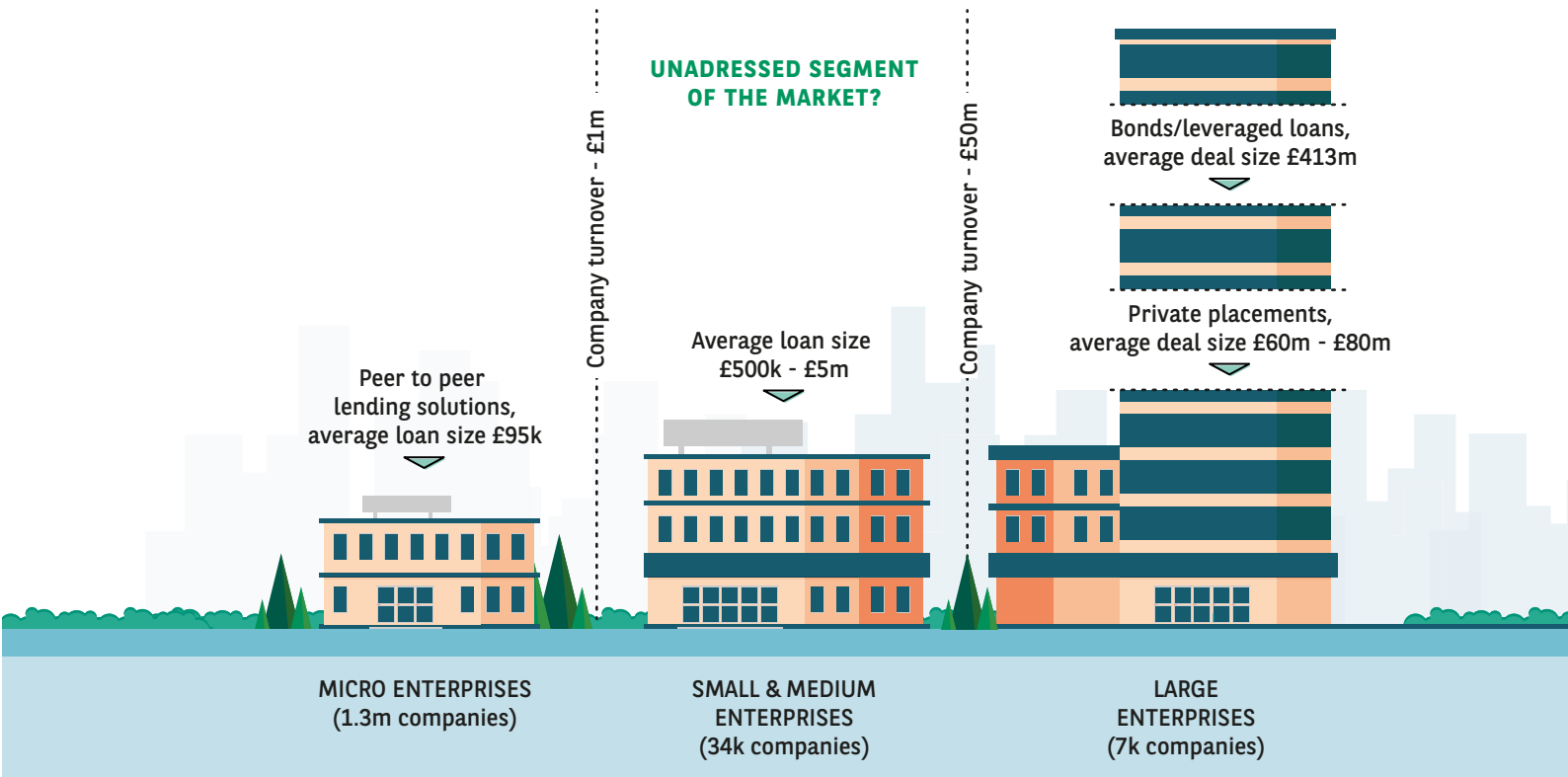
as with infrastructure debt ESG is embedded into the UK SME Alternative Financing team’s investment process and begins with the application of BNP Group principles and exclusionary principles.

To add to this pre-screening of UK SME transactions the Sustainability Centre has worked on an ESG questionnaire that is sent to companies to complete. Within the UK SME market this can serve the purpose of simply bringing ESG issues onto the agenda for these businesses, often for the first time, as genuine SMEs do not typically have CSR policies in place. It gives BNPP AM the opportunity to engage with these businesses, and encourage them to raise transparency and adopt best practice e.g. with respect to health and safety policies, energy usage or water management. For this reason it may also be more difficult to actively embed ESG oriented provisions into the loans provided. However, as credit memorandums are prepared, key financial metrics are monitored in the form

of covenants, triggers and waivers, and over time could be more formally linked to ESG metrics.

As with infrastructure debt, if transactions do not conform with BNPP AM’s Global Sustainability Strategy they will be declined e.g. a recent application from a company whose business was predicated on single usage plastic products. Equally, within the UK SME universe a number of high growth businesses are emerging linked to thematic trends that BNPP AM does favour, such as clean transport, electrification of vehicles, land remediation and assisted nursing. In all cases where loans are granted (and subject to the same approval process as for infrastructure debt described above) SMEs are able to implement growth plans that would not have been financed otherwise providing impact investing metrics such as employment growth that can be tracked and monitored on an ongoing basis.

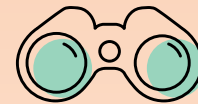
**The Business Funding gap**



Source: The department for Business, Energy & Industrial Strategy – statistical release November 2018

## ESG, PRIVATE CREDIT AND THE CURRENT ENVIRONMENT

The market volatility associated with the Covid-19 pandemic and further reduction in interest rates have once again brought private credit into focus. Private credit offers a solution to volatility as assets are typically marked to model and driven by fundamentals rather than market sentiment. Equally, the harvesting of the illiquidity premia can allow institutional investors to enhance returns and generate positive real returns compared to listed sovereign debt and corporate credit instruments. With interest rates at historic lows this margin comprises an even greater proportion of the overall coupon. There is no doubt that direct lending will see some reduced activity through 2020 as investors re-examine their portfolios in light of market movements throughout Covid-19 management. What is also evident is that opportunities will arise for institutional investors able to take a long-term view. Within private credit BNPP AM favour diversified private credit portfolios (including forms of impact investing) that have flexibility and discretion to be



## OPPORTUNITIES WILL ARISE FOR INSTITUTIONAL INVESTORS ABLE TO TAKE A LONG-TERM VIEW

nimble in identifying these opportunities for clients as they arise. As with traditional listed assets BNPP AM has worked on the taxonomies and methodologies required across the diverse and idiosyncratic private credit universe to enable ESG risks to be embedded into individual investment processes. As with listed markets the incorporation of ESG risks can lower downside risk and allow investors to participate in structural thematic drivers linked to climate change, the energy transition, environmental sustainability and equality and inclusive growth.



## SUSTAINABILITY IN PRIVATE DEBT INVESTING



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