ESG Special

European Direct Lending Perspectives

H1 2019 Review - Issue 3

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ESG not as easy as ABC

Welcome to the third edition of the Creditflux and Debtwire *European Direct Lending Perspectives (EDLP).* In this issue we investigate the environmental, social and governance (ESG) phenomenon and explore how deeply it is affecting direct lending

Mariana Valle
Co-deputy editor, head of primary markets
Debtwire Europe

If Brexit is top of the list for internal discussions on strategy for direct lenders, ESG is certainly closely following behind – and sometimes even ahead – in 2019. From a three letter acronym that was once just part of the lengthy terms & conditions of funds, ESG criteria have become a major influence in investment decisions in today's global investment world.

Direct lenders are acutely aware of restrictions imposed on them by limited partners, who are keen to see their money not only grow, but be put to use on deals that follow their corporate social responsibility policy. The prominence of ESG concerns is such that some managers even publicise their ESG credentials as a selling point.

Regulation has been driving this change, but limited partner (LP) pressure is a major force behind the growth of ESG. Pollen Street Capital's managing partner Lindsey McMurray tells us in this edition that in both Europe and the US, there has been a significant change in the level of engagement by LPs.

Increasingly managers are shying away from deals with any exposure to sectors such as tobacco, alcohol and firearms.

Some managers are taking a step further and signing up to the Principles for Responsible Investing (PRI), which is an international network of investors working to put six clear ESG principles at the heart of a more sustainable global financial system. Funds already signed up to PRI include Park Square, Pollen Street, CreditValue Partners, Capital Four and Alantra.

In this report, we explore how ESG is impacting investing and fundraising in direct lending. Fundraising data shows the European direct lending industry continues to prosper, with an additional €7.5 billion raised in the second quarter, taking total levels in the first half of 2019 to €18.3 billion. If momentum continues in a similar trajectory in the second half, 2019 could turn out to be one of the best – if not the best – years yet for direct lending.

But investors are increasingly choosing to park their money with "best-in class" managers, which is creating a bifurcation in the market, with some managers raising significantly more than others.

Deal activity in European direct lending also increased in the first half, with total issuance at €8.5 billion, up 35% from H2 2018, when it totalled €6.3 billion. And it is up a further 107% compared with H1 2018, when we tracked €4.1 billion of deals.

Unitranche continues to dominate direct lending activity, at 77% of deals in H1 2019. While the number of larger unitranches (above €150 miliion) stayed flat when compared to the previous half (H2 2018), at 17 deals, €5.3 billion was raised compared to €2.3 billion, suggesting the mega unitranche is not a one-hit wonder.

While the growth of the European direct lending market has been exceptional this year, it would appear that valuable ESG factors are becoming a greater factor for both general partners (GPs) and LPs and this can only be a good thing for the industry.

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Creditflux and Debtwire report on the biggest stories in the world of direct lending. Breaking exclusives on funds, launches, strategies and hires make these must-have services for a market hungry for news. The stories here are just a tiny sample of what is on offer

Creditflux News

Pole position for new CEE lending fund

CVI Dom Maklerski, a Warsaw-based private debt manager, is launching its latest direct lending fund focused on Central and Eastern Europe and has received the backing of the European Investment Fund. The Luxembourg-domiciled fund extends senior secured loans to companies with ticket sizes in the region between €2 million and €25 million. It will target returns above 10%.

CVI has mandated Arbour Partners as placement agent to support fundraising. According to James Newsome, managing partner at Arbour, there has been “deep institutionalisation of the private debt asset class worldwide, including the Central and Eastern EU countries.”

Founded in 2012, CVI has about €1.2 billion in assets under management (AUM) across private debt, and has invested more than €2.6 billion since inception. The firm has six funds investing across the capital structure including senior debt, sub-ordinated debt, junior debt, unitranche, mezzanine, restructuring instruments, convertible debt and private equity (PE).

Direct lending team at BlueBay in a spin

BlueBay Asset Management has today announced it is spinning off its €13 billion direct lending platform.

Dyal Capital Partners will inject equity into the standalone business, which will be led by BlueBay’s direct lending team. New York-based Dyal will initially hold a minority 40% stake.

Bluebay’s private debt team has signed a two-year non-compete agreement and management has a four-year vesting period on equity ownership. The eventual plan is to have equity flow through everyone at the new business.

Creditflux understands that the split was partially designed to manage conflicts raised when a company with public securities looks to issue loans. According to a research report by consultant NEPC, the private debt team, led by Anthony Fobel, had been receiving requests from borrowers in this predicament.

As part of the BlueBay brand, these deals had to go to a restricted list or be turned down — and Fobel’s team witnessed more than 15 deals like this in Q1 2019 alone. BlueBay, owned by RBC Global Asset Management, had US$60 billion AUM at the end of March.

Ohio fund backs GSO’s latest Euro fund

Ohio Police & Fire Pension Fund (OP&F) has approved a US$50 million commitment to a direct lending fund managed by GSO Capital Partners, according to notes from its 22 May investment committee meeting. GSO European Debt Fund II is focusing on providing privately-originated senior secured financing to upper middle-market European corporates.

The fund’s predecessor, GSO European Senior Debt Fund, focuses primarily on providing unitranche and senior first lien loans to performing middle market companies with EBITDA between €50 million and €150 million. GSO Capital Partners gained US$1.96 billion in commitments from GSO European Senior Debt Fund.

The US$15.6 billion Ohio Pension fund has invested 2% of its portfolio to credit, versus a 5% target allocation.

Debtwire News

Mid-market documents go large

In May, Debtwire took a deep dive into the rapid erosion of lenders' rights in the mid-market, where documentation today has a distinct large cap feel.

The story revealed how flexibility around EBITDA add-backs is allowing borrowers to adjust not only for synergies, as was common before, but for a variety of initiatives, with the definition of uncapped exceptional items ever expanding. The period in which synergies can be accounted for has also increased to 18 or even 24 months, from 12 months before, with the cap on those increasing to 20% instead of 10%.

Some more aggressive docs also allow borrowers to run-rate EBITDA from new sites on expected returns, and EBITDA cures are now commonplace.

The EBITDA definition flexibility also means borrowers are much less likely to breach covenants, which are now commonly down to just one leverage covenant.

Direct lending co-investments are on the rise

After becoming commonplace in the equity space, co-investment is now on the up in the direct lending market, with some managers saying it is present in around a third of all deals.

Most managers say LPs are becoming more sophisticated, and with that comes more requests for opportunities to co-invest. But GPs are also waking up to the benefits it could bring to them, giving them firepower to go larger, or to mitigate portfolio concentration risk.

A recent example is that of UK telco Daisy Group, which reached the £1 billion mark in the direct lending space, said several market sources. Co-investments appear more prevalent in the larger end of the market, as there is more to go around and some LPs also require a minimum co-investment amount of around €25 million to €30 million, so deals need to be large enough to accommodate that amount.

If co-investments continue to increase, some managers say it could make them even stronger players in the large cap space, allowing many funds to compete with the syndicated market.

Takeover pushes Primonial into the big league

Primonial, a French asset management firm, is the latest company in Europe to reach the €1 billion unitranche mark. Ares is providing the first out, last out (FOLO) unitranche, which backs the company's acquisition by a consortium of investors led by Latour Capital, sources told Debtwire in September.

The deal includes a €200 million first out piece, which is being syndicated.

The deal was upsized twice to finance acquisitions, according to Debtwire Par data, and Ares is again upsizing the unitranche, which represents around 75% of the deal's total financing, according to Primonial CEO Stéphane Vidal – who added that "we are very happy with the deal we have eventually structured."

US giant spies European expansion

Golub, the heavyweight US direct lender, is exploring European shores with a view to starting operations on the continent. The manager, which has over US$30 billion of capital under management, has reached out to several market participants in recent months, sources told Debtwire in August.

It remains a mystery why Golub wants to enter the European market at such a late stage, but sources believe Golub wants to service its US-based clients that are active in Europe with a satellite office.

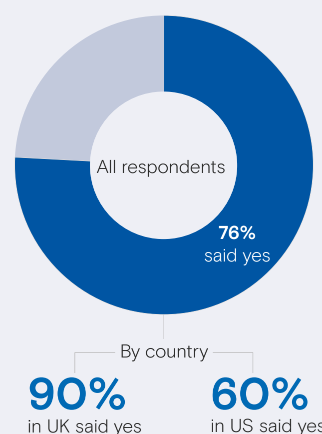
Golub is not planning to launch a dedicated European fund, and will likely instead invest out of its US fund

ESG: A challenging environment

Replies to our survey from 95 respondents in 11 countries show that environmental, social and governance (ESG) investing is growing in importance — but it is tricky for firms to define and implement

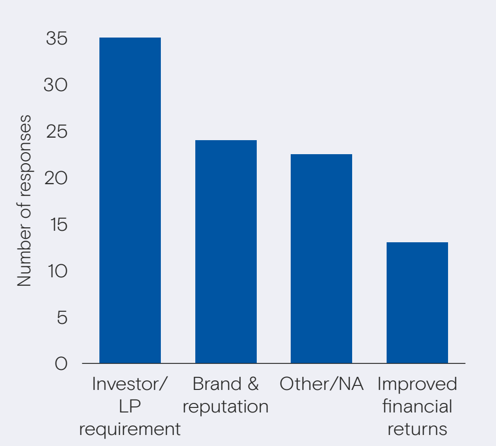
Daniel Davies
Americas fund research manager
Acuris

Have ESG considerations become more important over the past 12 months?



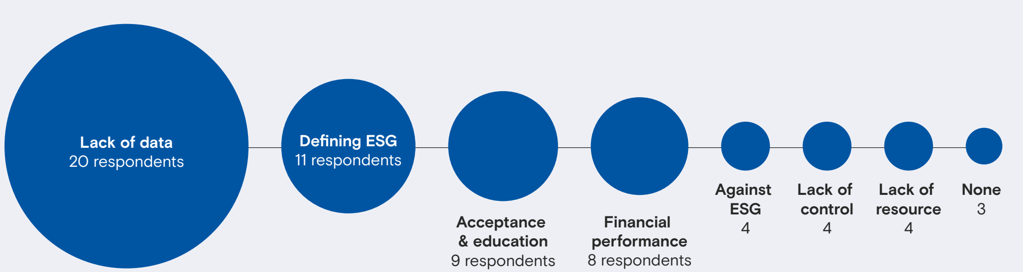
The survey shows that more than three quarters of respondents believe that ESG considerations have become more important in the past 12 months. This rises to 90% in the UK.

What is the main reason for this?



The majority of respondents feel that investors and LPs have driven the growth in ESG's importance. The second most important reason is the firm's brand or reputation.

What is the biggest challenge to ESG integration in your business?



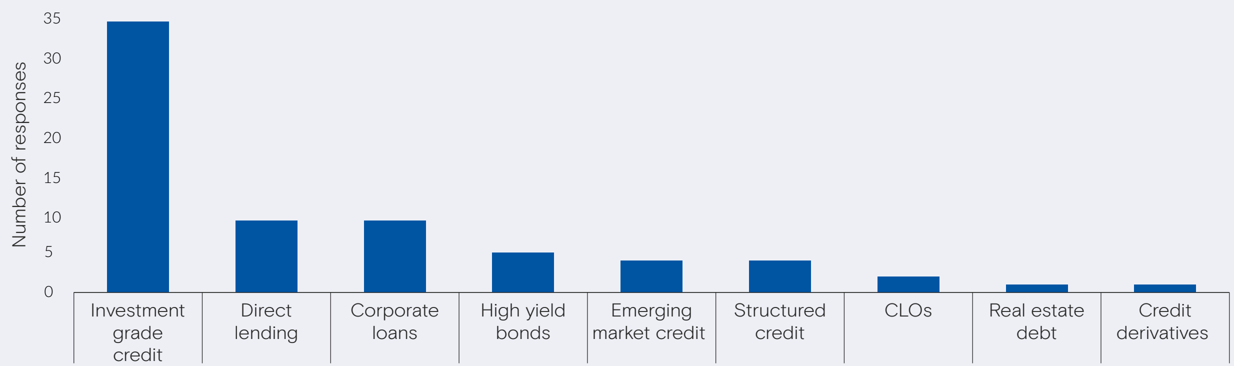
20 respondents (out of 95) – the top answer – feel that "lack of data" was the biggest hurdle to greater ESG integration while 11 believe that "defining ESG" is the toughest obstacle. Other answers include "acceptance and education" and "financial performance". Only 3 respondents said that there are no challenges.

What benchmark or disclosure companies does your firm use?

Benchmark or disclosure company	Number of responses
UNPRI	6
MSCI	4
Sustainalytics	2
TCFD	1
iBoxx High Yield	1
CBI	1
ICMA	1
Morningstar	1
SASB	1
Credit Suisse Leverage Loans Index	1

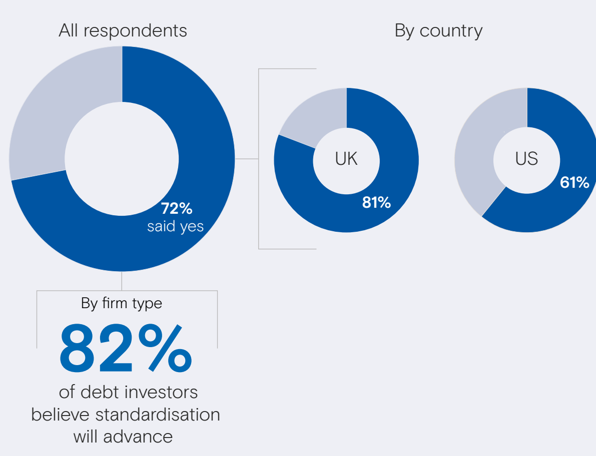
The respondents use a variety of benchmark or disclosure companies but the top two are the UN's Principles of Responsible Investment (PRI) and MSCI.

ESG is most advanced within which area of credit?



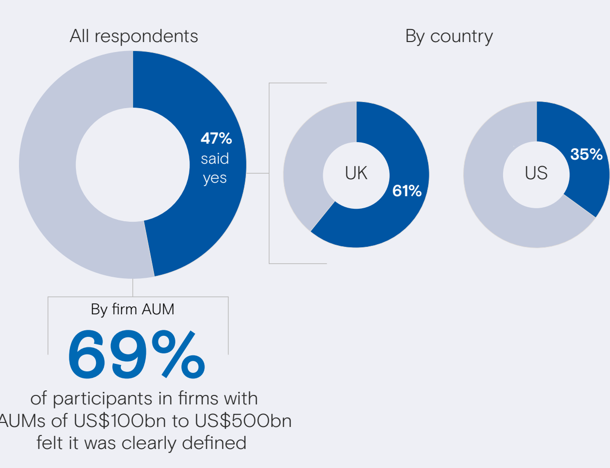
When asked which area of credit has the most advanced ESG, investment grade came out top by a wide margin – direct lending and corporate loans came in second and third.

Will standardisation around ESG reporting advance over the next five years?



Almost three quarters (72%) believe that there will be standardisation around ESG reporting in the next five years – this rises to 81% for UK firms.

Is ESG clearly defined across your business?



Only 47% of respondents say that ESG is clearly defined within their business. This falls to 35% of US companies.

Debtwire league tables

Debtwire's exclusive league tables show the top lenders across Europe, in the key regions and for mid-market and senior debt

Research by Darren Maharaj
Manager of EMEA fixed income data
Debtwire Par

H1 2019 all direct lending deals

Rank	Direct lender	Number of deals
1	Ares	25
2	Pemberton	12
3=	Tikehau	11
3=	Permira	11
4	Neos Direct Lending	10
5=	Barings	8
5=	Bain	8

H1 2019 direct lending senior debt only

Rank	Direct lender	Number of deals
1	Ares	25
2	Pemberton	12
3	Permira	11
4	Neos Direct Lending	10
5	Barings	8

H1 2019 mid-market direct lending deals only

Rank	Direct lender	Number of deals
1	Ares	19
2=	Neos Direct Lending	10
2=	Pemberton	10
3	Permira	9
4=	Tikehau	7
4=	LGT Capital	7
4=	Bain	7
5=	Barings	6

H1 2019 UKI direct lending deals

Rank	Direct lender	Number of deals
1	Ares	19
2	Permira	8
3=	Bain	6
3=	Barings	6
4=	Apollo	4
4=	LGT Capital	4
5=	Rothschild/Five Arrows	3
5=	Pemberton	3
5=	Beechbrook	3

H1 2019 DACH direct lending

Rank	Direct lender	Number of deals
1	Pemberton	4
2=	Kartesia	2
2=	BlueBay	2
2=	Ares	2
3=	Permira	1
3=	Capital Four	1
3=	Ardian	1
3=	Deutsche Bank Direct Lending	1
3=	Apollo	1
3=	Hayfin	1
3=	Bain	1
3=	Apera	1
3=	Muzinich	1
3=	BayBG	1
3=	Alcentra	1
3=	BlackRock Private Debt	1

H1 2019 France direct lending

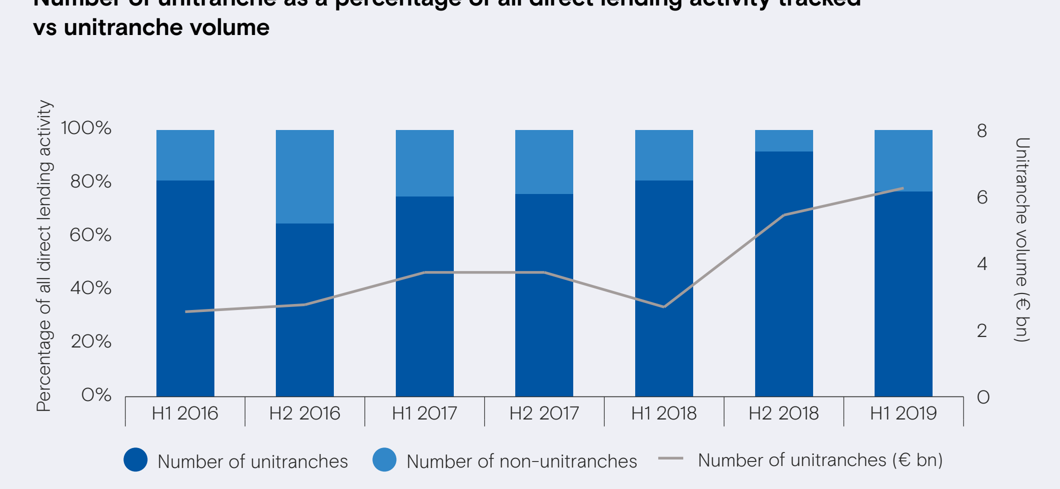
Rank	Direct lender	Number of deals
1	Tikehau	7
2	IDInvest	5
3	Pemberton	3
4=	LGT Capital	2
4=	Barings	2
4=	Goldman Sachs Direct Lending	2
4=	CM-CIC Private Debt	2
5=	Bridgepoint	1
5=	BlueBay	1
5=	Apera	1
5=	Capzanine	1
5=	Rothschild/Five Arrows	1
5=	Cerea	1
5=	Indigo Capital	1
5=	Apollo	1
5=	Omnes Capital	1
5=	Alcentra	1
5=	Permira	1
5=	Ardian	1
5=	Siparex	1
5=	Hayfin	1
5=	Ares	1
5=	CVC Capital	1

Debtwire direct lending data

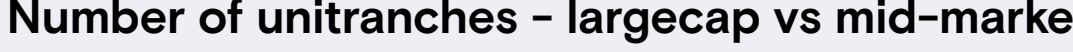
New analysis from Debtwire shows that European direct lending is on the rise

Research by
Darren Maharaj
Manager of EMEA fixed income data
Debtwire Par

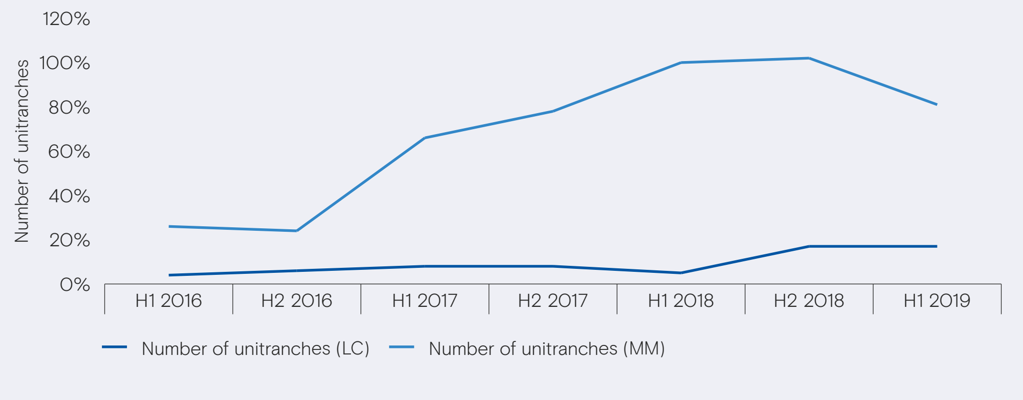
Number of unitranche as a percentage of all direct lending activity tracked vs unitranche volume



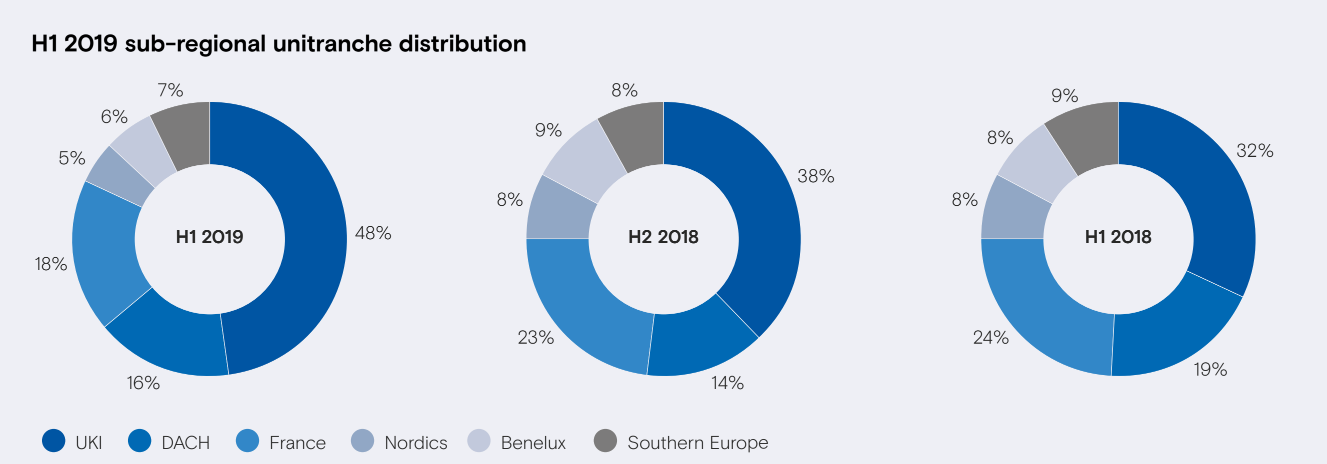
European direct lending activity in 1H19 climbed to €8.5 billion, up 35% from 2H18 (a total of €6.3 billion) and rising 107% compared with 1H18 (€4.1 billion). When we look at the number of deals, however, it has been fairly stable since 1H18 (130 deals), with 129 in 2H18 and 128 in 1H19. Several jumbo direct lending deals have pushed the overall volume significantly up, with Ion's acquisition of global media and data company Acuris at roughly US$1.25 billion, the refinancing of UK's IT and telecoms firm Daisy Group with £1 billion debt package and Irish B2B media business Tarsus's £425 million buyout financing.



Number of unitranches – largecap vs mid-market

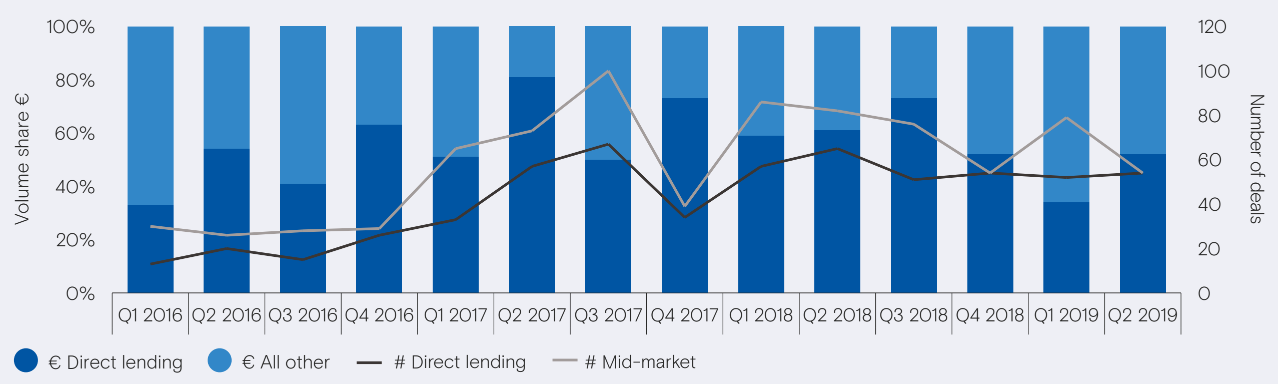


H1 2019 sub-regional unitranche distribution



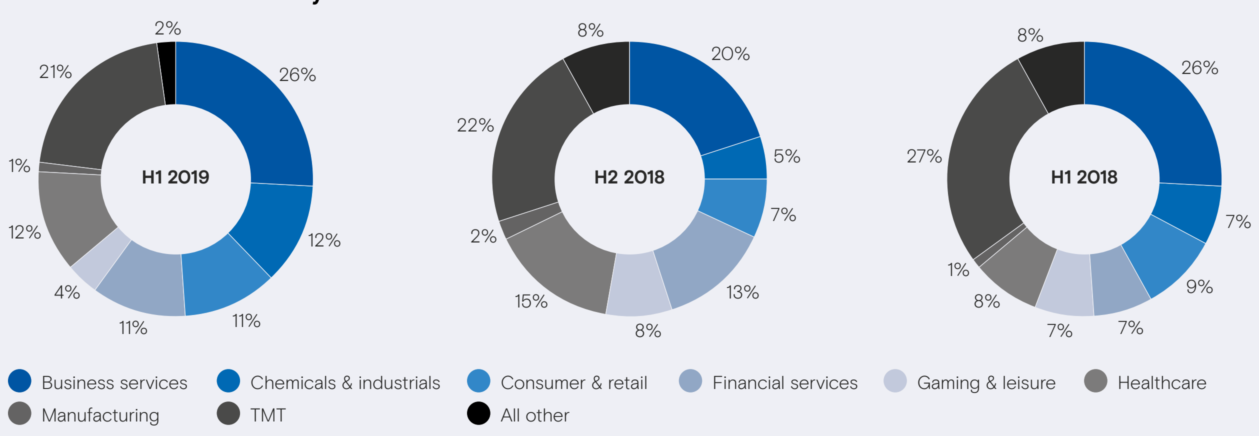
The UK continues to dominate direct lending issuance in Europe, with 48% of the market in H1 2019. Despite a slowdown in activity due to Brexit jitters, direct lenders continue to push for deals in the UK, with some large unitranches contributing to volume in the region. With €18.3 billion raised in the first half of 2019, excess liquidity is spurring further activity despite the uncertain economic outlook.

Mid-market volume vs number of deals



The proportion of direct lending issuance compared to the overall mid market (below €150 million debt) has remained fairly stable quarter on quarter when we look at the number of deals. Volume-wise, the figure is more volatile, with unitranche issuance in the second quarter of 2019 increasing from the start of the year.

H1 2019 sector dstribution by number of unitranches



Business services continues to be the most popular sector for direct lending issuance. At 26%, the share in 1H19 was in line with 1H18, but showed an increase on 2H18, when it took a 20% share. TMT (technology, media and telecommunications) was close behind with 21%, and healthcare and chemicals & industrials both took 12% each.

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ESG in the real world

EDLP investigates how private debt managers factor ESG into their investment process

Michelle D'Souza
Reporter
Creditflux

ESG has become a growing area of interest for private debt managers, with pressure coming from LPs and borrowers alike. While creditors have less of an ability to drive ESG criteria compared to equities (due to lack of control), ESG-related data is perhaps easier to collect on the private market side than public market. Mid-cap borrowers especially offer enhanced ESG visibility and monitoring capabilities. Here we explore how seven firms are figuring ESG into their investments.

1. Kartesia puts safety first

Investor: Kartesia
Company: GroGlass

In 2018, Kartesia provided over €50 million financing to GroGlass, a developer and manufacturer of anti-reflective and high-performance coatings on glass and acrylic. With a high usage of chemicals, employee safety was a key ESG consideration for the investment, according to Gaëtan Valcke, a member of Kartesia's investment team. As part of its investment process, the deal team visited the plants together with their advisor to ensure technical and safety measures were of a high standard.

The team conducted full technical due diligence on GroGlass, adding some energy-saving measures, which are currently being implemented. In 2018 reports from ESG research firm Sustainalytics for Kartesia, GroGlass represented a small part of the funds' carbon emission (respectively 2.8% and 2.4%). The chemicals company also implemented a certified environmental management system and assesses its carbon footprint. Meanwhile, Kartesia maintains seats on GroGlass' board.

As part of the social consideration, GroGlass offered to donate glass to Notre Dame and is investing in educating framers to become better businesspeople.

Kartesia has a corporate social responsibility (CSR) policy that excludes investments from certain sectors such as tobacco and gambling. Technical, environmental and governance due diligence are also carried out and documented in the investment memo.

The firm uses modelling to compensate for the lack of data in the private debt world. This includes working with Sustainalytics to assess the carbon footprint of its portfolios and benchmark this on an annual basis.

In 2019, Kartesia introduced ESG scoring into its investment process. Coralie De Maesschalck, head of portfolio at Kartesia, explained that the firm evaluates each category – the E, S and G – which are then given a low, medium or high rating. This goes into the deal's investment memo. De Maesschalck adds that Kartesia also has a three-page primary deal questionnaire that is filled out by investee companies, including GroGlass, on an annual basis.

2. Northleaf slips ESG into cooking oil investment

Investor: Northleaf Capital Partners
Company: US-based provider of cooking oil management solutions

Northleaf Capital Partner's investment teams aim to identify key ESG considerations for each investment opportunity under consideration. They then ensure that these considerations are incorporated into the diligence, review and assessment of the opportunity, as well as the ongoing monitoring if the investment is completed.

In 2016, Northleaf invested in a US-based provider of cooking oil management solutions to over 27,000 restaurants, grocery stores, hotels, casinos and other hospitality and food service operators. The investment was realised in 2018.

As part of ESG considerations, the company's business model focused on the sustainable recycling of cooking oil into renewable fuel, supported by the Environmental Protection Agency's Renewable Fuel Standard programme. In addition, the company's value proposition included eliminating excessive use of cardboard and plastic packaging.

As part of the ongoing portfolio management process, Northleaf monitors its portfolio companies' ESG matters and reports material ESG considerations in its financial reporting to investors. This includes the overall governance and the ESG policy of the private equity sponsor, social trends toward healthy eating, initiatives to reduce trans-fats from the global supply chain and the adoption of low-oil volume fryers in the restaurant industry.

Through the rigorous due diligence and iterative investment approval process, Northleaf's team validated the ESG risks and opportunities inherent in the investment and determined that the potential risks were sufficiently mitigated by the expected growth in the company's market share, driven by its strong value proposition.

3. Ares employs ESG tests on environmental firm

Investor: Ares Management
Company: RSK Group

In July 2018, Ares Management provided capital to RSK Group, a UK-based environmental consultancy firm, to refinance the business. Its funds committed £200 million in the initial transaction and have since provided an add-on.

RSK works with over 5,000 customers across the oil and gas, energy, nuclear, renewables, transport, construction and public sectors.

From an ESG perspective, much of RSK's work involves environmentally sensitive projects. These projects include contaminated water testing, remediation inspections, and nuclear de-commissioning, among many others.

Ares validated the company's ESG credentials through its own due diligence process, which included speaking with competitors and industry experts, and analysing customer testimonials.

4. Bain backs “strong ESG diligence for better outcomes”

Investor: Bain Capital Credit
Company: KPA Services

In June 2018, Bain Capital Credit provided unitranche financing to support the growth of Providence Equity-backed KPA Services, a leading environmental, health and safety compliance platform, though its unitranche joint venture with Antares Capital.

In KPA, Bain identified a compelling responsible investment opportunity to support a company that provides innovative solutions focused on promoting a safe and productive workplace. KPA helps customers achieve regulatory compliance by tracking metrics and flagging compliance issues, thereby limiting business/safety risks.

The company's main product is safety compliance software that enables control and management of environmental, health, safety, regulatory, and compliance risks.

During the diligence process, Bain engaged experts in the field to examine the importance and complexity of how the company helps customers achieve regulatory compliance. Once Bain makes an investment, the firm's dedicated private credit and industry research team actively monitors the credits. This includes monitoring the company's performance on key ESG metrics on a quarterly basis, regular meetings with the company's management team, participating in lender calls and meetings, and tracking covenant compliance.

“Our partnership with KPA is a great example of Bain Capital Credit's commitment to helping create lasting impact for our portfolio companies,” said Thomas Kolinski, a director at Bain Capital Credit. “We believe strong ESG diligence leads to better investment outcomes.”

5. Nothing negative about MV Credit's ESG exclusion

Investor: MV Credit
Company: The Binding Site

MV Credit funds supported the recent recapitalisation of The Binding Site, a global reagent and instrument provider. The company specialises in the research, manufacturing and sale of medical diagnostic products focused on immunodeficiency diseases.

MV Credit integrates ESG criteria into deal sourcing. “The MV Credit ESG strategy adopts ‘negative exclusion’ of sectors, companies or countries based on ESG criteria and moral or ethical views,” says Helene Barikmo, MV Credit investment analyst.

Two key areas that The Binding Site's business was most exposed to were animal welfare and regulatory healthcare compliance. The team did thorough diligence to make sure that the best standards around animal care were being met.

The quality of the antibodies produced are continuously monitored to ensure the strictest adherence with healthcare regulations. During due diligence, MV Credit researched the FDA approvals going back a number of years and sought management confirmation that there had been no issues.

6. LGT put ESG at the heart of the investment cycle

Investor: LGT Capital Partners
Company: ZyroFisher

LGT Capital Partners provided debt financing to ZyroFisher, a UK-based distributor of cycling accessories. Managing the ESG implications of its supply chain has been a major focus of ZyroFisher's overall ESG efforts.

For its Altura clothing brand, ZyroFisher works with 10 vendors, who operate factories in China, Vietnam, Portugal, Taiwan and South Korea. In managing these relationships from an ESG perspective, the company first focuses on vendor sustainability – ensuring that the vendor maintains high standards of supply chain reliability, service and product quality with a verifiable history of delivering according to the agreed terms.

Another area the firm prioritises is vendor contracts, ensuring that the vendor adheres to ZyroFisher's code of conduct, which requires adherence to the UN's International Labor Organization (ILO) conventions, a safe and hygienic working environment for employees and co-operation with ZyroFisher's audit and inspection practices. Employee welfare is also taken into consideration.

7. Anthilia beats the durum for ESG with pasta maker deal

Investor: Anthilia Capital Partners
Company: De Matteis Agroalimentare

Anthilia Capital Partners excludes companies operating in sectors such as arms, tobacco and gambling as part of its funds' regulations. When dealing with other ESG requirements, fund managers carry out specific analyses during the investment process.

De Matteis Agroalimentare operates in the pasta production sector with an integrated business model which allows constant control of the entire supply chain.

Anthilia BIT and Anthilia BIT Parallel Fund issued a €5 million bond to fund the acquisition and adaptation of a new plant for one of the company's brands. The company and the purpose of the loan were in line with the ESG requirements of the Anthilia BIT Fund, as De Matteis has always invested in projects that create value in the territory and reduce environmental impact.

During the due diligence phase, Anthilia found that De Matteis contributes to the reduction of CO_2 emissions through the reduction of imports of durum wheat from abroad. It also reduces pollutants and greenhouse gases through a co-generation plant capable of producing more than 80% of the energy needed. This confirms the company's constant commitment to a sustainable future.

The company also initiated the "Filiera Armando" initiative, a contract signed by 1,836 farms, which provides a guaranteed minimum wage meaning farmers can cultivate the land without sacrificing the quality of their produce.

In addition, every year, De Matteis draws up a social report where it sets out its objectives, its commitments and the results obtained in terms of ESG. This allows for proper monitoring by external parties including Anthilia BIT.

Fundraising in 2019 on course to be biggest ever

We reveal how direct lending in Europe is hitting new heights this year. Plus a look at how ESG has contributed to a potentially record haul

Paul Tilt
Head of fund research
Acuris

European direct lenders continued to build on the momentum seen in Q1, with an additional €7.5 billion raised in Q2, taking fundraising levels to €18.3 billion in H1 2019 secured across 13 funds.

The volume of closed funds is now higher than four of the past six years, according to Debtwire's funds database, and is on course to challenge the record €32.1 billion raised in 2017.

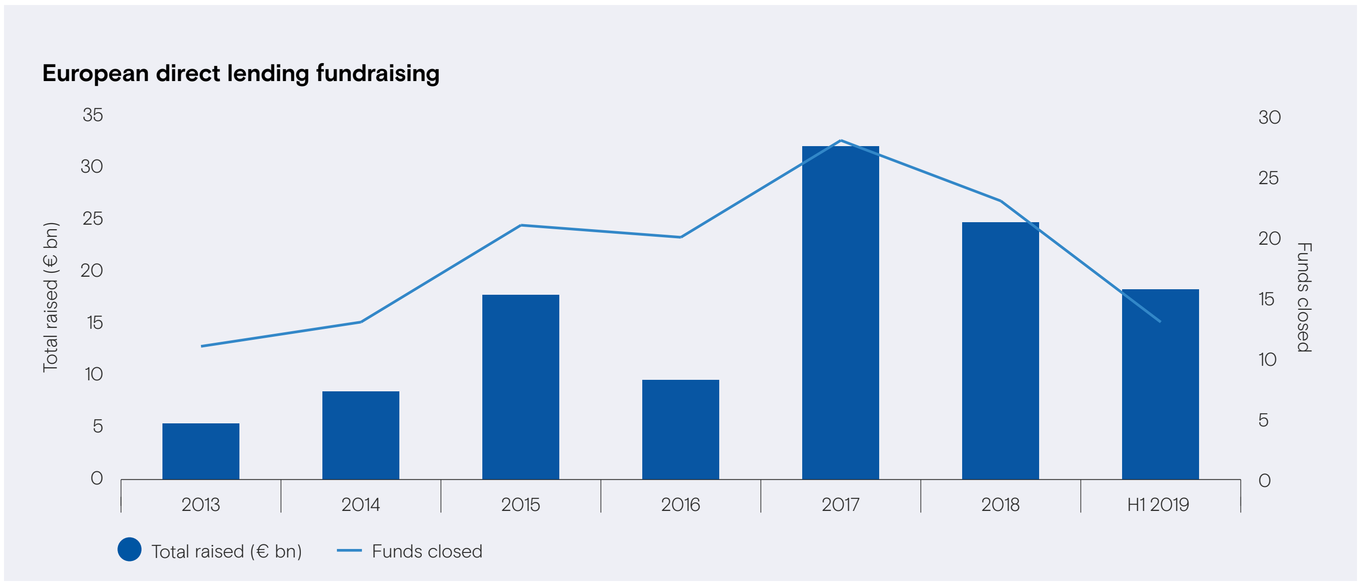
11 of the 13 funds surpassed €500 million, while 7 closed out at over €1 billion. Demand for "best-in class" managers has seen a concentration of capital, with those managers dramatically increasing the size of funds compared to earlier vintages (see table on page 19).

Of note in the period was the final close of Ardian Private Debt IV on €3 billion including SMAs, which is 50% larger than the firm's previous vintage. The fund targets European Mid-Market LBOs, focusing on Western Europe, with a sweet spot for companies with an EBITDA ranging from €10 million to €100 million and EVs of up to €1 billion.

Smaller funds in the market

Although the first half of 2019 was dominated by larger managers securing capital, several firms operating at the smaller end of the market also progressed fundraising during the period.

Tosca began marketing Tosca Debt Capital Fund III, securing a £20 million commitment from the Greater Manchester Pension Fund. The allocation came from the pension plan's impact allocation as Tosca's focus is on supporting regional small to medium-sized enterprises (SME), particularly in the North of England.



Beechbrook Capital launched the €35 million Beechbrook Ireland SME Credit Fund and is seeking to raise €100 million through 2019. The fund will provide senior secured loans to Irish SMEs with a turnover of between €3 million and €25 million.

Meanwhile, Spanish direct lender Talde held a €40 million first close on its debut private credit fund, Talde Deuda Alternativa. Bilbao-based Talde is targeting a €100 million final close for the strategy. The fund will invest in Spanish SMEs, deploying senior, subordinated and convertible debt as well as participative or hybrid loans with five- to seven-year maturities.

ESG is not about ticking boxes

One common theme among managers is the growing importance that institutional investors have placed upon ESG when selecting a fund manager. ESG is no longer a box-ticking exercise, and investors are increasingly demanding better ESG reporting and compliance from their fund managers.

BlueBay's €6 billion Direct Lending Fund III, the largest fund to close in H1 2019, disclosed in its marketing materials that ESG-related factors, particularly governance and compliance matters, are a key element of the due diligence process.

Since 2016, BlueBay has formalised ESG investment risk management within the pre- and post-investment phases of its investment process. In the pre-phase, borrowers are reviewed for potential violations of weapons and restrictions as a result of economic sanctions, followed by nine questions on an ESG checklist – three each for environmental, social and governance. In the post-phase, the manager stays current on ESG news and developments and produces quarterly reports detailing loan developments.

Likewise, Tikehau, which raised €2.1 billion across its fourth generation of direct lending funds (TDL4) in the period, highlighted its approach to ESG is more than a "social media-friendly trend". As well as incorporating ESG considerations into its investment strategy and life cycle, the manager also includes an ESG clause whenever possible in legal documentation.

According to Tikehau's 2018 annual report for TDL4, the 2018 ESG monitoring campaign saw 14 companies respond to most questions, representing an 82% response rate. Additionally, as of December 2018, no TDL4 portfolio companies were involved in the extraction and production of fossil fuel energy.

European direct lending funds closed in H1 2019

Fund Name	Amount Raised
BlueBay Direct Lending Fund III	€6bn
Broad Street Senior Credit Partners II*	$4.4bn
Ardian Private Debt IV	€3bn
Crown European Private Debt Fund II	€1.35bn
Tikehau Direct Lending Fund IV	€1.317bn

The top five European funds that have held a final close in H1 2019. Funds denoted with an * have a broader geographic remit, but can invest in Europe.

Select funds in the market

Fund Name	Target
Permira Credit Solutions IV	€2.5bn
RiverRock Senior Loan Fund I	€1bn
Bridgepoint Credit II	€750m
Hayfin Direct Lending Fund III	
GSO European Senior Debt Fund II	

Select funds that are currently nearing a final close or currently fundraising.

The Paris-based Eiffel Investment Group has gone one step further, launching a "positive impact" fund – the first private debt fund of its kind. Specifically, the manager will encourage borrowers to make a positive impact on the real economy – with dynamic financing in place to take into account whether objectives have been met. As a first step, Eiffel will assign an impact score to borrowers and identify areas for improvement. The second step sees these companies monitored and, if pre-defined criteria are met, the cost of financing may fall. Job creation is one of the factors which Eiffel will monitor as part of its impact investing effort.

A bright outlook for the rest of the year

Subsequent to the end of H1 2019, Alcentra, Barings and Pemberton pulled in a combined €10 billion in commitments, and according to Debtwire's fund database, there are an additional 43 European-focussed funds actively in the market, seeking roughly €25 billion based on disclosed fund targets and analysis on the funds.

Although not all of these managers will close off their raises in 2019, the near term should see Permira and Hayfin round off sizable raises for Permira Credit Solutions IV and Hayfin Direct Lending Fund III. Combined with the €10 billion recently closed, 2019 looks like ending on a high for Europe's direct lending managers.

PRI is just one stage on the ESG journey – not the destination

EDLP speaks with recent new signatories to the Principles for Responsible Investing about their reasons for joining PRI and their views on the future of ESG in the private debt market

Daniel Davies
Americas fund research manager
Acuris

While signing up to the PRI may be a milestone for many managers, it is clear that ESG principles have been intertwined in their investment approach for a much longer period.

"We've always had a great awareness of the value impact of ESG issues and therefore joining PRI hasn't changed our approach," said Andrew Haywood, CFO and COO of Park Square Capital.

For many managers, PRI is just a natural step in a much longer process. As ESG responsibilities become ingrained into firms, PRI has become a way of formalising and verifying those credentials.

"ESG considerations are an important component of our fundamental approach to credit investing," said Adam Kertzner, portfolio manager & senior partner, Oak Hill Advisors.

"Joining the PRI was a natural step to reflect what we were already doing in our day-to-day investment process," he added. "We have always felt aligned with the PRI and our recent joining is a reflection of the continued enhancements to our ESG program."

ESG institutional drivers

On the topic of LP pressure driving take up, managers were in agreement that there has been a strong European influence and that their Nordic LPs had been instrumental in the creation and defining of ESG reporting.

"We have historically seen the strongest demand out of European and UK investors. However, US consultants and pension plans are now becoming increasingly focused on ESG," said Kertzner.

The US may be less advanced in its ESG thinking, but their LPs are catching up quite quickly, said Haywood. "The indexing of US public entities when it comes to corruption and governance is often higher than other countries and this could help to explain why it blows through to investors," he added.

In both regions, there has been a fundamental shift in the level of engagement by LPs. "Long gone are the days of this being a side show or optional extra and last page of a deck," said Pollen Street Capital's managing partner Lindsey McMurray.

A hands-on approach?

When it comes to a firm's approach to ESG, there is technically less control in credit than in equity – either as an owner or a stakeholder. However, that's not to say credit are abrogating responsibility – far from it. "As a debt fund, our key point of control is our pricing and whether to invest or not," said Haywood. "We've seen companies that have a less strong ESG outlook, and therefore deemed to have an enhanced risk, receiving higher pricing from the market," he added.

As ESG responsibilities become ingrained into firms, PRI has become a way of formalising and verifying those credentials.

"We're always thinking about the material risk to profit and reputation and so anything that increases the risk of a hit to those items means we'll price our capital more richly or walk away," Haywood added.

McMurray feels that a firm's culture trumps ownership and equity. "Engagement comes through culture and not whether we own it or not," she says. "We believe that by embedding ESG in our culture and selecting the right credit partners that want to engage in ESG we are able to manage this."

Looking forward

The journey is already underway and ESG considerations and PRI responsibilities will continue to transform the industry and influence more firms to sign up.

Indeed, all interviewees agreed that ESG was here to stay. However, they were unsure of how specific covenants and floating pricing linked to ESG performance would materialise. "You could in theory have covenants based around health and safety that could result in a default," said Haywood.

The market has also seen new instruments introduced. In March 2019, Citibank announced they had issued a sustainability linked corporate revolver to Xylem that would go up and down based on [research firm] Sustainalytics' rating.

Ultimately though, it's about the stance that the firm takes, according to McMurray. "Potential covenants and niche instruments are positive and part of a necessary ESG journey, but the fundamental desire to create a positive impact has to be in a business's DNA."

The class of 2019

Acuris' research of PRI's website has identified the following managers as new PRI signatories since 1 January 2019 within the private debt/credit space:

Park Square Capital	Oak Hill Advisors
Pollen Street Capital	Bridging Finance
CreditValue Partners	Stonebridge Financial
Madison Capital Funding	ZAIS Group
Certior Capital	Alantra
Capital Four	TREA
MGG Investment Group	Balbec Capital
TransAsia Private Capital	Revolution Asset Management

The journey is already underway and ESG considerations and PRI responsibilities will continue to transform the industry and influence more firms to sign up.

ESG is high on investors' agenda but LPs still split over integration

Limited Partners have piled into direct lending funds in recent years as they attempt to generate extra yield. However, their approaches differ markedly when incorporating ESG criteria into the asset class.

Sofia Karadima
LP researcher
and writer
Acuris

The continuing low yield environment has pushed investors to look beyond traditional investments in their hunt for higher yielding assets, resulting in LPs increasing their exposure to alternative investments, including direct lending.

Regulations such as Basel III and Solvency II have restricted the ability of traditional bank lenders to provide capital, and direct lending funds have stepped in to fill the void. As the competition and interest in the asset class has increased, so too has the emphasis that LPs and GPs are placing on integrating ESG policies into due diligence and investment processes. However, depending on an LPs' profile, their approach towards ESG integration can differ markedly.

Some investors have a wait-and-see approach, excluding specific companies or sectors from their portfolio to make their portfolio look "greener" and "responsible investment" friendly. Others go one step further, either prioritising engagement, or by considering impact investing – a term used for investments that deliver a positive impact, while also seeking to generate good returns.

Appetite for ESG integration and impact varies according to region and sector.

"Development finance institutions will focus more on impact investing but to date we have not seen much in the direct lending space – more in private equity," says Filippo Casagrande, head of investments at Generali Investments Partners.

Creating an impact can be more difficult in non-sponsored deals than in sponsored PE deals, according to Anders Bertramsen, head of external products at Nordea Asset Management.

"Non-sponsored companies, which are founder- or family-owned, are not in tune with the ESG themes that are sweeping through the asset management and PE industries. And founders or families can sometimes be a bit more resistant to change compared to PE-owned companies, because sponsors have a more unemotional relationship with portfolio company," Bertramsen adds.

Location, location, location

Appetite for ESG integration and impact investing varies according to region and institutional sector. To date, public pension funds have been earlier adopters of ESG considerations, particularly in Europe, Australia and Canada.

"Nordic, Dutch, UK and French companies may be better prepared to answer certain ESG questions. However, we also notice significant progress in southern Europe," says Casagrande. "We believe that the European directive on non-financial disclosures as well as EU projects regarding sustainable finance will improve the quality of ESG disclosures for all type of issuers."

He adds that when large companies set up a responsible purchasing policy, they contribute to

improving the quality of ESG discloses at small to medium enterprise (SME) level.

LPs based in Scandinavia and the Netherlands, are considered the pioneers of ESG investments, with sources claiming that responsible investing is currently higher on the agenda of European investors than their North American peers. However, others highlight that the agendas differ in terms of priorities, with North American LPs more concerned about diversity, and focusing more on the "G" of ESG, while European investors engaging more on environmental and social issues.

Assessing the E, the S and the G

Laura Vaughan, head of direct lending at Hermes Investment Management explains that there is no difference in approach to risk assessment around E, S and G components but that the underlying risks considered in each component greatly differs. "For example, within environmental, key considerations may include the borrower's environmental policy, safety standards and regulatory or industry body governance," she says. "Social risks that we consider include the national living wage and auto enrolment adherence, equality and diversity policies and minimum hours' contracts. While in governance, we assess items such as the number of independent board members, any ongoing litigation and a corporation's code of ethics."

ESG analysis is considered an assessment of several current and potential risks; it complements traditional investment analysis by assessing non-financial risks which can impact profitability. By gaining understanding of the regulatory, reputational and managerial risks facing individual companies, investors can understand the implications that these risks would have on their portfolios and more effectively manage their investment exposure.

"Institutional investors are becoming more interested and engaged in ESG," says Gregg Disdale, head of alternative credit at Willis Towers Watson. "They realise how important it is for their investments and they expect their managers to incorporate ESG into their investment considerations. Due to the illiquidity in the direct lending space, you need to be confident that the elements of ESG, which are relevant to the loans that you are making, are sufficiently covered in your risk analysis of the credit."

ESG becomes standard practice

As LPs have become more educated within the private debt space, they have also become more sophisticated in their demands towards asset managers in regard to ESG. Having an ESG policy and a PRI signatory are among the key criteria when an LP is searching for a credit manager, according to Niels Bodenheim, senior director within private market at bfinance.

"For LPs, there have been requests for the credit manager to impose sector restrictions, and to lend with a potential impact to benefit society," he says. "If you are lending to a company that needs to improve its manufacturing to make it safer for the environment, this has a direct impact."

Historically perceived as a box-ticking exercise, ESG has now become an evaluation criterion when investors pick a new manager.

"We look for a multitude of things when selecting a new direct lending manager which includes ESG policy, signature to any credible commitment like PRI and ESG implementation," says Bertramsen. "Ultimately, it's not that different from what we would look for in an asset manager of traditional listed equity or fixed income products. The big difference is that the private debt manager cannot rely on an ESG score from MSCI or Sustainalytics, as they don't rate these companies, so they have to do a bit more of the legwork."

Sources also mention that investors demand more granularity from their direct lending managers, especially regarding transparency of investments and origination strategy. "A manager that ignores ESG risks is potentially exposing its investors to a high level of risk," says Vaughan. "Therefore, investors must demand that managers apply ESG analysis as standard best practice."

ESG factors and sustainability are also seen as a risk management tool within fixed income products, including direct lending. Companies with better ESG qualities are less likely to be affected by externalities such as scandals and reputational damage. Companies with a positive ESG reputation are also more likely to attract and maintain better staff, engage in more product and process innovations and enjoy better operational performance.

However, data quality and resources at the company level to oversee ESG developments are among the main challenges in embracing ESG in direct lending. "We need to remind ourselves that the key is for companies to deploy an ESG action plan rather than just answer our ESG questionnaires," says Casagrande.

Is ESG becoming a value driver for direct lenders?

The proof of whether ESG is just a path for good publicity or a sought after investment strategy is found down the value trail. Will direct lenders put their money where their mouth is?

Joelle Jefferis
Senior Reporter,
Debtwire

In recent months, there have been a growing number of deals where ESG concerns have been flagged by prospective lenders, according to Debtwire. Firms in the Nordics, in particular, have been vocal about the significance of ESG. Indeed, at the Nordic Private Equity Summit in June, ESG was at the forefront of conversations.

"In the beginning, ESG was more about value protection, now it is value creation," said one PE panellist. "Around a third of investors had questions about ESG for us, so it's clear that LPs now see ESG as a value driver."

Scandinavian scepticism

Where LPs drive GPs, they will surely drive the direct lenders as well.

One example where ESG concerns have been raised is QleanAir Scandinavia, a Swedish company that manufactures smoking cabins for airports and offices. Despite the company's steady performance and its diversification into different areas including industrial air-cleaning and cleanroom design, the link to tobacco was too strong for some lenders as it could breach their ESG criteria.

Danish surveillance company Covidence also caused concern among investors. The company manufactures miniature video and audio surveillance equipment and customers are mainly military intelligence and the security services. However, due to its confidential nature, the identities of its clients are not disclosed. The nature of the business provoked uncertainty among certain investors due to ESG issues. Eventually, Covidence was acquired by EMK Capital in May 2019.

ESG in Europe

Obviously, ESG issues are not just confined to the Nordic region. In May this year, concerns were raised about prison communications provider Telio, when it was put up for sale by owners DBAG. While its performance was strong with 21%-plus CAGR since 2017 and its long-term government contracts meant clear revenue visibility, the potential to clash with ESG criteria due to its role in prisons gave some potential investors pause for thought.

Certain lenders also raised ESG concerns with UK-headquartered software-testing company Qualitest. With much of its revenues coming from software tests for missiles, lenders needed do deep diligence to understand how the military links would sit with their fund ESG restrictions. Ultimately, the ties were fairly weak, and the solid growth profile of Qualitest won around several lenders. Bridgepoint's acquisition was backed by roughly US$160 million of drawn debt in a first out/last out (FOLO) unitranche from Permira, Park Square and Goldman Sachs with banks coming in for the super senior piece.

From smoking and surveillance to prisons and projectiles, these examples show that direct lenders are taking their responsibilities seriously and that ESG as a value driver is very much entering the mainstream.

“We recently declined a good business opportunity with great management based on ESG reasons”

Paul Shea, managing partner, Beechbrook Capital tells *EDLP* about his best and worst investments, the growth of private debt and his firm’s approach to ESG

Paul Shea
Managing partner, Beechbrook Capital

What is the best investment you’ve made?
Beechbrook made a successful investment in a firm called MDNX (Managed Data Network, now part of Easynet) in 2010. The private equity sponsor was trying to make two acquisitions partially funded through an IPO. Unfortunately, the fund raise was unsuccessful which created an opportunity for us. The vendors were getting anxious and we moved quickly to complete due diligence and provide a mezzanine financing solution. The company went on to perform well and deliver excellent returns for all stakeholders.

And the worst?
In a previous role, we invested in high yield bonds – typically buying to hold. On one occasion, we wanted to reduce our exposure to a name. Unfortunately, the secondary market wasn’t as deep or liquid as we hoped and we didn’t get the price we wanted for the bonds.

Where is the European direct market heading?
In the mid-to-long term, I think we will continue to see the shift from bank lending to private debt in Europe. The private debt market has grown successfully and is complementary to banks’ roles. In the short term, the market is exposed to macroeconomic and geopolitical risks. We focus on the lower mid-market which is impacted more by micro than macro issues. Competition in this market remains limited enabling us to be selective, maintain pricing and documentary discipline.

What is the biggest thing that needs to change about the way your industry does business?
In general, the direct lending market has been hugely successful with lots of companies benefitting from private debt funds providing them with alternative financing solutions. However, increasingly, fund managers are being paid management fees only on invested capital and not on committed. At the margin, I would question what behaviours this incentivises. This may also lead to some manager consolidation and reduced choice in the market.

How does Beechbrook approach ESG?
We have been investing with an ESG mindset for a while now, but we formalised that last year when we signed up to the UN PRI. We recently declined a good business opportunity with great management based on ESG reasons. The firm was in the payday loan sector where they charge very high interest rates. Profits for the business were good but it’s not something that fits with our investment philosophy.

Where are you seeing the best opportunities?
We are aiming to start raising our fourth European sponsored debt fund in Q4, which will be slightly different to previous funds. This fund will have two sleeves – one for senior loans and one for junior loans. PE firms are looking for a wide range of financing solutions – they may not know whether they want junior or senior capital during the early conversations. Previously, most of our lending was subordinated but the Fund IV flexibility will improve our PE proposition. There are also investors that can only do senior or mezzanine, while some can do both. Fund IV will provide a flexible offer to them too. We are also busy completing the fundraising for our UK and Ireland SME funds.

Creditflux/Debtwire 2020 H1 dates for your diary

	Credit Dimensions, *11 March, New York*	The only event for the rapidly expanding synthetic structured credit market returns for the fifth time, gathering all the key players in the tranches and bespokes market for a half day of buy-side led content and networking.
	European Direct Lending Forum, *1 April, London*	The marriage of two long running events will this year combine the best Creditflux content with that of Debtwire into a single conference covering the full life cycle of the European direct lending market.
	Symposium & Manager Awards, *29 April, London*	This global CLO conference gathers 500 senior executives in London for a full day covering both the US and European CLO market, followed by the hotly-contested Creditflux Manager Awards dinner.
	Debtwire Italian Restructuring Forum, *19 May, Milan*	This restructuring forum gathers 200 professionals from Italian distressed investing, workout and private credit communities to provide legal updates on the Italian bankruptcy laws, UTPs and sector opportunities.
	US Private Debt Forum, *12 June, New York*	Whether they call it direct lending, private credit or the middle-market, investors are continuing to pour money into this space. This forum will cover the whole life-cycle of the middle-market, from fundraising to origination to securitization.
	Women in CLOs, *28 April, London* **Women in CLOs,** *17 July, California* **Women in CLOs,** *10 November, New York*	Series of 3 networking events in key markets specifically aimed at women working in the CLO industry. Attendance by sponsor invitation only.

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