Direct Lending Managers Fire Up ESG for Credit Funds

By Tom Stabile

October 9, 2019

Direct lending managers are hopping aboard the responsible investing train, with more demand from institutional investors to apply environmental, social, and governance (ESG) criteria in strategies that directly originate loans for corporate borrowers.

The phenomenon is still at a “pretty early stage” for most direct lending managers and institutional investors, says **Brian Good**, co-head of the tradable credit team at **THL Credit Advisors**, a $16 billion alternative credit manager that recently outlined a new ESG investing framework. “We’re not quite there yet as an industry,” he says.

Corporate borrowers are even less up to speed on the changes, Good says. “They’ll look at the questionnaire and say, ‘Wait, this isn’t a European loan. Why do you want this?” he says.

PennantPark, a $3.2 billion private credit manager, adopted a formal ESG policy at the end of last year that is already paying dividends with investors, says **Art Penn**, founder and managing partner at the firm. “It’s terrific for building relationships with investors,” he says.

Applying ESG to direct lending strategies requires managers to pull different levers than their peers in private equity, which often use their controlling stakes to dictate portfolio company behavior. Direct lending managers instead introduce ESG at different entry points, such as deciding on whether to turn away particular borrowers, or to add clauses to loan documents that encourage positive moves or limit bad outcomes.

Most direct lending managers are playing “catch up” on ESG, especially as they get a nudge from European institutional investors, says **Raelan Lambert**, global head of private debt at **Mercer**.

Even direct lending managers that are applying ESG today are in a more “reactive” mode, tracking data on borrowers across responsible investing criteria, she adds. In many cases, managers that have both private equity and private debt businesses are simply copying their equity-side ESG framework, she says.

But more direct lending investors are asking and more managers are looking into sustainable investing practices, says **Ryan Miller**, partner at **Malk Partners**, an ESG consultant. “It has picked up in the past year,” he says.

ESG criteria should be a natural fit for managers that consider long-term risks in loan underwriting, says **Teresa Cutter**, head of ESG and impact investing at **White Oak Global Advisors**, an $8 billion manager in San Francisco.

“It’s more than a marketing strategy,” she says. “[It] could determine your ability to repay debt or refinance in the future.”

It’s also a critical defensive tool in what is already a very long credit cycle, and particularly useful for lending to companies outside of private equity transactions that may have little ESG exposure, Cutter says.

And it’s still a big point of differentiation for direct lending managers, she adds. “There’s quite a bit of runway for ESG in private debt,” she says.

A straightforward way managers are applying ESG in direct lending is by tracking data on environmental factors at existing borrowers, where statistical information is readily available, Lambert says. “You’ll see more activity now on the post-investment monitoring side,” she says.

Another standard approach is presenting an ESG analysis to borrowers as a jump-off point for more engagement over the life of the loan, Miller says. “They know in many cases they can’t enforce changes, but they want the company to know the lender has an interest,” he says.

That’s one method that White Oak has used to not trip rules preventing borrowers from having too much of a hand in the day-to-day management of businesses, Cutter says. “We encourage them to incorporate ESG at the point we offer a loan,” she says. “And then in a workout or restructuring, we can, for instance, encourage the leadership to seek a gender balance. That's when we have the opportunity to engage or even bring in new leadership."

But ESG tools are less in use at the initial loan underwriting stages, Lambert says. "There will be growth in that front-end activity, but it may take time to make it more scalable across strategies," she says.

In some cases, managers are applying negative screens to not lend to companies involved in high-risk industries, Ryan says.

That's one tool PennantPark has long used and is now part of its formal policy, in addition to regular ESG analyses and checklists, Penn says. "We've always had defensive drivers around reputation," he says. "We're always very cognizant of the behavior of those we finance… We have never financed tobacco or gun companies, as an example."

On the flip side, lenders can also choose borrowers whose businesses promote positive outcomes, Cutter says. "You can support companies whose medical technology improves health and wellness… or companies that have family-friendly work policies," she says.

The rarest tool so far, but one getting more attention, is managers introducing covenants into loans that require sustainable practices, Lambert says. "That's very emergent, where covenants may entail breaches to ESG-related requirements," she says.

Covenants may be more common in mezzanine debt where it's easier for managers to include code-of-conduct measures, says **Ashley Knight**, a private equity and debt specialist at Mercer.

Another tool under discussion is a lender offering borrowers a rebate on loan payments as an incentive to achieve specific ESG milestones, Knight says. "Managers may need to get creative to have influence," she says.

The market is already shifting, with more borrowers getting used to ESG requests from direct lending managers, THL's Good says. "Two years ago, this information was a lot harder to get," he says.

It won't take long for direct lending managers to embrace ESG, much like private equity firms did earlier this decade, Penn says.

"I think it's going to be regular way," he says. "We'll soon see investors asking us to drill down on ESG topics."

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