

EXPERT COMMENTARY

Denham Capital's Sabine Chalopin, ESG director, and Jorge Camiña, partner and head of sustainable infrastructure credit, set out a six-step approach



How debt managers can better integrate ESG

Over the last few years, ESG integration has gained traction, moving from a practice by a select group of forward-thinking private equity investors into the mainstream investment landscape. In part, this shift has been driven by LPs becoming more discerning – differentiating GPs that take ESG seriously versus those that may be greenwashing – but also by increased regulation, such as the recent EU Sustainable Finance Disclosure Regulation.

However, private debt managers are at an earlier stage of the ESG integration journey. From a market perspective, some of the challenges include the general market liquidity and

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competition from other lenders which may be behind in ESG integration. At an asset level, debt managers face barriers to ESG integration due to limited control over a portfolio company and lack of access to ESG data, which often is not covered by third-party data providers, particularly for mid-market private businesses.

Although ESG integration is more sophisticated in private equity compared with private debt, private debt plays a major role in sustainable infrastructure

investing. As a capital-intensive industry, sustainable infrastructure requires substantial amounts of debt at competitive terms, with most projects having more than 75 percent of capex funded by debt. Debt managers can, therefore, have significant influence in driving capital into sustainable infrastructure.

For debt managers looking to invest in sustainable infrastructure, here are six key ESG lessons we have learned from our own experiences.

1 Use frameworks, such as the EU taxonomy, to determine sustainable sectors

How private debt, private equity and public capital markets compare on ESG integration

Investment activity	Primary contribution to ESG integration	Equity vs debt	Private equity	Private debt	Public debt or equity
Sourcing and screening	ESG impact	Private debt and equity and public investors are both in control of the screening and apply ESG screens	High	High	High; limited universe of listed company
Due diligence	ESG risk	Private equity owners are typically in a control position and can drive ESG due diligence to a high standard Lenders have some additional diligence room for ad hoc requests but will ultimately gravitate towards market practices	High; control stake	Medium; lending syndicate	Low; public disclosures
Use of proceeds	ESG impact	Sustainable investments tend to be asset-heavy and financed with a large percentage of debt	High	High	Low; usually secondary trades
ESG covenants	ESG risks	Private equity owners can drive ESG sustainability policies in their portfolios, while lenders will have debt covenants related to compliance with ESG regulations, which tend to set minimum thresholds rather than targets	High	Medium	Low
Reporting	ESG impact and ESG risk	Ability to increase ESG reporting	High	Medium	Low
Investment management	ESG impact and ESG risk	Engagement with management to execute new ESG initiatives	High	Low	Low
Liquidity to exit	ESG risk	Ability to exit an investment promptly upon an ESG risk event	Low	Low	High

Source: Denham Capital

Recent regulations such as the EU SFDR and the EU taxonomy are seeking to enhance transparency and ensure that capital is flowing into sustainable investments. The EU taxonomy differentiates between Article 6 funds, which do not integrate any kind of sustainability into their investment process; Article 8 funds, or ‘light green funds’, which promote environmental or social characteristics; and Article 9 funds, or ‘dark green funds’, which have sustainable investment as their core objective.

This differentiation not only drives transparency but is also helpful in determining whether an investment sector can be categorised as sustainable. While there are teething issues with the EU regulations, we believe that developing frameworks which capture these nuances can help GPs set their sustainable investment objectives.

2 Being sustainable means evolving with the times

Given the fast-moving pace of sustainable infrastructure and ESG, debt managers must be prepared to update existing responsible investment policies to reflect changing standards and regulations. At Denham, we rely on an agile approach, and fully expect that our Sustainable Infrastructure Responsible

“Debt managers can have significant influence in driving capital into sustainability”

Investment policy will evolve over time to remain aligned with shifting definitions of sustainability and ensure implementation of ESG best practice.

3 Bolster your internal ESG resources

To ensure credibility, ESG should be thoroughly embedded within an organisation, starting from the top. ESG should be overseen by a dedicated sustainability professional in a senior management role to guarantee ownership and influence of the organisation’s ESG commitments.

At Denham, we have an internal sustainable infrastructure ESG committee, made up of senior management, our ESG director and an independent ESG consultant. The committee meets on a biannual basis with a remit to review current ESG work and push forward new initiatives.

Analysis

4 The screening and due diligence processes are critical gate posts

Denham's sustainable infrastructure team has a number of years' experience screening investments, with a focus on power/renewable projects. We have recently expanded our screening tool to include three steps: first, assessment against our exclusion list; second, evaluation of EU taxonomy alignment; and finally, identification of material ESG factors. All potential investments are filtered through this screening tool before any further steps are considered.

The screening tool also helps to determine the ESG risk profile of an asset and to allocate appropriate resources for further assessment and due diligence. As the sponsor in equity investments, we often drive the due diligence process, engaging with third parties to conduct due diligence. This contrasts with our role in debt investments, where we may need to rely on due diligence completed by either the sponsor or other lenders.

Having the internal capacity to assess ESG issues offers better insights; the ability to direct knowledgeable query for follow-up, where appropriate; engagement with independent due diligence consultants; and ongoing, active dialogue with the borrower. These advantages allow for a better understanding of the ESG risk profile of an asset and the management team's capacity to manage ESG risks and opportunities.

5 Challenge current ESG covenants in legal documentation

The legal documentation stage is where ESG integration for equity and debt really start to diverge.

In equity investments, legal agreement can include quite detailed ESG requirements with respect to action items, monitoring and reporting. Conversely, legal documentation for debt investments tends to be less

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substantial, including high-level ESG requirements.

Part of our mission at Denham is to work with other lenders and sponsors to move the market to a place where ESG monitoring and reporting, which meets our robust criteria, is the standard.

6 Encourage the use of GRESB reporting

For sustainable infrastructure equity investments, we have a structured monitoring and reporting process, which includes monthly ESG calls, quarterly reporting and – increasingly – making GRESB reporting compulsory for our assets.

The GRESB framework is an important tool to help both funds and assets compare themselves against peers and identify areas of both strength and weakness. The GRESB assessment is

comprehensive and refined on an annual basis, pushing assets to continuously seek improvements in their ESG management and performance.

For sustainable infrastructure debt investments, that engagement is the most effective approach in terms of monitoring investments. For our newly launched debt platform, we will provide training where appropriate and will encourage GRESB reporting at the asset level. We will also contribute to the GRESB Infrastructure Debt Group to maximise the use of GRESB for debt managers.

ESG has moved from being considered a cost to a value driver, and both investees and borrowers are more open to improving ESG practice and participating in initiatives.

Looking forward

Private debt managers have made significant progress in recent years in screening assets, dramatically increasing capital allocation towards sustainable versus unsustainable investments. Now that capital is flowing into the right places, private debt managers must improve ESG engagement, monitoring and reporting. We anticipate that there will be an uptick in the way that debt managers integrate ESG throughout the investment process as markets, investors and regulators alike mandate more robust ESG commitments.

We encourage debt managers to work together towards using common frameworks and tools in the same way that equity investors have over the last 10 years. Now the question is, are equity owners willing to share and covenant to their lenders the same ESG standards and ESG reporting frameworks they already impose on their own investments? Since the bulk of ESG monitoring on assets is already being done by equity owners, we expect that there will be a natural convergence between private equity and private debt. The trend is our friend. ■