November, 2021

Impact Investing in Private Debt: A Five-Point Approach

25 years of ESG

About the authors

Coralie De Maesschalck

Head of CSR & ESG,
Kartesia

Head of CSR and ESG, Coralie was previously Head of ESG criteria at Portfolio Level since joining Kartesia in 2015. Previously, she spent five years in private equity and five years in audit services, including a roles in the development of SRI practices at Inter Ikea. She holds a masters in Commercial and Financial sciences and external audit from the Haute Ecole Group ICHEC in Brussels.

Frantz Paulus

Head of Investor Relations,
Kartesia

Responsible for fundraising and investor relations, Frantz has been with Kartesia since 2016. Prior to that, he set up and headed equity co-investment at Crédit Agricole Private Equity, worked for a family investment office, and practiced as an auditor and due diligence officer for PWC. He is a Chartered Financial Analyst, and holds an MBA from Chicago Booth.

Vincent Compiègne

Deputy Global Head, ESG Investments & Research,
Candriam

Vincent, Deputy Global Head of ESG Investments and Research since 2019, joined Candriam in 2017 as a Senior ESG Analyst. Most recently at AXA IM and Bloomberg, he began his career at ERAFP, the French SRI pension fund. Vincent holds a Masters in Economics and Finance from the Sorbonne.

Introduction

In the world of private debt, impact investing is emerging as a sector in its own right. Does a creditor have sufficient influence to steer a company into a positive social and environmental direction?. Indeed! We believe that at the small- and medium-size enterprise (SME) end of the market, a carefully-conceived approach implemented over time can be effective.

The cost of the loan is the key tool available to a lender. A *meaningful discount on the interest rate* is an effective incentive for meaningful social and environmental improvements. What's more, if the lender is responsible for a sizeable amount of a company's borrowings – as may be the case with an SME – then the incentive is greater still.

Only a material discount, *matched by challenging targets and ongoing support*, will make a genuine impact on society or the environment. At a time when the charge of 'greenwashing' is everywhere, some sustainability-linked loans (SLLs) in public markets have been criticised for offering minimal discounts in reward for soft improvements.

The long holding periods of private loan investors – typically four to five years – make this asset class ideally suited to partnership. A lender can guide a company in creating a positive social and environmental impact, alongside a financial return. The asset manager has time to develop a meaningful impact plan with the borrowing company, and to monitor its implementation over multiple years. The impact made should contribute to one or more of the 17 Sustainable Development Goals (SDGs) of the United Nations.

Given the intensifying interest in sustainable investing and the success of SLLs, it seems apparent that impact elements in private lending will also grow. Over the four years to 2020, global sustainable debt issuance as a whole rose by approximately 45% to $732 billion.[i] While green bonds are the largest and most established sector within sustainable debt, the small SLLs sub-set has grown from virtually nothing in 2017 to $120bn in 2020.

Private debt investors are closer to company managements than investors in traded debt. In some cases, the strategic relationship is very close, with private debt investors even holding Board seats. This provides an excellent opportunity for private debt investing to generate ***meaningful and measurable impact alongside a financial return.***

A Five Point Direct Lending Impact Approach

1. Lead by Example

In contrast to equity investors, debt investors are not owners. The manager of a private debt impact strategy must lead by example -- for instance, by embracing diversity and inclusion, and progressing towards carbon-neutrality in their own operations.

Debtholders may not own companies, but they do provide most of the new funding for expansion and new projects. If the debt markets deny capital to coal miners, new coal mines will be fewer. If green bonds finance new water projects, green bond funding will encourage solutions to the global shortage of clean water. problem. For large companies with publicly-traded securities, one might say that a Responsible equity investor aims to be a good owner and steward, through voting and engagement. One might say that a Responsible debt investor aims to ensure that financing is allocated to companies to pursue sustainable activities. For a smaller company and a direct lender, might the debt investor be both a steward and a capital allocator?

Direct lenders typically have a closer relationship with management than owners of publicly-traded companies. With these Small- and Medium-sized Enterprises, lenders become part of the financing and strategic thinking, offer advice, or even occupy Board seats.

The UN PRI was established with the view that companies with robust Environmental, Social and Governance (ESG) standards are typically better run, both at asset manager level and portfolio company level; have better control over business risks; and ultimately deliver better value. A strong social and environmental commitment must part of the plan.

2. Make a Genuine Impact: Define the Goal, Define the Measurement

Investors, and the press, are expressing justifiable scepticism that in some cases green investing may contain more marketing than substance. To avoid suspicion of greenwashing, asset managers must justify their sustainability claims.

As a first step, the incentives and mechanisms in a private debt impact strategy must meet the broad definition of impact investing.....that is, ***"to generate positive, measurable social and environmental impact, alongside a financial return."***

We believe the key is to design a structure which offers a company a discount of as much as 50 basis points on the loan rate in return for achieving substantial pre-defined social or environmental improvement goals. All too often, public market SSLs offer far lower discounts of 5 to 15 basis points as incentives for actions that make little difference.

With a long holding period of typically four years, a private lender is a partner, and can influence real change at a company. The lender/investor can request a seat on the Board to enshrine its part in ESG or other strategic matters, or negotiate monthly meetings with either management or the company sponsor (typically a sponsor would be a private equity fund).

The Core Characteristics of Impact Investing: Impact and Return

The Global Impact Investing Network (GIIN) defines impact investments as those made with the intention to generate positive, measurable social and environmental impact, alongside a financial return. It defines an impact investment as having four characteristics.

Intentionality: Impact investments intentionally contribute to social and environmental solutions. This differentiates them from ESG investing, responsible investing and negative screening.

Additionality: Investments must achieve an outcome that would not have occurred otherwise.

Measurability: A hallmark of impact investing is the investor's commitment to measure and report the social and environmental performance of underlying investments.

Returns: Impact investments seek a financial return on capital that can range from below market to the risk-adjusted market rate. This distinguishes impact investment from philanthropy.

3. Direct Investing: the Ultimate Engagement

Dialogue and engagement with companies are central in sharing information and best practices. One generally thinks of large shareholders of publicly-traded companies as having influence and direct access to engage with managements, though dialogue, proxy voting, shareholder resolutions, collaborative engagement with other shareholders, or on rare occasions, Board seats.

Consider the position of a private equity investor, or a direct lender. Often, they are a partner as well as an investor. Managements of SMEs often rely on these investors for financial or strategic advice. Direct access to senior management is frequent and close, and Board seats for investors are much more common. These are true partnerships, and close influence.

For direct lenders, especially in impact lending, accessing a company should be easy and regular. A private debt manager should also have access to a range of departments, going beyond investor relations or even senior management to include research and development, as well as company management.

At the outset, due diligence and the full investment and monitoring process must embed ESG analysis to understand where good practices exist and where improvements might be made. That allows the company to understand what risks and opportunities have been identified, and to share in knowledge gained by investors' contacts with other companies. An impact action plan is negotiated with the investee company, with measurable

Sustainable Finance Directive Regulation: SFDR

Implemented in March 2021, the EU Sustainable Finance Directive Regulation (SFDR) was designed to increase transparency into how financial market participants integrate sustainability risks and opportunities into their investment decision-making. In an effort to prevent greenwashing, the regulation introduced a classification system with specific new disclosure requirements.

SFDR Investment Classifications:

Article 6 refers to funds that do not integrate any kind of sustainability into the investment process.

Article 8 covers financial products promoting, among other things, environmental or social characteristics, provided that the companies in which the investments are made follow good governance practices.

Article 9 encompasses financial products targeting bespoke sustainable investments, and applies where a financial products has sustainable investment as its objective and an index has been designated as a reference benchmark.

targets and Key Performance Indicators (KPIs). An example of a targets could be reducing the carbon footprint by 20% over three years, based on a specific measurement such as Standard&Poor's Trucost measure. Another example might be a goal to increase employee diversity by a specific annual increment. Annual KPIs, when met, would trigger a ratchet mechanism to reduce the loan margin by a pre-agreed amount annually. As the private debt market generally lends to small or medium-sized companies, these ESG concepts may be new to them.

The framework for a private debt impact strategy should be twofold. First, the goals, and therefore KPIs, should relate to the UN SDGs which are most relevant to the firm – for instance, a manufacturer might focus on SDG 8 – Decent Work and Economic Growth. Second, the EU's Sustainable Finance Directive Regulation (SFDR) sets out a legal framework for impact funds, which must reach the regulations highest standard, article 9. This framework also requires that asset managers disclose their policies regarding the 'principal adverse impacts' (PAIs) of their investment decisions – in other words, the negative impact their investments have on the environment and society. By bringing greater clarity to the market, the SFDR is reducing the potential for greenwashing.

4. Link Financial and Impact Returns

The debate continues over whether sustainable investing sacrifices investment returns. While some impact investments are explicitly designed to sacrifice some return for greater impact, broadly speaking, ***the impact investment category increasingly targets market or above-market returns.*** Is this achievable? The latest research suggests it is.

"Impact investors seeking market rate returns can achieve them," concludes the Global Impact Investors Network (GIIN).[ii] citing a growing body of evidence which helps refute doubts about the potential of impact investing on performance grounds. The GIIN offered some specific data, stating that "Across various strategies and asset classes, top quartile funds seeking market-rate returns perform at similar levels to peers in conventional markets. In many cases median performance is also quite similar."

For a private debt impact strategy, providing a 50 basis points discount on a loan margin that might typically be in the region of 4% is significant for the underlying portfolio company, but it is not a hugely material reduction in investment performance.

There is a growing ***consensus that ESG investing reduces a company's risk*** by improving environmental and social performance. In the medium term, this logically improves the risk-adjusted return of a portfolio of loans. Anecdotally, there is evidence in Kartesia's private equity portfolios that good practice can improve a company's revenues and growth. For instance, International Cookware Group, which makes Pyrex tempered glass products, is a CSR and health-and-safety leader in its sector. Not only do we believe this reduces risk, but the supermarkets selling Pyrex prefer it to competing products because of its sustainability credentials.

5. Measure and Report Impact

The SFDR provides a list of KPIs for monitoring and reporting – some of them mandatory and others voluntary. These KPIs can be agreed with a portfolio company when a loan is being negotiated. Kartesia reviews those KPIs during the due diligence phase and monitors them on an annual basis.

Social KPIs might relate to the number of permanent employees, the number of female board directors or the number of lost-time accidents at work. Environmental KPIs would be likely to focus on a company's carbon footprint or the intensity of its waste in areas such as water and energy. It is important to select KPIs which truly lead to the desired result.

Reporting those measurable KPIs is also a must. The field of measuring and reporting non-financial results is growing and changing rapidly.

Kartesia and the Five-Point Impact Approach

Lead by Example

Kartesia's own efforts include the Kartesia for Women initiative. Launched in 2020, the program is designed to inspire women to join the private debt industry, especially in investment roles. And, in 2021, the Kartesia wellbeing and energy survey assessed our employee working conditions in the context of the pandemic. Other initiatives include a MBTI workshop, a 360 review, or a leadership training program for all managers. Kartesia has been carbon neutral since 2018, conducting an annual carbon assessment to maintain and share practices.

Make a Genuine Impact

We proactively communicate with the management teams of our portfolio companies to closely monitor critical areas, including cost structures and cash management. Kartesia regularly launches specific initiatives at portfolio level, such as an extensive Covid-19 portfolio action in the second quarter of 2020, or a cyber security portfolio review in the final quarter of 2020.

Direct Investing: The Ultimate Engagement

Dialogue and engagement with companies is central in sharing information and best practices. We hold director or observer positions in over 78% of our portfolio companies. This allows us to engage directly with our portfolio companies as a part of management, participating strategic planning and ensuring that discussions cover ESG-specific efforts.

Link Financial and Impact Returns

An impact action plan is negotiated with impact investee companies, with measurable targets and Key Performance Indicators (KPIs). As members of the UN PRI since 2014, we incorporate the six Principles for Responsible Investment, and incorporate the framework of the 17 UN Sustainable Development Goals when designing our KPIs.

Measure and Report Impact

Kartesia reviews those KPIs during the due diligence phase and monitor them on an annual basis. Reporting those measurable KPIs is a must to prevent 'Greenwashing'. Kartesia includes an ESG section and a SFDR section in all its quarterly investment reporting[iii]. We have also launched an annual Sustainability Report, available on our website.

Forming a Meaningful Business Partnership

Relationships are key to impact investing, both to help asset managers to lead by example and to complement in-house expertise.

Kartesia has been a signatory of the UN Principles for Responsible Investment since 2014, while our shareholder Candriam was a founding signatory. Kartesia follows the six UN PRI guidelines as practical support and as guidance for incorporating ESG risks and opportunities into investment analysis and decision-making. Kartesia strives to be an active member of the UN PRI community, for example, by contributing to UN PRI's first report on the private debt in 2019. Kartesia reports to the UN PRI annually and uses its scoring to benchmark against peers.

Sustainalytics, the ESG rating agency, has performed an annual assessment of the carbon footprint of Kartesia's investment portfolios since 2015. On the company side, Kartesia has been carbon-neutral since 2018, with the help of *Carbonfootprint.com*.

On the private debt impact strategy specifically, Candriam is Kartesia's strategic partner. Candriam, which stands for **C**onviction **AND** **R**esponsibility **I**n **A**sset **M**anagement, is a pioneer in sustainable investing, with 25 years of experience in the area. Candriam helps to perform due diligence, to establish the impact action plan and to define KPIs for monitoring. Candriam's Head of ESG Investments and Research sits on the Impact Advisory Committee of the Kartesia Impact strategy, alongside Kartesia's Head of CSR and ESG, as well as two independent members.

Conclusion:
The Private Debt Model for Avoiding Greenwashing

The shift to ESG and impact investing is a once-in-a-generation transformation of the investment world. Private debt has an important role to play, both as an effective way of investing for impact and a tool for diversification of portfolios.

Important challenges must be addressed for private debt investing to genuinely to result in a positive impact. Private debt as an asset class is well suited to the task, with its ability to reward companies through reduced financing costs. The key is to design and implement a framework that makes achieving a positive impact a fundamental strategic objective and benefit for the investee company.

Looking forward, the EU's 2021 Sustainable Finance Disclosure Regulation is likely to accelerate market growth. By defining investment funds according to whether and to what degree they invest sustainably, SFDR is introducing much-needed clarity. This transparency should provide assurance for European investors who wish to invest sustainably -- indeed, many institutional investors now need to invest sustainably. SFDR should also provide some assurance for the impact community as well.

Asset owners such as insurers, pension funds and family offices have a growing appetite for truly sustainable assets. As we meet them, they tell us how they now have to invest sustainably due to laws such as France's 2019 PACTE[iv] Law, which requires a company to declare its *raison d'être* through social and environmental objectives. There is a growing trend towards companies having a wider social purpose. For this reason, they need to find investment vehicles that are genuinely committed to making a positive impact.

We hope we have helped asset owners understand how impact investing in private debt can contribute to the UN SDGs – with transparency, and without greenwashing!

[i] Source: Bloomberg NEF.

[ii] Global Impact Investing Network. ***GIIN Perspectives: Evidence on the Financial Performance of Impact Investments.*** 14 November, 2017. https://thegiin.org/research/publication/financial-performance accessed 7 October, 2021.

[iii] New since 2021.

[iv] PACTE – *Parcours d'Accès aux Carrières de la Fonction Publique Territorial, Hospitalière et de l'État,* roughly 'action plan for business growth and transformation regulation.'

CANDRIAM
Founding Member of UN PRI, 2006

€150 B

AUM as of
30 June 2021

570

Experienced and
committed professionals

25 years

Leading the way in
sustainable investing

This document is provided for information and educational purposes only and may contain Candriam's opinion and proprietary information. The opinions, analysis and views expressed in this document are provided for information purposes only, it does not constitute an offer to buy or sell financial instruments, nor does it represent an investment recommendation or confirm any kind of transaction.

Although Candriam selects carefully the data and sources within this document, errors or omissions cannot be excluded a priori. Candriam cannot be held liable for any direct or indirect losses as a result of the use of this document. The intellectual property rights of Candriam must be respected at all times, contents of this document may not be reproduced without prior written approval.

The present document does not constitute investment research as defined by Article 36, paragraph 1 of the Commission delegated regulation (EU) 2017/565. Candriam stresses that this information has not been prepared in compliance with the legal provisions promoting independent investment research, and that it is not subject to any restriction prohibiting the execution of transactions prior to the dissemination of investment research.

This document is not intended to promote and/or offer and/or sell any product or service. The document is also not intended to solicit any request for providing services.

KARTESIA

CANDRIAM
A NEW YORK LIFE INVESTMENTS COMPANY