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DNA of a Manager Search:
ESG in Private Debt

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Throughout 2016, innovative ESG-focused pension funds have sought ways to integrate sustainability factors in asset classes where these considerations are not necessarily mainstream.

One such investor is the Environment Agency Pension Fund: their September 2016 search for a private debt manager placed ESG issues high on the priority list, despite the potential challenge of applying responsible investment criteria in this burgeoning sector.

"We were very realistic in our expectations here," CIO Mark Mansley told one shortlisted manager, "recognising that the typical sector mix in private debt limits how material ESG issues are in many cases (except for governance) and that the industry is generally at a fairly early stage on ESG integration. Our approach here is best expressed as responsible." Yet what did this mean in practice?

About bfinance

bfinance is an independent, award-winning consultant that provides investment implementation advice to institutions around the globe. With highly customised processes tailored to each individual client, our aim is to empower investors with the resources and information to take key decisions. The team is drawn from portfolio management, research, consultancy and academia, combining deep specialist expertise with global perspective. bfinance has conducted more than 800 engagements for over 300 clients in 32 countries. The firm is headquartered in London with offices in Paris, Amsterdam, Munich, Montreal and Sydney.

Maximum inclusivity

In September 2016, bfinance conducted a search for a private debt manager on behalf of the EAPF, seeking to allocate £50 million in one or two mandates.

Basic ESG indicators were allocated a relatively low weighting (5%) during the initial suitability analysis, which was used to whittle down a long-list of 19 to a more refined group of 10. That assessment did take account of which managers were signatories to PRI (8 of 19), which had dedicated ESG staff, which adapted screenings for clients, which used external ratings providers such as Sustainalytics and so forth, but with a scoring system that would not preclude managers without these blunt indicators from progressing further. It is appropriate that these simplistic indicators are not given excessive weight. The presence of a dedicated ESG head doesn't necessarily translate into real influence. Membership of relevant organisations does not require a high degree of integration or commitment.

Yet from that point onwards, during the more qualitative stages, sustainability considerations came to the fore. In-depth assessment of each team's practices relative to this investor's requirements proved to be crucially relevant during the later stages.

Mandate at a glance
Net IRR target of 6-8%+, regular income distributions of 6%.
Strategy focus: corporate debt, buy-and-hold. Open to most corporate debt types across senior, unitranche, with limited exposure to subordinated and mezzanine investments.
Predominantly focused on Western Europe including UK but could consider Global.
Duration target of 8 - 10 years.
Investor wishes to represent no more than 25% of Fund commitments.
The strategy should consider ESG sustainability.

Box-ticking versus substance

Deeper scrutiny on the ten managers that reached the second stage of the process revealed ESG shortcomings.
In one case, the firm – one of the three strongest candidates from a pure investment standpoint – held a good ESG rating from the investor's main consultant, despite their poor score on this point during bfinance's initial suitability analysis. Yet they proved to be weak on sustainability issues during meetings with EAPF and bfinance staff. In another example, the manager claimed to be very focused on this area: they are members of many relevant organisations including PRI and possess a dedicated impact team. Yet the reality was less impressive, as Niels Bodenheim, Director of Private Markets at bfinance, explains: "when you dig into the role that the team plays into the process we got a different picture."

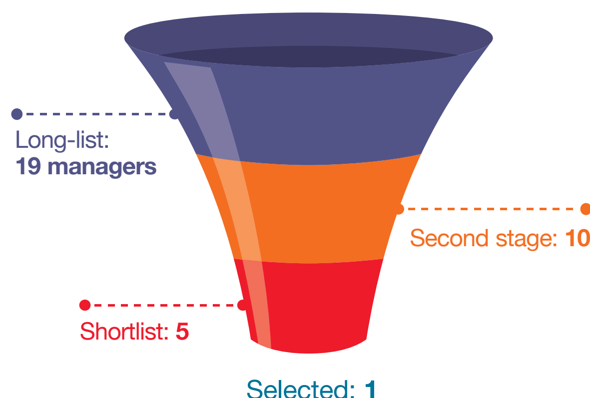
"You need to hear from a range of people," says Bodenheim. "If the ESG person comes and presents then of course you will hear that ESG is fundamental. You need to question the people that are doing the transactions day to day. You also need to hear from the people who do the monitoring. The approach to work-out - how the manager treats distressed situations - is very important with private debt and very much has an ESG dimension: is it consistent with ESG principles, i.e. not fee-generative but really involving working with the companies to make sure sustainability and governance aspects are high priority?"

The winning debt manager, it's worth noting, was not rated by any of the largest investment consultants in Europe. They were also not a PRI signatory, although they indicated their intention to become one and EAPF intends to encourage them in this direction. Aside from strong fundamental processes, the investor felt that their strategy itself - which is very much focused on growth capital - can also be considered societally beneficial.

Range of styles

It would be possible to categorise ESG integration approaches among the 19 long-listed private debt managers into two broad camps, which are not mutually exclusive: early incorporation, where ESG factors are considered during the first phase of screening for deals, and late-stage assessment where they were part of the final approval process.

With the latter, the manager does run the risk of becoming wedded to the opportunity before considering the ESG aspect. Yet the truth is that one approach isn't necessarily superior to the other. "There's always a flip-side," says Bodenheim. "When a firm does ratings - rating the level of ESG risk from low to moderate to high - what's actually done with that information? We have done due diligence



on managers who do deals that were given a high-risk ESG rating by their own process."

Negative exclusion was also practiced by several private debt managers that participated in this search but, as our research demonstrated, these exclusions are not always rigorously adhered to if they're not formalised as part of fund policy. "We have seen managers that refer to or imply restrictions but then turn out - for instance - to have a gaming business in the portfolio," says Bodenheim. If certain exclusions are vital to an investor, due diligence on this point is key.

Read more

Further details on this search including **fee information**, plus insights from other bfinance searches in 2016, can be found in *ESG Under Scrutiny: Lessons from Manager Selection* [December 2016], available at www.bfinance.com. Key themes from the white paper:

- When rating or scoring managers on ESG issues, an approach that is specific to the individual investor can significantly increase the universe of providers from which that investor can choose.
- ESG integration should not, in theory, involve increased fees. That being said, the frequent need for customisation - even among investors that would prefer pooled fund structures - can add an extra layer of cost to ESG investment.
- Culture, attitude and internal organisational conflicts of interest can outweigh formal processes and practices where ESG matters are concerned. Avoid giving excessive weight to signs of commitment that may be superficial.

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