REVOLUTION ASSET MANAGEMENT

THE EXPANDING ROLE OF ESG IN PRIVATE DEBT

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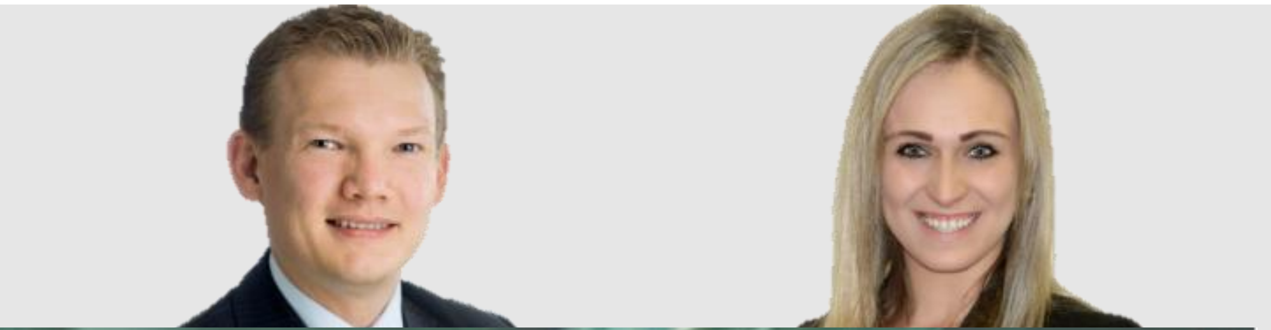
EXPERT Q&A WITH STEVE SUTINEN AND LUCIE BIELCZYKOVA ON THE EXPANDING ROLE OF ESG IN PRIVATE DEBT

The interest in responsible investing within the private debt asset class is mounting as investors seek to understand ESG objectives and outcomes within private assets. Revolution Asset Management's Steve Sutinen and Lucie Bielczykova provide their knowledge and insights into the growing demand for ESG, their investment approach and the role in helping portfolio companies integrate ESG principles.



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What is driving the increasing push to Responsible Investment? Has it become more important for companies to think about risks to, and implications of, their operations when seeking to access capital?

Changes in social and investor expectations have been at the forefront of the drive towards responsible investing. Asset owners are increasingly demanding that their capital is directed to companies that do the right thing, and with that – the expectation that over time – companies and investors that back them will get rewarded.

When private companies seek to access capital, it is often too late to think about ESG for the first time. What society and investors look for is what is embedded in the company's operations, culture and actions.

There is increasing pressure on companies to report on ESG issues such as sustainability and to be aware of, and manage, the implications of risks beyond their own, such as risks embedded within their supply chains.

What does this mean for Revolution? How do you view Responsible Investment?

We see ESG risks as being a core component of overall credit risk. That is, responsible investing is a key component of our investment process and has been since inception of the firm. Revolution's founders recognised very early that ESG principles were quickly becoming key criteria in assessing private companies.

As custodians of investor capital, we recognise that our investment decisions can have a real impact on environmental and social outcomes, and this led us to becoming a Principles for Responsible Investment (PRI) signatory to support this initiative as well as developing our ESG policy to help guide each investment.

Following the recent addition of two more portfolio managers to the team (now a team of five), we have been able to utilise the experience and perspectives to enhance ESG practices. Internally we have 'ESG Champions' that include Steve Sutinen and myself – we are internal advocates for responsible investing principles and keeping the entire team honest about the ESG risks we are accepting into the portfolio.

We want each investment to be reviewed from an ESG perspective specifically to ensure that all ESG-related considerations have been identified and appropriately addressed, by thinking of and asking the right questions. We want to continuously think about what we can do better, what is the next area we can we develop so we live and breathe best practice, because ultimately this strengthens our investment process and outcomes for our clients.

As part of this evolution, we have incorporated several developments into our investment process and rolled out an expanded ESG policy to underpin this progress. We have sought to provide stronger guidance by specifying the factors considered for both Leverage Buyouts (LBO) and Asset Backed Securities (ABS) transactions in more detail, expanded the suite of the tools available to portfolio managers, and broadened our industry-based screens related to fossil fuels.

- Our ESG beliefs are aligned with our investment philosophy and long term process
- ESG risks are a core component of an overall credit assessment
- Adhering to sound ESG principles may improve risk-return outcomes
- Private markets allow for engagement and positive influence

Are there any specific considerations when it comes to private debt?

There certainly are key distinctions that shouldn't be forgotten. The first one relates to addressing "private". We are investing in private markets and that brings certain challenges with it (but also benefits).

Compared to public markets, there is generally limited information available on private companies, the level of public disclosure is minimal, and each deal is unique. Each investment is a bespoke arrangement between the lender or lending syndicate and the borrower, so ESG research must be done on a case-by-case basis and there is no shortcut such as screening based on external ESG ratings.

It is the investor's responsibility to conduct their own due diligence. But the result is that when a portfolio company is endorsed for its ESG practices and passes Revolution's due diligence, it is truly aligned with our philosophy.

The second relates to "debt". There is a fundamental philosophical difference when considering responsible investing in the context of fixed income as creditors versus equities as company owners.

Equity investors are typically focused on ESG in terms of identifying specific companies that will outperform their peers and generate superior returns over the longer term. Debt investors are instead focused on using ESG to identify, and avoid, specific types of risks that could result in their investments incurring losses over the long term by becoming impaired.

How does your approach inform origination, credit selection and loan documentation?

ESG is not a new concept. The risks that are highlighted by ESG analysis have always been a part of assessing the credit, however the formalisation of responsible investing has brought ESG issues into focus and increased their importance.

We think about ESG risks, or opportunities, for each potential investment as we assess each investment on a case by case basis. We consider ESG at three layers, and these layers differ for each asset type.

In case of corporate loans, we first assess the industry through factors inherent in the sector and any relevant mitigants, then we look at the company itself – what they do and how they manage specific risks, and finally we engage during the deal documentation.

Similarly, when we invest in real estate, we consider the real estate asset, its underlying tenants and the deal structure, or for an ABS it's issuer, collateral pool and the terms.

Ultimately, what we are trying to do is to assess the credit risk holistically and to hold issuers to account. If our assessment is that the investment carries higher risk but that the risk is well managed and mitigated, then we will demand higher margin to compensate for it.

Where the risk is heightened and we are not satisfied it has been appropriately mitigated, we simply won't participate in the deal and will decline to provide funding.

But don't get us wrong, it's not just about punishment, we are also open to rewarding ESG-positive behaviour.

It is interesting you mention ABS. Everyone can picture ESG considerations in relation to corporates. But what do you consider in structured asset pools?

When considering ESG issues in relation to ABS transactions, we need to examine risks from three different perspectives.

First, we start with the servicer of the transaction and are primarily focussed on social and governance related issues within its origination and servicing procedures.

We need to be satisfied that the manager is correctly licenced and has strong processes in place to make loans to borrowers in not only a legal but ethical manner. From a social perspective, all regulated loans must be originated in compliance with the National Consumer Credit Protection Act (NCCP) and appropriate validation of a borrower's circumstances, including the suitability of the loan and their capacity to repay, are established before loan approval.

We also need to see that the originator has the systems and processes in place to manage borrowers who enter hardship.

Next, we look at ESG issues related directly to the underlying pool of loans and any assets used as security against them. As an example, consideration is given to potential environmental impacts from climate change events like bushfires, floods and rising sea levels causing coastal erosion. A particularly relevant social concern currently exists around the structural integrity of new build apartment blocks and use of combustible cladding.

Climate change is a very high-profile issue. How do you approach it and manage climate-related risk?

Revolution believes that any actions it takes in relation to climate change need to be science based. This starts with the acknowledgement that climate change is real and if left unabated will have significant impacts on all aspects of society and the economy.

We believe that climate change is one of the greatest challenges faced by humankind, and everyone has a role to play – whether it's a government, a corporate, or an individual.

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Being a detriment to the society, these issues also have the potential to severely impair the value of the collateral underlying residential mortgages.

Finally, we look at the overall structure of the transaction, the quality of the transaction participants including the trustee and backup servicer, and the structural protections embedded within the transaction. The transaction structure can be used to mitigate identified ESG risks by increasing the required credit enhancement or imposing restrictions in the pool parameters governing the portfolio.

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Whilst some climate-related risks are long-term risks, and Revolution's strategy is focused on the medium-term investment horizon which mitigates climate-risk in our strategy, it certainly doesn't mean that's where it ends for us.

It also doesn't mean that we would only invest in green and sustainability-fuelled assets like alternative green energy and so on and completely avoid anything else.

What it does mean is that we raise the awareness, engage with borrowers and demand that they consider how they affect the climate and how it impacts their businesses and what they can do to mitigate those impacts.

Also, reinvestment risk is a key consideration for us. As investors in illiquid loans, we need to think about what happens when the investment nears maturity. We don't want to be left with stranded assets which cannot be refinanced and therefore need to consider our exit at the time we invest. So, we incorporate physical climate risk, transition risk, and the ever-evolving views of the wider investment community and society in our investment process.

Lastly, climate change is not only a source of investment risk but also opportunity. Going forward, we expect more and more "green" investment opportunities to come into the market, given the world's increased focus and investor demand in this area.

You say you 'engage and demand' from borrowers – how does this happen in practice? What role can you play in helping your portfolio companies in integrating ESG principles?

Private markets offer a unique position because we have direct access to the management of our portfolio companies and ABS originators. It allows us to ask questions and get 'under the hood' of how they approach and manage things.

We have the ability to shape terms during the deal documentation stage, and this can be particularly powerful in ABS where we typically lead the deal structuring process. For example, we mentioned earlier our concern around new build apartments – we demand complete exclusion of these collateral types from the ABS warehouses which we fund.

We can incentivise sustainability at the time of the transaction by requiring a higher rate of return from companies, or declining access to capital to investee companies with weak sustainability credentials.

As a lender, Revolution is ultimately concerned about holistically and accurately assessing the credit risk profile of an issuer and mitigating any downside risk. Accordingly, our focus is on identifying and mitigating potential significant incidents that can impact the creditworthiness of the issuer or the underlying collateral pool.

What happens beyond making the loan?

We continue to engage with our investee companies and management during the entire life of the loan. This allows us to stay close to the company from quarter to quarter and promptly assess potential changes in the issuer's credit risk profile.

How do you see ESG momentum developing into the future? Will we reach a point where we do not differentiate responsible investors?

In our view, it will become more and more common to incorporate ESG initiatives into loan documentation.

For example, one of the transactions we have recently participated in has sustainability-linked margin adjustment embedded in its pricing. That is, if the company meets its expected KPI target, nothing happens. If they go above and beyond, they get rewarded for it as their interest rate drops. If they fail to meet expectations, they get punished by having to pay more.

It has been the gold standard in other jurisdictions, particularly Europe for some time, and we are starting to see it come through to the Australian market.

For more information

Visit our website to sign-up to our regular insights or contact Channel Capital - Revolution Asset Management's investment manager partner:

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