

The A-Z of ESG

December 2022/January 2023 • privatedebtinvestor.com

26 ways to approach responsible investing



E X P E R T Q & A

ESG data and KPIs are moving up the agenda in private debt, especially where due diligence and sustainability-linked loans are concerned, say Jason Park, a partner in the Ares Credit Group, and Salma Moolji, European ESG lead at Ares Management



Setting goals and measuring progress through KPIs

Q What steps have you taken to mature your approach to ESG integration in the investment process over the past year?

Salma Moolji: The market right now is volatile and exacerbated by macro-economic factors, which makes ESG more important as a tool for business resilience. We have worked to integrate ESG into our investment processes over several years, creating a pool of knowledge among our 'ESG Champions'.

Now we are in the process of institutionalising that knowledge, taking lessons from markets that have moved faster on ESG, including Europe,

SPONSOR
ARES MANAGEMENT

and adapting those learnings into our global processes.

Our approach has focused on three key areas: sustainability-linked loans, where we focus on measurable indicators that are tailored to the company's overall ESG profile and areas of improvement; KPIs, where we are working to make sure we are calculating more credible and measurable data; and deepening our commitment to more specific and more urgent themes across our portfolio, including climate change and diversity, equity and inclusion (DE&I).

Q How are your investment professionals using ESG data to enhance due diligence?

SM: ESG-related data, while not explicitly defined as such, has been part of due diligence for a long time. For example, traditional governance assessments have been core to our investment process. At a fundamental level, it is used as both a negative and a positive screening tool to analyse transactions that are within our risk appetite and to understand the extent to which our partners and companies are actively invested in ESG.

The story is now evolving towards using that information to engage with portfolio companies, build

“The market is pushing solutions forward, including consolidation of global data standards, converging on clearer metrics, language and methodologies”

JASON PARK

relationships and drive more meaningful conversations. We want to be a strong voice in collecting more quantitative metrics, engaging with peers and helping move forward standardisation.

Q How are you helping to improve ESG performance in your portfolio companies?

Jason Park: Ares supports private equity sponsors with long-term capital. Our capital represents a material part of the overall capital structure, often as much as 50 percent. Because of this, we believe we have the opportunity to promote change within many of our portfolio companies.

Our approach might include providing our internal ESG team’s experience to help portfolio companies and private equity sponsors set up their own policies and frameworks. We know there are quite a few sponsors and companies out there that are very early in this journey relative to Ares.

We are also pitching and investing in sustainability-linked loans, where we are seeking to increase our participation. We seek to drive ESG improvement through ongoing monitoring of ESG risks that we identify either up-front or through the life of an investment.

Q How do you see the EU’s Sustainable Finance Disclosure Regulation changing the market for ESG data in private debt?

SM: Regulation is trying to address a lack of transparency and confusion in the market around ESG, to some extent with a targeted focus on ESG data. The efforts we see with SFDR are echoed by investors, who want to focus on Article 8 funds and get behind that initiative. We are committed to demonstrating transparency, and we understand the demands for operating in this environment.

Most of our new funds are Article 8 light at minimum and are meeting the ESG standards described in the regulation. But SFDR is driving a data collection effort, and we are working to meet that regulatory need through enhanced KPI collection.

In addition to encouraging greater transparency, this should also lead to information sharing and insights that can help improve ESG in portfolio companies. Ares has always leveraged data – and the scale at which we can collect it – to inform and improve our practices, and we intend to do the same with ESG-focused work.

Q Last year you reached a major milestone with your £1 billion (\$1.2 billion; €1.1 billion) sustainability-linked loan to British environmental and engineering services provider RSK Group. Can you explain the defining factors of sustainability-linked loans compared with green bonds?

JP: The defining feature of green bonds is a use of proceeds test, where the money raised must go towards an environmentally-focused initiative.

Sustainability-linked loans are differentiated by their potential scale and impact. Instead of a use of proceeds test, these loans have a margin adjustment benefit – and sometimes a penalty – based on the borrower achieving agreed upon KPIs. Those KPIs can be anything across the ESG spectrum, including, for example, reducing carbon intensity, improving employee diversity, closing the gender pay gap or improving workplace health and safety.

In addition, almost any company can be eligible for this type of loan because all companies have room for improvement, and the potential list of KPIs can be vast and specifically tailored.

Q Since the RSK deal, how has your approach to sustainability-linked loans evolved?

SM: The RSK deal was a watershed transaction for Ares, and we have become much more efficient at scaling sustainability-linked loans, both in terms of the variety of investees and across geographies. We have done transactions in Europe, the US and Australia, with a diverse range of companies. We believe there is strong demand for SLLs as we seek to continue building on the momentum we’ve achieved.

We have learned we need to have a deep dialogue with companies to set sustainability performance targets and make sure they are business-specific and meaningful. As Jason noted, we have also found two-way margin adjustments work well for making sure we have transparency and accountability.

Q What are the main challenges or roadblocks you see ahead for ESG data? And what are some of the solutions?

JP: I believe our greatest challenge is that we are primarily servicing mid-market borrowers, and many of



“ESG-related data, while not explicitly defined as such, has been part of due diligence for a long time”

SALMA MOOLJI

them are earlier on the ESG curve than public issuers and larger companies. They might lack formalised internal ESG functions or policies, and they may not easily be able to collect the data or calculate KPIs – or at least do so in a cost-effective way. Private equity sponsors, too, are at various stages of maturity.

The market is pushing solutions forward, including consolidation of global data standards, converging on clearer metrics, language and methodologies. There are more and more software vendors that help collect this data and provide portals for borrowers

to roll up the data and use it to support management teams.

Ares has dedicated resources to provide guidance and experience to help portfolio companies work through the specifics of calculating and monitoring KPIs, while collaborating on the evolution of ESG strategies.

Q What international ESG standards or industry initiatives are you actively contributing to in order to drive improved maturity to ESG KPIs across the industry?

SM: This is a very collaborative space. Many of the GPs and LPs we work with are asking businesses for this information and diverging requests can create a major drain on resources for portfolio companies. In an ideal scenario, there would be a consistent set of criteria that everyone could use, which would provide strong alignment in the positive outcomes we seek to achieve.

We think it is important for us to lead the way where we can. For example, we chair the new Private Debt Advisory Committee of the UN Principles for Responsible Investment (UN PRI). We are also supporting and participating in other initiatives more focused on specific ESG factors, such as the Initiative

Climat International’s private equity working group, ILPA’s Data Convergence Project and the Partnership for Carbon Accounting Financials (PCAF).

We have also aligned Ares’ reporting with the Task Force on Climate-Related Financial Disclosures and produced our inaugural *Climate Action Report* in 2022. We are practising what we preach by collecting data on our own practices across a number of ESG criteria. We believe this improves our ability to understand the challenges and collaborate with and support portfolio companies, GPs and partners as we share this important journey together.

Q As a lender, how do you plan on incorporating the increasing focus on climate commitments in your portfolios?

JP: We have three focus areas. First, we are working on a top-down carbon footprint estimate across our portfolio to establish a baseline. We are starting that process in a subset of companies in the US and Europe and then plan to roll it out across the portfolio.

The second element is collecting actual emissions data and decarbonisation targets for our portfolio companies. We are using software vendors to help and are doing pilots with a small number of companies to see what responses we get and what issues we encounter. Again, we will use those learnings across the portfolio over time.

The final focus is on the use of sustainability-linked loans as a means to continue engaging along the way. We think that’s a differentiated tool that creates immediate incentives for borrowers to improve their environmental impact and to build out their data collection capabilities. This is an exciting time for everyone, and we are very focused on realising the potential benefits of this work. That said, we recognise that we are still in the early stages of these efforts and will continue to refine and enhance our approach to optimise our impact. ■