



Benefit Street Partners & Malk Partners examine

# ESG Integration in Private Credit

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As the private credit investment landscape continues to evolve, there is no doubt that environmental, social, and governance ("ESG") initiatives will continue to grow in prominence. To be successful in the near future, investment managers will need to establish repeatable and scalable investment processes with integrated ESG principles that can identify and support companies with sound ESG fundamentals.

At Benefit Street Partners, we believe that a robust credit underwriting and monitoring process, with integrated ESG investment criteria and policies, enhances a private credit manager's ability to make more informed investment decisions. Partnering with an independent ESG specialist to co-diligence opportunities ensures process efficiency and unbiased findings, resulting in expert-level ESG analysis and better investment decisions. By combining our respective areas of expertise, we believe that more candid and informed conversations can occur between sponsors, management teams, and investment professionals. Ultimately, the integration of an ESG program into a manager's investment process should lead to better outcomes for both the manager and its investors.

This paper seeks to demonstrate how traditional financial diligence and credit underwriting, paired with an independent evaluation of ESG criteria, will strengthen the investment process and lead to better decisions. We believe embedding ESG into the private credit investment underwriting and ongoing monitoring processes reduces downside risk, and lays the groundwork for a future of potential ESG value creation.

Public and private equity markets have numerous ESG ratings databases and benchmarks – all of various sophistications and maturities. However, the existing coverage of private, middle-market companies by established databases is cursory. Private credit managers are leading the charge and making substantial investments in order to create better ESG data through asset-level evaluation. This allows the manager to adequately assess the ESG risks and potential value creation opportunities. Furthermore, this has the effect of advancing and enhancing the quality of data collection for the future. The resulting analysis is unique to each investment and yields custom insights that have the potential to affect underwriting outcomes. We will highlight these outcomes in case studies throughout this paper.

In the future, we anticipate ESG programs will continue to evolve across the private credit landscape, including: new sustainability frameworks, technologies, and key performance metrics; all fostering the intention of becoming more socially responsible investors. The private credit market has lagged the public and private equity markets in these initiatives not only because of the aforementioned ESG data challenges, but also because private credit investors have been bound by the scope of the equity owners' objectives. As we dive into these ideas and the application of these efforts, we do so with the awareness that, as an organization and as an industry, we are actively setting the standard for establishing best practices in private credit which will put private credit managers in a position to drive sustainable outcomes.

**Benefit Street Partners has engaged Malk Partners, a third-party consultant and leading advisor to private markets on both ESG and Impact Investing. Malk supports ESG analysis for original underwriting on relevant investments. Additionally, Malk provides advisory services at the firm level for effective integration of ESG practices across all of our verticals.**

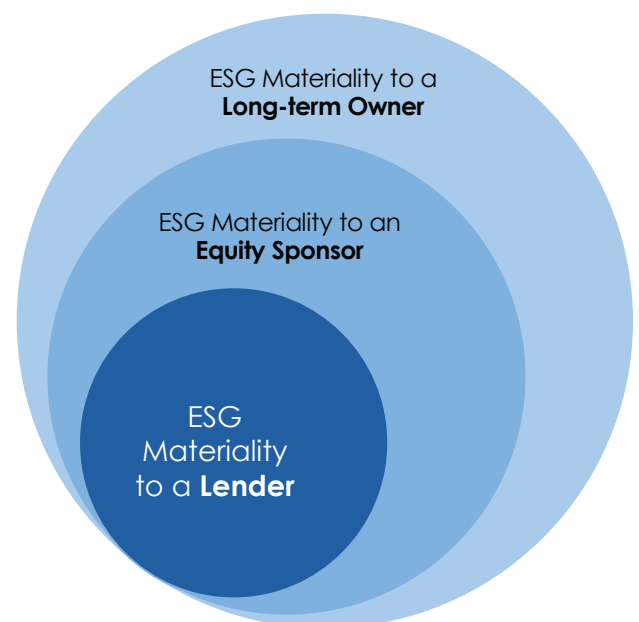
## ESG Philosophy in Private Credit

Given the return profile of private credit investments, underwritten returns tend to have a more structured (and predictable) set of outcomes as compared to private equity investments. Robust ESG policies support risk mitigation by encouraging private credit managers to invest in companies with lower likelihoods of encountering company shortfalls through errors around poor governance, environmental negligence, diversity challenges, and other operational deficiencies.

It is expected that the risk tolerance threshold for ESG issues across financial and reputational matters will differ depending on the stakeholder. In other words, an investor's position in the capital stack and level of operational control determines whether the same ESG risk surpasses the stakeholder's risk tolerance threshold.

	Long-Term Owner	Equity Sponsor	Lender
<b>Financial Materiality:</b>	Issues with potential to affect revenue or cost-structure now and in the future	Issues with potential to affect revenue or cost-structure now, beyond investment thesis thresholds	Issues that affect issuer's ability to generate cash flows necessary for repayment of loan
<b>Reputational Materiality:</b>	Potential to receive stakeholder scrutiny inclusive of calls to change strategies or managers	Likely to be mentioned in news coverage of a major incident and potentially held accountable by regulators and/or LPs	Possible to be mentioned in news coverage of a major incident and may have to address LP concerns

Importantly, this ESG philosophy is not an expectation or justification to change fundamental investment criteria. Rather, it is focused on bringing additional information to light on potential ESG risks for a prospective portfolio company. If that information changes the investment decision for the private credit manager, it is because the information uncovered during ESG diligence, combined with any other credit risks, breaches the investor's previously defined materiality threshold for risk. Additional ESG practices are not intended to arbitrarily reduce the investible universe, but instead enhance the existing investment process.



ESG risks and opportunities are rooted in the operations of a company, whereas impacts are driven by the products and/or services offered by the company. Malk's analysis typically focuses on ESG risks and negative impact issues that are material to a private credit investor which may affect an investment decision or subsequent investment monitoring. Products and portfolios focused on ESG opportunities or positive impacts within the credit space are still developing and will be an area of increased future focus.



Due to the limited level of control private credit managers have over portfolio companies, current ESG strategies implemented by managers are designed to present a form of downside risk protection. Many credit managers have identified that material ESG risks and negative impacts have the potential to undermine a company's ability to repay a loan and, in extreme cases, damage the manager's relationship with investors and its reputation in the general public. These risks are wide-ranging and can include workforce health/safety and discrimination/harassment incidents, corporate misconduct issues, and physical damage to real assets driven by climate change trends. Negative impacts, on the other hand, reflect how a company's products or services may be viewed as harmful to society. They can include issues related to product safety, greenhouse gas emissions or other environmental impacts from products, life destroying munitions, and negative consumer privacy implications arising out of consumer utilization of certain services.

**As the private credit investment landscape continues to evolve, there is no doubt that ESG initiatives will continue to grow in prominence.**



# Applied Thinking in ESG

Credit managers' commitment to the integration of ESG criteria within investment processes is growing, driven by a convergence of investor expectations, regulatory initiatives, and accessibility of information. Access to data remains one of the biggest challenges in private credit, especially with middle-market private businesses which are often not covered by third-party data providers. As such, we view it as essential to approach ESG integration with applied thinking (i.e. human analyst coverage), so that all material aspects of ESG risk exposure and ESG management are considered.

## ESG CRITERIA

Below, we offer a deeper look across risk factors, and provide illustrative considerations.

	<b>ANTI-BRIBERY &amp; CORRUPTION</b>	Companies that operate in regions at higher risk of corruption and in close proximity to foreign officials should have internal controls in place to identify, investigate, and remediate any concerns related to improper interactions.
	<b>CLIMATE CHANGE</b>	Companies should identify real assets and operations vulnerable to climate change-related physical risks and develop business continuity plans and asset protections accordingly.
	<b>DATA PRIVACY &amp; SECURITY</b>	Companies that collect and process sensitive data of customers, employees, consumers, and other stakeholders should safeguard this data against exploitation by bad actors, support data privacy, and communicate data stewardship principles to stakeholders.
	<b>DIVERSITY &amp; EQUAL EMPLOYMENT OPPORTUNITY</b>	Companies should endeavor to seek out and retain diverse talent and foster inclusion in the workplace to bolster innovation and better serve diverse consumers. Moreover, companies should have policies and procedures in place that seek to protect their workforce from all forms of discrimination and harassment, and preserve employee wellbeing.
	<b>ENVIRONMENTAL MANAGEMENT</b>	It is paramount for companies with environmentally hazardous inputs, waste, and by-products to reduce the use of hazardous/toxic substances where possible and otherwise store and dispose of these materials in a manner that protects surrounding ecosystems.
	<b>ETHICS &amp; COMPLIANCE</b>	A strong ethics and compliance program allows companies to meet corporate conduct standards established by stakeholder groups, prevent products and services from negatively impacting society, and ensure all engagements with stakeholders are conducted in an ethical and fair manner, helping protect public reputation and mitigate risk of regulatory infractions.
	<b>PRODUCT &amp; FOOD SAFETY</b>	Companies should seek to avoid using product/food components that are hazardous or toxic to human and animal health. When risk exists, companies should implement comprehensive procedures, trainings, and audits across manufacturing and sourcing operations to prevent negative impact on brand reputation and business performance.
	<b>SUPPLY CHAIN SOCIAL &amp; ENVIRONMENTAL MANAGEMENT</b>	Best-in-class businesses should consider supply chain risks such as human rights abuses, natural resource depletion, and negative impact on communities in order to prevent costly supply chain disruption and reputational damage.
	<b>SUSTAINABLE BRANDING</b>	Companies that brand their products around sustainability-related characteristics should use an evidence-based approach to substantiate these claims to mitigate risk of "greenwashing" and, in turn, create and preserve consumer trust.
	<b>WORKER HEALTH &amp; SAFETY</b>	Companies should follow the hierarchy of hazard controls and improve designs and processes where possible to create a workforce and environment that is safe and resilient.
	<b>SOCIAL &amp; LABOR CONDITIONS</b>	Companies should seek to create human capital structures that attract, retain, and promote world class talent within that industry. Management teams should constantly be reviewing and improving the "employee value proposition" and understand the levers within their control. Such programs help limit financial and operational risk associated with heightened employee turnover and avoid regulatory scrutiny from poor labor practices.

Credit managers that have established a process to evaluate the above ESG criteria for a given company typically enjoy a much more nuanced understanding of the company's overall risk profile.

Utilization of an independent ESG specialist to present unbiased findings that are integrated early in the overall investment diligence process ensures a manager cannot manipulate ESG findings to support a pre-existing investment thesis. It is important that determinations of risk tolerance thresholds remain independent from any pre-conceived investment narrative. In practice, this often leads to constructive dialogues within the investment team regarding ESG risks. These dialogues allow the investment team to leverage institutional knowledge of ESG criteria and consider suitability earlier on in the underwriting process, which creates time and process efficiencies over the longer-term.

### **DIFFERENTIATED DISCOURSE**

For some high-risk industries or investments, constructive engagement in an ESG conversation with the underlying management team has the potential to improve investment underwriting. These dialogues allow for a deeper understanding of both ESG risk factors as well as management's capacity to mitigate these risks. Keeping process efficiency top of mind, these discussions often occur in cooperation with existing legal diligence workstreams. An important note – ESG is not just legalistic compliance. It is critical to intentionally segment operational ESG consideration from legal nuance in order to improve information gathering across both fronts. Legal diligence provides insight into the past, while investigation of ESG considerations can help investment professionals assess the ability to avoid future issues.



## ASSET-LEVEL APPROACH

Each individual company presents such nuanced exposures that managing ESG risks from an asset-level evaluation is often preferable to that of an industry-level analysis. Industry-level negative screens are generally informative and time-effective only to the extent that they are used to exclude companies in industries that are commonly featured on an investor's exclusion list (e.g., tobacco, firearms), for which there is significant, unmitigable, and obvious downside risk, as well as high reputational risk. However, for many opportunities, industry-level screens pose more questions than they do answers. This type of ambiguous, generalized risk analysis prompts a number of 'what-ifs' which can only be answered by a more thorough analysis than what is detailed in a tear sheet.

While there are certainly ESG risk exposure trends within certain industries (e.g., data privacy and security risks among SaaS companies), there are even more telling indications of a company's ESG profile that may be gleaned from an asset-specific review. This can be achieved through the previously identified ESG criteria and materiality considerations.

To the extent that more granular detail is available from the deal sponsor, lenders can more effectively identify ESG findings that may ultimately be deciding 'go/no-go' factors for the investment committee to consider. An asset-level approach enables an investor to favorably view a company in a higher-risk industry because of the social or environmental benefits of their products and/or services.

**We believe that a bespoke, company-specific analysis of ESG criteria—rather than an industry-level checklist—empowers credit managers to become more confident and comfortable in accurately determining which ESG risks are material for a particular investment.**

**Relying solely on public information or industry-level checklists is not an effective way to navigate the reality of a nuanced investment universe.**

Supplementing these tools with applied thinking and the reasoning of an experienced analyst may reveal an investment opportunity that might otherwise have been eliminated. Malk recently raised a red flag on a prospective BSP opportunity in which publicly available information identified litigation and reputational risk based on a claim that the CEO had violated the False Claims Act. After the raising of this red flag, deeper diligence by Malk and our investment team confirmed that the claim was voluntarily withdrawn after the Department of Justice declined to prosecute. Additional attention to the company's processes provided comfort with the initial concerns and gave our team confidence in moving ahead with full diligence.

## CASE STUDY

## ESG Integration In Practice: An Evolving Case Study

### BSP AND MALK PARTNERS: SPECIALIST PARTNERSHIPS MATTER

At BSP, we believe that our foundational responsibility is to deliver strong performance for our investors and cultivate responsible partnerships. As responsible investing tenets continue to expand, we have engaged one of the industry's leading ESG advisors, Malk Partners. We believe that the best way to integrate ESG into our investment process is by partnering with an independent ESG specialist who can co-diligence opportunities and deliver asset-level findings without bias. In coordination with Malk, we have been able to add consistent and rigorous underwriting practices focused on ESG, enhance existing monitoring efforts, and position our commitment to ESG integration as a competitive advantage. Beyond playing a critical role in risk mitigation, we view ESG management as an embodiment of a value creation lever for our investors.

### A FULLY INTEGRATED PROCESS

In lock-step with our traditional investment and credit underwriting processes, we have developed an integrated ESG due diligence workstream for our direct lending investment process. Integrating ESG factors into investment decisions must enhance and complement the existing investment process. Identifying a path that is the most efficient for investment teams improves adoption and compliance.

The status of both workstreams is centrally tracked from initial sourcing through funding, to ensure that our preliminary ESG screens, full ESG assessments, and presentation of findings occur at the appropriate point within the investment process timeline. In addition, we have committed to monitoring our investments annually following the initial ESG due diligence to assess any new or emerging ESG risks within our portfolio.

**Partnering with an independent ESG specialist to co-diligence opportunities ensures process efficiency and unbiased findings, resulting in expert-level ESG analysis and better investment decisions.**

**We believe that a robust credit underwriting and monitoring process, with integrated ESG investment criteria and policies, enhances a private credit manager's ability to make more informed investment decisions.**



## DEEPER DIVE: RED FLAG SCREENING

ESG criteria are best incorporated as early as possible in the investment process to forego opportunities where the risk profile exceeds our risk tolerance threshold, improving efficiency of time and cost. With the introduction of the Malk relationship, there has been significant ESG education for the investment teams resulting in a refined investment process. ESG thought processes are now infused into the fabric of the deal team and how they think about an opportunity in a long-term investment. Originations are evaluated with an ESG lens alongside our pre-existing investment qualifications.

We have embedded an ESG red flag analysis at the origination and pre-screen/pre-Investment Committee (pre-IC) phase. Screening for red flags is not unique to BSP, as it is noted in the UN PRI's publication, "Framework for RI in private debt," but our formalized integration is differentiating. Our objectives with red flag screenings are to identify high-risk investments, generate related questions for the management team or the sponsor that allow us to assess the presence of any high-risk exposure and/or the management team's capacity to mitigate this risk, and determine whether or not to move forward with full diligence.

**BSP's private debt team reviewed an investment opportunity for a leading provider of post-secondary education and certification training to working adults who do not fit the traditional on-campus model.**

The investment team's initial diligence, combined with Malk's red flag screenings, raised multiple concerns across ESG findings which threatened the sustainability of the business model, including regulatory risk, media and public scrutiny, regulatory influence, and compliance concerns that are believed to have negatively impacted student academic and financial outcomes.

Our Investment Committee declined the investment opportunity, citing that the ESG risks outweighed any financial merits of the deal.

## CASE STUDY

In this ESG screen, a red-flag investment is defined based on its potential to pose significant unmitigable ESG risk that could impact our return on investment or our reputation, through association with the borrower and its operations. This pre-IC analysis is informed by available public and private ESG information, and also takes into account the traditional red flag/exclusion list industries that are held internally and by our investors. Typically, exclusion list industries may include coal, for-profit prisons, firearms/weapons, and other sectors that are broadly viewed as having significant negative societal impact.

The BSP-Malk partnership is a dynamic engagement that provides a forum for the deal team to have deep and rich discussion with ESG industry experts. As needed, investment professionals and Malk will discuss the red flag area(s) highlighted and the potential mitigants against those risks, as well as subsequent steps to be taken by both parties to perform detailed and robust diligence around these areas. Our investment team is empowered and educated to integrate ESG findings from these reviews into investment decisions, further strengthening the consistency and quality of our ESG approach.

## CASE STUDY

### **BSP's private debt team reviewed an investment opportunity for a company operating multi-service car washes.**

Due to the Company's operations and geographic profile, the Company is exposed to physical risks associated with climate change, which become operational risks posed by droughts and associated water scarcity. Additionally, the car wash industry is inherently water-intensive; water is a necessary resource for the application of detergents and other cleaners, as well as their subsequent rinsing. As such, water availability is a core requirement within the Company's operations and represents a key operating risk for the business.

### **Engagement with Malk**

Through its diligence, Malk identified that all of the Company's locations have reclamation systems that can recycle used water for future washes which drastically increase water use efficiency. Utilization of reclamation systems is generally considered a strong practice, and helps to avoid issues of carryout evaporation which have been cited as a significant problem area, particularly in hot, arid climates. Water that is not reclaimed becomes wastewater and is then diverted to special sanitary sewer systems where the contaminated water can be safely treated without being exposed to the environment, further improving environmental friendliness.

Our Investment Committee approved the investment opportunity after evaluating the risks and the mitigation techniques employed by the company, in conjunction with our standard investment underwriting and diligence.

## **ACCOUNTABILITY**

BSP has taken steps to embed ESG and responsible investment considerations into our day-to-day operations, ranging from our initial prospecting to our investment committee meetings, and beyond. This shift requires cultural buy-in, reinforced through explicit accountability mechanisms and designated ESG responsibility among our team and leadership. Our responsible investment policy describes the ESG principles that our organization is committed to upholding. This policy considers the status of our parent company, Franklin Templeton, as a signatory to the UN's Principles for Responsible Investing (PRI), to reflect our collective interest in supporting and growing our ESG integration and responsible investment approach in a manner that aligns with global standards.

Further, we established an internal ESG Committee to bring together professionals from across our investment platform under the common goal of advancing our commitment to responsible investing. The Committee establishes a governance structure that will guide and provide oversight for BSP's responsible investing policies and processes, and it provides a forum for sharing best practices across the firm.

## KEY TENETS OF ESG INTEGRATION IN PRIVATE CREDIT TODAY

- Partnering with an independent ESG specialist to co-diligence opportunities and present unbiased findings results in stronger ESG thinking and better investment outcomes
- A robust ESG process should serve as an essential pillar of risk management policies
- Bespoke, company-specific analysis of ESG criteria is preferable to industry-level analysis and results in an expanded perspective of investment risk

## Looking Forward

The integration of ESG strategies into the credit investment process continues to develop in line with changing market and investor expectations. In the future, ESG integration is likely to extend beyond the downside risk-mitigation practices that are presently common. We believe this will evolve as more private credit managers align their investment strategies with global sustainable investment standards and recognize the value adding aspects of ESG. Further, discerning lenders may monitor their investments at a regular cadence to ensure ongoing comfort with ESG risks and risk-mitigation programs associated with their portfolio companies.

Impact investing, which is related to ESG strategies but distinct in that it seeks to accomplish specific positive environmental and social outcomes, may be well-suited to private credit in the long-term. Notably, the Global Impact Investing Network (GIIN) indicates that the global impact investment market was worth approximately \$715 billion in 2019, after years of rapid growth. In the same study, GIIN noted that private credit now makes up the largest contributing class to impact AUM, representing over a third of impact AUM. Importantly, direct lending often relies on a limited number of lenders, which may facilitate relationships between lenders and borrowers that enable direct lenders to propel the collection, reporting, and distribution of necessary data. Access and availability of data is the primary barrier of progress in private credit's ability to successfully execute impact strategies.

Lastly, we see global regulatory initiatives as one of the primary forces shaping the evolution and adoption of responsible and sustainable practices in investment management. Competing regulatory schemes may create tensions for global asset managers seeking to meet or exceed investor expectations when investors are bound by differing (sometimes inconsistent) regulatory goals. Investors are driving change with higher expectations of adoption, transparency, and accountability while regional initiatives are setting new ceilings, as we are seeing with the Sustainable Financial Disclosure Regulations (SFDR) in Europe. As we move towards common standards and frameworks, we believe ESG integration and applied thinking will sustain as the high mark to drive good investments and long-term value.

## About the Authors

**BENEFIT STREET PARTNERS L.L.C. (“BSP”)** is a leading credit-focused alternative asset management firm with over \$34 billion in assets under management as of July 31, 2021. BSP manages assets across a broad range of complementary credit strategies, including private/opportunistic debt, structured credit, high yield, special situations, and commercial real estate. BSP is a wholly owned subsidiary of Franklin Templeton.



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**MALK PARTNERS** advises private market managers and their portfolio companies to protect and create value through ESG management and impact investing strategy. Malk has advised many of the world's most respected investment firms, specializing in ESG integration and impact advisory across buyout, growth equity, venture capital, private debt strategies, and real assets.



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## Disclosures

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Please note there is growing regulatory interest, particularly in the U.S., UK and EEA (which may be looked to as models in growth markets), in improving transparency around how asset managers, among others, define, measure and disclose impact of ESG factors on the performance of any fund, account or client. BSP's ESG considerations could become subject to additional regulation in the future, and BSP cannot guarantee that its current approach will meet future regulatory requirements

The process describe above is as of the date of this presentation and is subject to change, including in response to changing regulations, at BSP's discretion.