EXPERT COMMENTARY

Will 2021 be the year environmental, social and governance comes of age in finance, as well as in the wider economy? Jill Wilson and Jonas Persson of Lloyds Bank think so

ESG: The new alpha in private markets?

With the hope of a successful global vaccine rollout, attention is shifting back to ESG, a topic that has been increasingly growing in significance.

What makes 2021 different? Firstly, there is the financial sector context, with investors keen to demonstrate ESG credentials and deploy capital in assets they see as aligned to their own values. Secondly, the environmental aspect will take centre stage as the US looks to re-enter the Paris climate agreement and the COP26 UN climate change conference focuses minds across politics and finance alike. Thirdly, there is 'the way we do business', as social factors and governance components are now at the forefront

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of driving a sustainable recovery from covid-19.

As we move towards the midway point of the year, it's worth taking stock and considering how ESG is shaping the world of private fund finance.

The hot topic, not a new one

While ESG is by no means a new topic in private markets, the key protagonists, namely general partners (GPs) and limited partners (LPs), are focused on this all-encompassing theme now more than ever, as global momentum to drive positive environmental and social change grows at pace.

These principles have gained general acceptance from both GPs and LPs. They are based around fully embedding ESG fundamentals into all aspects of their investment platform DNA, which will ultimately drive better long-term value creation in their portfolio investments. These goals are well aligned given the symbiotic relationship that exists between the two: GPs must deliver consistent investment returns over time to attract long-term capital allocations and LPs rely on GPs to deliver appropriate returns for their ultimate beneficiaries. Yet the devil, as always, is in the detail. Specifically, embedding an ESG

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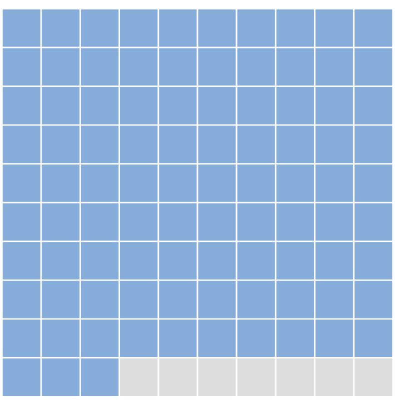
Agree

93%



Source: ERM

framework in a private market manager/fund model is no simple task. The inputs need to be workable and adaptable, and the outputs must be consistent and measurable to deliver the desired economic outcomes. Many private market-specific complexities are being worked through by GPs without having formal industry standard benchmarks around 'what good actually looks like'.

GPs also have the added complexity of how to embed and drive ESG across their entire operating platforms, which typically include ring-fenced funds with different LPs, maturity profiles (vintages), underlying strategies, geographic focus and spread of underlying industry sectors.

A point of differentiation

Despite the challenges, it is crucial to approach ESG in the right way. Those who get it right will gain a true competitive advantage, both in terms of winning investment opportunities, delivering strong returns and attracting LP capital at scale.

As the global dataset builds, the inextricable link between positive ESG input and investment performance is becoming more widely accepted. Sentiment is overwhelmingly positive: in a 2020 poll by sustainability consultancy ERM, 93 percent of firms agreed that a focus on ESG helps generate good investment opportunities. Meanwhile, a Fidelity International study identified a 'remarkably strong linear relationship' between ESG ratings and performance. The study goes on to cite an 11.2 percent high/low spread in terms of resilience during the covid-19 pandemic.

The reality is that non-ESG compliant businesses are perceived as higher risk – and this applies both to GPs themselves and to the portfolio companies in which they ultimately seek to deploy LP capital. As a result, ESG diligence is now a core part of LP and GP investment propositions to ensure alignment with their own ESG goals and long-term investment objectives.

In our experience, managers have progressive ESG strategies of varying degrees of sophistication. This includes, in a growing number of cases, creating roles for dedicated ESG executives responsible for implementing and driving appropriate practices, both for their own businesses and for the portfolio companies they acquire. Managers must demonstrate intent across all their activities, at both 'corporate' and investment level, to ensure sustainability is embedded in their organisation's culture. Yet it is not necessarily a level playing field, as some smaller managers lack the access to in-house resources. It means that accessing the right advisors and working closely with other stakeholders is key.

Encouragingly, most institutional LPs are also progressing at pace when it comes to embedding their ESG strategy. Manager selection has always been key in private market investing and a strong ESG strategy is now a growing part of that assessment. Some early adopters already base their investment decisions entirely on ESG factors and we expect this to become more commonplace. Put simply, we believe ESG is the new alpha in private markets.

What approach are fund finance banks taking?

The banks that engage in fund finance are also on their own sustainability journeys, aimed ultimately at driving long-term shareholder value and reinforcing their corporate responsibilities to drive positive change.

Lloyds Bank is no exception. ESG sits at the heart of our strategy, with our recent commitment to cut our financed emissions by 50 percent by 2030 a key example of our ambition and the strong alignment with our clients and their own goals. We fully recognise the interplay between bank and client is symbiotic and we believe that appropriate ESG alignment will become a critical decision factor for GPs choosing their long-term banking partners.

Similar to LPs, the leading established fund finance players have focused on seeking to work with the 'best managers'. ESG is now a core part of determining what 'best' means so governance frameworks are also being created by banks to ensure the application of ESG in financing structures is both robust and consistent.

With a global and diversified client-set, we have unique insight into how GPs are approaching ESG. Unsurprisingly, there is no 'one size fits all' approach and as such it is critical that we fully engage with our clients to understand their ESG strategies and share our own vision, strategy and experience.

We have recently invested in a dedicated Sustainability and ESG Finance team to work alongside relationship teams in supporting our clients with their ESG objectives. This approach has already delivered a number of key ESG financing solutions to GPs during the course of 2021.

ESG and fund lending

ESG-linked fund finance is a nascent market, with only a handful of deals seen to date. However, given the importance and dynamism of ESG in private markets it is quickly permeating the landscape. Clear evidence of change is supported by a significant increase in the number of discussions with GPs around sustainable financing since the beginning of 2021.

Accordingly, an appetite for innovation and a solution-oriented mind set are 'must-haves' in a lender's toolkit as the inclusion of ESG-linked features in fund financing is a natural extension of a GP's sustainability journey. Effectively, the ESG component seeks to reward the manager and ultimately the LPs for achieving ambitious KPIs.

There is limited conformity in the approach to embedding KPIs in financings given the wide range of approaches being taken by GPs in ESG application as well as limited deal volume to create meaningful precedents. What is clear from our experience of leading and co-ordinating facilities, which have a specific ESG component, is that a growing population of lenders are willing to invest the time to find ways to support GPs in their ESG ambitions.

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The lack of conformity is not in itself an issue. However, the need for flexible solutions and ESG recognition via pricing benefits must be supported by meaningful, ambitious KPIs with an increasing focus on each component of ESG. Specific application and measurement are not merely window-dressing but important in ensuring banks support and reward the right GP behaviours, while also ensuring the lending exposures align to their own sustainability goals.

There are still several topics being worked through, for example the approach to setting ambitious targets and robust reporting, which are key elements in determining pricing benefits. There is some way to go before universally accepted benchmarks are available, in the meantime, leading lenders will continue to work with GPs to assess each case on its own merits.

Embracing sustainability

It is now universally accepted that ESG is virtuous and has the potential to enhance private market investing. Yet challenges remain, chiefly in the need for the consistent application and measurement of ESG across scale, asset class strategies and industries.

Nonetheless, GPs are working hard and moving quickly to embed ESG across all aspects of their operations. Leading fund finance banks are aligned to this, mobilising at pace and seeking client relationships that are consistent with their own long-term sustainability goals. In turn, this offers the potential to improve the range of ESG-specific products on offer across the market.

Such developments will take time. However, with 2021 looking like the year of ESG, there is no time like the present. ■

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