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2022 Capital Markets Outlook (Fourth of a series)

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This week Churchill's Carol Loundon, managing director, underwriting and portfolio management, joins her colleagues Kelli Marti and Jessica Nels as we continue our special series for 2022 [link] with a discussion of ESG and private credit.

Increased focus on ESG in the past five years has mirrored the rise of private credit as an established asset class. This may not be a coincidence. The examination of environmental, social and governance factors as part of risk management has a long history in private credit given its illiquid nature. However, we are seeing more specificity and demand for detailed ESG information, putting additional responsibilities on both investors and managers.

Additionally, the size of the private market – at over $1 trillion rivaling both the broadly syndicated loan and high-yield bond markets – means more institutional investors are being introduced to privates. Investors looking to expand into private credit are also seeking similar transparency on ESG data.

Middle market borrowers lack the scale and sophistication of their large-cap counterparts, so the due diligence process requires specialized access. The good news is that experienced private credit owners and lenders are uniquely equipped to meet that need.

Private debt lenders don't directly control borrower management, but do have access to operating level information not found with public entities. Forming close partnerships between lenders and sponsors for corporate data and strategy is critical to managing potential pitfalls.

And as a recent Principles for Responsible Investment (PRI) study put it,"ESG analysis can enhance risk analysis."

This is particularly true with the buy-and-hold approach typical of most direct lenders. Such a long-term window means ESG risks and opportunities are more likely to come into play over time. Private equity owners have had ring-side seats on how issues such as pollution or regulation can dent or destroy enterprise value. Margins can be impacted by poor ESG management if it runs into regulatory or financial risk, which ultimately impacts lenders.

Covid not only exposed the global population to the deadly effects of a relentless biological agent, it also heightened institutional investors' sensitivities to exogenous risks. Those investors are now increasingly scrutinizing asset managers of all stripes on how ESG is positioned in their playbooks.

According to a January 2022 report from our content partners S&P Global, 2021 "saw more large asset owners, asset managers, and banks adopt negative screening strategies" to weed out borrowers with "weak ESG practices or high exposure to ESG risk."

For 2022 and beyond, these exclusionary practices will become more prevalent. For private credit managers who aspire to be ESG leaders, box-checking won't be sufficient. In the middle market, credit risk and ESG risk are inseparable.

Demonstrating an integrated approach to analyzing how environment, social and governance factors impact smaller companies will be a key element to private credit's legitimacy.