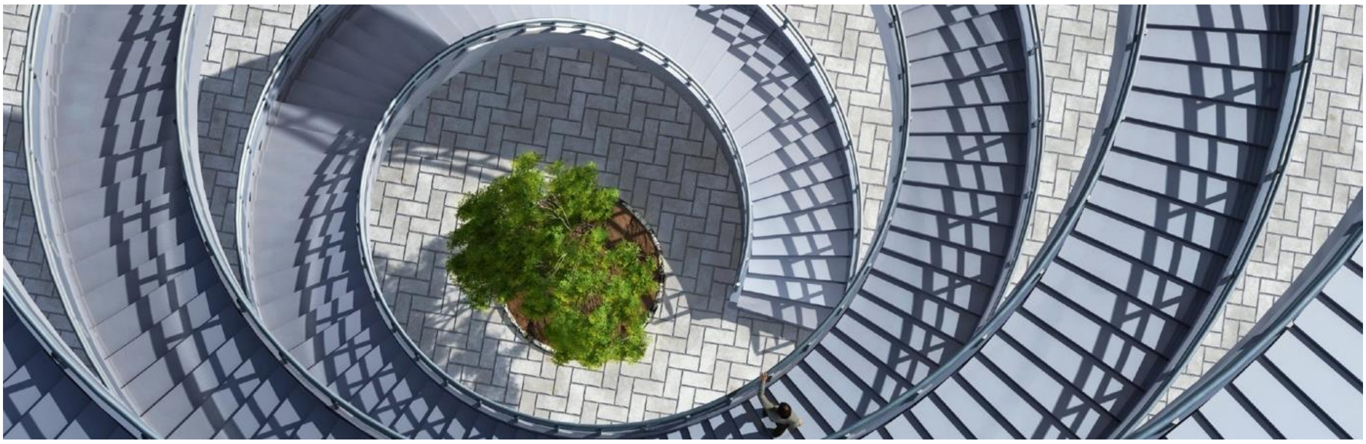

ESG Integration in Alternative Investments – Private Debt

As early as 2005, Freshfields Bruckhaus Deringer published a legal framework on behalf of the UNEP on why Environmental, Social and Governance (ESG) factors have to be included in Asset Management.[1]

With the EU Action plan on financing sustainable growth in 2018, the subsequent regulatory environment provided by the EU taxonomy and the SFDR, a regulatory and political integration of sustainability, has been levelled up substantially in the past years. Specifically, this is intended to create much-needed comprehensive consistency for the term "sustainability" that will help the markets to direct financial cash-flows to the relevant projects.

While on the one hand political and social initiatives are pushing aspects of sustainable finance, on the other hand extremely low interest rates drive institutional investors away from classical securities to other asset classes. Due to the regulatory and financial parameters, more and more institutional capital already is and will continue to be flowing into alternative asset classes such as Private Equity, Private Debt and Infrastructure. For Alternative Asset Managers like Prime Capital AG, these developments on the investor side as well as the political initiatives mean a great opportunity for their services on the one side and yet a challenge on thorough ESG process implementation on the other side.

Due to their role and position in the economy, financial centres and intermediaries have a unique potential to advance effectiveness as well as collect and direct capital flows towards sustainable assets for an overall sustainable development. Thus, several world-wide initiatives to direct capital flows towards sustainable products as well as to benchmark reporting and integration of ESG factors have been established, e.g. the UN Principles on Responsible Investments (UN PRI) and the Task Force on Climate-related Financial Disclosures (TCFD).

The major services that financial institutions and financial intermediaries offer to their clients are risk mitigation and assessment, linked to the customers' needs and expectations. With the impact of climate change on the one hand and drivers out of politics and society on the other hand, customers as well as financial institutions have to deal with "new" risks and opportunities, which are linked to ESG-factors. Thus, identifying these ESG-related parameters and assessing them becomes an increasingly important and challenging task for financial institutions.

In their publication mentioned above, Freshfields Bruckhaus Deringer additionally discuss and advice that the integration of ESG factors is necessary as being part of the fiduciary duty of asset managers.

Focussing on financial risks and opportunities, the TCFD differentiates between transition risks, which are regulatory, and markets induced, as well as physical risks, mainly deriving from climate change. This implies that opportunities can be found in new products and markets.

[1] Cp. Freshfields Bruckhaus Deringer (publ.) (2005): A legal framework for the integration of environmental, social and governance issues into institutional investment, London, 2005 p. 13f.

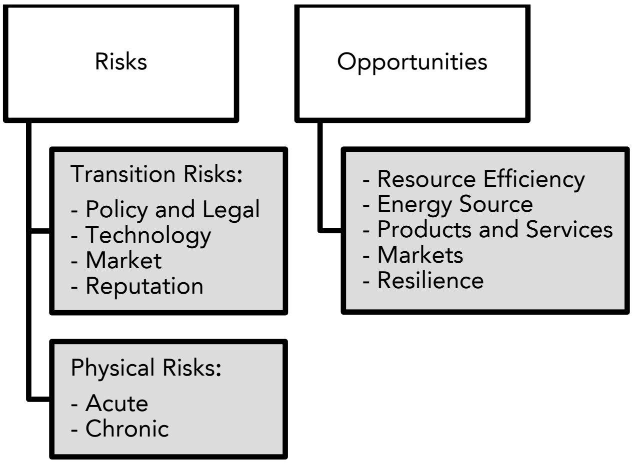

Figure 1 ESG Risks and Opportunities, Source: TCFD 2018

ESG risks and opportunities or general ESG criteria may be integrated into investment decisions at different levels, ranging from simply excluding certain sectors, thematic investments into "sustainable" sectors to a fully-fledged integration of ESG assessments into the investment process. These ESG strategies vary in complexity of implementation into investment processes and follow individual targets.

Prime Capital's Private Debt Team has implemented a rigorous investment process, which fully integrates sustainability factors alongside bottom-up credit analysis. The process is tailored to the particular characteristics of private debt transactions, i.e. the bilateral and individual documentation, special regulatory environments and the real asset base. All of this is accompanied by a natural complexity, illiquidity and limited transparency. To ensure accountability and a repeatable implementation, the details are documented in a top-down approach to guarantee a consistent implementation across the different and heterogeneous products of the company. The entire process is governed by the responsible investment policy on company level, which is further detailed in asset class-specific responsible investment policies, as well as explicit guidelines and restrictions, which focus on ESG on product level.

To leverage the full potential for positive sustainability outcomes of Private Debt investments, our investment process incorporates in-depth sustainability assessments using three different, complementary ESG strategies with individual targets:

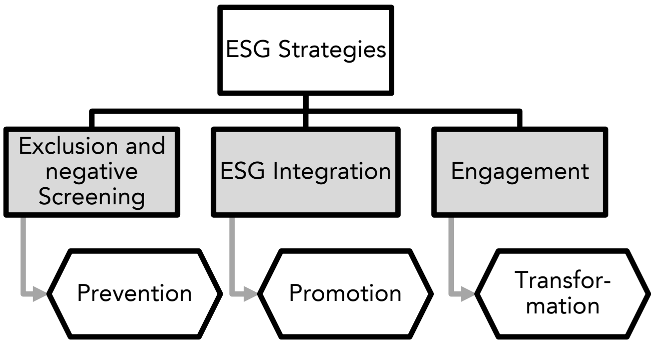

Figure 2 ESG strategies implemented in PCAG investment processes

Those strategies are applied into the investment process holistically, from the initial portfolio strategy, origination, and transaction management to asset management and divestment.

Exclusion and negative screening applies a number of defined criteria to exclude certain companies right away without further analysis, e.g. specific sectors (weapons, tobacco etc.). Norm-based screening involves assessing each company held in the investment portfolio against specific standards of Environmental, Social and Governance performance.

ESG Integration is the explicit and systematic inclusion of (potential) ESG issues in the investment analysis and investment decision.

Lastly Engagement describes the active approach to influence the investee to improve policies and practices for better ESG integration and transparent reporting.

The following paragraphs will highlight the implementation of those strategies into two sub-asset classes of Private Debt: Corporate Private Debt and Infrastructure Private Debt.

The paragraphs focus on advantages and disadvantages of specific ESG assessments and discuss approaches to overcome specific hurdles, when integrating ESG factors into investment processes, while showing the additional benefits for investors due to increased transparency into each investment.

ESG assessment in Corporate Private Debt

While the general concept of ESG is not "new" to the Corporate Private Debt space, it is still faced with substantial challenges in certain parts of the market. Large direct lending managers have been promoting their ESG approach for years, including dedicated ESG Analyst Teams, solely focussing on "E", "S" and "G". Over the past years, the regulatory framework covered in the introduction has provided a clearer guideline on how to approach the topic and while the different fields have become more precise, this also leads to challenges for borrowers as well as for

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lenders. As in other cases of regulation the one-size-fits-all approach disadvantages smaller borrowers with less resources and who are slower to adapt. Also different market access provides different abilities to engage, from prevention to transformation (see chart above). Given that Private Debt is usually a "non-control asset class", especially engagement is often limited and can only be achieved to a certain extend.

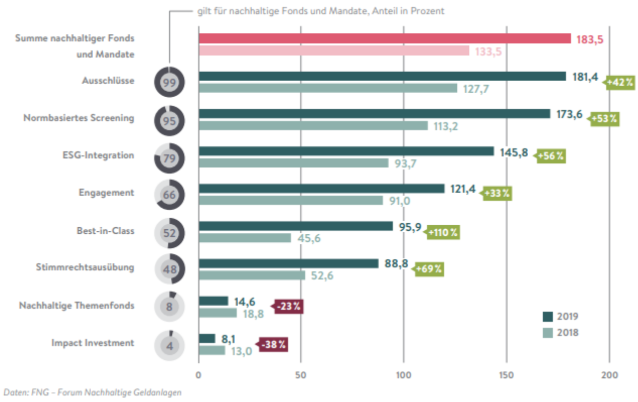

Figure 3 FNG Marktbericht 2020 – Sustainable investment strategy-funds and mandates in Germany 2019 compared to 2018 Source: https://fng-marktbericht.org/

While the majority of sustainable funds in Germany use the lowest hurdle of exclusion and norm based screening, true promotion and particularly transformation is still a rare concept for Private Debt funds.

Especially the introduction of the SFDR in Europe has accelerated the requirement from investor level to ensure asset managers are providing sufficient information, to fulfil the disclosure requirements. While dedicated ESG funds have been around for several years, most of these products have been focused on the environmental aspect of ESG, with obvious applications in renewable energy or "purely" sustainable projects. Large companies have started to produce glossy sustainability reports as part of their investor relations program. While these reports often provide some insight, they remain marketing tools to gain new and retain existing investors, without proper standardisation. The European Commission is addressing the issue with the Non-Financial Reporting Directive (NFRD) and Corporate Sustainability Reporting Directive (CSRD), which mainly addresses large companies, but will also extend to smaller companies in the coming years. Many data providers have jumped on the bandwagon and provide automated ESG scorings and ratings, based on the publicly accessible information. This provides a wide-ranging tool set for broad based equity funds and large-cap investors, but offers no immediate solution for tailor made small and mid-cap lenders and their respective borrowers. The only option remaining is crafting a feasible model and related processes to meet the new regulation and - more importantly - to provide investors with meaningful strategies.

Due to lower reporting burdens and less resources a lot of smaller companies still lack a comprehensive and standardised reporting package on ESG relevant data. This information usually needs to be gathered by the lenders through questionnaires, interviews with the company and external research. This extra effort is not yet fully compensated by the market, given that there seems to be no additional fee premium for meaningful ESG concepts. It can be expected, that this will change over time, as investors will prefer or even require funds which fit into the regulation.

Another challenge for lenders is the blind spot aspect, sourcing transactions for an "ESG" portfolio. Since there is usually little or no information easily available, a detailed view on ESG aspects can only be formed in a later stage of the due diligence process. Given that a meaningful ESG integration requires hard limits and consequences on certain aspects, lenders might face higher broken deal costs, as deals have to be declined at a later stage; or are done anyway putting in question the relevance of the ESG approach. Hence a lot of funds default to exclusion criteria, which can more easily be screened at the beginning of the investment process.

Compared to other asset classes, proceeds in Corporate Private Debt are often used to fund a broad range of applications, from specific expansion projects to general payroll and working capital. This makes it more difficult to tie a loan to a certain purpose and thus to declare it "sustainable". There are numerous examples of green bonds and loans to corporate borrowers, with the next evolution being sustainable linked products. However the vast majority remains "general purpose" loans.

According to its slogan "Enabling Alternative Investments", Prime Capital strives to provide institutional investors access to the Corporate Private Debt market, including a meaningful approach to sustainable investing. As described in the introduction, ESG factors are directly embedded into the risk assessment throughout the life cycle of the investment process, which is governed by a special Responsible Investment Policy for our Corporate Debt strategies. Hence already in deal origination, environmental, social and governance factors are considered, these are further analysed during the due diligence phase and monitored throughout the life of the investment. The approach is adapted to deal with as little information as possible coming from the respective borrowers so gaps need to be filled by the investment and risk professionals, as part of the in-depth analysis. Given that market access not only includes direct origination but can also include the access through banks for non-sponsored-, non-syndicated deals, the complexity of the analysis can be even higher. This highlights the requirement for an autonomous analysis framework, which does not rely on certain pre-requisites like a company being listed, in order to have sufficient information for an ESG assessment. Hence the respective products are not limited to a universe, where ESG reporting is already common practice, leaving out companies, which are just starting out to develop their ESG framework and thus should be supported even stronger. This also allows institutional investors to access the market of relationship driven bank lending without being restricted to the respective banks ESG initiatives, which are often still limited to exclusion criteria.

The ESG-relevant information for transactions is often even more limited in the early stage of a transaction. Hence a meaningful ESG assessment is usually not possible, with a few exceptions. At this stage of the investment process for Corporate Private Debt, Prime Capital employs a detailed range of exclusion criteria, which are aligned with the FNG fund label[2]. To avoid collective punishment, the criteria are nuanced to allow for companies which earn non-significant amounts (<5% - 10%) of revenue in some of the restricted sectors. These exposures will then be analysed in more detail in the due diligence phase and can still lead to an exclusion of the transaction.

Once a transaction is approved in the first assessment, it moves to the due diligence stage. This stage includes an in-depth analysis of the business model, especially the credit risk, and can be supported by external due diligence providers e.g. for commercial and financial due diligence. The analysis also covers all relevant risk factors, which of course also include the risk originating from environmental, social and governance factors. In order to assess the factors in a standardised and consistent approach, Prime Capital has developed an internal ESG scoring model, which captures and weighs the progress of the borrower in certain areas of "E", "S" and "G". The result is weighted to derive a total score, which can be monitored over time, highlighting deficiencies, which might require increased attention. Already the initial result emphasizes weaknesses, which can potentially be addressed in the final documentation in form of covenants, ratchet criteria or increased reporting requirements for this specific aspect. The ESG scoring is supplemented by a second set of exclusion criteria, which are more qualitative in nature and require more information about the company than are available in the first assessment phase. These criteria rely on research about negative news and controversies regarding the borrower, assess norm based aspects like human rights, corruption and environmental protection. The results will be evaluated according to frequency and severity. The result of the risk assessment including the score and the screening are detailed in the credit assessment, which is presented to the Investment Committee. The investment team is supported by a dedicated internal ESG professional and by the risk management department throughout the entire process.

Once the transaction is closed, the same framework can be applied in the ongoing monitoring of the transaction, which is conducted at least annually, unless any development requires a more frequent monitoring. The news search is conducted on an ongoing basis, and can trigger a more frequent monitoring or an ad-hoc follow up with the borrower. The ESG score will be updated at least annually, too, and the total score as well as the sub-categories are used to track the development in the different aspects of ESG related risks.

This framework ensures the stringent and consistent integration of ESG throughout the investment process.

ESG assessment in Infrastructure Private Debt

While standard ESG integration methods are geared towards listed equity and debt, one could think that alternative asset classes have been a blind spot. However, ESG assessment has always been part of a thorough infrastructure investment analysis process, mainly due to great exposure of infrastructure to environmental, technical and social aspects. In fact, some sub-sectors of Infrastructure Debt investments are a natural field for ESG integration, such as Renewable Energy or Social Infrastructure.

Hence, many thematic funds can be seen in the market with a clear focus on single sub-sectors, most prominent Renewable Energy and Green Energy. Such funds often fulfil requirements for impact funds or SFDR Art. 9 funds by their sheer limitation of investment horizon and focus on Renewable Energy. Those funds generally exclude other broad infrastructure assets and allow for a direct assessment, such as carbon emission reduction, due to financed green energy.

However, the individuality of infrastructure projects in all relevant sub-sectors offers many advantages for a detailed ESG integration and is not limited to specific sub-sectors, such as the Renewable Energy sector. These advantages are as followed:

- The funding and financing of infrastructure projects is precisely linked to the project itself.
- Infrastructure projects have typically high interdependencies with the government, the regulatory regime and laws as well as the overall region and society, which makes them systemically relevant and allows for an assessment of the direct impact and legal and regulatory conformity.
- Infrastructure Debt is usually linked to precise covenants, which cover financial elements and can additionally be linked to sustainable outcomes.

Especially the direct linkage between the financing and the project is a distinct advantage compared to other ESG conform investments. Furthermore, the direct interaction with governmental institutions offers the possibility for

[2] https://www.fng-siegel.org/

investors in emerging markets or markets with lower social and governance standards to raise issues and support improvement. The UN PRI particularly sees the integration in every step of the due diligence, including an analysis of all deal participants and other stake holders as the most integral part for Infrastructure Debt.

Similarly to our approach in all Private Debt asset classes, a specific Responsible Investment Policy for Infrastructure Debt guides our investment and risk management process with respect to this sub-asset class. Again, ESG factors are embedded into the risk assessment throughout the full life cycle of the investment process.

Despite the advantage of fixed allocation of funds to a specific asset, in the early stage of the investment process, the in-depth ESG analysis also remains challenging in Infrastructure Private Debt. This is especially true for the analysis of all deal participants and stake holders. Thus, Prime Capital has also implemented a screening strategy for the origination phase to have a transparent and efficient tool at hand for the initial ESG analysis. Since limited information of the deal is given, this screening strategy's main focus is on sector, sub-sector and asset (e.g. Utilities → District Heating → power generation in network). Here, our screening strategy identifies any potential ESG deal breakers and detects ESG factors to be explored in the detailed due diligence, such as the exact share of fossil power in the district heating network, or the planned increase of Renewable Energy in the network.

In addition to this screening strategy, where Prime Capital sources via infrastructure financing banks, deal access comes along with international initiatives established in the banking industry such as the Equator Principles supporting the ESG analysis. The majority of banks in this market align their credit processes with those Equator Principles and thus give additional information on the consideration of ESG principles on those deals.

After the first assessment of a deal it moves to the subsequent due diligence phase. Here, Prime Capital performs an in-depth ESG analysis making use of an ESG integration strategy. It must be noted, that to some extent sustainability assessment of assets has always been a part of credit assessment of Infrastructure Private Debt. Focus herein has always been the assessment of risks mainly deriving from construction risk (environmental pollution, social standards as well as regulatory risk exposure). In addition, Prime Capital has put a framework in place, which allows for structured and harmonised analysis of relevant ESG aspects based on a criteria catalogue.

Prime Capital has implemented such ESG integration strategy to get a holistic coverage of ESG factors as well as being independent of thematic over-weighting of specific elements. Best example for such an over-weighting is the general connotation of sustainability as environmental-friendly, where Prime Capital has a clear focus on all three pillars E, S and G. Furthermore, Prime Capital's approach does not consider specific assets as sustainable per se. A good example is the assessment of different onshore wind projects, where local resistance against projects is quite common and is taken into consideration (i.e. comparing projects by their distance to residential buildings).

An extract of ESG factors, which are part of the criteria catalogue are shown in the table below:

Environmental	Social	Governance
Carbon transition	Customer relations	Financial and Risk Management
Physical climate risks	Human capital	Credibility and track record
Water management	Labour Rights	Organisational Structure
Waste and Pollution	Health & Safety	Compliance & Reporting
Biodiversity	Responsible Production	Board structure & Policies

This process is further supported by external due diligence providers.

One distinct advantage of Infrastructure Private Debt at this point is that such a DD is not only focussing on legal, technical or commercial aspects, but that dedicated environmental and social due diligence has also been established in the past. This dedicated due diligence further increases the reliability of ESG assessment in Infrastructure Private Debt. In addition to the ESG integration strategy, the Engagement strategy is applied during the credit documentation phase. In particular, the integration of non-financial covenants related to sustainability impacts is becoming more and more common in the documentation of Infrastructure Debt. This can range from information covenant on ESG performance of the project to an impact on interest cost in case of positive or negative ESG performance.

Again, once the transaction is closed, the same ESG assessment is applied in the ongoing monitoring of the transaction, which is conducted at least annually, unless any development requires a more frequent monitoring. The news search is conducted on an ongoing basis, and can trigger a more frequent monitoring or an ad-hoc follow up with the borrower.

Outlook

As the alternative asset management industry is constantly evolving, especially in ESG-related topics, Prime Capital regularly reviews its policies and related processes. While the infrastructure financing market has already started adopting reasonable guidelines and standards on sustainability, the Corporate Private Debt market still faces a decent hurdle with regards to disclosure and transparency. With the first publications through the EU Action Plan (EU taxonomy, NFRD, CSRD and the SFDR), ESG and sustainable finance are finally provided with a regulatory framework. This rapid development has led to an increase in voluntary reporting and a simultaneous increase in reporting requirements for companies and investors, thus it can be expected that also small and medium sized companies will catch up soon, to provide ESG-risk related data as standard of the due diligence package. In any case it is clear that adding a dedicated analysis for ESG-related risks provides a deeper insight for each investment and can only provide additional protection for investors, having a holistic view on each asset.

Prime Capital has recognised the responsibility to ensure a thorough integration of ESG into the investment process and to provide clearly meaningful products to its clients. Since Private Debt is generally a non-control asset class, Prime Capital currently does not offer dedicated impact products for Private Debt. However, with enhanced data being available and an increased awareness on the borrower level this is likely to change also for broader Private Debt products.

Prime Capital's Private Debt Team

Prime Capital's Private Debt Team manages portfolios for institutional investors in excess of EUR 2bn across the asset classes Corporates, Infrastructure, Real Estate and Aviation Debt. We expect significant further asset growth in these areas, while providing satisfactory risk adjusted returns to four largely institutional investors.
Our Corporate Debt Team has accompanied and executed transaction in excess of EUR 700m.
Our Infrastructure Debt Team, which has been active in the Infrastructure Debt market for many years, has executed transactions of more than EUR 850m.

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