Private Funds CFO

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NEWS & ANALYSIS

Fried Frank and Pemberton dig into the asset manager's ESG journey

The approach to ESG is evolving and market participants are developing their own thinking as to how environmental, social and governance issues will shape their activities.

Neil Caddy, a finance partner at Fried Frank, teamed up with Cassandra Fahy, an executive director at Pemberton Asset Management, to look at how Pemberton's ESG approach has developed and may evolve in the future.

At Pemberton, the key driver behind its ESG approach has been the desire to effect change and the view that corporate citizens have a role to play in society.

Pemberton started its ESG journey in 2015 when it started investing its maiden fund and has since made significant strides, having become a signatory of the United Nations Principles for Responsible Investment in July 2018. It completed a review of ESG processes and implemented a new series of initiatives in August 2019; for instance, the requirement to include a section on ESG considerations and diligence in all investment memoranda.

Limited partner/investor engagement and investment process

The increased transparency the Pemberton approach creates is very important for Pemberton's LPs. They are increasingly interested in, and will often ask about, ESG-related matters on new investments. For the investment team at Pemberton, this has become a key part of what one would call the "sniff test" for any new investment including "negative screening" – avoiding investments in industries such as tobacco, pornography, weapons and more. All of this sounds obvious, but there will be more subtle situations where ESG screening requires further thought. For example, Pemberton has invested in meat producers, which entails considering animal cruelty and ensuring that the highest possible standards are adhered to. Pemberton endeavors to ensure this is the case for its portfolio companies and therefore has passed on opportunities where they felt those standards fell short, even though technically applicable regulations were complied with.

Standardization

The Sustainable Finance Disclosure Regulation has imposed transparency and disclosure requirements with the aim of making it easier for investors to compare different financial products through an ESG lens, reduce information asymmetries and tackle perceived "green-washing," which aims to convey a false sense of ESG alignment of a business which is not evidenced through data.

Likewise, the Loan Syndications and Trading Association and Loan Markets Association have published green loan and sustainability-linked loan principles to promote consistency. Whilst these are worthy goals, the views as to whether standardization is helpful are manifold. At Pemberton, the view is that standardization is helpful but complex. For instance, Pemberton has a standard ESG questionnaire it asks all portfolio companies to complete prior to the original investment and on an annual basis. This allows Pemberton to track trends, compare outcomes and set a baseline for ESG standards across the board, which is helpful for its investors' own reporting and monitoring.

In some parts of the market, proceeds of "green" loans and bonds might be ringfenced for green/sustainable purposes but the issuers themselves are still free to engage in activities that do not further ESG goals. So, whilst part of the attraction of ESG financing is the ability to tailor the specifics to focus on particular aspects of E, S and G, such focus may be of limited utility from an overall ESG perspective. A more holistic approach such as that taken by Pemberton is arguably more beneficial.

Margin ratchets

As well as the growth in "green" loans and bonds, there has been an increasing acceptance in public and private markets of sustainability/ESG-linked pricing in order to promote ESG goals. This typically takes the guise of a margin ratchet based on achievement (or not) of certain ESG-linked criteria. The particular criterion will vary, and we've seen examples like ESG ratings (provided by agencies such as Moody's, S&P and Sustainalytics), carbon footprint reduction, board composition, use of renewable energy and various other KPIs. There is clearly scope to include whatever KPIs investors feel drive the most appropriate behaviors and/or furthers a particular investment mandate. The savings on offer if targets are met – and in some cases, penalties applied if targets are not met – vary but tend to range between 2 and 15 basis points, depending on the initial borrowing cost.

In late 2020, Pemberton introduced its own ESG Margin Ratchet which allows companies to receive a margin discount if an independent third party is able to certify that the company satisfies key criteria across each of the E, S and G spectrum. The majority of Pemberton's new platform investments made in 2021 include the ESG Margin Ratchet and it has been positively received by management teams and shareholders alike. In fact, since December 2020, Pemberton has made 17 investments incorporating a ratchet, which equates to around €2.1 billion of ESG-linked private lending.

Reporting

In order to monitor and verify compliance with any ESG requirement, investors will need information from their borrower. But in addition to information needed to test specific KPIs, there is an increasing recognition that financial institutions will have ESG regulatory reporting obligations (ie, SFDR) and other requirements from their own stakeholders which are in turn fed down the chain. At Pemberton, there is a real desire to monitor, measure and track progress on ESG to ensure this isn't just a fad. So over time the expectation is that there will be more regular reporting required around metrics such as energy consumption, labor practices, governance, etc.

Ideological or just logical?

In the past, a focus on ESG may have been seen as a 'nice to have' rather than a key component of investment analysis. More recently however there is an acceptance that focusing on ESG and on fiduciary duties/returns for investors are not mutually exclusive; quite the opposite.

This is borne out at Pemberton where there is a firm belief that there is a strong correlation between strong ESG credentials and strong financial performance. If one considers a pyramid of what a business needs in order to prosper, at the foundation of the pyramid are things like: business model, what it does or sells, does it have a unique selling proposition? Once that's achieved, it can consider other strategic questions climbing the pyramid and tackling topics such as: are they in the right markets or could they expand? Could they hire better people? Could they be more efficient and improve margins? All of which ought to lead to a stronger business.

It's only once those priorities are achieved that as part of improving performance further do most management teams typically consider ESG factors. That's not to say that up until then there's been a disregard for ESG factors. In most cases they will be present to some degree, but it's taking that next step to enhance ESG factors and their impact on the business that can make the real difference.

As time goes on, more and more ESG data will be available and we'll be able to test empirically (in the same way credit agencies have been able to test their credit rating methodologies) the notion that companies that invest in governance, diversity, suppliers, local communities and their employees tend to be higher performers to the benefit of all stakeholders, including lenders.

Looking ahead

It's a really exciting time to be in the industry and looking ahead to where we might be in five years. The belief at Pemberton is that its ESG focus is only going to grow. Pemberton is already focused on ensuring ESG factors are part of management teams' focus across its portfolio. This is done through financial incentives like the ESG Margin Ratchet but also through the annual ESG questionnaire.

Over time and given the depth of Pemberton's portfolio, which at any given point is around 75 companies, its hope is to be able to better track trends across the portfolio, to share that more widely with LPs but also within their borrower base so they can see where they rank, what others are doing differently and share best practices. Pemberton has already started to roll out an ESG-related talk series, which is available to LPs and borrowers. Over time, it hopes to make these more granular and open them more widely to portfolio companies in order to enhance their ESG journeys.

Cassandra Fahy is an executive director in the origination group at Pemberton Asset Management, a European private credit firm, responsible for originating new investment opportunities. Neil Caddy is a partner in the finance practice at global law firm Fried Frank.