Arcmont
ASSET MANAGEMENT

ESG in Private Debt: Rising to the Challenge

December 2021

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About the Authors

Arcmont Asset Management

Arcmont Asset Management ('Arcmont') is a pioneer in the market for Private Debt in Europe and is credited as a key driver of the growth of Private Debt as an asset class. The firm was founded in 2011, originally as the BlueBay Private Debt business. Arcmont is now an independent firm having raised more than €18 billion since inception. We have committed €15 billion in 190 deals across 12 European countries. We are specialists investing in a wide range of businesses, industries, and markets, which require expertise, flexibility, and innovative thinking. Arcmont aims to provide capital to high quality businesses with strong management teams. Our approach is that of a true investor in businesses, rather than a lender, and we strive to build relationships to ensure we are continuously backing our partners as their needs evolve.

KKS Advisors

Established in 2013, KKS Advisors ('KKS') is a leading, global advisory firm working with investors, corporations, foundations, and NGOs to develop bold and effective strategies that pave the way to a more sustainable society. Co-founded by George Serafeim, the Charles M. Williams Professor of Business Administration at Harvard Business School, we combine academic insights with strategy expertise and years of experience in investment and sustainable business development to deliver solutions that foster systemic change. With offices in Boston, London, and Athens, our vision is to reshape markets, creating a world where business and investment decisions take environmental, social and governance factors into account, and maximize the power of capital to achieve a positive impact.

Executive Summary

Until the mid-2010s few investors paid attention to Environmental, Social, and Governance ('ESG') information. Today, ESG has proliferated financial markets and a growing number of investors around the world are implementing a wide range of ESG incorporation practices to inform investment decisions. This represents nothing short of a revolution in financial markets, promising to fundamentally shift how the financial services industry and society in general views and approaches capital allocation. The combined positioning of Arcmont and KKS as market leaders in Private Debt investing, ESG, and sustainable investment puts us at the forefront of this unfolding revolution. As such, we are confident we can contribute to industry-wide knowledge on ESG by offering an introduction to, and an assessment of, the state of play and evolving trends regarding ESG integration in Private Debt. In turn, we believe this can act as a key driver of change for ESG investing in the Private Debt industry.

With this in mind, the goals of this thought leadership paper are (i) to serve as an introduction to ESG integration viewed through the lens of a mid-market private lender, (ii) to offer a framework for integrating ESG into the Private Debt asset class, and (iii) to help the industry create ESG integration best practices by providing insights and current practices from Arcmont.

ESG 101 – Embarking on the Integration Journey

What is ESG Integrated Investing?

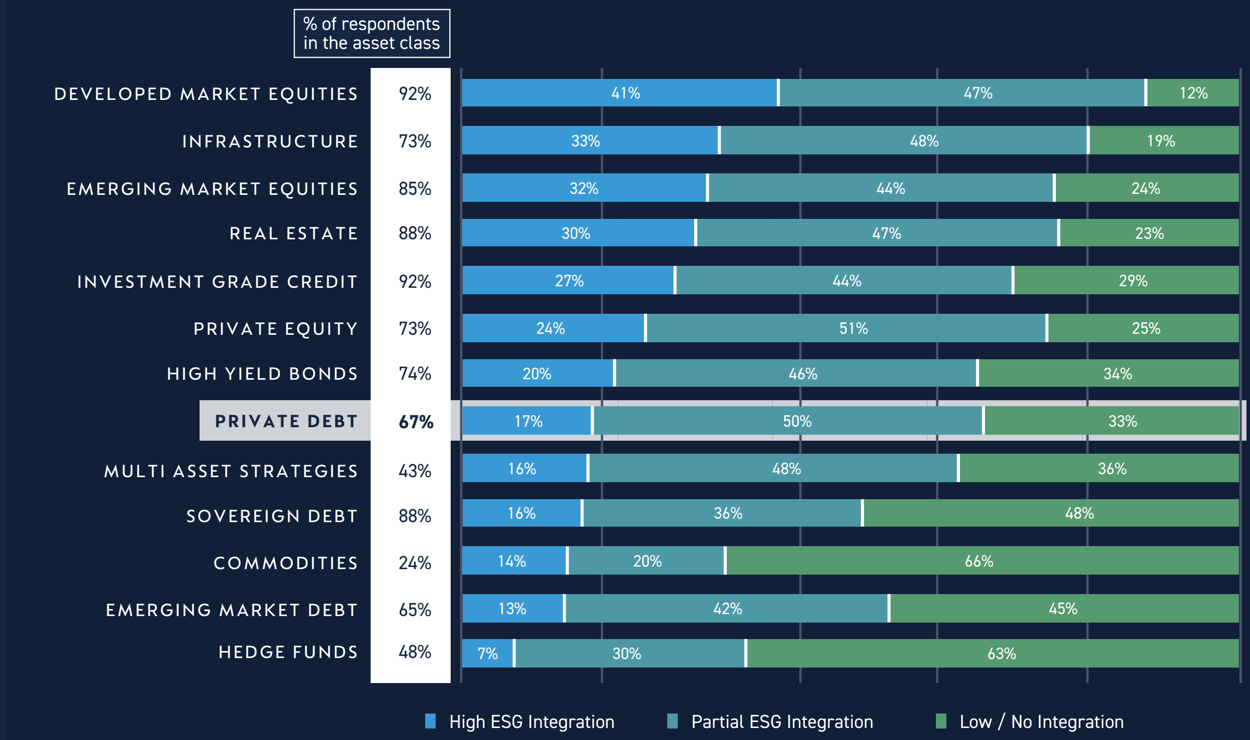
ESG Integrated Investing is the systematic consideration of environmental, social, and governance criteria in investment decision-making and portfolio construction. For an ESG Integrated Investor, ESG considerations are factored into the investment process alongside conventional fundamental analysis, with the goal of identifying both investment risks and opportunities that are likely to be overlooked when analysing traditional financial metrics alone.

ESG Integrated Investing does not dictate the exclusion of any one investment or economic benefit. Neither does the consideration of ESG factors imply avoiding 'sin stocks' or implementing negative screens for ethical, moral, or political reasons. ESG Integrated Investing is not an ethical or values-based investment strategy. It is an approach that enhances "traditional" financial and credit analysis to value the business relevance of financially material ESG factors of an investment that have the potential to impact risks and returns. However, in order to effectively capture these impacts, ESG must permeate all facets of the firm and investment lifecycle, becoming an intrinsic part of how a manager thinks and acts in relation to its portfolio companies.

Sample ESG Issues

	ENVIRONMENTAL	SOCIAL	GOVERNANCE
Definition	Environmental factors cover a company's contribution or impact on the natural world.	Social factors cover a company's relationship and performance concerning people and the community in which it operates.	Governance factors cover the internal system of practices, controls, and procedures that a company adopts to govern itself.
Examples	• Climate change • Resource depletion • Deforestation • Pollution • Water and waste management • Biodiversity	• Human rights • Working conditions • Employee relations • Diversity and inclusion • Health and safety • Community relations	• Risk management • Tax transparency and accounting • Board structure and diversity • Executive pay • Corporate reporting • Shareholder protection
Business Risk	Concerns around the physical consequences of climate change resulting in new regulation that leaves assets in the fossil fuel industry at risk of becoming 'stranded'.	Evidence of illegal human rights practices in supply chains could represent a supply risk for retailers, impacting brand value and reputation.	Lack of diversity in the c-suite could introduce biases into decision-making, thus creating a more exclusive culture which could impact employee engagement and productivity.

ESG approach across asset classes



Note: bars only show results for investors who use the asset class. The proportion of respondents shown for each asset class is indicated in the column to the left of the chart (i.e. 48% of respondents use hedge funds and, of that group, 7% describe their approach in hedge funds as "High ESG Integration").

ESG and Private Debt – A Risky Business

For most Private Debt investors, ESG integration is a relatively recent phenomenon. While governance has always been a large focus of the fundamental credit analysis performed for debt instruments, environmental and social issues have been less commonly incorporated. These however have quickly grown to become a crucial part of credit analysis, so much so, that according to a recent survey on ESG across asset classes from bfinance, as many as two thirds of Private Debt strategies are described as at least partially ESG integrated.

The limited upside potential of Private Debt investments post-closing means the focus is drawn to the potential downside risks that may lead to a default. This generally means that managers tend to prioritise ESG issues that might be drivers of risk as opposed to sources of opportunity. Identifying such risks is vital, as in Arcmont's view, strong ESG risk management is part of strong risk management overall. Depending on the level of access to the borrower's senior management, private lenders can get a good understanding of ESG risks as long as they have a systematic framework in place to allow assessment and monitoring of material ESG factors.[i]

Materiality Matters

In recent years, a significant amount of research has shown that ESG is inherently linked to the financial performance of a firm. In the seminal paper on the topic, Professor George Serafeim of Harvard Business School and co-authors found that firms with good ratings on material sustainability issues deliver significant financial outperformance over firms with poor ratings on the same issues.[ii] The research made a clear distinction between ESG issues that are deemed to be "material" and those that were not within an industry. Material ESG issues can be defined as issues that are likely to impact the financial condition or operating performance of a company and, therefore, can have an impact on the financial performance of an investment.

In light of these significant findings, investors have been increasingly seeking to understand the ESG risks and opportunities of the companies they invest in, and how these issues impact returns over time. Many managers now see the incorporation of ESG factors as a requirement for their clients, using ESG analysis as a tool to both enhance returns in accordance with their specific investment objectives and to mitigate downside risks.

Arcmont's Practices – Materiality and Risk Mitigation

For Arcmont, the identification of material ESG factors is a fundamental part of our investment risk analysis, allowing us to price risks more effectively whilst avoiding companies or industries where risks are not appropriately priced. Arcmont's belief is that ESG factors can have a material impact on a borrower's financial performance. Poorly managed ESG risks can lead to inefficiencies, operational disruption, litigation, and reputational damage, which may ultimately impact a borrower's performance or ability to meet its financial responsibilities. For example, a Bank of America Merrill Lynch report recently found that 15 out of 17 bankruptcies in the S&P 500 between 2005 and 2015 were of companies that had poor environmental and social scores five years prior.[iii] Other credit markets also acknowledge the price relevance of material ESG factors. In 2019, 33% of Moody's private-sector credit rating actions were influenced by ESG factors.[iv] Likewise, in a recent study, MSCI found that public companies with high ESG scores, on average, experienced lower costs of capital compared to companies with poor ESG scores across both developed and emerging markets.[v]

Case Study

The effects of corporate mismanagement of material ESG issues can be severe. A classic modern example is the case of PG&E, who filed for bankruptcy protection in 2019 due to $30 billion in potential liabilities for deadly 2017 and 2018 wildfires that were tied to the mismanagement of their utilities equipment. California's wildfires — with the 2017 devastation ruled the state's most expensive ever at $11.8 billion — are increasingly destructive, and the fire season's duration is being stretched by climate change, scientists and officials have said.

Double Materiality

More recently, the concept of materiality has been extended to include an additional perspective, coined as "double materiality". First introduced by the European Commission ('EC') as part of the non-binding guidelines on Non-Financial

Reporting Directive ('NFRD'), double materiality identifies not only the impact of sustainability issues on a company, but also the impact of a company on society, the environment, and the world around it. The objective of this extended definition is to provide decision useful information to a broader stakeholder group, including the growing number of investors seeking to align their investment practices with climate or wider sustainability goals. Likewise, this extended definition caters to the informational needs of a range of other users of financial statements, such as employees and labour unions, as well as local communities and regulatory authorities. These key stakeholders can make significant investments in companies besides financial investments, such as investments in time or infrastructure spending, and these may be influenced by the information contained within a company's double materiality profile.

> "ESG is now at the forefront of how we think about investing and this is reflected in conversations with our investors."
>
> ANTHONY FOBEL, CEO,
> ARCMONT ASSET MANAGEMENT

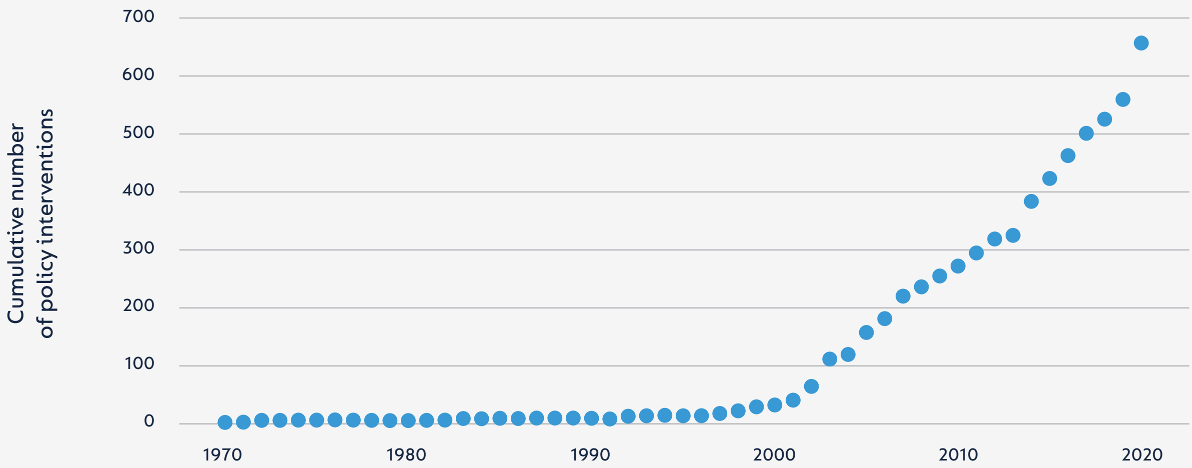
Investor Demand for ESG

The institutional market plays a vital role in levelling the sustainable finance playing field. In recent years, institutional investors and Limited Partners ('LPs') have been experiencing increasing pressure from their boards and stakeholders to manage ESG risks and provide sustainable investment returns. This has translated into a significant increase in demand for ESG integration and from institutional investors and LPs, and this has been reflected in their manager selection and due diligence processes. Findings from a recent study of Private Debt LPs indicated that 88% of respondents currently include ESG as part of manager evaluations.[vi] For Arcmont, there has been a significant uptick in LP ESG requests. In fact, our advanced approach to ESG integration is often one of the main topics of discussion with our investors.

Regulatory Pressures

Despite the onset of Covid-19 in 2020, the growth in responsible investment regulation remained a key driver of ESG integration in the investment industry. Last year, over 120 new or revised policy instruments were established, the highest number ever recorded and a 30% increase over 2019.[vii] More specifically, regulation focusing on investor ESG disclosure requirements increased by 74% over the same period.[viii] As transparency regulation around sustainable finance forces more managers out into the open, Private Debt General Partners ('GPs') have been working to solidify their approach to ESG integration, raising the bar across the board.

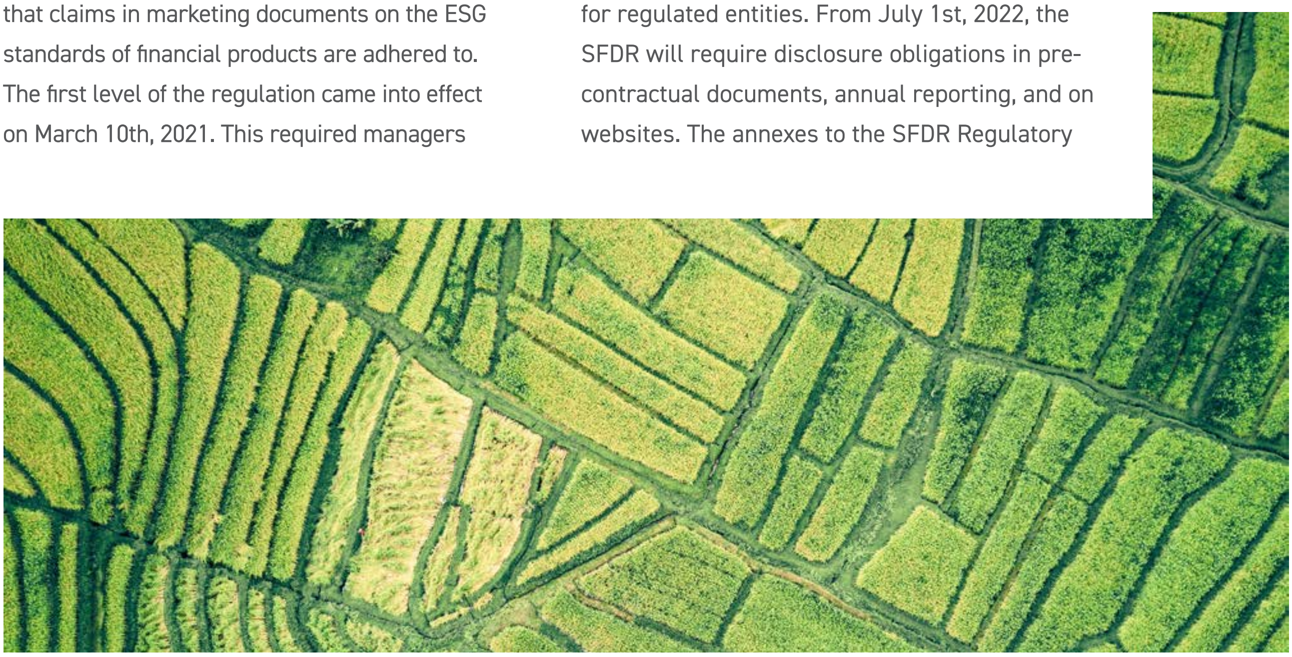
Number of ESG policy interventions[ix]



In the EU: The Sustainable Finance Disclosure Regulation

The European Union ('EU') is a global leader on sustainable finance policy and EU regulators are driving the agenda for responsible investment and sustainability disclosures. The cornerstone of the EU approach is the Sustainable Finance Disclosure Regulation ('SFDR'), which imposes mandatory reporting obligations on financial market participants with the goal of ensuring that claims in marketing documents on the ESG standards of financial products are adhered to. The first level of the regulation came into effect on March 10th, 2021. This required managers to categorise funds into Articles according to their ESG characteristics. The classification of funds determines the depth of future reporting requirements, with the EU Taxonomy Regulation adding additional obligations in the future. The overleaf provides a timeline of recent and future EU legislative developments.

While Level 1 of the SFDR sets out some relatively straightforward obligations, Level 2 is expected to include more detailed requirements for regulated entities. From July 1st, 2022, the SFDR will require disclosure obligations in pre-contractual documents, annual reporting, and on websites. The annexes to the SFDR Regulatory



Overview of the main EU legislative developments and forthcoming compliance deadlines[x]

Dec 2020

NFRD
EC proposal on the review of the NFRD

Q1 2021

EU TAXONOMY
Climate mitigation and adaptation technical criteria finalised

NFRD
EC to issue an additional consultation regarding a revised NFRD framework

10 Mar 2021

SFDR
First level of disclosures in pre-contractual documentation kicks in

30 Jun 2021

SFDR
Financial market participants to explain how main adverse impacts on environmental and social matters are considered

EUROPEAN BANKING AUTHORITY
Guidelines on loan origination and monitoring

Dec 2021

EU TAXONOMY
Technical screening criteria for remaining four objectives finalised

1 July 2022

EU TAXONOMY
Climate mitigation and adaptation criteria reporting applies

SFDR
Periodic reporting obligations apply

Q4 2022

MIFID II, UCITS, AIFMD, IDD, SOLVENCY II AMENDMENTS
Expected applicable date

1 Jan 2023

EU TAXONOMY
Expected applicable date for remaining four Taxonomy criteria

Technical Standards include mandatory templates for these disclosures which are to be filled out and included in investor prospectuses and annual reports. Furthermore, for funds categorized as Articles 8 and 9 that either promote or make sustainable investments an objective of the fund, additional disclosures will be required from investee companies in accordance with the EU Taxonomy Regulation, consisting of metrics related to key sustainability issues such as greenhouse gas emissions, biodiversity, water, and social matters.

In the UK: The Climate-related Disclosures Roadmap

In tandem with the EU, the UK recently laid out its climate-first regulatory strategy for addressing ESG considerations in capital markets. In November 2020, the UK government published a 2025 roadmap for mandatory climate-related disclosures across the UK economy, using the recommendations of the Financial Stability Board's Taskforce on Climate-related Financial Disclosures ('TCFD').[xi] The goal of the roadmap is to ensure that information on the climate impact of companies is available across the financial industry, thus allowing investors to appropriately price and align climate risk with investment decisions. In June 2021, the Financial Conduct Authority ('FCA') published a consultation paper, setting out a climate-related disclosure regime for asset managers and FCA regulated pension providers to be included in a new "ESG Sourcebook" in the FCA Handbook. The proposal includes entity, portfolio, and product-level disclosures that are to be made available on company websites or to investors on request. The FCA has stated that aligning disclosures with the TCFD is their recognition that some international consistency on ESG disclosure requirements is necessary to ensure information is comparable and useful to investors across jurisdictions.[xii]

In the US: The SEC Risk Alert

While the EU remains the leader on ESG regulation, the US has also acknowledged the rise in demand for ESG and sustainable finance measures. In April 2021, the Division of Examinations of the Securities and Exchange Commission ('SEC') issued a Risk Alert regarding investment advisers, registered investment companies, and private funds offering ESG products and services. The Risk Alert highlighted observations from examinations of businesses, providing examples of problematic conduct with respect to ESG practices. The Risk Alert also outlined the SEC's key focus areas for examining investment advisers' and funds' ESG offerings going forward, stating that it "encourages market participants promoting ESG investing to clients to evaluate whether their disclosures, marketing claims, and other public statements related to ESG investing are accurate and consistent with internal firm practices."[xiii] The Risk Alert represents the clearest and most granular articulation of the SEC's concerns around the marketing of ESG-related investment products, and the sufficiency of managers' practices, policies and procedures when selling them. For managers offering ESG-related products in the US, a thorough review of the Risk Alert is advisable, both to assess their potential exposure to regulatory risks and to ensure ESG policies and practices match any articulated commitments made in product marketing material.

Industry Standards and Frameworks

With the rise of ESG in Private Debt, the demand for industry standards and reporting to codify these efforts has increased considerably. However, the advent of multiple ESG frameworks, standards, and data offerings, which can be conflicting in their requirements and conclusions, has been confusing and overwhelming for many practitioners. As investors seek to deepen the integration of ESG information into investment decision making and risk management processes, we are seeing a push for better quality and more investor-friendly information, linked to corporate strategy, that enables an understanding of their impacts on society and the environment. Overleaf we highlight a few of the current industry efforts attempting to standardize the way we speak and report on ESG efforts.

INITIATIVE	TYPE	PRIMARY STAKEHOLDER	DESCRIPTION
Principles for Responsible Investing ('PRI')	Reporting framework and database	Investors	The PRI sets out six voluntary principles, supported by 35 actions, that Investors can use to integrate ESG into investment practices. The PRI provides a database of standardized company transparency reports that signatories update on a yearly basis.
Task Force on Climate-Related Financial Disclosures ('TCFD')	Climate-related reporting framework	Corporates and Investors	The TCFD provides guidelines for companies, banks, and investors to improve the access and pricing of climate-related financial risks and opportunities in their disclosures.
Global Reporting Initiative ('GRI')	Reporting standards	Corporates and Investors	The GRI was the first and most widely adopted standard for global reporting. Its guidelines on ESG issues are broad, covering around 900 sustainability topics. Its structure allows for integration with other reporting methodologies such as SASB and IIRC.
Sustainability Accounting Standards Board ('SASB')[1]	ESG materiality accounting standards	Corporates and Investors	The SASB sets standards for 77 different industries, providing information on financially material issues and associated metrics. This makes SASB more granular than some of the other frameworks.
United Nations ('UN') Sustainable Development Goals ('SDGs')	General guidelines and mapping tool	All Stakeholders	The UN SDGs are a collection of 17 goals adopted by the UN member states as part of the 2030 Agenda for Sustainable Development.
International Integrated Reporting Council ('IIRC')[2]	Integrated Reporting Framework	Corporates and Investors	The IIRC lays out a framework for integrated reporting using a principles-based rather than compliance driven approach to limit box-ticking and promote business relevance.
United Nations Global Compact ('UNGC')	Guidelines for responsible business	Corporates and Investors	The UNGC is a non-binding pact encouraging businesses and firms worldwide to adopt minimum standards of responsible business. The UNGC aims to address 10 principles covering human and labour rights, the environment, and corruption.
OECD Guidelines for Multinational Enterprises	Guidelines for responsible business	Corporates	The Guidelines are recommendations on principles and standards for responsible business conduct. They are the only multilaterally agreed code of responsible business conduct that governments have committed to promoting.

1 & 2 SASB recently merged with the IIRC, the new combined group is known as the Value Reporting Foundation

The Challenges

Despite the clear appetite for ESG information from all parties in the Private Debt space, the idiosyncrasies of the asset class have created a number of hurdles for managers wishing to achieve deeper and more holistic ESG integration.

INCOMPLETE DATA

In private markets, access to and availability of company data represents a significant challenge. As opposed to public markets where listed companies are required to produce certain disclosures and data, the opaque nature of private markets and lack of publicly available ESG data means private-market investors must conduct their own bottom-up fundamental analysis on prospective investments. In the majority of cases, any data that is collected is discretionary and driven by the mandates of the equity owners, leaving lenders with the responsibility to collect the required information from the borrower. Not only does this lead to incomplete data sets, but this can also place a significant burden on the investment team. The often tight timeline for due diligence means even greater pressure on the deal and risk teams.

Our Approach: Arcmont views this extra layer of ESG due diligence as fundamental to our analysis, without which we risk missing key components of a prospective investment's risk profile. Arcmont has worked in collaboration with KKS to streamline our investment process to accommodate the additional workload created by our ESG data requirements, thus ensuring we have access to the full suite of available ESG information for a prospective investment. Whilst collecting all data points is often not possible, Arcmont engages with investments post-closing with the goal of improving data availability over the life of the loan, employing our proprietary ESG scoring system to help us identify the areas where further due diligence is required to appreciate the risk profile of the business.

INFLUENCE OVER MANAGEMENT

Private markets in general tend to have limited secondary markets, and these are even more limited for middle market private loans. Tools such as the ability to vote against management, or to divest from holdings as a last resort are not often open to private lenders. Therefore, ESG analysis often primarily focuses on the pre-investment and sourcing stages of a deal. However, more sophisticated ESG lenders understand that once a deal is closed and an investment is brought into a Private Debt fund, engagement with portfolio companies becomes an important tool to mitigate evolving ESG risks. As such, it is vital that managers maintain an open and active dialogue with borrowers, prioritising ESG engagement around the most salient issues over the lifetime of an investment.

Our Approach: Arcmont has traditionally maintained a dialogue with borrowers in order to gain a deeper insight into ESG policies and practices, and to monitor material ESG risks. More recently, Arcmont has implemented an Environmental & Social ('E&S') Target Improvement Plan ('TIP') programme for new primary borrowers, with outcomes linked to the coupon rate repayable on loans. This approach leverages our control over the cost of capital to gain influence over the borrower's E&S management practices, allowing us to guide the borrower to a more effective E&S management approach, thus bypassing the constraints on engagement traditionally faced by private lenders.

FIRST MOVER RISK

The competition amongst European private lenders can be intense, leaving many as price-takers in the majority of prospective deals. As a result, investors that are skilled in ESG analysis, such that they can identify and price ESG risks more effectively than their peers, may face a first mover risk. That is, given an ESG risk has been identified, the manager will require compensation for the risk that other less sophisticated ESG investors will not, either through harsher pricing or stricter loan terms. As such, the skilled ESG investor may lose out on potential investments to other lenders that are not considering such risks. For example, if the skilled ESG investor prices climate risk into a proposed coupon rate for a potential fossil fuel investment, they are more likely to lose the bid to debt providers that have omitted this type of analysis. In such cases, the skilled ESG lender is punished commercially for correctly pricing risks that others do not.

Our Thinking: In this context, an analysis of ESG opportunities alongside risks becomes crucial for the skilled ESG investor. This is because the lender may also be able to identify investments where ESG risks are significantly lower than the market. Using the example mentioned, the skilled ESG investor may be able to identify leading companies in the industry that have the potential to develop climate solutions that others do not, thus representing an improved positioning in the market, and in turn, incurring less risk than the market is measuring. The skilled ESG investor is then able to loosen the proposed loan terms and gain a competitive advantage over its peers.

LACK OF STANDARD MARKET BEST PRACTICE

While progress has been made in the integration of ESG within the Private Debt industry, there remains no industry-wide best practice for evaluating environmental and social considerations when underwriting a loan. While ESG integration in Private Debt can be implemented across the entire investment lifecycle, developing a firmer grasp of what best practice looks like for ESG integration in Private Debt is a necessary condition for its accelerated adoption across the wider market.

Our Approach: Arcmont aspires to be an industry leader in ESG integration for Private Debt. Through leading by example and continuing our ESG advocacy and thought leadership, we hope to accelerate the adoption of ESG integration across the industry, using our own practices as a guide toward the creation of a standard practice. To facilitate this goal, Arcmont has formed an ongoing relationship with KKS, a firm at the forefront of ESG consulting and research, to provide guidance where no standardization exists. Arcmont intends for this paper to act as a flagship document pioneering engagement and progression in standardization efforts.

Rising to the Challenge

While ESG integration may often be used as a tool to gain a competitive advantage and to better manage risk, an overarching goal of sustainable investment practices is to maximise the power of capital to create a positive impact on society and the environment. We are encouraged by the progress that has been made up to this point, as well as the self-evident desire of many to further develop and progress best practices across the industry. However, there is clearly still work left to be done, meaning continued transparency is vital. It is with this goal in mind that we outline our insights and practices regarding ESG integration for private lenders in the following sections, in the hope that (i) we can inspire other lenders to continue along the journey of deeper ESG integration within their own investment and risk management practices, (ii) we serve to initiate and continue discussions around ESG, and (iii) we contribute towards the development of robust and industry-wide best practices.

The Stages of ESG Integration in Private Debt – It's a Journey

While ESG in the Private Debt space may yet be in its early stages, we are increasingly seeing lenders following a similar route when moving from no ESG integration to advance ESG integration. More specifically, our view is that a lender must progress through three phases across four key competencies on the journey towards impactfully bringing ESG into the investment process. We call these phases the

The Private Debt ESG Integration Journey

NO INTEGRATION	**PHASE 1:** INITIATED	**PHASE 2:** INTEGRATED	**PHASE 3:** ADVANCED
Competency 1: ESG Oversight and Accountability	Individual level and function specific	Firm wide and with senior management involvement	Firm wide, with senior management involvement, and board oversight
Competency 2: Pre-investment ESG Analysis	Basic screening	ESG screening/ underwriting with qualitative analysis of material issues	ESG screening/underwriting with qualitative analysis and quantitative scoring of material issues
Competency 3: Post-Investment ESG Monitoring and Engagement	Risk identification and monitoring focused, ad hoc engagement	Open and active dialogue with management to influence practices	Open and active dialogue with management to influence practices, as well as sustainability link in loan terms to financially incentivize stronger ESG performance
Competency 4: Transparency and ESG Reporting	Generic qualitative reporting at the portfolio level	Qualitative reporting at the portfolio and portfolio company level	Qualitative and quantitative reporting at the portfolio and portfolio company level

> "Too often ESG activities become the focus of public relations and reporting, as opposed to playing a role in strategic business decisions and how an organization creates value."

GEORGE SERAFEIM, CO-FOUNDER OF KKS ADVISORS AND CHARLES M. WILLIAM PROFESSOR AT HARVARD BUSINESS SCHOOL

Initiated, Integrated, and Advanced stages of ESG integration. Overleaf we summarize this evolution across the four key competencies, considering the current state of the market and where we expect the industry is heading. Together, each of the four competencies makes up the full Private Debt investment process covering the entire life of a loan. Only through effectively tackling each of the four competencies can a lender credibly claim their approach is creating ESG impact, thus serving the needs of each of the lender's core stakeholder groups, from borrowers to investors. The sections that follow provide a more in-depth analysis of each dimension, including examples of Arcmont's own practices as an illustration of advanced practices in the industry.

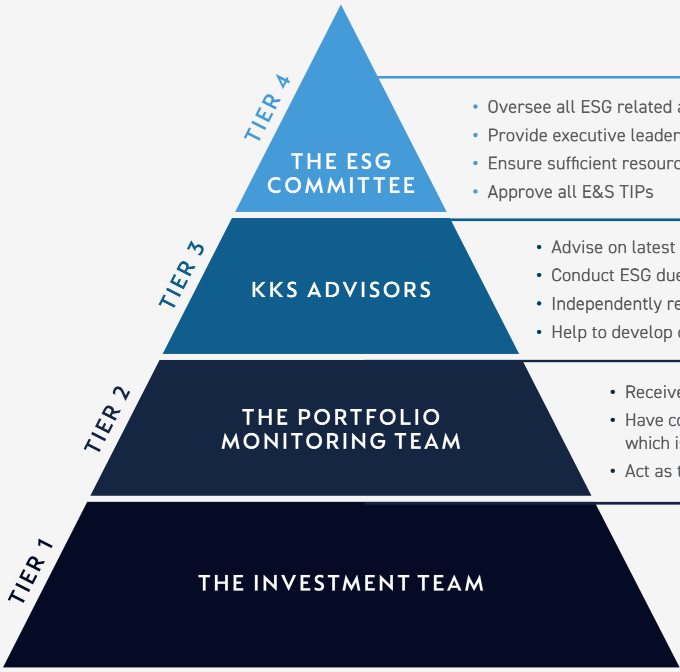
Competency 1: ESG Oversight and Accountability

The oversight and accountability of ESG practices is intrinsically linked to the importance ESG plays in the high-level strategic decision-making of a firm. While having strong oversight and accountability ensures senior decision makers are involved, it also ensures firms commit the resources to have the right people, knowledge, expertise, and tools in place for implementation. Whereas Initiated (Phase 1) firms tend to delegate ESG oversight and implementation to a standalone group or person, more sophisticated firms (Phases 2&3) understand that ESG is a core part of the investment strategy and business model, which hence falls under the purview of the board and the firm's top management and leadership. Too often, ESG strategy becomes the focus of reporting, marketing, or investor relations material, as opposed to playing a role in strategic business decisions. The implementation of a meaningful ESG integration strategy often involves large operational and strategic changes. It must therefore start at the top with the board and be diffused throughout the entire organization.[xv]

ARCMONT'S PRACTICES – ESG OVERSIGHT AND ACCOUNTABILITY

Developing and clearly articulating a robust accountability structure for ESG integration is a vital first step for an Integrated (Phase 2) manager. All ESG related activities at Arcmont are overseen

Arcmont's four-tiered approach to firm-wide ESG governance



- Oversee all ESG related activities across the firm and investment process
- Provide executive leadership on integrating ESG into Arcmont's wider corporate strategy
- Ensure sufficient resources are available to execute on ESG-focused initiatives
- Approve all E&S TIPs

- Advise on latest developments and best practices through ESG training
- Conduct ESG due diligence reviews and advise on due diligence reports
- Independently review ESG analysis as well as quarterly ESG updates
- Help to develop company specific E&S TIPs

- Receive regular ESG specific training
- Have completed the UN PRI's Foundations in Responsible Investment course which is recognised as the international gold standard for ESG training
- Act as the link between the investment team and KKS

- Receive regular ESG specific training
- Equipped to apply Arcmont's ESG Exclusions Policy and conduct ESG analysis
- Embed ESG principles into primary due diligence
- Actively monitor ESG issues at portfolio companies and prepare ESG reporting

by the ESG Committee, which is led by our Chief Operating Officer. In addition, in July 2020, Arcmont integrated KKS, an independent ESG advisory firm, into our ESG governance structure. As an organisation at the forefront of ESG research, KKS' role is to provide guidance on strategy, advise on developments in the market, provide training, conduct due diligence, as well as assist with the implementation of ESG into investment processes. The incorporation of an independent entity into our ESG governance structure enhances our firm-wide approach to ESG oversight, both due to the research-backed knowledge and impartial advice KKS provides. As such, Arcmont now operates a four-tiered approach to the governance of ESG across the firm.

Competency 2: Pre-Investment ESG Analysis

For Private Debt investors, strong pre-investment ESG analysis is vital for ensuring that ESG information is valuable in credit decisions. For Initiated (Phase 1) lenders at the beginning of their ESG integration journey, pre-investment ESG analysis is often restricted to the basic screening of investments against activities in illegal or highly controversial industries, with limited focus on ESG due diligence past sourcing and origination. As the journey progresses, Integrated (Phase 2) investors will begin conducting ESG-orientated due diligence in order to identify the issues that are relevant to the prospective investment, which are then to be factored into credit decisions. For the most Advanced (Phase 3) lenders, such considerations must permeate the entire pre-investment process, from sourcing to signing, using quantitative metrics and data to make robust and informed decisions. The use of quantitative data is challenging but vital to ensure consistency and comparability across investments. Where this isn't feasible, Advanced (Phase 3) lenders may use qualitative data as an input to create internal quantitative investment ratings, based on internal guidelines on the potential investment impact of different ESG issues. This approach brings preliminary but much needed rigour into ESG integration practices, allowing the advanced lender to set their risk tolerance level by creating comparability in ESG impact across investments. The adoption of quantitative data into ESG analysis and then into credit analysis represents a crucial next step towards achieving a quantifiable and measurable impact through a Private Debt ESG strategy.

ARCMONT'S PRACTICES – SCREENING

At the deal origination stage, business activities that are deemed too risky from an ESG risk perspective are filtered out with an initial screening framework. In general, Arcmont believes it is preferable to engage with portfolio companies on ESG matters to try and correct any controversial practices and improve a borrower's ESG profile. However, at the deal origination stage, we believe that some activities are fundamentally counter to Arcmont's responsible investment objectives by virtue of their operations. We therefore elect to exclude borrowers engaging in these activities from our investment universe. Arcmont uses a combination of industry specific and principles-based exclusions across our funds.

ARCMONT'S PRACTICES – DUE DILIGENCE 'IT'S ALL ABOUT THE NUMBERS'

Arcmont has worked extensively, in collaboration with subject matter experts, to develop a robust approach for bringing a quantitative methodology into pre-investment ESG analysis in Private Debt. In 2019, Arcmont's ESG due diligence process transitioned from a qualitative approach to a qualitative and quantitative combined approach, which has since been further refined with the guidance of KKS. Our ESG analysis begins with the investment team performing a materiality

List of activities and the associated exclusion thresholds[3]

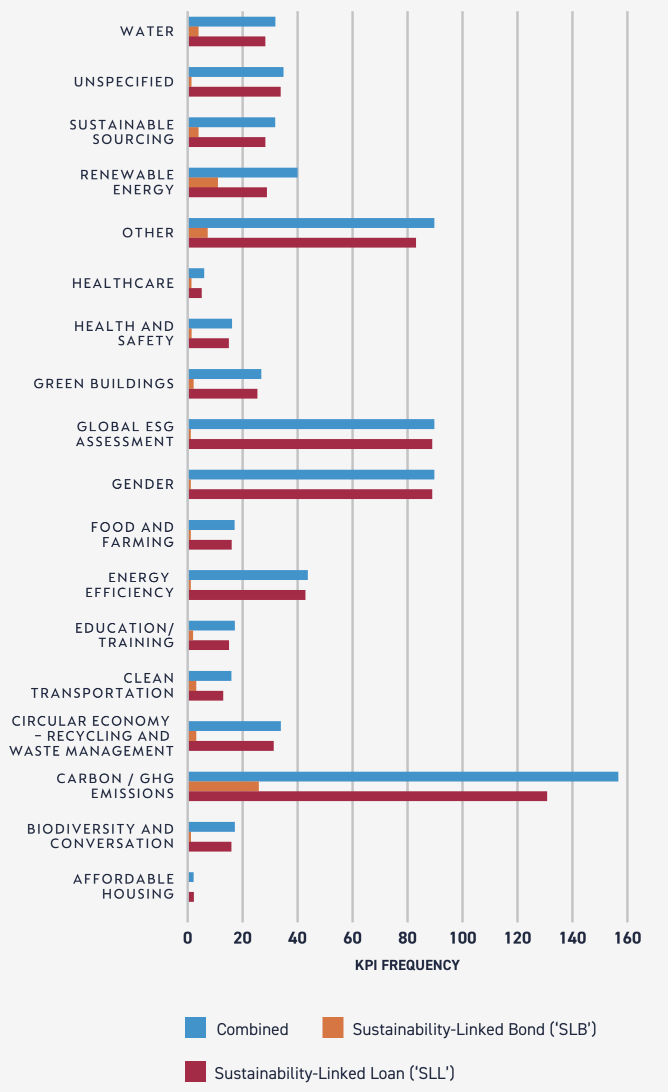
DESCRIPTION	EXCLUSION TYPE
Violation of the UN Global Compact Principles	**Absolute Exclusion**
Adult Entertainment	**Absolute Exclusion**
Controversial Weapons	**Absolute Exclusion**
Conventional Weapons	**Absolute Exclusion**
Fur Products	**Absolute Exclusion**
Genetically Modified Organisms	**Absolute Exclusion**
Tobacco	**Absolute Exclusion**
Thermal Coal	**Revenue Threshold - Greater than 5%**
Oil / Tar Sands	**Revenue Threshold - Greater than 5%**
Nuclear Power Generation	**Revenue Threshold - Greater than 10%**
Gambling	**Revenue Threshold - Greater than 25%**

3 Applicable as of March 2021

assessment which involves outlining any key ESG factors that are likely to be relevant to the investment, indicating the extent to which an issue is a concern, and whether the issue is being addressed by management. For this analysis, the team relies on a number of resources, including materiality maps, sponsor ESG due diligence reports, interviews with stakeholders, desk-based research, proprietary sector specific guidance, and on-going training on the identification of ESG factors.

Once the materiality assessment has been conducted, prospective investments receive a rating along each pillar of E, S, and G according to their potential investment impact. These are then aggregated to get an overall ESG Investment Impact Score capturing the overall likely impact of ESG issues on the investment, given the information available. The scores are reassessed on a quarterly basis based on monitoring updates. Our scoring approach leans on methodologies used by data providers and rating agencies to deliver a robust, systematic, and comparable approach to evaluating ESG considerations in the underwriting process, this then informs and enhances our investment decision making. All scoring decisions, both the initial and quarterly scores, are ultimately reviewed by our external ESG advisor. If further monitoring or action is needed for a specific issue post-closing, this is documented and reported on in the quarterly and annual external reports.

Types of ESG KPIs used in sustainability-linked debt products[xvi]



Competency 3: Post-Investment ESG Monitoring and Engagement

ESG issues are often dynamic in nature and, as such, it is possible for controversies to arise during the holding period. Even private lenders at the Initiated (Phase 1) stage of ESG integration must monitor investments for ESG-related incidents and identify areas of growing risk exposure. This is vital from a risk management perspective but also from a reputational risk perspective. Managers should, where feasible, identify ESG metrics that they can track and monitor to assess the severity of the risks, whilst moving to take appropriate action should a risk become too great. Integrated and Advanced (Phase 2&3) lenders must commit to maintaining an open and active dialogue with management, helping to identify any changes in an investment's ESG risk profile, but more importantly, enabling discussions to influence business practices to mitigate ESG risks.

More recently, Advanced (Phase 3) lenders have begun introducing sustainability-related metrics into the terms of debt instruments. Linking such metrics with interest rates represents the next phase of evolution for ESG in Private Debt. As an asset class where access to and influence over management is limited, assigning bespoke sustainability metrics to loans creates the opportunity for Private Debt lenders to play a much more active role in supporting and increasing the sustainability profile of their portfolio companies, as determining company-specific sustainability metrics, targets, and timeframes requires detailed discussions with management on their approach to ESG risk management.

KEY PERFORMANCE INDICATORS

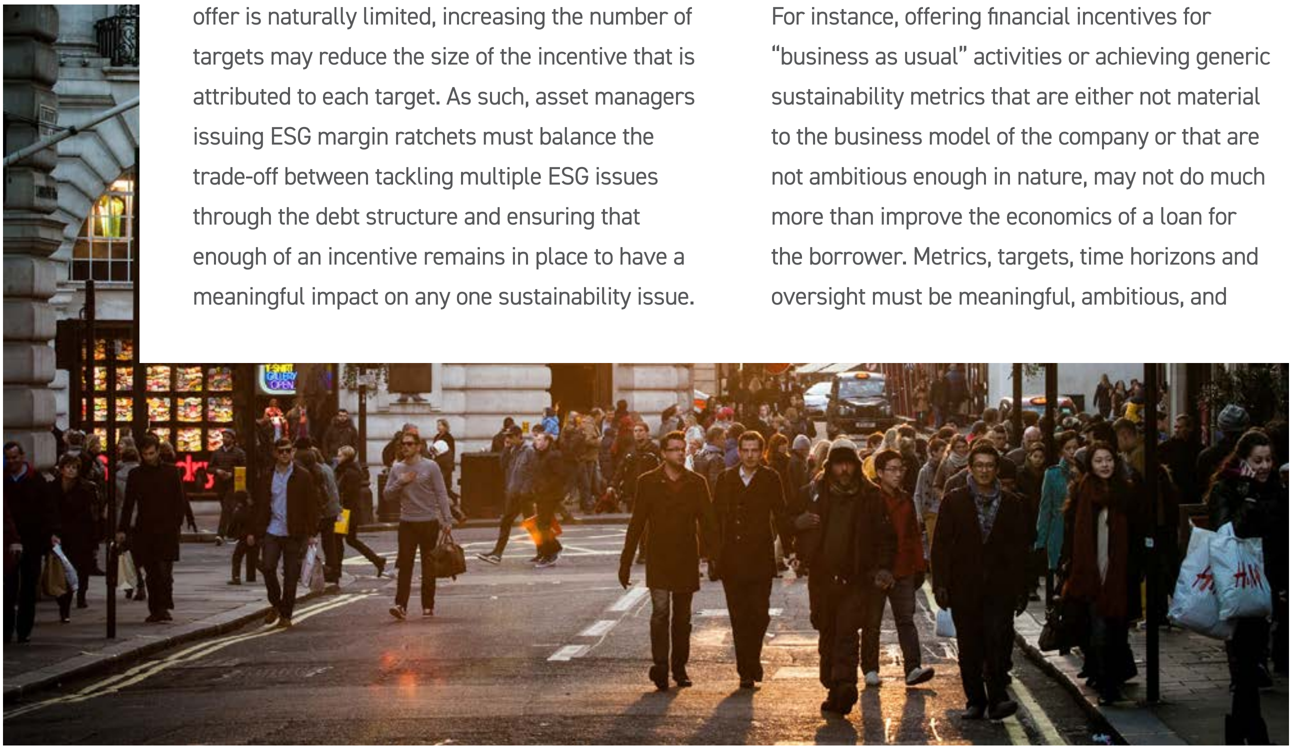
Of critical importance to the success of sustainability-linked debt instruments is the Key Performance Indicators ('KPIs') used to determine the discount or premium on interest rates. The majority of sustainability-linked loans have a single KPI, although there can be multiple KPIs and multiple targets for each indicator. Note however that as the size of the incentive a manager can offer is naturally limited, increasing the number of targets may reduce the size of the incentive that is attributed to each target. As such, asset managers issuing ESG margin ratchets must balance the trade-off between tackling multiple ESG issues through the debt structure and ensuring that enough of an incentive remains in place to have a meaningful impact on any one sustainability issue.

As shown in the figure on the previous page, carbon / Greenhouse Gas ('GHG') emissions is currently the most common KPI used in the market, most likely given its salience as an ESG issue, but also the relative ease with which it can be quantified relative to social issues. Nevertheless, KPIs that consider social factors, such as education and training, gender diversity, and health and safety are still relatively common.

DEVELOPMENTS IN THE MARKET

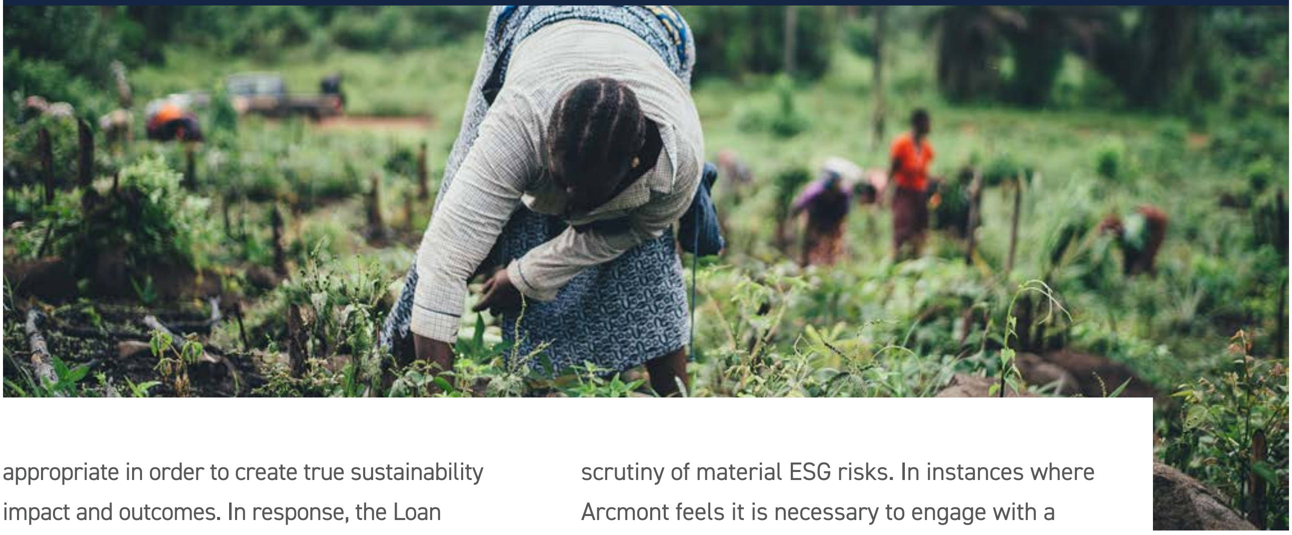
With the advent of the SFDR in Europe, managers are required to assign funds to categories based on their ESG and sustainability characteristics. A number of asset managers have begun offering ESG step-downs or margin ratchets on the interest rates of loans to their borrowers, where borrowers are rewarded through a discount on the interest rate they pay if they achieve a sustainability target.[xvii] While in general we view this as a positive development, it has had the effect of creating extremely heterogeneous sustainability-linked products in the loan market, with some methods more likely to have an impact on sustainability outcomes than others.

For instance, offering financial incentives for "business as usual" activities or achieving generic sustainability metrics that are either not material to the business model of the company or that are not ambitious enough in nature, may not do much more than improve the economics of a loan for the borrower. Metrics, targets, time horizons and oversight must be meaningful, ambitious, and



> "ESG is an integral part of our risk management process. The identification and assessment of ESG risks performed on all of our borrowers enhances our credit analysis and enables meaningful engagement with our portfolio companies to help promote sustainable business practices."

NATHAN BROWN, COO, ARCMONT ASSET MANAGEMENT



appropriate in order to create true sustainability impact and outcomes. In response, the Loan Market Association, the Asia Pacific Loan Market Association, and the Loan Syndications and Trading Association recently released a set of sustainability-linked loan principles, outlining a voluntary set of standards to be applied on a deal-by-deal basis to preserve the integrity of the sustainability-linked loan market.[xviii] The principles attempt to outline best practice regarding sustainability-linked loan creation, placing an emphasis on ensuring that targets are both meaningful and ambitious, and are applicable over the entire life of the loan.

ARCMONT'S PRACTICES – ENVIRONMENTAL AND SOCIAL TARGET IMPROVEMENT PLAN

Arcmont prides itself on maintaining close, long-term relationships with borrowers and sponsors. Traditionally, this has enabled a high degree of post-deal monitoring of investments, providing deeper insight into a borrower's ESG policies and practices, and permitting closer scrutiny of material ESG risks. In instances where Arcmont feels it is necessary to engage with a borrower to influence their business practices, this is prioritised using a risk-based approach. This means focusing on material ESG risks faced by the borrower, the quality of their mitigation efforts, and the size of Arcmont's investment.

Through our close communication with sponsors and investees, we have come to appreciate that borrowers who are actively working to identify, measure and manage their ESG risks represent less risky investments, and therefore a successful engagement that improves a borrower's management of environmental and social issues should be reflected in the risk premium. It is with this in mind that Arcmont has developed our E&S TIP programme which is offered to all new primary borrowers. The TIP focuses on E&S because governance factors have always been a primary focus for Arcmont as part of the ordinary course of business and it is E&S promotion that is the focus of Article 8 of the SFDR. Through this proprietary approach, we aim to introduce bespoke sustainability-linked targets for each of our new investments, financially incentivizing improved performance on E&S issues via discounts on the borrower's interest rate. In our view, the benefits of the E&S TIP are three-fold: (i) we enhance our post-investment ESG engagements with borrowers; (ii) we promote sustainable business models in the private mid-market; and (iii) ultimately, we reduce the risk profile of our portfolios.

Competency 4: Transparency and ESG Reporting

Regular ESG reporting acts as a vital mechanism through which a manager communicates any material changes to the ESG profiles of their portfolio companies. While an Initiated (Phase 1) investor may offer some overall narrative on ESG considerations at the aggregate firm, or fund level, Integrated (Phase 2) lenders will report on ESG at the portfolio company level, providing bespoke updates on the evolution of material ESG risks over the life of the investment. However, to be considered an Advanced (Phase 3) lender, managers must combine this narrative with borrower level data and metrics, a fund level view of ESG risk management, and a link to the overall firm ESG strategy and any existing fund-specific sustainability objectives. As in the pre-investment ESG analysis, bringing quantitative data into reporting provides investors with insightful and comparable information. Note however that with additional transparency comes additional scrutiny, as such the governance process around the production of ESG reporting should be subject to the same level of oversight as with financial reporting.

ARCMONT'S ESG PRACTICES – REPORTING

Arcmont's reporting strategy provides detailed and transparent information on ESG-related matters, including quantitative and qualitative ESG analysis at both the portfolio company and fund level on a quarterly and annual basis, alongside the financial reporting. Reporting in this way provides Arcmont with the opportunity to update our investors on changes to each borrower's ESG Investment Impact Score and in turn their investment risk profile, thus providing a more holistic view of the investment. Arcmont's approach continues to evolve as we work to improve our understanding of our investors' needs, whilst incorporating more quantitative information into our ESG management processes.

What's Next? Trends to Watch

ESG integration in Private Debt is still in its infancy relative to some other asset classes. This section outlines some developments in the ESG space that we expect will profoundly influence how Private Debt investors think about and integrate ESG factors into the investment process over the coming years.

THE GROWTH OF ADVANCED ESG INTEGRATED PRIVATE LENDERS

The ESG space within financial services is evolving rapidly, the combination of investor demand, regulation, and enhanced risk management makes ESG integration an attractive prospect for managers ready and willing to the undergo the transformation required to harness its benefits. From the Private Debt perspective, we expect that managers will begin following the lead of a select few innovators that have reached the Advanced (Phase 3) stage of ESG integration. Continuing along their ESG journey from implementing a simple ESG policy and carrying out a short qualitative underwriting review, to an in-depth and fully integrated approach, covering both the asset manager and the loan lifecycle, with quantitative as well as qualitative data. Similarly, we expect that more managers will move towards offering bespoke sustainability links in the loan terms for borrowers and indeed in their own borrowing terms in order to help drive change at the asset manager level. We view this as a positive development that will provide benefits to both allocators and society. As the ESG space continues to develop, Arcmont will continue to innovate for Private Debt, guiding the credit market towards a more robust approach for making a meaningful contribution to a more sustainable financial system and society.

ADDRESSING CLIMATE RISK

Climate change is the key ESG risk of this generation, representing an existential threat to humanity and the planet. To achieve the ambitious goal of limiting warming to below 1.5 degrees Celsius, we must rapidly transition from carbon-intensive consumption to low or no-carbon alternatives across all areas of the global economy. Currently 9 out of the 10 largest economies in the world have committed to net-zero emissions in the next 20 to 30 years. To achieve these ambitious goals, significant structural changes will need to happen impacting all sectors of the global economy. In our view, Private Debt managers have a significant role to play in supporting the transition, given that long lock-in periods can leave lenders exposed to the medium- and longer-term material impacts of climate change. Learning to properly identify, measure, and engage on climate risk in Private Debt investments is therefore a short-term necessity for the industry.

We expect to increasingly see lenders taking steps to identify and report on transition and physical climate risks and opportunities in their portfolios over the coming years. Measurement will play an important role as the deadline for mandatory TCFD disclosures draws closer. For those in private markets, managers will begin including requests for carbon foot-printing data in their due diligence requests, using carbon footprint and carbon intensity estimates to fill in any data gaps. This should be supplemented by robust climate scenario analysis methodologies, where feasible, for investments or portfolios deemed to be at high risk. However, to have a tangible impact, managers must look beyond identification and measurement, towards achieving real outcomes. For this, maintaining an open and active dialogue with portfolio companies to discuss their climate strategy, identify operational improvements, and create net-zero transition plans will be a crucial and necessary development. With this in mind, Arcmont is due to formally set out our approach to climate risk management later this year through the publication of a standalone climate policy. This policy will contain our carbon neutral commitment at the firm level and outline a strategy for addressing potential climate risks in our portfolios.

SUSTAINABILITY OUTCOMES

Up until recently, much of the focus around ESG in Private Debt has been centred on ESG integration that prioritises identifying and understanding ESG factors. While this is an important and essential first step, we expect that in the future, the focus will shift towards the intentional steps managers are taking to shape ESG outcomes in their investments, driven by increasing investor demand and more stringent regulations. For example, the 2020 Transparency Reporting cycle for signatories of the UN PRI included a voluntary module addressing sustainability outcomes from ESG integration activities. This prioritises reporting on the actions of managers that were making a tangible difference to the sustainability profile of their investees and the wider industry, including engagement with investees, policy makers, and other actors. As both GPs and LPs in the Private Debt space continue to enhance the sophistication of their ESG integration strategies, ever-increasing standards will pressure GPs to display the positive impact their ESG actions are having, both on their borrowers and the wider world. As such, lenders that use robust methodologies for creating, measuring, and reporting on sustainability outcomes are likely to enjoy a strong market position. We therefore expect sustainability-linked products, such as Arcmont's TIP, to proliferate the Private Debt space as well as impact focused lending funds.

Conclusion

The goals of this thought leadership paper are three-fold. The first is to serve as an introduction to ESG integration viewed through the lens of a mid-market private lender. Section one discusses some of the key definitions and characteristics of effective ESG integration, and highlights the challenges of its implementation in private credit markets. The second goal is to offer a framework for integrating ESG into the Private Debt asset class and the third is to help the industry move towards the creation of ESG integration best practices by providing some insights and practices from Arcmont. Section two discusses ESG integration in Private Debt across 4 Competencies and 3 Phases using Arcmont's practices to give tangible examples of advanced practices that other market participants might work towards. Section three finishes the paper with some expectations and trends for the future of ESG in Private Debt.

In an industry where expectations around ESG integration are outpacing the practices of many lenders, we felt it important to offer our insights in the hope of educating and inspiring the industry to cement its place as a key player in the creation of more sustainable financial markets. Both Arcmont's and KKS' aim is to encourage business and investment decisions to be made for the long term, maximizing the power of capital to achieve a positive impact. We invite any financial market participant who shares this view to contact us to collaborate and make this goal a reality.

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