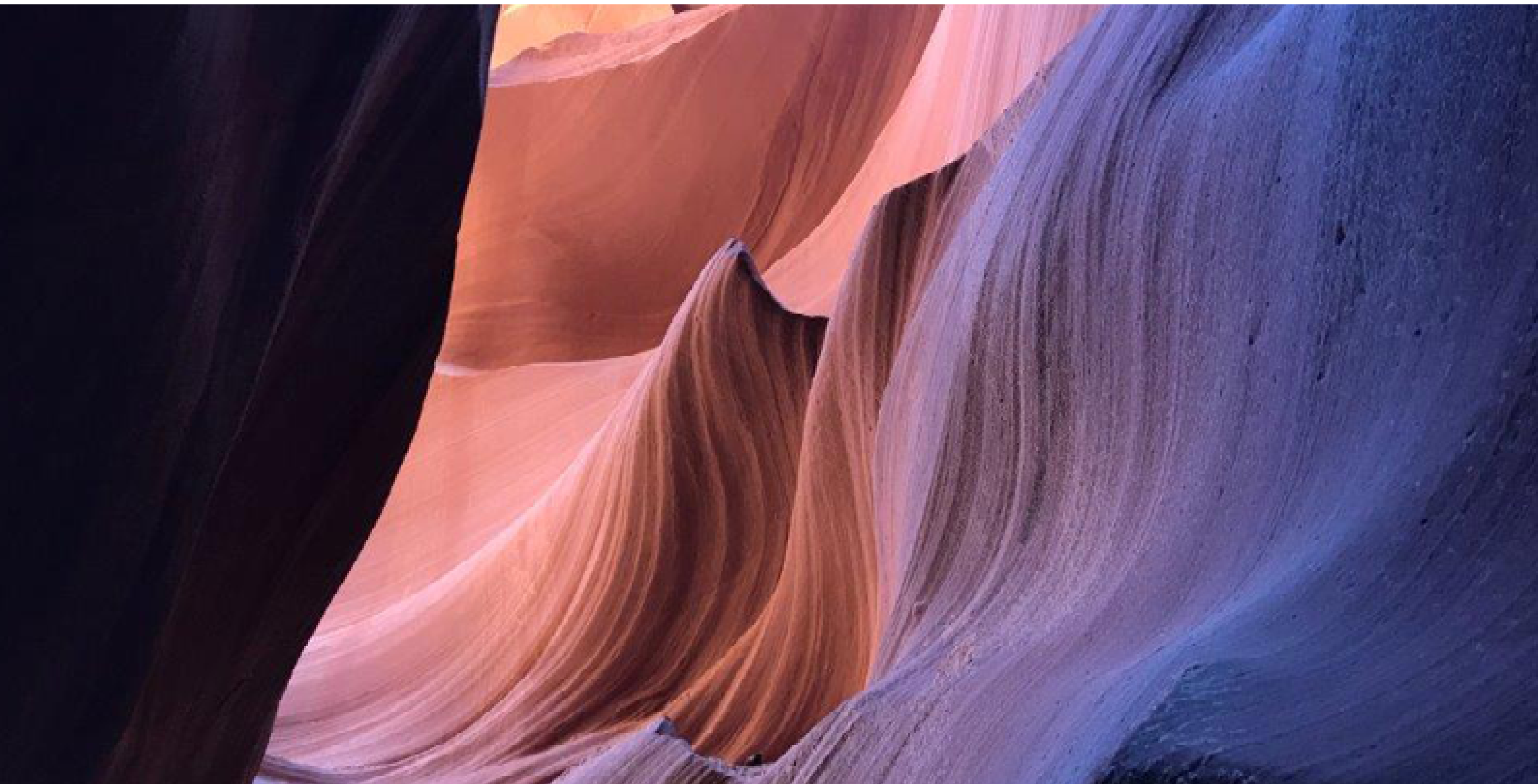
INVESTMENT
PERSPECTIVES

CapitalDynamics
TRULY INVESTED.

FEBRUARY 2022

THE EVOLUTION OF ESG IN LOWER MIDDLE-MARKET DIRECT LENDING



AN OVERVIEW OF ESG IN U.S. MIDDLE-MARKET CREDIT

The U.S. middle market is a significant growth engine of the U.S. economy, accounting for one-third of private sector gross domestic product[1]. As one of the largest contributors to employment, small companies also play a critical role in the social welfare of society. Historically, U.S. middle market companies relied on commercial banks to meet their debt financing needs. Since the Global Financial Crisis, a combination of regulatory pressure and market dynamics has resulted in an exodus of commercial banks from the space. Dedicated private credit funds have emerged to fill this significant financing gap and participate in building institutionalized and resilient small businesses over time.

While evaluating corporate ESG performance has always been integral to underwriting processes, it is typically used by middle market lenders as a negative screening mechanism to eliminate investments from consideration. For example, companies operating with little regard for the environment or with poor employee relations open themselves up to, among others, financial, legal and reputational risks. Identifying and quantifying those risks often leads such investments to fail review from rigorous investment committees. That said, leveraging ESG performance as a positive screen to identify companies that are likely to outperform their peers and command premium valuations over time and across cycles is an emerging and invaluable tool in credit investment selection and underwriting. Importantly, an improving corporate ESG profile is often rewarded with enhanced financial performance, valuation multiple expansion and greater access to capital markets. As such, identifying and underwriting resilient business models requires not only screening those investments for ESG attributes at the time of underwriting but also ensuring that those companies prioritize sustainability along the three dimensions of ESG over time. Refocusing the lens from negative screening to using ESG metrics as an investment selection and management tool, however, is not a trivial undertaking. Part of the challenge in implementing the practice lies in the role that private creditors assume in transactions. Lenders are often expected to be silent partners with, absent the occurrence of an event of default, limited input into the strategic direction or operating trajectory of the company being financed. Nevertheless, middle market lenders are in a position to influence corporate behavior. As essential capital providers, private creditors have the capacity to engage with management teams and private equity sponsors during underwriting and post-closing of a financing and to motivate behavior through inquiry, dialog and contractual stipulations, such as maintenance covenants or financial incentives, including, for example, positive or negative interest rate ratchets.

Another challenge with building a strong ESG screening and monitoring framework is access to measurable and predictive data. Middle market, entrepreneur-owned companies often lack financial, technological and human resources to identify, gather and synthesize key performance data. That includes financial and operating data as well as data directly related to a company's ESG attributes. Lenders, along with private equity managers bring both capital and strategic/operational oversight to assist companies in improving data gathering, analysis and reporting capabilities. As such, lenders can be influential in determining how ESG performance is measured and monitored and in defining key performance indicators ("KPIs") that help drive improvements across ESG dimensions over time.

[1] *National Centre for the Middle Market (2018): The DNA of Middle Market Growth. The Three Types of Growth Champions and the Factors that Drive Their Success. Available at: https://www.middlemarketcenter.org/Media/Documents/three-types-of-growth-champions-and-factors-that-drive-success_NCMM_DNA_of_Growth_FINAL_Web.pdf (Accessed 24th November 2021).*

The benefits to a company of enhancing its ESG profile are evidenced not just through improved relative financial performance but also by the impact that it has on its employees, the environment and communities in which it operates. Strong ESG performance drives growth in employment, reduces environmental waste, generates incremental tax revenues that fund essential social services (education, healthcare, law enforcement, etc.) and helps raise living standards. Given the critical role they play in providing essential capital to support the growth of middle market companies, private creditors have an opportunity to meaningfully impact society by working with borrower management teams and private equity owners to design, implement and institutionalize strategic and operational ESG priorities.

In this paper, we explore several aspects of responsible lending in lower middle-market credit, including:

(i) the benefits of strong ESG on the performance of small companies;

(ii) techniques to underwrite ESG as a direct lender; and

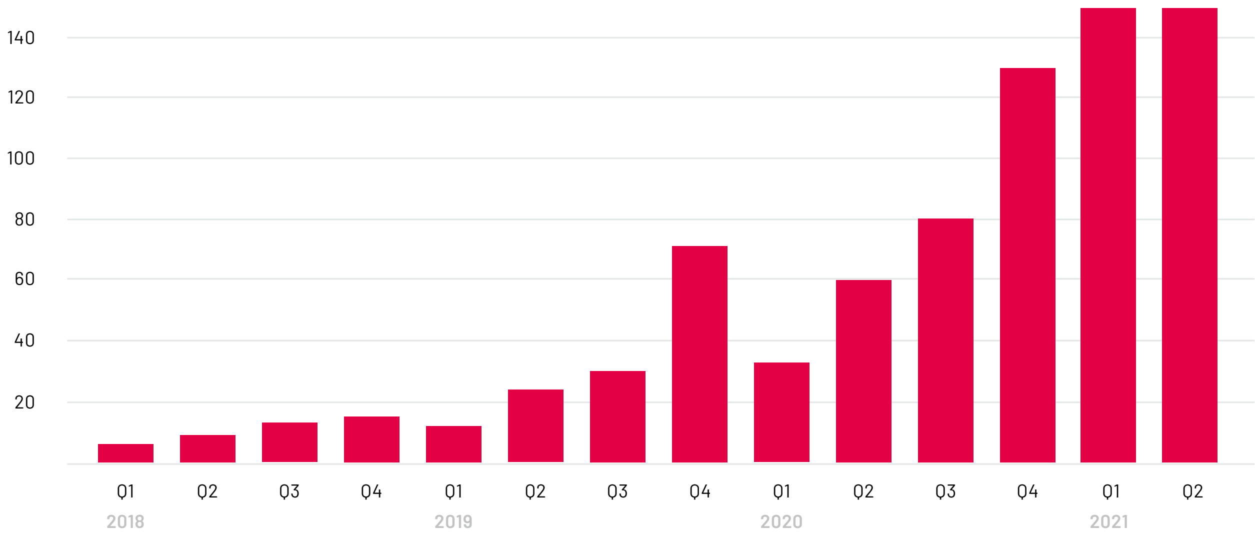
(iii) the strategic use of influence on the sponsor and borrower absent the ability to control corporate action.

THE PERFORMANCE BENEFITS OF ESG FOR SMALLER COMPANIES

Small companies with strong ESG attributes outperform their peers for several reasons. These businesses often exhibit higher relative top-line growth because (i) they can attract customers and gain share by delivering more sustainable products and services, and/or (ii) they can command premium pricing based on the positive attributes associated with their brands and/or organizational reputation. Such companies often enjoy operating expense advantages relative to peers from investing in health and safety (resulting in fewer accidents), lowering waste and energy consumption, and reducing personnel turnover due to greater employee job satisfaction. Greater job satisfaction may also translate into increased productivity from reduced absenteeism, greater employee motivation, and the ability to attract and, critically, retain better talent. According to a 2017 survey, 88% of consumers will be more loyal to a company that supports social or environmental issues.[2] Furthermore, the effective implementation of an ESG strategy at a company can impact operating profits by as much as 60%.[3] Companies with better ESG also tend to have greater strategic freedom due to enhanced public support and less scrutiny from regulatory agencies or advocacy groups. Combining better operational performance with more strategic freedom facilitates longer-term thinking, including investment in more sustainable plants, equipment, and business models.[4]

The below chart demonstrates that even in larger markets, ESG is increasingly becoming a point of interest for discussions with respect to company earnings, valuations and strategy with executive management, analysts and other stakeholders.[5]

S&P 500 companies mentioning ESG on earnings calls



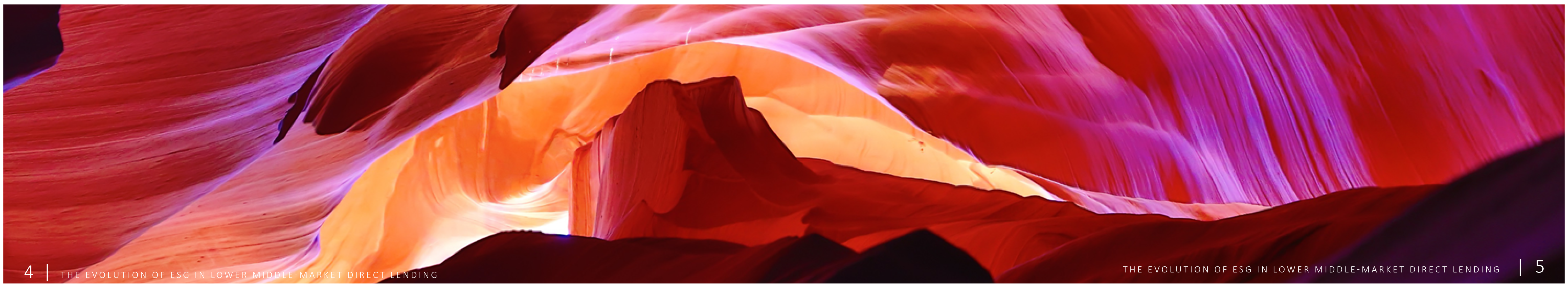
Through September 10, 2021, categorized by quarter of earnings not date of call
Source: FactSet

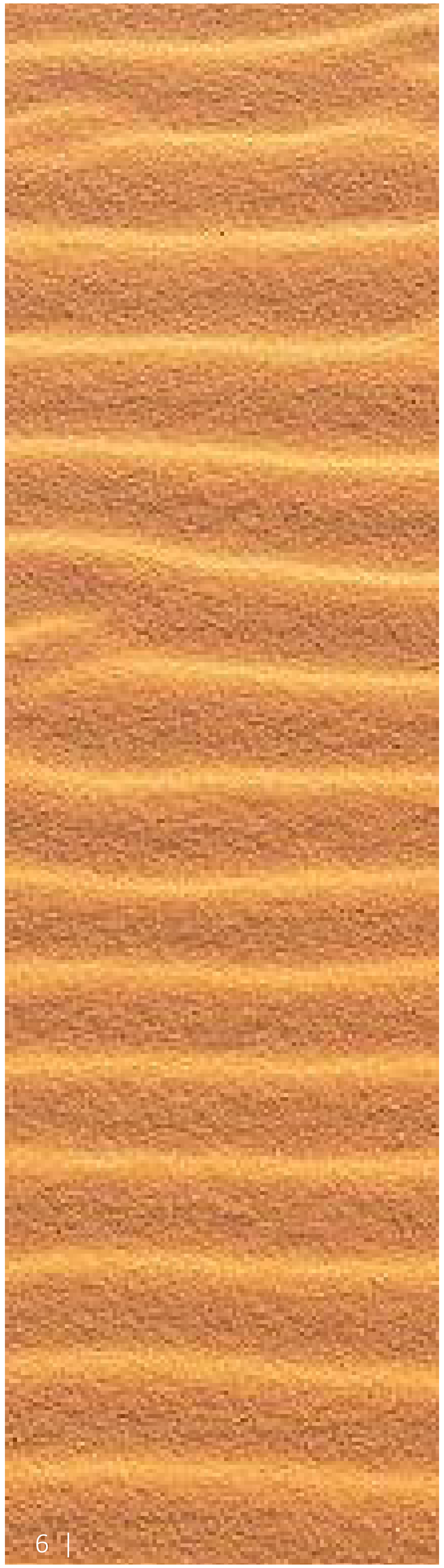
Conversely, companies with weak ESG profiles face obstacles. Unsustainable practices or the perception of unsafe products and services can lead to loss of customer support, legal proceedings and potentially damaging remediation expenses. These businesses also have more difficulty accessing resources, may experience operational disruptions, and often have poor community and labor relations. They commonly generate unnecessary waste, experience relatively higher employee turnover, and have limited capacity to pass through input cost increases, all of which negatively impact margins and financial performance. In addition, they are more likely to attract greater regulatory scrutiny, exposing them to potential fines, penalties and enforcement actions. Opaque governance structures can also lead to both inefficient decision-making and poor job satisfaction levels. On their own, each of these challenges present a credit risk and collectively they may result in greater financial stress on the business through economic cycles.

At first glance, it may appear that the benefits of good ESG practices accrue mostly to equity investors as stronger relative performance typically translates into valuation multiple premiums; private credit funds (outside of a default and workout scenario) typically do not participate in the equity upside of a business. That said, outperformance in credit is often the result of loan portfolios experiencing fewer defaults and minimizing losses if, and when, such defaults occur. As discussed above, companies with stronger ESG profiles tend to be more resilient. They have greater flexibility to maneuver challenging environments, given stronger profit margin and cash flow profiles, the capacity to pass along increased input costs (labor and/or materials) to their customers, and greater resources in terms of both access to capital and talent that can help navigate market dislocations. In addition, the favorable investment characteristics of companies with strong ESG attributes provide lenders and private equity managers with more degrees of freedom when faced with market headwinds. Besides the aforementioned operating flexibility, if warranted, recovering proceeds through a sale of the company is also likely to be more successful (in terms of valuations and proceeds received) with companies demonstrating strong ESG credentials than for those that do not.

---

[2] *2017 Cone Communications CSR Study*
[3] *Capital Dynamics based on McKinsey & Company, McKinsey Quarterly "Five ways that ESG creates value" November 14, 2019*
[4] *Capital Dynamics based on McKinsey & Company, McKinsey Quarterly "Five ways that ESG creates value" November 14, 2019*
[5] *SS&C Intralinks. "How Top M&A Professionals Are Embracing ESG in the Deal Process"*



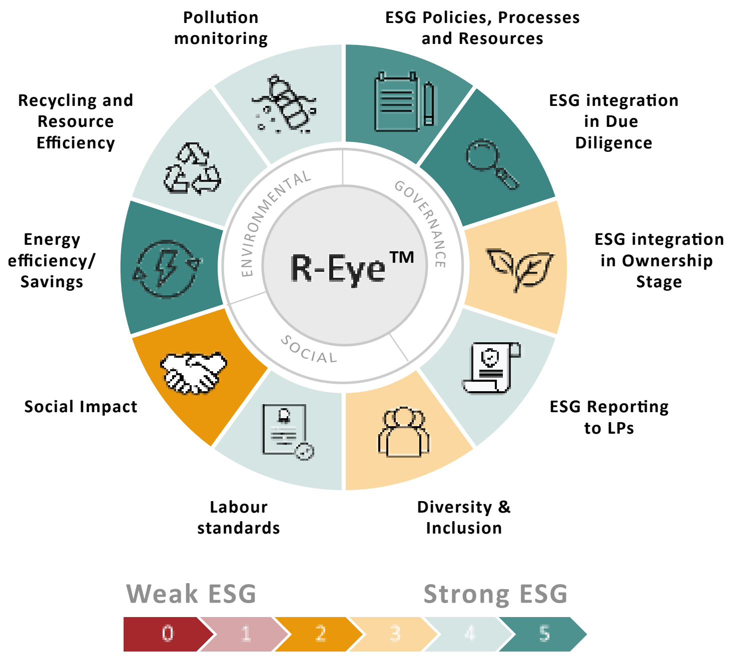


HOW TO UNDERWRITE ESG IN LOWER MIDDLE-MARKET CREDIT

At Capital Dynamics, we have developed a trademarked framework for underwriting ESG in private credit called R-Eye™. This framework rates, on a scale of 0-5, the sustainability and risk profile of a company's environmental, social and governance attributes by drawing on the United Nations 17 Sustainable Development Goals ("UNSDGs").[6] In developing and assigning a rating, and as part of its broader due diligence effort, the investment team asks private equity sponsors and / or management teams a series of targeted questions, developed in consultation with the firm's dedicated ESG specialists. Questionnaires are tailored to the business based on several factors, including, for example, the industry, products and services rendered and geographic location of company's operations. In addition, the ESG team utilizes artificial intelligence tools to identify or fill any information gaps in the hands-on due diligence. All of this information is reviewed by the investment committee ("IC") and dedicated IC observers (covering ESG, compliance, and risk) who collectively make a recommendation as to the ESG merits of a lending opportunity.

The illustration below highlights the ESG elements that inform the R-Eye™ ratings.

Capital Dynamics' R-Eye™ Rating



CAPITAL DYNAMICS' PRIVATE CREDIT R-EYE™ RATING

After an investment is made, the R-Eye™ rating of each borrower is reviewed and updated on a quarterly basis. Any significant deterioration of ESG during the life of an investment will trigger a review by the Firm's Responsible Investment Committee, which will issue a formal recommendation with a proposed action plan to the private credit investment team. Based on this recommendation, the private credit team may take additional steps including issuing an investor alert, actively communicating with the equity sponsor or management team (including making formal recommendations or demands for sustained change) and revisiting the internal ESG analysis to promote better decision-making over time. In certain extreme cases, the team may also put an equity sponsor on watch for future investments by the Capital Dynamics platform or look to the secondary credit market to exit positions.

United Nations 17 Sustainable Development Goals

[6] *United Nations 17 Sustainable Development Goals are (1) No Poverty (2) Zero Hunger (3) Good Health and Well-Being (4) Quality Education (5) Gender Equality (6) Clean Water and Sanitation (7) Affordable and Clean Energy (8) Decent Work and Economic Growth, (9) Industry, Innovation and Infrastructure (10) Reduced Inequalities (11) Sustainable Cities and Communities (12) Responsible Consumption and Production (13) Climate Action (14) Life Below Water (15) Life on Land (16) Peace, Justice and Strong Institutions (17) Partnerships For The Goals*

HOW TO STRATEGICALLY INFLUENCE POSITIVE ESG OUTCOMES AS A LENDER

Lack of control creates a challenge for private credit managers seeking to promote strategic and operational actions designed to enhance ESG attributes at companies they finance. In private equity buyouts or corporate mergers / recapitalizations, the sponsor (private equity manager) and / or other equity owners control the business. As such, they are in charge of plotting the strategic direction of the enterprise, overseeing its operations, building the senior management teams and shaping Boards of Directors. They are also responsible for designing and adopting ESG related policies and identifying ways to promote sustainability goals, including setting, measuring and interpreting ESG KPIs. While senior creditors have a priority security interest in the cash flows and assets (including equity) of a company, they are not in a position to exercise control over corporate actions. Unless lenders have the experience to influence corporate behavior more subtly, they are expected to be silent partners absent a covenant breach or other event of default.

At Capital Dynamics, however, the intersection of our lower-market lending focus, ESG credentials, and deep private market relationships afford us greater influence. Unlike the syndicated and core-middle market, a meaningful supply-demand imbalance exists in the smaller end of the credit market, offering experienced lenders the opportunity to have a greater say in the pricing and structuring of loans. Inefficiencies in our market also means that we, as critical capital providers, often have multiple weeks or months (not weeks or even days as is often the case in the syndicated and core middle-market) to underwrite a transaction, allowing us more time to analyze the ESG merits of a borrower and evaluate means to enhance those characteristics over time. These same favorable supply-demand dynamics make it easier to secure covenants and other protections in the governing documents. Further, as originator and lead arranger of such financings, Capital Dynamics is intimately involved in negotiating those credit agreements and establishing covenants and other contractual obligations that borrowers must live by while the loans remain outstanding. Leveraging its capacity to shape transactions, Capital Dynamics is increasingly pushing for the inclusion of express ESG covenants or contractual language that indirectly provides protections to reduce risk and promote sustainability across environmental, social or governance dimensions. While the introduction of ESG covenants in financing agreements is in its infancy in the broadly syndicated loan markets, it is even less common in U.S. lower middle-market lending. As such, change and the incorporation of these covenants cannot be forced in this market and will take time. At Capital Dynamics, however, we see this as a long-term opportunity to drive positive change and value creation in lower-middle market lending in the U.S.

In developing these frameworks and KPIs, key questions we ask to better understand the ESG dynamics of a potential borrower include:

(i) What is the borrower’s environmental footprint, adherence to relevant environmental regulations, and litigation history

(ii) How does the borrower and sponsor address the workplace environment, health & safety, human resource policies, and inclusionary/diversity practices

(iii) How does the company manage its relationships with vendors, suppliers and customers

- Global supply chains and manufacturing footprints require an elevated focus on labor and environmental standards across the borrower’s network of suppliers

(iv) What are the borrower’s reporting procedures, compliance policies, and the management team’s track record of acting fairly and transparently

(v) What is the sponsor’s track record for improving ESG at a portfolio company during the holding period

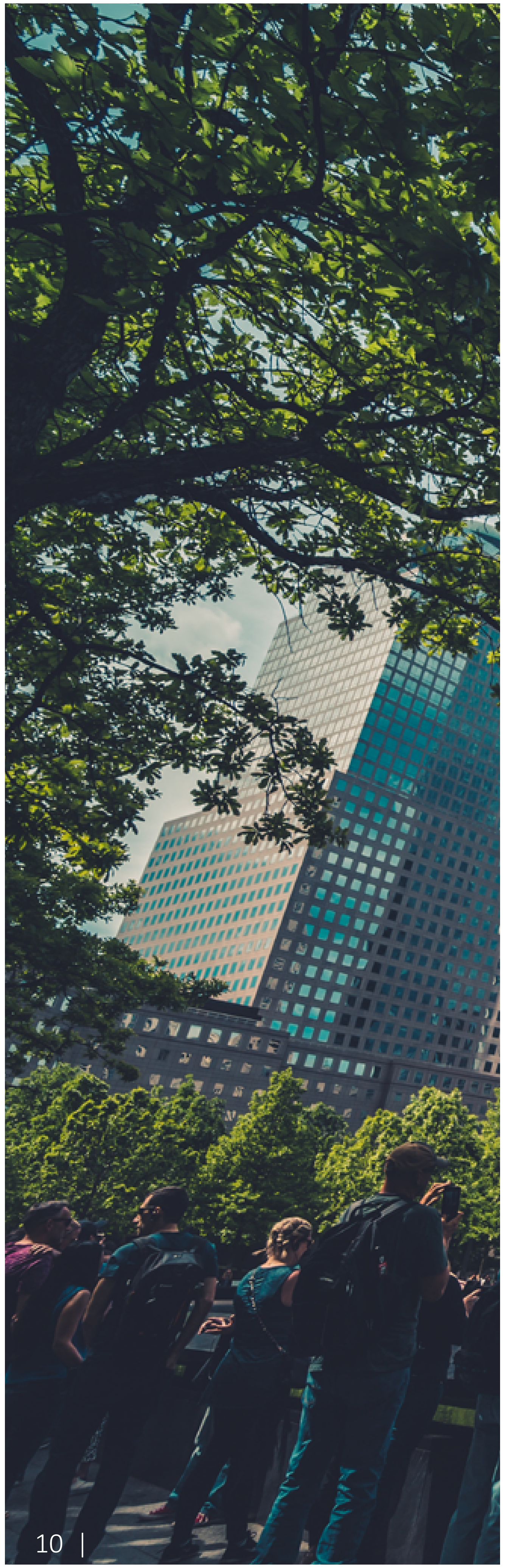
As a dedicated investor in private equity, Capital Dynamics also has long-standing relationships with many of the managers to whom we extend financing. This creates an opportunity for us to work collaboratively with sponsors to build more ESG resilient business models. By demonstrating the benefits of good ESG principles to sponsors, we are often able to exert influence, which extends beyond our contractual rights as a lender. As an example, Capital Dynamics’ Diversity & Inclusion Committee recently worked with a private equity manager to provide them with guidance on their approach to D&I. Our recommendations resulted in meaningful improvements to the sponsor’s approach to diversity and inclusion in the workplace at both the sponsor and underlying portfolio companies. Key changes included:

(i) Partnering with D&I organizations to attract diverse and inclusive job candidates

(ii) Better involvement with local communities to help under-represented individuals gain access to a career in finance

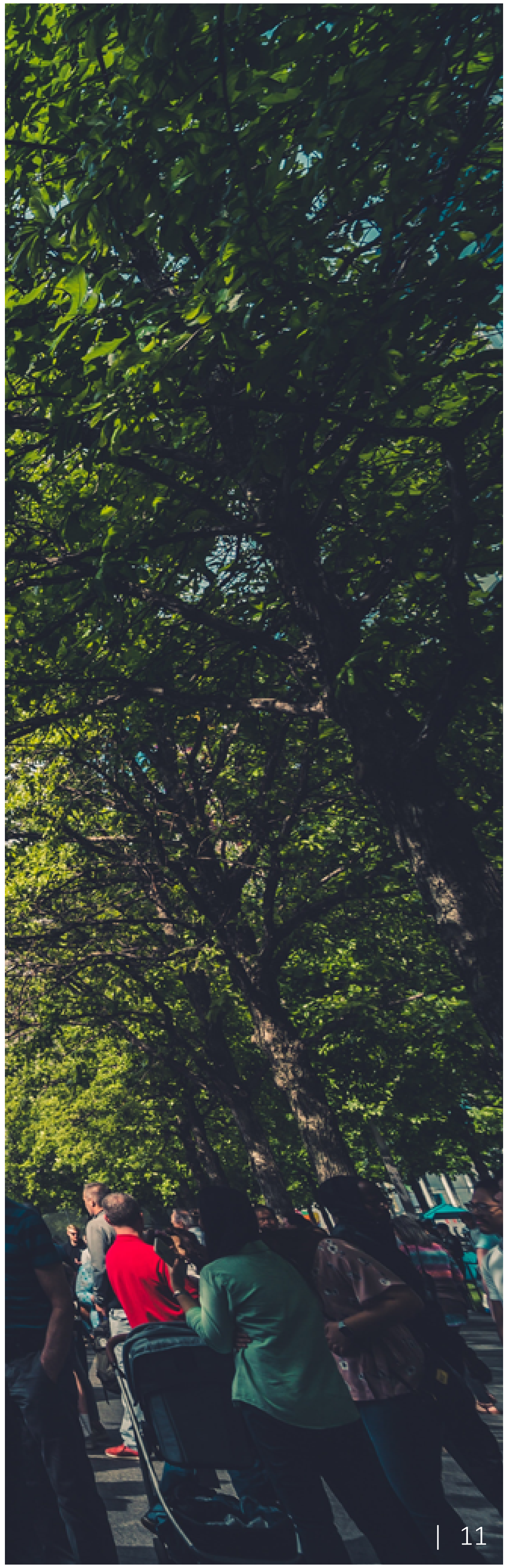
(iii) Setting achievable D&I Key Performance Indicators and encouraging employees to get more involved in the initiative

(iv) Implementing an annual D&I survey to better understand the composition and evolving dynamics of the workforce



We believe that ESG covenants are powerful tools that lenders can utilize to influence sponsor and management team behavior. These covenants can be structured with both negative and positive incentives. One example which has received growing media attention is ESG ratcheting, a tool which is increasingly being implemented in Europe and to a lesser extent in the North American lending market. ESG ratcheting is a mechanism by which a company may lower its borrowing costs with a lender by achieving pre-set ESG KPIs (e.g. improvements in environmental performance or increased diversity in positions of responsibility) over the holding period of the loan. In theory, this should better align the sponsor and portfolio company to achieve environmental or social objectives to reduce borrowing costs. In practice, however, the effectiveness of this tool has been mixed because ESG ratcheting faces an intrinsic problem: if the ratcheting mechanism results in only a modest reduction in borrowing costs (we have observed that ESG ratcheting usually improves borrowing rates by 10 basis points or less), it is not likely to influence behavior; whereas, if the ratcheting mechanism results in materially lower yields the loan may have limited uptake and prove difficult to syndicate (an important aspect of functioning credit markets). Furthermore, poorly-designed ratcheting mechanisms may lead to companies making short-term decisions without considering longer-term consequences to enjoy the immediate economic benefits resulting from such actions.

A further challenge with implementing ESG covenants and / or ratcheting incentives in the lower middle market is related to data availability. Capital Dynamics typically invests in entrepreneur-owned businesses where the sponsor provides the first layer of institutional capital and, importantly, the first institutional oversight. A significant part of the sponsor's value creation strategy involves formalizing processes around strategic decision-making, board appointments, human resources, capital allocation, financial planning and other similar processes. As such, the data needed to set achievable ESG KPI goals is often not in place at the time of investment. Nevertheless, there is an important role for lenders to play in steering the sponsor to include environmental and social objectives as part of this institutionalization of the entrepreneur's business. For these reasons, Capital Dynamics believes the usefulness of ESG covenants as a tool to improve the sustainability metrics of a business in the lower end of the credit market, particularly in North America, is still in its infancy and must be adopted cautiously. That said, we are closely monitoring the development of structural features in loan agreements designed to promote enhanced ESG performance, including specific covenants and rate ratcheting mechanisms, and are committed to leading the way in implementing such tools.



CONCLUSION – ESG IN DIRECT LENDING, A TOOL FOR BOTH ENHANCED RETURNS AND REAL-WORLD IMPACT

As an asset class, private credit has been slower to adopt formal ESG guidelines. In practice, however, experienced direct lenders have been underwriting environmental, social, and governance risks since before ESG became mainstream. Doing so is an indispensable part of fundamental credit underwriting. When lending to smaller companies, the importance of evaluating ESG risk may be even more pronounced. Not only can ESG issues be more acute at smaller companies, but these organizations also stand to benefit the most from the institutionalization that accompanies responsible lending practices. The key is to diagnose ESG deficiencies at the outset of the investment, track them over time, and find ways to influence good ESG outcomes by establishing strong relationships with equity sponsors, sharing best practices, and focusing on contractual protections.

It is our expectation that evolving ESG screening from an exclusive focus on risk mitigation to screening for favorable and improving ESG attributes will not only result in credit portfolio outperformance, but also direct capital to companies that are contributing to an improving society. Companies with favorable ESG credentials generally outperform their peers as they experience relatively stronger revenue growth, enjoy cost advantages from reduced waste, more efficient operations, better employee and vendor relationships and fewer regulatory and legal challenges. Such businesses also have a growing base of social, consumer and governmental support. These factors contribute to such companies being more resilient across cycles and over time. Given the importance of middle market companies to the U.S. economy and social fabric, experienced lenders have an opportunity to impact the environment and society at large by using their influence to accelerate the implementation and institutionalization of ESG strategies.

Dynamics in the lower middle market provide direct lenders in that market with the ability to have greater influence over the borrowers. That includes being involved in underwriting ESG merits alongside the management team and private equity sponsors and designing frameworks for implementing and monitoring ESG enhancing priorities over time. While tools such as ESG-linked ratcheting has intellectual merit, for now Capital Dynamics prefers to focus its core offerings on mechanisms for change that promote building resilient portfolios that deliver consistent yields and compelling risk-adjusted returns, including strong downside protections. Not only because this is our first priority as a fiduciary to our clients but also because it promotes the virtuous cycle of ESG investing in the private markets whereby strong ESG delivers enhanced performance – resulting in more industry focus on responsible lending practices over time.

> *“At Capital Dynamics, we recognize that our commitment to, and targeted goals for, ESG are evolving. What will not change is our fundamental belief that good ESG disciplines have the potential to enhance long-term financial returns for our clients. In achieving enhanced returns, and as our mission evolves, we also recognize that this ambition ties directly to ensuring that our investments deliver across a broader set of constituents and impacts. With this is mind, we believe good ESG practices and investments must include identifying an inclusive pathway to net zero across both environmental and social impacts.”*
>
> **Bryn Gostin**

ABOUT CAPITAL DYNAMICS

Capital Dynamics is an independent global asset management firm focusing on private assets, including private equity (primaries, secondaries co-investments), private credit, and clean energy . The Firm has been investing in middle and lower middle market private assets for over 30 years. The private credit group within Capital Dynamics provides tailored, one-stop financing solutions to private equity-backed lower middle market companies, focusing on financings that support leveraged buyouts, acquisitions, business expansions, re-financings, and short-to-medium term liquidity needs. Capital Dynamics private credit offers directly originated, senior secured loans, including first lien, unitranche, and second lien, as well as other flexible capital solutions.

Comprised of over ten professionals based in New York, London, and Zug, Capital Dynamics private credit draws upon its vast experience investing across the capital structure and in a wide array of industries to deliver flexible, value-added solutions customized to fit the unique needs of each borrower.

PRI Principles for Responsible Investment

Highest Scores for:

- Strategy & Governance (A+)
- Private Equity (A+)
- Clean Energy (A+)
- Private Credit (A)

AUTHORS

Bryn Gostin
Chair of Capital Dynamics Responsible Investment Committee and Head of Product Development & Strategy

+1 917 691 8917
bgostin@capdyn.com

Jens Ernberg
Managing Director
Co-Head of Private Credit

+1 212 798 3400
jernberg@capdyn.com

CapitalDynamics
TRULY INVESTED.

DISCLAIMER

"Capital Dynamics" comprises Capital Dynamics Holding AG and its affiliates.

The information contained herein is provided for informational purposes only and is not and may not be relied on as investment advice, as an offer to sell, or a solicitation of an offer to buy securities. Any such offer or solicitation shall be made pursuant to a private placement memorandum furnished by Capital Dynamics. No person has been authorized to make any statement concerning the information contained herein other than as set forth herein, and any such statement, if made, may not be relied upon. This document is strictly confidential, is intended only for the person to whom it has been addressed and may not be shown, reproduced or redistributed in whole or in part (whether in electronic or hard copy form) to any person other than the authorized recipient, or used for any purpose other than the authorized purpose, without the prior written consent of Capital Dynamics.

The recipient should not construe the contents of this document as legal, tax, accounting, investment or other advice. Each investor should make its own enquiries and consult its advisers as to any legal, tax, financial and other relevant matters concerning an investment in any fund or other investment vehicle. Capital Dynamics does not render advice on tax accounting matters to clients. This document is not intended or written to be used, and it cannot be used by any taxpayer for the purpose of avoiding penalties which may be imposed on the taxpayer under said individual's tax laws. Federal and state tax laws are complex and constantly changing. The recipient should always consult with a legal or tax adviser for information concerning its individual situation.

When considering alternative investments, such as private equity funds, the recipient should consider various risks including the fact that some funds: may use leverage and engage in a substantial degree of speculation that may increase the risk of investment loss; can be illiquid; are not required by law to provide periodic pricing or valuation information to investors; may involve complex tax structures and delays in distributing important tax information; and often charge high fees, and in many cases the underlying investments are not transparent and are known only to the investment manager. Any such investment involves significant risks, including the risk that an investor will lose its entire investment.

By accepting delivery of this document, each recipient agrees to the foregoing and agrees to return the document to Capital Dynamics promptly upon request.

CONTACTS

NORTH AMERICA

Susan Giacin
North America
sgiacin@capdyn.com

EUROPE

Klaus Gierling
DACH, Nordics & Benelux
kgierling@capdyn.com

Carolyn Skuce
UK, LGPS & Australia
cskuce@capdyn.com

Robert H. Berlé
Italy
rberle@capdyn.com

Jean-Yves Lagache
France
jlagache@capdyn.com

Martine Sessin-Caracci
France
msessin-caracci@capdyn.com

ASIA

David Jung
Korea, HK, Taiwan & Singapore
djung@capdyn.com

Eiichiro Hara
Japan
ehara@capdyn.com

CapitalDynamics
TRULY INVESTED.

www.capdyn.com