E X P E R T Q & A

What measures do direct lenders need to take to make a real difference to their portfolio companies? Jonathan Smith from LGT Capital Partners, head of the firm's ESG and impact investing efforts in its private debt unit, outlines the priorities

How to make a lasting impact

Q Can you tell us how you approach impact investing and how that has evolved over time?

LGT Capital Partners has a long heritage with regard to ESG and impact. It has been a big part of our ethos since we were founded more than 25 years ago. We started integrating responsible investment clauses into our fund documentation back in 2003, before becoming a signatory to the Principles for Responsible Investment in 2008. We made our first impact investments in 2010 as a principal investor.

Q What led you to launch dedicated impact funds for clients?

It was the logical next step for us to launch our own impact funds for clients, so we developed our own impact frameworks and practices in 2019. These were broadly rooted in LGT's activities in venture philanthropy, which date back to 2007. The first impact fund we launched was in private equity and then private debt followed shortly afterwards.

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Q How would you describe the key ingredients of your impact strategy?

We feel it is important for any impact strategy to have a clear and comprehensive approach, an impact framework, investment criteria from both a credit and an impact perspective, and governance around that.

Furthermore, we are looking to make investments that generate authentic and measurable impact without compromising on returns. We aim to deliver competitive financial returns while driving change through investments that are impactful and sustainable over the long term.

Q You mentioned that LGT Capital Partners also pursues impact strategies in private equity. How are those activities aligned with what you do in private debt?

Our impact strategy within private debt is consistent with what we do elsewhere in private markets, allowing us to leverage group-wide expertise and experience. It is based on three themes: climate action, healthcare and inclusive growth, by which we mean addressing societal inequalities around provision of things like financial services and education.

Q Where do you see the biggest opportunities in this space?

We see real opportunities to support European mid-market companies addressing the UN Sustainable Development Goals through the provision of sustainable debt financing, while also capturing attractive returns for investors. In our view, direct lenders have a clear opportunity to engage closely with companies as they navigate their impact journey.

Q What kind of companies do you typically work with, and how do you identify these opportunities?

We are lending exclusively to privately owned companies, typically coming in at a point where they complete a change of control at the shareholder level or there is a meaningful and material financing event.

Our contribution as a lender starts with asset selection – and here we benefit from the broader platform of LGT Capital Partners, where we monitor hundreds of GPs and thousands of underlying companies. For identifying eligible assets, we are looking to financially support the best companies with the strongest management teams, whose products or services have provable impact across our three objectives.

Q Once you have made an investment decision, how does your capital support the company's growth and impact agenda?

Our funding is typically quite meaningful to support an ownership change (the initial buyout by a private equity sponsor) and future growth of a business. For instance, we provide additional funding to support M&A, capital expenditure or research and development. All of those should enhance the impact profile of the business.

Q How do you think managers can best approach impact assessment?

It is important to define really clearly as a manager what is meant by impact and what is being used as impact criteria. For us, that means making proactive investments in the goods and services of our portfolio companies. Companies need to be contributing to specific SDG targets in a measurable way and we test that through something we call the 'theory of change'.

Q How does that work in practice?

That approach is holistic. We ask what challenge the company is looking to address, why is there a need for its product or service, what solution does its product or service provide, what outputs would we expect to see and what outcomes can we measure. We also look at what risks are associated with the company and its products and services in relation to addressing that challenge.

Q Do you use a specific framework to guide this assessment?

We use a proprietary framework to form a view around a specific company. That has four dimensions: the company's alignment to the challenge; its

Q What are the main challenges facing impact in private debt?

We see three challenges, the first of which is impact measurement. That comes down to what impact looks like, which will be different company by company and how you aggregate that.

The second challenge is the market challenge, where we see lots of change based on macroeconomic and sociopolitical issues. There can be a mixed view on ESG and impact and, during down cycles, there is sometimes pressure to make concessions around impact. Right now, we see some changes to the terminology that people are looking at in ESG and impact, but our focus is on staying true to our approach.

The third challenge is perception. Hopefully, we are addressing that by showing how we as a lender can make meaningful contributions and drive engagement with companies to make an impact.

reach and ability to expand that into new audiences; its inclusiveness, particularly in areas such as enhancing access to healthcare; and its risks, which could be in relation to shareholders, the management team or governance, for example.

Furthermore, we also think third-party verification is important in validating those assessments for our investors and other stakeholders.

Q What about impact engagement and stewardship?

That comes through things like engagement with the management team, board-level participation and impact-linked KPIs tailored to companies and their specific products and services. On the KPI side, typically we would offer margin discounts linked to hitting incrementally harder bespoke targets that are agreed with management based on an impact action plan and focused on the impact story of the company. These are tailored to each company and are either agreed annually or will be multi-year targets that get increasingly harder to hit.

Q What kind of dialogue do you have with companies around this?

We have found sharing best practice with management teams resonates and the KPI discussion is often a good starting point in this process. We are happy to share our views on companies and where we think they have the ability to enhance their sustainability and impact approach, and we find management teams respond well to that. They understand our experience across private markets and how it can benefit them.

Q How important are partnerships when it comes to ESG and impact?

Two types of partnerships are important: internal and external. Our internal partnerships are key because we have a dedicated team of impact and ESG professionals, and their feedback and advice is based purely on an independent impact assessment of an investment opportunity.

For investors and external stakeholders, there is also a big emphasis on validation and a sizeable external service industry has grown up around that. Investors expect us to leverage more than one tool and more than one partner to give a range of validations for what we are doing.

Q Looking at your activities more closely, can you give examples from your portfolio?

On the services side, we support, for instance, a very acquisitive UK public services provider to vulnerable people. Post deal closing, we shared our assessment of them as a company, which referenced the potential to help them develop an impact diligence framework they could use for future acquisitions. We have since helped them implement that to ensure companies they are acquiring fit into their impact approach and profile. From an ESG perspective, we have also worked with them on a decarbonisation plan across all eight of their operating companies.

On the products side, to name an example, we work with a European manufacturer of energy-efficient lighting and have incentivised it through company-specific KPIs to increase the efficacy of its products and drive new product development.

Another example is our work with a Spanish healthcare provider that is rolling out diagnostic centres in underserved rural areas of Spain. There are lots of ESG and impact considerations, including reducing energy consumption and increasing the use of renewable energy as the business grows from an impact perspective.

Q How are these targets structured financially?

In all these cases, we include financial incentives for the companies if they can hit these targets, which are reviewed with a third party to ensure they are ambitious and measurable. These are not meaningful to our financial returns perspective, but operationally for companies they can be material. With decarbonisation plans, the loan discount for this one-year target will help cover the cost to the company for the engagement with a third party service provider to complete the assessment and planning.

Q What are your ambitions for the future of impact in direct lending?

Climate adaptation and resilience is going to continue to be an essential focus for the economy as we transition towards net zero, with most people agreeing we are behind on that. We as direct lenders are seeing a lot of opportunities to support companies address this challenge. The majority of those opportunities are currently being financed by public players and we think private markets need to be a bigger part of the solution, leveraging our capital to support change.

Q How do you hope the industry evolves in the coming years?

I would love to see a market where impact KPIs are used across portfolios, not to diminish the importance of ESG, but because there needs to be an increased focus on what we do, not just how we do it. We want to support companies at the forefront of addressing these challenges and work with stakeholders around that.

We need to continue to apply rigorous approaches to impact frameworks for our activities and themes. Impact investing right now is very popular, both in terms of private equity and private debt, but there continues to be a need for substance. If an investment approach has substance, it will have longevity, and if it has longevity, it will deliver meaningful and lasting impact. ■