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A short guide

Race to net zero: Decarbonising a private credit portfolio

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A greener future in private credit

There is a difference between reducing the carbon footprint of an investment portfolio and decarbonising the real economy. Accomplishing the former does not necessarily result in the latter. An investor might simply sell off high emitters to reduce the portfolio's carbon emissions. But the consequence may be that the same divested companies do nothing - or worse, increase emissions over time - under other investors.

A similar dynamic may occur if investors only focus on decarbonising investment strategies in public markets, which have experienced relatively greater demand and incentives to lower carbon emissions. Yet with more capital channelling into private markets, ignoring their carbon footprint could leave investors vulnerable when balancing their decarbonisation ambitions and financial risk-adjusted returns to meet the goals of the Paris Agreement. Furthermore, financial incentives - including regulatory requirements on private issuers to reduce emissions - are likely to increase. And as investors commit to portfolio decarbonisation goals, more will need to be done to extend decarbonisation efforts to private assets.

In this paper, we discuss how investors can progress their decarbonisation pathway in private credit, including addressing one of its biggest challenges - the availability and quality of the underlying data. We also consider the advantages and challenges of the decarbonisation journey by examining them in the context of specific asset classes, including collateralised loan obligations (CLOs), leveraged loans and direct lending.

Key takeaways

1	Lenders must apply a different toolset to advance the environmental standards of private credit issuers relative to public markets. The differences arise from factors such as the time horizon of investments, information availability, ownership structure and channels of influence.
2	Data can be less consistent, verifiable, and comparable than in public markets. However, combining public market knowledge with private credit data can help bridge this gap. Applying recognised international data methodologies further adds informational coverage and consistency
3	For private credit investors implementing climate-aware strategies, real-world reductions in portfolio carbon emissions require a nuanced understanding of regional, sector, and asset-class differences.
4	Lenders may have broader scope to incentivise private credit issuers to mitigate climate risks. For instance, engagement can be carried out more directly with senior executives.
5	A climate-aware decarbonisation plan for private credit strategies can help add portfolio resilience at all investment stages - sourcing, ownership, and exit.

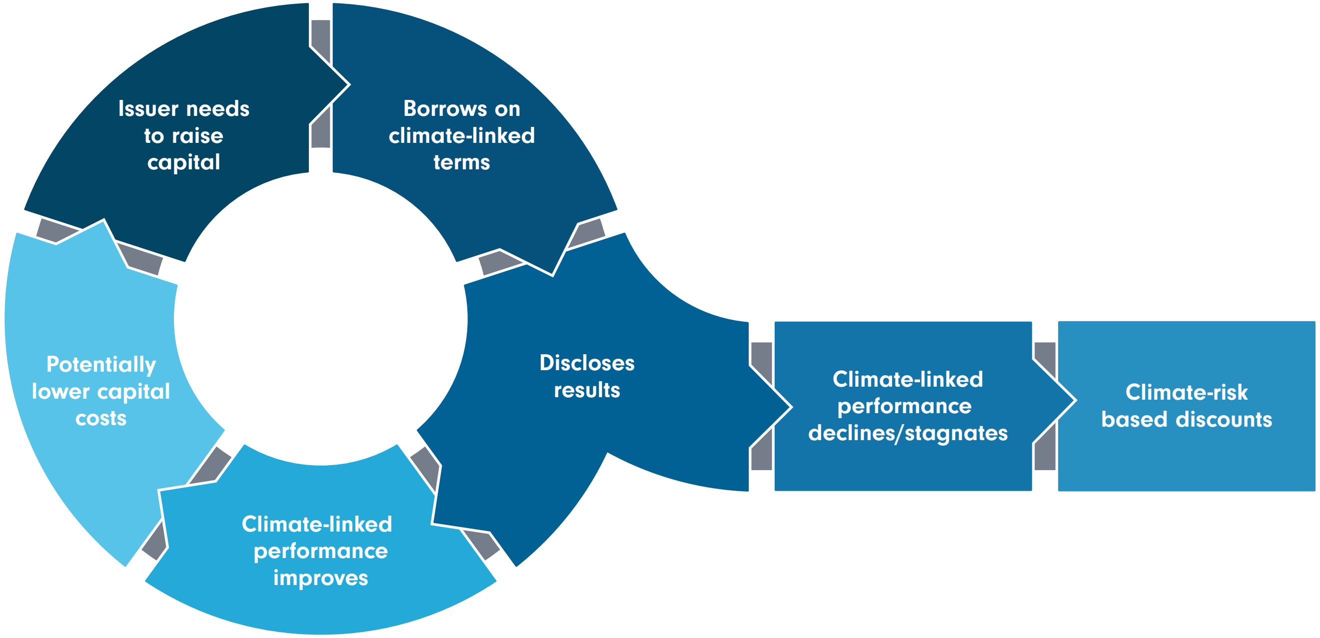
Climate conscious: Reducing private credit's carbon footprint

Private companies are increasingly under the same scrutiny as listed companies that publicly disclose carbon emissions and other environmental data. This is particularly the case in countries and regions with decarbonisation targets, such as the UK and the European Union. Yet relative to public debt markets, climate risk in private credit portfolios remains less transparent and, therefore, less understood. In some ways, it is more crucial for lenders to manage climate risk in private credit portfolios (see Figure 1), given the typically longer holding periods, liquidity constraints, and more complicated exit strategies.

We expect trends in public markets to reshape the environmental standards in private markets, benefitting investors who can efficiently manage climate risk and opportunities. Optimising a portfolio decarbonisation strategy requires measuring existing carbon data, conducting forward-looking climate assessments, and strengthening technological capabilities to manage environmental risks and opportunities.

Lenders also should consider the effects of their investments at each investment stage - sourcing, ownership, and exit, depending on factors such as seniority within the capital structure, the type of sector, the degree of influence and the holding period. For example, debt with higher credit ratings and seniority is typically associated with a lower risk of default. In the context of decarbonising a portfolio, this adds a level of stability for long-term decarbonisation goals.

Figure 1: Private credit's decarbonisation cycle



For illustrative purposes only.
Source: Fidelity International, September 2023.

While fixed income is more senior in the capital structure and therefore has higher built-in defences against loss potential, it also comes with an asymmetric risk profile with a more acute emphasis on the downside risk. As a result, there is a perception that any upside due to effective engagement campaigns is more limited when compared to equities. In our view, however, this perception is changing as investors' understanding of climate factors improves and their motives for engagement evolve.

Other characteristics like longer holding periods allow more opportunities to improve corporate environmental practices. Climate due diligence also becomes more relevant. Additionally, strong relationships and effective collaborations with key stakeholders are critical to reach decarbonisation goals.

The data gap

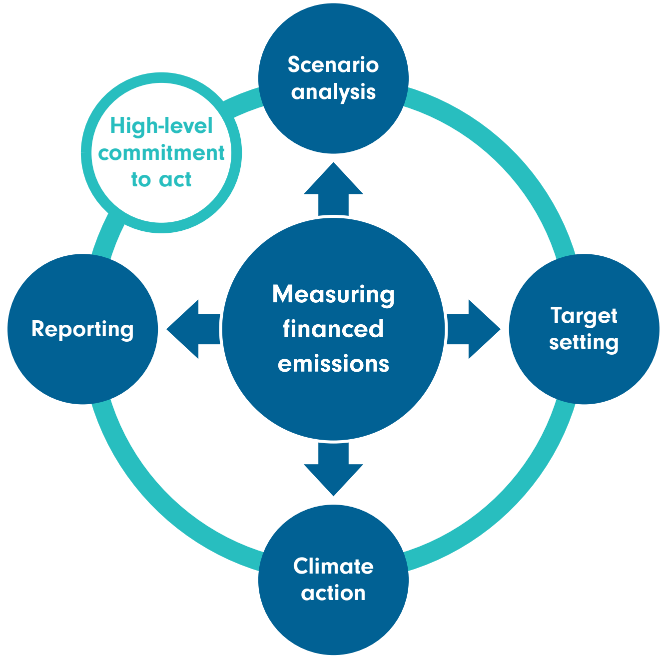
Issuers in private credit are often smaller companies relative to their public market peers. The former also has limited resources to improve environmental standards. Take measuring the operational carbon footprint, typically publicly available when investing in listed companies. The same data is often unavailable, incomplete, or inconsistent with international standards for private corporate issuers. This lack of data can make it more challenging for private issuers and lenders to gauge climate risks, integrate them into decision-making and measure progress.

Additionally, the private nature of the issuances means there is less pressure and requirements to be transparent about environmental standards, including carbon emissions disclosures. Indeed, the proportion of issuers in private markets reporting greenhouse gas (GHG) data tends to be low compared to public markets. Regulatory trends suggest this should improve, though we believe there is more investors can do. A combination of engagement, advisory support and financial incentives through green clauses and other means may incentivise more relevant environmental disclosures, a critical aspect of decarbonising portfolios (see Figure 2).

How can lenders and their asset managers help close private markets' data gaps? First, data obtained from private companies should be scrutinised against peers, integrating additional information from proprietary, third-party, and public-market sources. Second, engaging with issuers can improve quantitative and qualitative information. Third, a consistent process for cross-checking, updating, and monitoring data to align with industry best practices helps mitigate greenwashing risks. So does collaborating with other stakeholders, such as other financial institutions or third-party industry organisations, to improve the integrity of sustainability metrics.

Significantly, integrating information from public markets can improve decision-making in the private credit sphere. By using public and private market data, investors can gain informational advantages relative to relying solely on private market data. The insights, knowledge, expertise and best practices in public markets can be applied to help private companies develop their decarbonisation trajectory.

Figure 2: The role of data in a climate-aware investment strategy



Source: Partnership for Carbon Accounting Financials, December 2022.

Figure 3: Estimated degree of influence at key phases of the investment process

Private debt strategies	Description	Extent of lender influence: Sourcing	Ownership	Reporting
Direct lending	Bilateral loans to small to medium-sized companies, typically without intermediaries and therefore more potential to customise structures	Medium	High	High
Leveraged loans	Debt typically issued to finance M&A, buyouts and other leveraged activities by private equity or other leveraged owners	High	Low	Medium
CLOs	Debt arranged by banks or other financial institutions on behalf of a single issuer, typically offered to a group of lenders via a portfolio of leveraged loans structured into different credit tranches	High	Low	Medium

High | Medium | Low

For illustrative purposes only.
Source: Partnership for Carbon Accounting Financials, December 2022.

Focus on direct lending: Top-down and bottom-up influence

Once available data are used to establish a carbon baseline, the tasks of setting and implementing decarbonisation goals will require a more nuanced approach in private credit relative to public markets. This is due to differences in factors such as the company's size and composition, corporate structure, and ability to mitigate and adapt to climate transition and physical risks.

For lenders, an essential tool is engagement, with significant differences in the degree of influence, depending on the investment strategy and investment phase - sourcing, ownership or reporting (see Figure 3).

For instance, direct lending offers more influence to advance environmental standards in the ownership and reporting stages due to a relatively larger controlling stake and a higher level of access to management. However, at the sourcing stage, direct lending involves smaller-size issuers who may not have the resources to gather the required data to carry out detailed environmental due diligence relative to CLOs and leveraged loans.

As an asset class, direct lending typically raises funds from limited partners such as pension funds and insurers. It significantly expanded following the 2007-2009 Global Financial Crisis as banks began withdrawing from loans typically made to small and middle-market companies. Although deal sizes have been increasing, it is in the middle-market segment where we believe there is more attractive risk-adjusted return potential, as well as opportunities to decarbonise portfolios.

The extent of influence relies on the strength of relationships, due diligence, and how the debt is structured. Relative to leveraged loans and CLOs, deals in direct lending tend to be smaller with sole lenders or fewer stakeholders in bilateral agreements. Documents are bespoke, and lenders can use their position to shape ESG conditions in the documentation for specific deals. Their ability to influence management, therefore, is often higher when engaging to improve environmental standards, including carbon data disclosures that are measurable, relevant and material to the issuer's corporate strategy.

While private credit lenders do not have the voting power that public equity investors do, access to management can be a key differentiator. Lenders in this asset class have relatively high levels of access to management of all asset classes discussed in this paper, so top-down engagement can potentially yield measurable results in ways that directly link to portfolio decarbonisation targets.

To enhance engagement potential, integrating bottom-up public market research can provide an additional tool to assess environmental efficiencies and improvements. At Fidelity, for example, we conduct about 18,000 company meetings annually, allowing for a multi-dimensional view of company fundamentals, including environmental, social, and governance (ESG) standards. Leveraging that public market knowledge to engage with private issuers has several advantages:

- Gain deeper insights through more meaningful dialogue with borrowers to better understand their decarbonisation trajectories.
- Share data, technology, and best practices to add sustainability value. This includes energy consumption, energy efficiency, and carbon emissions reduction.
- Work closely with borrowers to integrate public markets expertise to leapfrog the knowledge gap in private markets and improve sustainability standards.
- Influence borrowers to clarify objectives, set more ambitious targets, report progress with supporting data, and improve sustainability practices.

Leveraged loans and CLOs: Impact of data on the decarbonisation pathway

Leveraged loans and collateralised loan obligations (CLOs) are also appealing from a climate-aware perspective for several reasons:

- Relative to many public market fixed-income equivalents, lenders typically have higher seniority in the capital structure and more influence at the sourcing stage.
- The potential for stricter covenants, among other controls in loan agreements, also allows lenders more influence over issuers' decarbonisation pathways.
- Integrating best practices in public markets adds credibility to net-zero pathways. To improve carbon emissions data, for example, partnering with international organisations such as Partnership for Carbon Accounting Financials (PCAF) can bolster data reliability.

Given the complex nature of the CLO structure, data plays a more critical role in portfolio decarbonisation. As previously mentioned, the quantity and quality of emissions data remain limited. Still, they should improve over time, supported by regulations such as Sustainable Finance Disclosure Regulation (SFDR) and Corporate Sustainability Reporting Directive (CSRD), as well as adoptions of reporting standards such as the Task Force on Climate-related Financial Disclosures (TCFD).

Furthermore, informational advantages from integrating public market research with data provided by private issuers can help identify materiality, provide comparison baselines, and assess environmental strengths and weaknesses. For instance, we are collaborating with PCAF to estimate GHG accounting (see Figure 4) supporting the following corporate activities:

- Promote environmental data transparency for stakeholders.
- Manage climate-related transition risks.
- Advance climate-friendly financial products.
- Align capital flows with the Paris Agreement.

Through partnerships with international organisations such as PCAF, more detailed information can be extracted from the underlying assets held within CLO portfolios – even for issuers that do not report their emissions. PCAF helps estimate a firm's carbon footprint using information such as a company's economic domicile, sector, and revenue. The typically conservative nature of PCAF estimates should incentivise issuers to disclose their own data because the latter is likely to have a lower carbon footprint.

These figures are then used to calculate metrics such as the weighted average carbon intensity (WACI) and the relative carbon footprint to establish a baseline, set targets, build portfolios, conduct engagement campaigns, and track improvements. As demonstrated in Figure 3, the ability to influence lenders of CLOs and leverage loans is higher when sourcing deals and conducting due diligence. Therefore, the quality of data to base investment decisions is critical.

Another way lenders can influence outcomes is when borrowers approach the market to extend their maturities. Investors can then review the evidence of environmental advancements or apply additional provisions to incentivise borrowers. To this end, developing guidelines in advance to assess progress is advisable.

Figure 4: Data quality attributes for private credit

Data Quality	Options to estimate the financed emissions		When to use each option
Score 1	**Option 1: Reported emissions**	1a	Outstanding amount in the company and EVIC are known. **Verified emissions** of the company are available.
Score 2		1b	Outstanding amount in the company and EVIC are known. **Unverified emissions** calculated by the company are available.
	Option 2: Physical activity-based emissions	2a	Outstanding amount in the company and EVIC are known. Reported company emissions are not known. Emissions are calculated using primary physical activity data of the **company's energy consumption** and emission factors specific to that primary data. Relevant process emissions are added.
Score 3		2b	Outstanding amount in the company and EVIC are known. Reported company emissions are not known. Emissions are calculated using primary physical activity data of the **company's production** and emission factors specific to that primary data.
Score 4	**Option 3: Economic activity-based emissions**	3a	Outstanding amount in the company, EVIC, and the **company's revenue** are known. Emission factors for the sector per unit of revenue are known (e.g., tCO_2e per euro or dollar of revenue earned in a sector).
Score 5		3b	Outstanding amount in the company is known. Emission factors for the sector per unit of asset (e.g., tCO_2e per euro or dollar of asset in a sector) are known.
		3c	Outstanding amount in the company is known. Emission factors for the sector per unit of revenue (e.g., tCO_2e per euro or dollar of revenue earned in a sector) and **asset turnover ratios** for the sector are known.

(score 1 = highest data quality; score 5 = lowest data quality)

Source: Partnership for Carbon Accounting Financials, December 2022. Note: EVIC is enterprise value including cash. PCAF prefers options 1 and 2 over Option 3 from a data quality perspective. Outstanding amount refers to the amount of debt or equity provided by the lender. In the case of debt, the outstanding amount is defined as the value of the debt the borrower owes to the lender.

Incentives to decarbonise portfolios

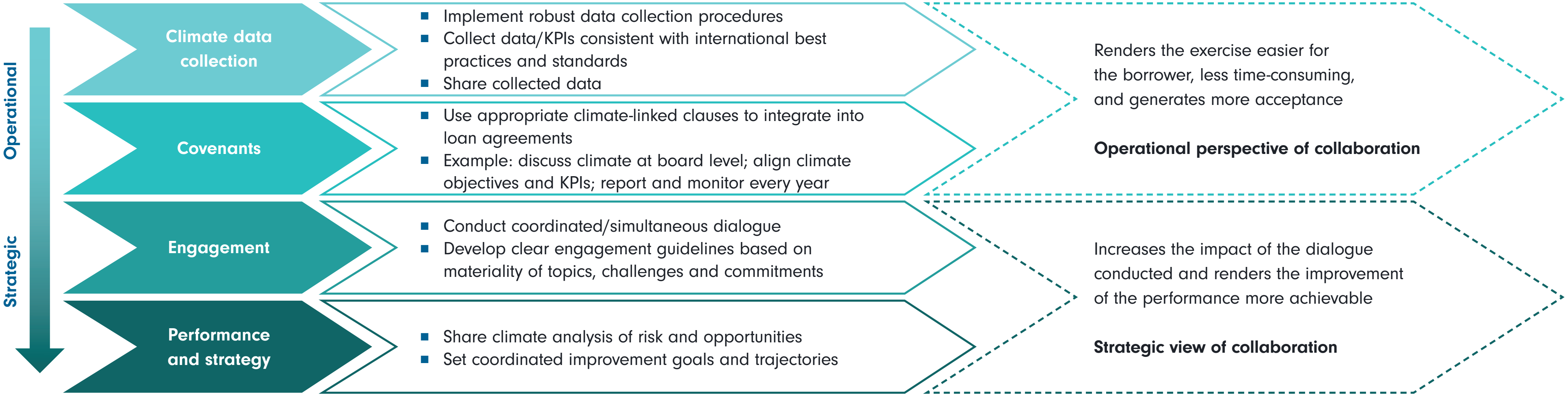
For lenders, reducing the carbon footprint of their portfolio must go hand in hand with assessing the effects of their investment decisions on the real economy. In our view, several value-creating levers are required to support forward-looking analysis, active engagement, and effective collaboration with other stakeholders (see Figure 5).

To summarise, lenders have several distinct advantages relative to public market equivalents when advancing sustainability ambitions as follows:

- Closer relationships between lenders and borrowers.
- Ability to offer financial incentives such as preferential interest rates or loan terms based on improvements in environmental standards that are measurable, ambitious, and material to the borrowers' core sustainability and business strategy.
- Customised data reporting that addresses challenges that are core, relevant and material to the company, sector and region.

As with any deal, the first step is access. Having established and broad pipelines, influence to obtain an 'early bird' invitation, and multiple origination channels improve the chances of constructing a more climate-resilient portfolio balanced against financial goals. In our view, credit selection should focus on issuers with clear,

Figure 5: Climate levers



Source: CAIA Association, Fidelity International, September 2023. Note: KPIs are key performance indicators.

measurable, and timebound goals backed by a proven engagement process to advance greener practices to have real-world impact. Monitoring and reporting should also be consistent throughout the sourcing, ownership, and exit stages.

Lenders also face some additional considerations. Relative to public equivalents including European high yield, the nature of the European private loans investment universe is that they typically have lower exposures to carbon-intensive sectors such as oil & gas, utilities, and airlines. To optimise a decarbonisation strategy, lenders should evaluate and prioritise funding for companies and projects demonstrating the highest potential to reduce emissions.

How loan agreements are structured can also help mitigate climate risks. Market conditions and investor demand may affect the extent to which loan agreements can include green clauses and other environmental controls. For example, if there is high demand for a particular debt issuance, the ability to include climate-related margin ratchets may be reduced. In the longer term, however, we believe the use of climate-related margin ratchets to align environmental goals will likely increase. And guarding against greenwashing will also become more relevant, according to the European Leveraged Finance Association (see Figure 6).[1]

Figure 6: Ways to reduce greenwashing risk

- Use external verification, assurance and second-party opinion providers
- Align loan agreements with regulatory disclosure, reporting requirements, transparency best practices, and ESG data gathering and analysis across the investment cycle
- Use external benchmarks and references, and where feasible, use relevant standards to analyse the materiality of KPIs and the ambition of SPTs
- Formalise process for reviews and updates to align ESG reporting and disclosure with internal requirements, industry standards and stakeholder demands

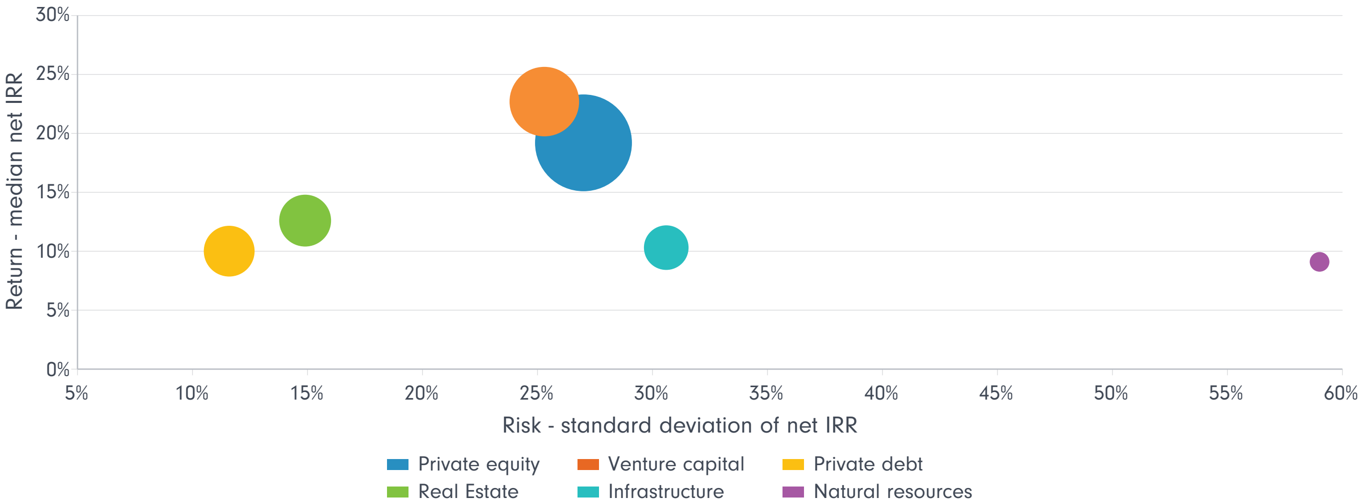
Source: European Leveraged Finance Association, Fidelity International, September 2023. Note: SPTs are sustainability performance targets.

Growth of private credit and its implications for climate change

In recent years, assets under management (AUM) growth in private credit has outpaced other alternative asset classes such as real estate and private equity. Private credit AUM is expected to reach US$2.3 trillion by December 2027 at a compound annual growth rate (CAGR) of 10.8% from December 2021, according to Preqin. In comparison, the CAGR of all alternative assets is 9.3% in the same period.[2] This growth trajectory will likely continue due to the following reasons:

- Private credit has traditionally provided stable income, diversification, and lower volatility (see Figure 7) due to factors such as its floating rate characteristics and positioning in the capital structure.
- Recent market volatility, worsened by the recent turmoil in the banking sector, may pressure banks to further reduce lending, creating opportunities for private credit investors at attractive terms, including incentives to improve climate standards.
- An elevated interest rate environment potentially reduces issuers' abilities to service debt payments. Under these circumstances, the stricter covenants and controls in private credit combined with the typically closer relationships between lenders and borrowers may help mitigate risk.

Figure 7: Risk-return estimates, by asset classes in private markets (vintages 2009-2019)



For illustrative purposes only. Past performance is not a reliable indicator of future returns.
Source: Preqin, data as of January 19, 2023.

With more capital flowing into private credit, applying a climate lens to the portfolio construction process is critical to meet financial and environmental responsibilities. Perhaps more relevant in private markets relative to their public counterparts, the strength of relationships is essential to reaching decarbonisation targets.

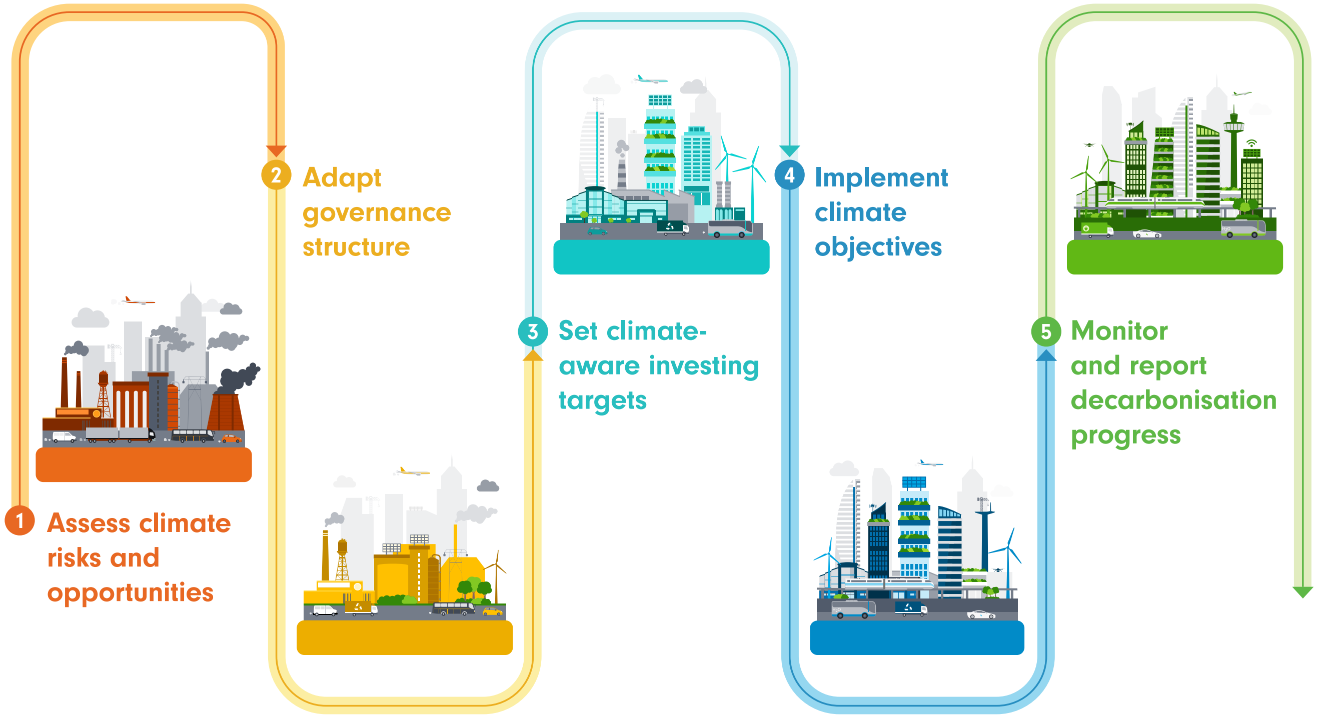
This begins with due diligence analysis of material data during the sourcing stage to better understand the related risk to revenues, regulatory and litigation trends.

Deal structuring is another vital element, including green clauses to help mitigate climate risks and add operational efficiency, such as lower energy bills that impact profitability. Likewise, engaging with issuers to reduce their carbon footprint can strengthen stakeholder relationships, yielding informational advantages to enhance investment decisions. The interconnectivity of incentives to decarbonise is imperative to mitigating climate risks in the real economy.

[1] Leveraged Finance Association, "The Evolution of Sustainability Provisions in the Private Debt Market", European Leveraged Finance Association, February 16, 2023.

[2] Valerie Kor, "Preqin Global Report 2023: Alternative Assets", Preqin, January 19, 2023.

This guide is part of our "Race to net zero" series.



Source: Fidelity International, January 2023.

Risk Warnings

- Investments in private markets are highly illiquid and therefore unsuitable for investors who cannot hold their investments for a long time (at least 10 years).
- The value of investments and the income from them may fall or rise, so investors may get back less than the amount invested.
- Past performance is not a reliable indicator of future returns.
- Investors should note that the views expressed may no longer be current and may have already been acted upon.
- Private assets strategies do not offer any guarantee or protection with respect to return, capital preservation, stable net asset value or volatility. These strategies may invest in private or less liquid assets, which can be difficult to sell. As a result, it may be that investors are not able to redeem their investments when they want to.

Important Information