Private Credit: beyond income, towards impact – a portfolio perspective

Key takeaways

- Greater access to Private Credit markets by borrowers supports the UK Government's 'Levelling Up' approach and can help address the UK's regional economic disparities
- Private credit is gaining attention from global investors
  - It is particularly relevant in the current market environment
  - It is an important asset class, worth considering for well balanced asset allocation in UK pension schemes. Risk-adjusted returns in today's environment are attractive
  - It is giving pension scheme trustees an opportunity to improve their portfolio sustainability and deliver on impact objectives

What is Private Credit?

Private credit is a type of lending provided by investors (often via specialist private credit funds). The loans that comprise the asset class are neither listed nor traded on public markets. Terms, which might include specific borrower covenants that improve lender protections, are typically negotiated directly between lender and borrower.

The growth in private credit

Private credit is one of the hottest topics in the UK pensions industry landscape. In June 2023, the £40bn BT Pension Scheme announced plans for a significant portfolio exposure to this asset class. BT isn't alone. In a 2022 survey, private market data provider Preqin estimated that 63% of institutional investors were planning on increasing their allocation to private credit. The surge of interest in private credit is undeniable. Typical of any investment trend, there are reasons to be excited. But, investors should also be alive to the context within which the trend is emerging.

Building the case for private credit

Private credit isn't entirely new to many pension schemes; Cardano has been assisting pension schemes for over 14 years by incorporating this asset class into strategic asset allocations and portfolios. However, current macroeconomic challenges and the evolving regulatory environment for UK pension schemes create a new landscape, which make private credit a suitable allocation for many pension scheme portfolios.

Recent decades have been defined by a steady trend of declining interest rates and, since the Global Financial Crisis in 2007-2008, plentiful liquidity in the financial system. A heady cocktail of cheap finance, expanding margins and rising valuations dominated financial markets. Conversely, today's investors are grappling with record inflation that, for many SMEs, is eroding corporate margins, and higher interest rates that are increasing financing costs for businesses and infrastructure projects alike.

Addressing returns and sustainability challenges

The once crystal-clear equity growth thesis is now under threat. Compounding these financial challenges, UK trustees and their stakeholders are awakening to the reality that we all must address sustainability challenges, as well as achieve financial returns. Regulatory measures, such as TCFD, have forced many investors to confront the urgency of addressing environmental and societal imbalances.

However, the same factors that challenge equity markets - rising rates and traditional bank retrenchment - support the case for private credit, which offers attractive potential returns for investors alongside better lender protection. And sustainability developments in this asset class mean that private credit can increasingly help to solve pension schemes' sustainability objectives, as well as improve financial outcomes.

Why Private Credit?

Private credit answers a real need for both borrowers and lenders:

- **Borrowers can access capital that may not be available through traditional bank sources, particularly if they are raising capital to fund growth, acquisitions or working capital solutions**
- **Lenders (and investors in the funds of private lenders) are offered an attractive source of return, ranging from 5%-20%+**
- **For both borrowers and lenders, private credit can offer more flexible loan structures than traditional banks (tailored to market participants' risk tolerance)**

Common private credit strategies

Strategy	Return Range	Description
Direct lending	Low-Medium	• Senior and junior (typically secured) loans made directly to companies • Loans structured as part of a traditional capital structure (senior/mezzanine) • Coupons are typically floating rate
Subordinated debt	Medium	• Subordinated capital • Typically unsecured and second ranking (i.e. paid after senior creditors in the event of a default) • Coupons are typically fixed rate
Distressed debt	High	• Debt securities provided to a company experiencing distress • Traded at a discount, maybe in non-accrual • Requires an active, multi-skilled approach – including turnaround expertise

The rise and resilience of private credit

The private debt market has grown more than six-fold since the Global Financial Crisis of 2007-2008, with senior lending strategies having experienced the most robust growth. Private credit has repeatedly demonstrated its resilience in stressed economic environments. From the first Global Financial Crisis, to the European Banking Crisis in 2010–2012 and, most recently, during the COVID-19 pandemic, private credit issuance reached record levels as the market offered strong relative value and highly negotiated credit protection. Today, the global private credit market stands at $1.2 trillion.[1]

> **Private credit once again offers investors incremental relative-value and enhanced sustainability opportunities. For UK companies seeking financing, and investors alike, this can only be good news.**
>
> **Kerrin Rosenberg**
> CEO, Cardano Investment

Protective structures such as financial covenants are a key component of private credit agreements. A borrower may be required to prepay or renegotiate terms if they find themselves unable to maintain prescribed balance sheet, cash flow or profitability conditions.

Private credit - attractive for UK borrowers and companies

Borrowers often find that the governance model adopted by many private lenders engenders more collaborative approaches to emerge and enables quicker decision-making. Private lenders' bespoke approach to structuring terms and negotiating security packages gives borrowers a more responsive, attractive and valuable financing option.

Private lending has become a vitally important tool for UK small and medium-sized enterprises (SMEs). In 2020, it provided over $100bn of funding to 2,000 UK firms for a variety of purposes such as acquisition and expansion, improving working capital and refinancing existing debt.[2] A vibrant, productive and adequately financed SME sector is an important component of providing the growth and job creation opportunities needed as the UK Government pursues its 'Levelling Up' agenda. Private credit has given SMEs a healthy financing alternative to bank lenders, who have continued to exit from funding for the middle market.

SMEs – a key driver of UK real economy

99.9%
SMEs made up 99.9% of the business population in 2022

16m
Employ more than 16 million people

£2tn
Contributing over £2 trillion in turnover (over half the total UK private sector turnover)[3]

Bilateral negotiation provides a critical source of protection for investors in the asset class. In an environment of tighter project and corporate margins, as well as rising cost inflation, flexibility and an ability to tailor terms is key to managing against the risk of default. Contrasting with more uniform approaches to lending in the public markets, private lenders negotiate terms specific to each borrower's financing requirements, often limiting maximum leverage or minimum interest coverage alongside other restrictive covenants. Stronger lender protections not only reduce the risk of a default, but also reduce the loss of capital that an investor might experience should a default occur.

Additionally, allocations to private credit provides investors with an alternative and differentiated asset exposure that enhances risk-adjusted returns at total portfolio level. A reliable cash flow stream, as well as portfolio diversification, appeals to investors seeking to enhance the income-generating characteristics of their assets.

Sustainability in the UK and 'Levelling Up'

Private credit has a critical role in helping the UK economy transition to a more sustainable footing. While it is straightforward to conceptualise how this might relate to the 'E' of a scheme's ESG (environmental, social and governance) considerations, the 'S' is important too. The development of fair and just societal structures, housing and regeneration are all part of the UK Government's 'Levelling Up' approach, which are policies designed to address the longstanding problem of the UK's regional economic disparities. These are all areas in which financial markets have a role to play.

"The supply of finance for productive investment is important for long-term growth and productivity. It also helps to promote financial stability by increasing growth in a sustainable way," the Governor of the Bank of England has stated.[4] We agree.

The plethora of UK corporate sustainability pledges are a positive development, but they all require funding. Recent research highlights that many UK SMEs trying to prioritise environmental solutions find access to finance is a major

1 Preqin, as of Q4 2021. Based on total AUM at year-end 2021 compared to AUM at year-end 2007
2 Financing the Economy 2020 (aima.org)
3 UK Government, Business population estimates 2022
4 roadmap-for-increasing-productive-finance-investment.pdf (bankofengland.co.uk)

barrier to success and they're unable to get adequate funding from other sources.[5] This is often the case for early-stage businesses looking for growth capital, and because banks and other traditional finance providers generally stick to lending to companies focused on traditional business segments.

Challenging the consensus view that impact is only possible via equity investments, interest is growing in the ability of impact credit to provide an innovative, targeted, and effective response to big issues, including climate change. Private credit has a real part to play in sustainable financing and 'Levelling Up' the UK economy.

The UK Government states that an estimated £50 billion - £60 billion of additional capital investment is required each year to meet national climate goals.[6] Britain has just 27 years to become a net zero economy, effectively ending the nation's contribution to climate change by 2050. The UK requires a step-change in levels of investment to transition to a resilient, nature-positive, net zero economy, with trillions of pounds reallocated and invested into new technologies, services and infrastructure.

Sustainability developments in private credit

Private credit investors are increasingly incorporating sustainability into investment strategies. Compared to asset managers in equity markets, credit asset managers have often been slower to deliver on sustainability agendas, with many viewing a focus on ESG factors as a risk mitigation activity within their investment strategies.

The world is changing. Driven in part by government policy and regulation, but also by stakeholder and investor demand, private credit managers are increasingly having to find ways to deliver positive, real-world impact alongside their financial risk and return objectives.

Below are three examples of this evolution. What ties them together? They all go beyond seeing ESG factors as risk inputs. Each deliberately targets positive, real-world outcomes at the same time as delivering contractual, attractive risk-adjusted returns.

Private credit meets sustainability

Sustainability performance ratchets

What is it?
A clause inserted into loan documentation where lenders agree to lower the cost of financing (typically by up to 0.5% per annum), if certain pre-agreed sustainable objectives are achieved by the borrower.

This allows a private lender to effectively engage with a borrower without exercising formal control. For example, a reduction in financing if CO2e emissions have reduced by a set target over a given period.

In practice
ESG-linked direct lending deal a sign of things to come

RSK Group is a leading UK-based global environmental consultancy business. As sole lender to RSK, Ares and RSK structured a refinancing of RSK's existing facilities with ESG-linked objectives.[7]

Sustainability performance targets are focused on carbon intensity reduction, and continual improvement to health and safety management and ethics.

RSK has also committed to donate a minimum of 50% of margin benefits toward sustainability-related initiatives or charitable causes.

Blended finance

What is it?
An innovative structure that combines concessionary capital or official funding (e.g. from the UK Government) with commercial capital.

A first loss tranche (subordinate to the commercial lender) acts as a buffer, de-risking the overall project for the commercial investor.

In practice
A world first, game-changing approach towards decarbonisation at city-scale

Bristol Leap is a joint venture between Bristol City Council and two private companies to direct more than £600m of public and private investment into solar, wind, heat networks and heat pumps in the Bristol area.

Private credit impact strategies

What is it?
Investment strategies that provide loans with the intent to create measurable social or environmental impact alongside a financial return. This creates explicit dual objectives: a financial objective and a real-world impact objective.

In practice
Supporting SMEs by helping them to access finance

Tikehau Capital's impact lending fund, lending to European and UK SMEs that contribute to sustainable economic transition in Europe. Tikehau Capital's impact lending strategy provides more favourable financing conditions, such as lower interest rates, to companies that meet their sustainability goals.

5 British Business Finance Markets Report 2023
6 Mobilising green investment: 2023 green finance strategy - GOV.UK (www.gov.uk)
7 Sustainability-Linked-Loans-White-Paper_vF.pdf (aresmgmt.com)

Action: implementing an income and impact portfolio

Implementing private credit in a portfolio requires specialist knowledge. Read on for guidance on manager selection and asset allocation.

Selecting private credit managers

Within private credit's variety of strategies, there's a spectrum of possible outcomes. Even within a given strategy, such as direct lending, the range of returns can vary based on the skill and expertise of the manager.

Finding the right manager is critical to delivering a pension scheme's objectives: financial returns and real-world impact. We don't underplay the risks of green-washing or that some managers use sustainability credentials merely to boost fundraising in a difficult environment. We advocate rigorous underwriting of every investment.

Assessing a manager's process, investment approach and strategy from every angle is critical. Understanding a manager's culture, decision making and implementation processes is paramount to selecting teams that deliver repeatable performance. At Cardano, we follow a detailed four-stream assessment process when selecting any private credit manager, whether they follow an impact dedicated strategy or not.

Figure 1: Cardano's manager research

1	2	3	4
Investment Due Diligence	Impact Assessment	Operational Due Diligence	Legal Due Diligence
Strategy & Track Record	Intention	Valuations	Investor risk & protections
Team	Process	Fund Structure	Tax DD
Business	Contribution	Governance & Process	Impact Obligations
ESG Assessment	Measurement		

When thinking through investment diligence (part of column 1, figure 1) it's important to focus on key questions such as:

Counterparty risk	What borrower are they lending to?
Credit security	What are loans secured against and where in capital structure do they sit?
Documentation	Do they adequately negotiate protection into loan documentation?
Track record	Have they invested through down cycles & can they evidence successfully managing through distressed or loan work-out situations?

Beyond financial assessment

When selecting an impact credit manager, trustees should ensure their asset managers are tested with as much rigour upon their impact credentials as upon their financial ones. We follow a rigorous impact assessment at two levels, with a detailed sub-framework:

1 Strategy Level

How does the manager demonstrate, invest and mange to maximise impact outcomes in its portfolio?

2 Enterprise Level

How do the underlying business models generate positive real-world impact?

Good impact manager selection assessment will assess **both** levels

Through a combination of structured interviews, questionnaires and case-study reviews, we assess manager's impact process across five key areas:

	Dimension	
Strategy Level	**Intention**	Do they have a clear objective?
	Process	Is impact considered sourcing through to exist?
	Measurement	What are they measuring? How and when?
	Contribution	Would the impact have happened without the investment?
Enterprise Level	**Real world impact**	Assessing quality and quality of impact generated at the underlying assets level

What to consider when building an income and impact portfolio?

Individual private capital and particularly private credit investment can help drive growth in SMEs in the UK and provide critical finance to the energy transition through development financing. This can also be harnessed as part of an intentional approach at a portfolio level to deliver returns alongside positive real work change.

Impact investing is often a new approach to many trustees and a key starting point is to first define what their impact objectives are, and what areas or themes trustees want to focus on. In many cases, the risk characteristics of impact investments are substantially different than those from regular investments in the same asset classes. Differing risk characteristics substantially improve portfolio diversification.

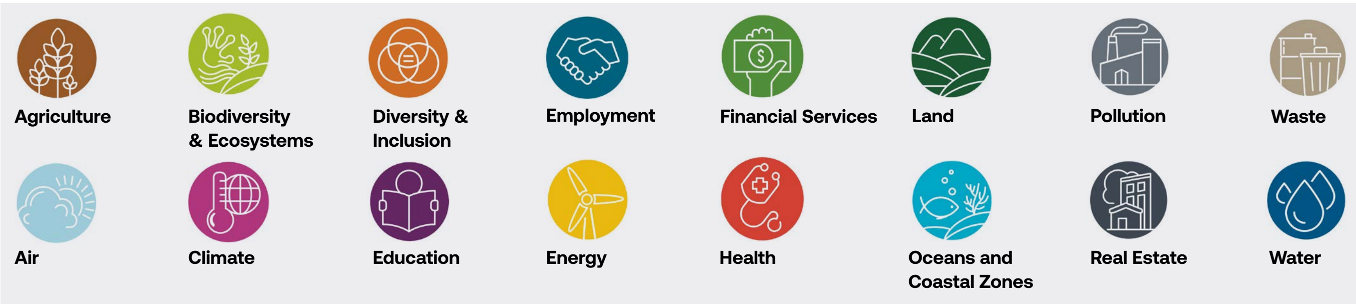
What is Impact Investing?

Impact investing is investing with the intent to create measurable social or environmental impact alongside a financial return.

Applying this at a portfolio level means explicitly having dual asset allocation objectives: financial and real-world impact. Increasingly, pension schemes are considering this approach for a portion of their portfolio and it's something we've been helping clients implement.

Impact frameworks such as IRIS+ (see figure 2) can help initial thought framing. IRIS+ is the generally accepted system for impact investors to measure, manage, and optimise their impact.[8] Similarly, trustees may even want to consider surveying members about particular impact themes that are important to them, so to better engage and align to stakeholders.

Figure 2: IRIS+ Thematic Taxonomy[9]



Once broad theme objectives have been established, we advocate using a 'theory of change' or impact pathway to help focus investments on areas that align with the identified objective. This impact pathway is designed to define exactly how investment actions of the strategy will lead to specific outputs, outcomes and eventually positive real-world impact.

Figure 3: An example Theory of Change for SME finance:

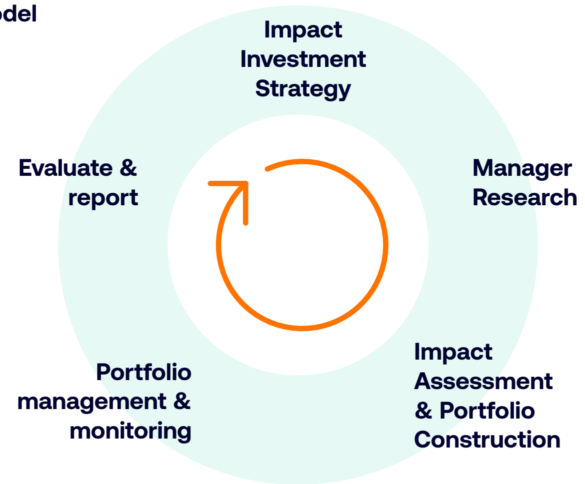
	Activities		Outputs	Outcomes	Impact
LGPS	Members contribute to pension		SME growth	Increase in the number of quality jobs (direct and indirect)	Contribution to local inclusive and sustainable development
LGPS	LGPS decides to invest in Private Market Investments				
LGPS	LGPS invests in a fund		Increased number of SMEs	Increase in start-up and survival rates of SMEs	
Fund Manager	Identify SME investment opportunities	Provide equity investment			
Fund Manager	Design funds with focus on specific geographical areas and sectors	Provide debt finance	Bespoke Outputs based on the SME business model	Bespoke Outcomes based on the SME business model	
Fund Manager		Support management			

Source: Impact Investing Institute's 2021 white paper, "Scaling Up Institutional Investment For Place-Based Impact, 2021"

8 IRIS+ System | About | IRIS+ System (thegiin.org)
9 https://s3.amazonaws.com/giin-web-assets/iris/assets/files/iris/2023-03-20_IRIS_FND_Taxonomy-R5.pdf

Once a clear direction has been established, we advocate being deliberate in integrating impact into every ongoing stage of investment: from thematic focus to asset class or fund selection, through to monitoring, engagement and reporting. At Cardano, we believe this is best done through implementing an explicit impact management and measurement model (see figure 4 for example).

Figure 4: Example impact management & measurement model



Many trustees have started taking this form of approach but first taking a geographical reference point - a "place-based" approach, as advocated by the Impact Investment Institute.[10] Place-Based Impact Investment (PBII) emphasises positive local impact, addressing the needs of specific places to enhance local economic resilience, prosperity and sustainable development.

Localising impact in this way can help bring sustainability alive for members, aligns with 'Levelling Up' and can help stimulate growth and employment in deprived areas. We are also advocates of PBII but at the same time believe that a good impact portfolio is well diversified across asset class, target impacts and geographies.

Whatever approach trustees choose, the tool-kit on offer today includes the ability to deliver financial return, alongside real-world impact, through individual investments in asset classes such as private credit, or taking a more holistic approach and building an impact investment portfolio. A portfolio approach not only recognises that diversification of risk is important but also that the majority of future carbon emissions that need to be addressed from a financing perspective are going to come from global emerging markets.

Cardano: building impact investment solutions

At Cardano, we've been using private credit to deliver risk-adjusted returns, alongside real-world impact for more than 14 years. We've also helped pension schemes go through the process articulated above, engaging with stakeholders to design impact strategies, measurement frameworks and how to build an impact solution to deliver financial as well as impact objectives.

An investment advisory platform dedicated to helping clients build sustainable and impact investment solutions

Design	Build	Manage
Objective Setting	**Structure**	**Operations**
Impact Measurement	**Sourcing**	**Monitoring**
Asset Allocation	**Investment Selection**	**Impact Reporting**
Governance	**Portfolio Construction**	**Financial Reporting**

2008
first impact fund

£5bn
private market investments under management & supervision

24
strong sustainability & impact team

14 year
private lending track record delivering return with impact

14 year
track record in manager selection

Tailored
Impact and financial reporting

Robust
full-service investment and operations platform

550+
employees across the UK and the Netherlands

We fundamentally believe that neither sustainable investing nor impact investing strategies should require trustees to sacrifice returns, while pursuing improved sustainability. We hold up our emerging impact credit products as examples.

Our investment strategies have helped hundreds of underfinanced individuals and SMEs access critical finance, at the same time as delivering market rate returns (see our latest Annual Impact Report from our financial inclusion strategy). Our Financial Inclusion Fund, for example, extends loans to SMEs in emerging markets.

10 https://www.impactinvest.org.uk/resources/publications/report-scaling-up-institutional-investment-for-place-based-impact/

Figure 5: Cardano's Emerging Market impact products

Climate Credit Fund

Geography: emerging & developing markets

Impact: Increasing the renewable energy production capacity in emerging markets

Asset class: private debt

Target start date: Q4 2023

Target size: EUR 1bn in 2024

Performance: target 8-9% net of fees & losses

Investment advisor: Client Fund Managers

78% Female Borrowers

Sanitation & Water Fund

Geography: emerging & developing markets

Impact: Access to WASH loans to low-income people, increasing access basic services

Asset class: private debt

Target start date: Q1 2024

Size: EUR 250m (final close)

Performance: target 3-5% net of fees & losses

Investment advisor: Blended Finance: 5%-15% first loss protection against losses in the portfolio.

70% Rural Borrowers

Financial Inclusion Fund

Geography: emerging & developing markets

Impact: Access to financial services to SMEs, reducing inequalities and basic needs

Asset class: private debt

Start: 2014, open since 2019

Size: EUR 180m / target size 500m in 2024

Performance: 3.8% (since inception) net of fees and losses

34% < National Poverty Line

Source: Cardano Asset Management

Our impact private market investment team is contemplating launching a similar initiative to provide senior project finance for the development and continued operation of renewable energy producing projects (Climate Credit Fund, above), as well as a sanitation and water fund (incorporating elements of blended finance). In our existing and contemplated strategies, we are targeting under-served geographies, together with the generation of a market rate of return.

To find out more about how we can help you incorporate private credit and / or a dedicated impact solution within your strategic asset allocation framework please contact our team.

Sasha Mandich
Head of Business Development
+44 (0)7548 093747
s.mandich@cardano.com

Kerrin Rosenberg
CEO, Cardano Investment
+44 (0)7917 365040
k.rosenberg@cardano.com