EXPERT Q&A

A rising focus on sustainability is creating opportunities in private debt markets, with scale being a key differentiator, say Daniel Pietrzak and Matthieu Boulanger, KKR's co-heads of Private Credit

Taking a more proactive ESG approach

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Q ESG has been a key area of focus for private funds. How do you approach it within credit at KKR?

Daniel Pietrzak: Thoughtful integration and management of environmental, social and governance issues has been a core area of focus for our business for over a decade. We benefit from a robust framework of internal and external resources, including a dedicated 13-person ESG team that works with investment teams and portfolio companies across the firm, an ESG working group within KKR Credit, and a strong network of external advisers and partners.

We recently launched a framework that is enabling us to be even more proactive. We now evaluate every new deal from an ESG perspective, analyse whether companies are contributing to the UN Sustainable Development Goals, and engage more with sponsors and borrowers.

Matthieu Boulanger: As credit investors, we don't own these companies; however, we believe that we can and should still engage with them. We believe that the more we engage, the greater the likelihood that sponsors, owners and borrowers will pay attention to ESG issues and take action to address them, whether for a specific transaction or in the future.

Q Is the rising focus on ESG creating new opportunities for KKR's credit business?

MB: We are seeing a growing demand for ESG-focused credit strategies. We think that KKR is well positioned to meet this growing demand as we have robust, repeatable and measurable methods for integrating ESG considerations into our investment process.

Recognising the importance of the EU's Sustainable Finance Disclosure Regulation, we also believe that we are well placed to bring Article 8 compliant strategies to market.

DP: There's certainly a growing opportunity with investors focusing more on these topics. We've seen particularly strong demand out of Europe but are also seeing interest gathering pace globally.

Q What are the principal challenges around sourcing ESG data from borrowers?

MB: For us, both in the public and private markets, data availability and disclosure is a moving target and something we seek to influence. We are seeing more sell-side ESG due diligence reports, which help us access information, but not all borrowers have ESG strategies or infrastructure, which means the data is not necessarily available or even in existence. The risk is that lack of data can give rise to unreliable data, which complicates efforts to evaluate companies from an ESG perspective.

DP: We're seeing momentum gathering now. In private debt, we are one of the few firms doing both sponsored and non-sponsored transactions. We want to make the origination funnel as wide as possible and pick the best deals. We try to address data challenges by providing our own ESG questionnaire and requiring our teams to fill out an ESG scorecard for every investment.

Q Where did KKR see the most activity in relation to asset-based finance last year? How did that strategy perform?

DP: ABF has been a focus for us since 2016. We saw a need for non-bank lending and built a large platform, with 35 investment professionals globally.

We bring scale and breadth of approach: we cover everything from consumer debt and mortgages to hard assets, SMEs and contractual cashflows, and we are willing to buy loan portfolios, lend against loan portfolios and lend to, or invest in companies that create portfolios.

We have done 50-plus deals with more than $6 billion of deployment. In the last 12 months, we have been most active in residential real estate transactions. We have stayed away from plain vanilla residential risk and favoured residential mortgage bridge lending and the single-family rental space.

The consumer lending sector has also outperformed. Government stimulus and successive lockdowns meant a two-year saving period for consumers. We have been happy to add exposure there through assets like auto lending and home improvement consumer loans.

Q Where do you expect to see most value created in ABF going forward?

DP: Thematically, we want to be involved in secured, collateralised deals with strong upfront current cashflows. We are in a world that's worried about inflation and these deals provide a certain amount of inflation protection. At the same time, many investors are shifting from traditional fixed income to private debt, so there's a lot more investor appetite for ABF.

Q In which sectors and geographies do you expect to see the most interesting direct lending opportunities in 2022?

MB: We remain focused on the larger businesses in direct lending, whether at the top of the capital structure or deeper in subordinated debt. In fact, as we move down the capital structure, the size of the businesses gets bigger (for fundamental credit reasons and competitive dynamics). We focus on businesses with defensive positions and pricing power, which is particularly relevant given the supply chain issues and cost inflation that we are seeing globally.

Geographically, we continue to see opportunities in the US and Europe, which have large and mature credit markets. We have also seen a growing opportunity within the private credit market in Asia. We have built out our Asia credit franchise accordingly and see growing appetite for that asset class from investors globally. We apply the same underwriting standards and investment process as we do in Europe and the US, operating both at the top of the capital structure and further down in subordinated debt.

DP: One of the biggest recent developments for the US direct lending market has been the rise of the mega unitranche over the last 12-18 months. We either led or participated in 13 deals north of $1 billion in 2021, some of which were as large as $3.5 billion. Borrowers want to have closer relationships with their lenders, greater certainty of execution, and they see us as better sources of capital to grow with them. That's a big change and something we find pretty interesting. ■

Q What is your perspective on sustainability-linked loans, and how do you see best practice in that market developing in the year ahead?

MB: Sustainability-linked loans provide a good incentive to borrowers to improve their ESG profiles. We have seen them be successful in the public markets and continue to see real potential for their application in private markets. Typically, these deals come with economic incentives such as a margin ratchet, but our goal is to be able to offer broader upsides, whether that's a maturity extension or some covenant flexibility. One trap is this becomes a tick-the-box exercise pitting one lender against another to deliver easier targets and avoid tackling material ESG issues. To prevent this from happening, we are trying to set meaningful targets, and so that we don't mark our own homework, we are working with a third-party consultant to build a framework that aligns with industry best practices and allows us to determine where and how incentives can be most impactful.