Invesco Direct Lending

ESG Integration in Middle Market Lending

July 2021

Invesco Direct Lending Overview

- The Invesco Private Credit Platform is one of the largest global managers of private credit with USD 38+ billion in assets under management supported by 100+ dedicated professionals.[1]
- Our Direct Lending strategy (the “Strategy”) originates senior secured loans to ‘core’ middle market companies primarily in North America. We believe these loans represent an attractive opportunity for investors seeking to generate strong risk adjusted returns with lower volatility relative to traditional fixed income.
- The Strategy draws upon the team’s significant experience originating middle market credit opportunities. The team seeks to preserve capital by focusing on disciplined asset selection with rigorous due diligence.
- In our opinion, Invesco’s size and scale creates a differentiated model relative to other traditional middle market direct lending providers. Our Direct Lending team collaborates with Invesco’s broader Private Credit Platform – leveraging its embedded sector expertise, institutional sponsor relationships, and decades of experience investing in senior loans.

I. Our ESG Goals in Middle Market Lending

Invesco’s global Private Credit Platform manages over USD 38 billion in assets under management with capabilities across broadly syndicated loans, direct lending, distressed credit and structured products (CLO’s). Our experience investing over multiple decades has taught us the value of having dedicated experts in each investment capability, enhanced by the **scale**, **resources**, and **capabilities** of a globally integrated platform.

Over the last decade, our clients have become increasingly interested in adopting Environmental, Social and Governance (‘ESG’) considerations into their credit investment portfolios. We view this increasing focus on ESG integration as a positive evolution for the global capital markets. ESG considerations and integration has naturally expanded most notably in the public markets’ asset classes allowing limited partners to align their views on responsible investment with their capital allocations. However, private asset classes, such as direct lending, have presented more of a challenge to integrate ESG considerations as the direct lending is a private asset class and borrowers and are not typically evaluated by third party ESG ratings providers.

Beyond the societal benefits of ESG integration, we believe that ESG integration allows for improved downside mitigation and the potential for more favorable outcomes as ESG risks pose potential credit risks that could impact valuation. By systematically evaluating ESG considerations in our investments, we believe we are in a better position to mitigate principal losses for our limited partners.

In 2015, Invesco’s Private Credit platform began incorporating ESG considerations into our investment process for each issuer. Since that time, we have continued to build and enhance our ESG capabilities, and today, we manage over USD 4 billion in dedicated ESG strategies. We set out to be a leader in ESG integration in private credit with the development of a proprietary framework specifically suited to investments in private senior loans. Across our platform, we have evaluated more than 800 issuers utilizing this methodology.

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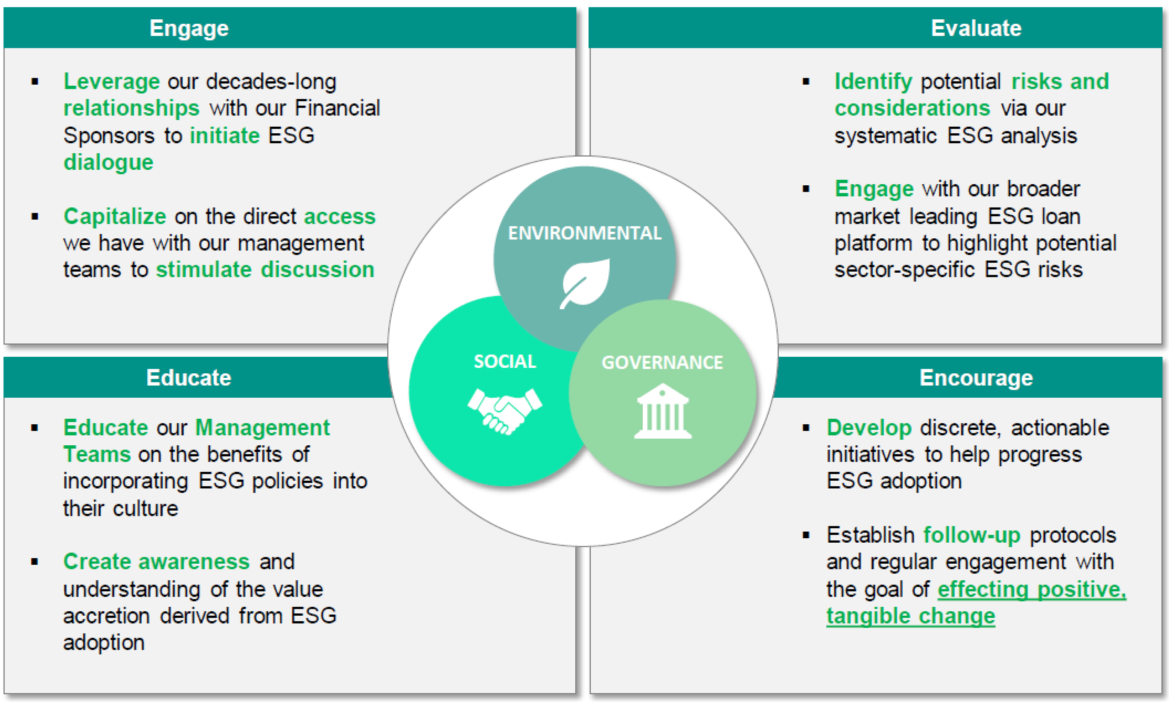
[1] Source: Invesco as of June 30, 2021.

As part of our continued commitment to offering our clients ESG opportunities within private credit, we are keen to discuss the broadening of our dedicated ESG strategies to include middle market direct lending. This area of private credit has historically presented additional challenges beyond those of larger, more sophisticated corporate entities. In addition to the inherent challenges of the private nature of these companies and the lack of third party ESG ratings, middle market companies may lack the awareness of ESG principles, the ability to track ESG metrics, and the resources to implement the measures.

Despite these headwinds, Invesco's private credit platform sees significant opportunity in the integration of ESG considerations into middle market direct lending – we believe the direct dialogue with the issuer's management team and sponsor sets up an opportunity for tangible change. We highlight 4 elements of our philosophy to direct lending investments with regard to ESG:

Figure 1. Invesco Middle Market Direct Lending ESG Philosophy



Source: Invesco as of June 30, 2021. $ = USD.

The primary driver around our ability to implement ESG integration in middle market direct lending orients from our ability to **engage** with management teams and sponsors. Our direct lending team typically maintains a regular dialogue with the issuer throughout our underwriting / diligence phases and throughout the investment horizon. Invesco is able to comprehensively **evaluate** ESG risks and considerations using our systematic framework. In addition to direct engagement with the sponsor or management team, our direct lending group also looks to leverage the embedded expertise and proprietary knowledge of our 20+ member sector-based credit research team which has evaluated over 800 issuers using our ESG framework.

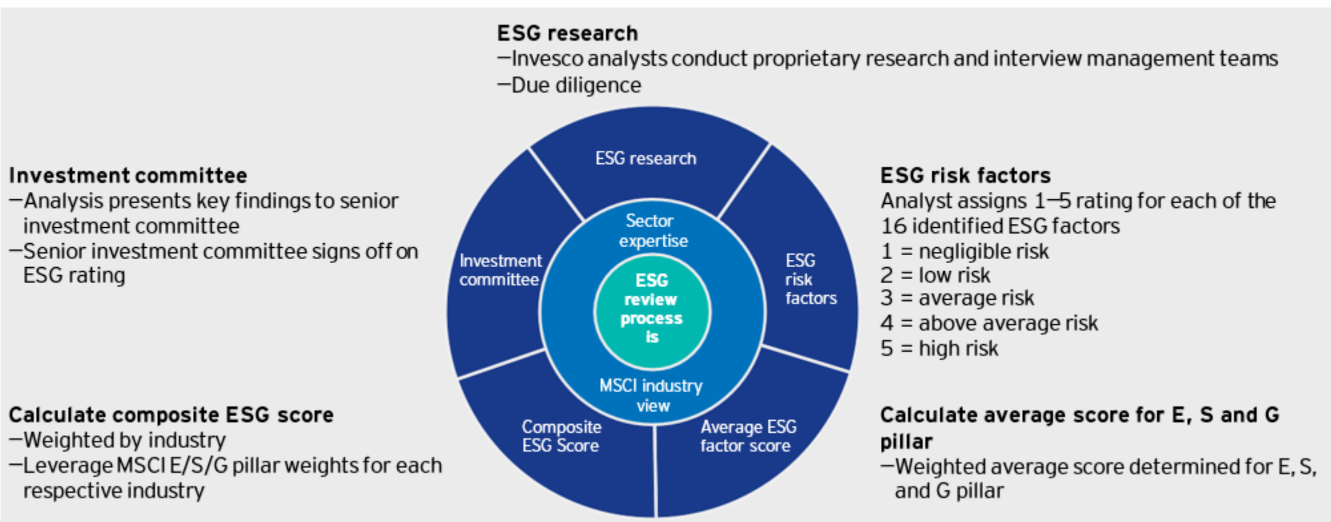
Given that middle market companies are often less systematic with regard to the benefits of incorporating ESG into their culture, we often find early opportunities to **educate** on the mutually beneficial nature of these initiatives, and create awareness of the financial and non-financial benefits of ESG adoption. In our experience, we have been impressed by these conversations as we have found the dialogues to be constructive as management teams and sponsors are often eager to learn more about our evaluation, relative ESG positioning within their sector, and opportunities and benefits associated with ESG improvements.

Finally, and perhaps most importantly, our approach culminates with regular engagement, designed to **encourage** the adoption of discrete and actionable initiatives to progress their ESG implementation. We work with our portfolio companies to identify these efforts, help identify the benefits of change, and use our regular engagement to follow up on these efforts with the goal of effecting positive, tangible change.

II. Executing ESG Ratings in Middle Market Lending

Invesco Private Credit's proprietary framework to integrate ESG considerations is designed to create a systematic process of evaluating ESG concerns both at underwriting as well as throughout the life of the investment. We view the development of our framework as a unique differentiator in our approach to ESG in middle market direct lending.

Figure 2. How Does the ESG Ratings Process Work?

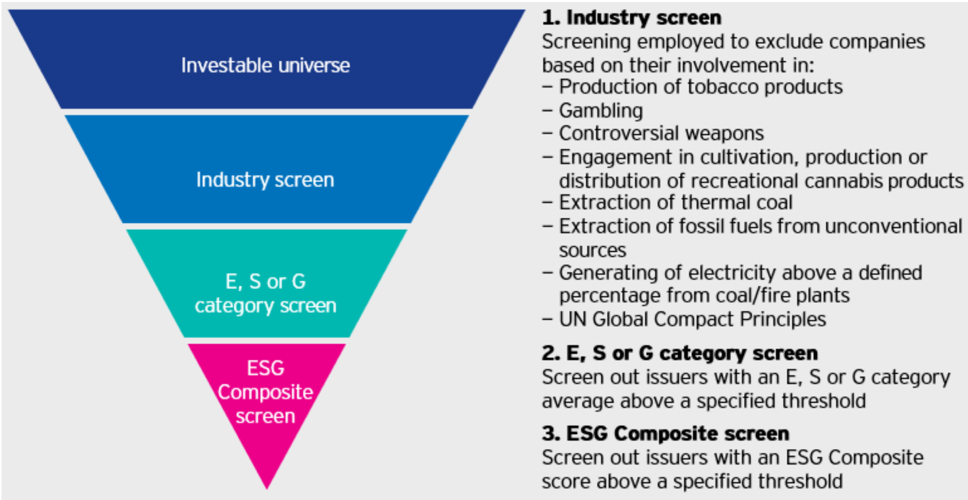


Source: Invesco. For illustrative purposes only.

A. Initial Screening

Screening is employed to exclude companies and / or issuers from the investment universe that do not meet the Invesco Direct Lending ESG criteria. In addition, the Strategy may not invest in loans from companies that have an aggregated ESG rating or single category E, S, or G ratings above levels set within the internal ESG rating methodology.

Figure 3. ESG Portfolio Construction



Minimum ESG ratings criteria and certain sector exclusions are applied during portfolio construction. Companies and / or issuers from the investment universe that do not meet the portfolio's ESG criteria, include but are not limited to:

- level of involvement in the production of tobacco and tobacco products,
- gambling,
- controversial weapons (including nuclear weapons),
- whole or partial engagement in the cultivation, production or distribution of cannabis or cannabis derived products for the purposes of recreational use (including any company that derives a part of its revenue from recreational cannabis),
- extraction of thermal coal,
- extraction of fossil fuels from unconventional sources (including Arctic drilling, tar sands, shale oil and gas, or other fracking activities and/or mining of oil shale),
- generation of electricity above a defined percentage from coal-fired power plants,
- status in terms of respecting the UN global compact principles), as well as based on the status of these companies and/or issuers in terms of respecting the UN global compact principles as assessed by third party providers for the global universe they cover, as updated from time to time.

The ESG industry "screening" process for direct lending transactions aligns with our team's investment process at the "sourcing" stage. As deal opportunities are introduced to the direct lending team, the group will make a determination on whether to advance an investment to undergo an investment "screening memorandum." Direct lending investments which do not meet our ESG industry screens do not advance in our investment process.

B. ESG Ratings

Our ESG ratings process orients around the three pillars of E, S, and G along with underlying factors by which companies are evaluated. These pillars and factors include:

Figure 2. Factors Incorporated into Our ESG Framework

Environmental Pillar	Social Pillar	Governance Pillar
– Natural resources – Pollution & waste – Supply chain impact – Environmental opportunities	– Workforce – Community – Product responsibility – Human rights	– Management – Shareholders – Board of Directors – Auditor – Regulatory issues – Corporate social responsibility Strategy – Anti-corruption – Business ethics

Source: Invesco. For illustrative purposes only.

Our direct lending team uses a weighting schematic for the issuer's broad industry category to determine an ESG rating. These ratings are averaged into an overall ESG score that is approved by our Investment Committee, subject to updates and reviews on at least an annual basis.

To derive an issuer level ESG rating:

1. Our team averages the various factors under each E/S/G pillar to determine Pillar Ratings.
2. Each pillar is weighted by the average E/S/G pillar weights published by MSCI ESG Research by industry sector to come up with an ESG Composite Score. Those pillar weights as of 30 September 2020 are shown in table 3.
3. These ratings are averaged into an overall ESG score. Each overall ESG rating is reviewed with and approved by our Investment Committee (the same committee that approves all direct lending transactions).
4. Each ESG rating is included in any new deal underwriting and reviewed at least (minimum) annually. ESG criteria will be reviewed and applied on an ongoing basis as part of the investment process for credit selection and portfolio construction.

Figure 3. ESG Pillars Weighted by Broad Industry

To derive issuer level ESG ratings, we further weight E, S and G factors by broad industry pillars as follows:

GICS Sector	Environmental pillar	Social pillar	Governance pillar
Communication Services	5.0%	54.8%	40.3%
Consumer Discretionary	21.1%	51.9%	27.0%
Consumer Staples	30.4%	46.8%	22.8%
Energy	49.6%	17.1%	33.3%
Financials	8.9%	58.7%	32.4%
Health Care	5.9%	49.1%	45.0%
Industrials	21.5%	38.1%	40.4%
Information Technology	21.4%	51.0%	27.6%
Materials	53.8%	23.0%	23.2%
Real Estate	32.9%	32.7%	34.4%
Utilities	57.6%	18.6%	23.8%

Source: MSCI ESG Research, average E/S/G pillar weights, as at 30 September 2020. Sector ESG pillar weightings are updated annually each September. For illustrative purposes only.

Using our framework, our direct lending team is able to determine a composite score quantifying ESG risks for potential transactions. After initial investment, our team is committed to maintaining a dialogue with our issuers to continue to encourage our companies to implement ESG change. We believe this process allows for regular conversations with our companies and allows us to continually re-visit ESG initiatives to effect positive progress.

III. Conclusion

Over the last decade, our platform has sought to be at the forefront of ESG integration in private credit. While executing ESG considerations in private credit does have obstacles, we have embraced those challenges and developed a proprietary process, to **engage**, **evaluate**, **educate** and **encourage** our middle market issuers not only as a risk mitigation tool but also to increase awareness of these critical global issues. Continuous improvement and refinement of our processes has been a hallmark of Invesco Private Credit over the last two decades and we are committed to using our global platform and capabilities to work with our limited partners to align their capital allocations with their views on responsible investment while advocating for tangible, positive changes.

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