BLUE OWL

Assessing ESG Factors in Direct Lending

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Integrating ESG analysis into a firm's investment process

is a widely adopted concept that has evolved drastically in the last five years. Within direct lending, the practice fundamentally involved the incorporation of environmental, social or governance factors as a part of investment decision-making, and has historically been focused on whether those factors inhibit a borrower's ability to repay.

More recently, however, the 'ESG' lens has broadened. The scope now includes how non-financial factors, including environmental, social and/or governance-related issues, could be incorporated into an investor's decision as a whole. The implication is that ESG analysis has a role in shareholder value more broadly, not only with respect to short-term repayment risk, but whether the underlying borrower presents any risks or opportunities that may affect medium to longer-term value creation.

This expansion of scope necessitates a wider view on the types of underlying risks and opportunities within a transaction and who or what is impacted by them. Will the consequences of those risks or opportunities impact longer-term value for investors, shareholders as well as other stakeholders?

The role of ESG analysis in investment decision-making has evolved in an effort to remain commercially relevant, proportionate to the limitations of different asset classes, and sufficiently scalable. Here, this innovation of practice is being and will continue to be driven by direct lending.

ESG Disclaimer - Blue Owl's objective when considering Environmental, Social and Governance ("ESG") factors is to seek to maximize risk-adjusted returns consistent with the investment objective of the relevant fund as set forth in the partnership agreement and memorandum for such fund. ESG initiatives or practices related to underlying investments do not apply in every instance.

The views expressed herein are those of the author and represent her opinion on an approach to ESG integration in direct lending. This paper is not, and should not be construed as, the ESG policy or practice of Blue Owl which is available at **www.blueowl.com.**

What do we want to achieve?

We want to enhance our investment decision-making by using 'ESG' analysis to supplement our overall view on the quality of an investment opportunity. ESG analysis is an opportunity to identify and, to the extent applicable, mitigate or monitor investment risks that may hinder our financial returns or the medium to longer-term value of a company. Our overall investment philosophy is to offer clients attractive risk adjusted returns and we see effective ESG analysis as an important tool in our overall toolkit to address risk and find opportunity. Over time as we and the asset management industry further evolve, we see this type of analysis as equally providing clear pathways for opportunities to enhance potential returns and overall value.

What do we mean by ESG risks?

We see ESG risks as being environmental, social or governance-related practices or activities that are embedded or may become embedded into a company's core business that have the potential to negatively impact the company's financial performance or its stakeholders, including but not limited to, its investors, employees, customers and physical environment. ESG risks may or may not have reputational consequences for a company and its investors. The reputational concern itself is not the ESG risk; rather, the underlying practice that may cause reputational concern is the ESG risk to focus on.

What do we mean by ESG opportunities?

An ESG assessment of a company could reveal intentional or inadvertent positive benefit of a social, environmental or governance-related nature. These opportunities will have implications and possibly positive outcomes for a company's financial performance, its stakeholders and/or to medium to longer-term value creation. We see ESG analysis of risks and opportunities going hand in hand.

What underpins our overall approach to effective ESG assessment?

We have a core set of principles that guide our approach to effective ESG assessment as it relates to direct lending and other non-control investing.

1

ESG assessments must be integral and complementary to the investment decision process, including our internal investing cycle.

2

They should enhance a deal team's view of a business and strengthen its overall diligence and analysis.

3

Tools, processes and procedures should be proportionate to the nature of the investment (i.e., amount of information available, length of transaction and decision-cycle, rights afforded to and obligations required of the investor, etc.)

4

Our approach must be able to scale at pace with our investment ambitions.

5

Overall, it must be sufficiently robust to substantiate our decisions but not disproportionately cumbersome and resource inefficient to impede our ability to be good stewards of capital.

Our conceptual framework aims to incorporate these principles

The goal of our ESG assessment is to prioritize the ESG risks that are most relevant and material to the transaction in question, and to have a clear path to action. Conversely, we want to be able to underwrite and check-off potential risks early on in our investment process, and by substantiating our analysis, we can demonstrate that we are comfortable moving forward with a transaction under those circumstances. This allows us to assess investments at scale and ensure effective and efficient portfolio management.

We are confident that by employing this methodology we can:

1

De-prioritize risks that are not sufficiently material

Set aside risks that may be relevant to consider (as per global standards and frameworks) but are not sufficiently material to the specific transaction in question.

2

Check-off after focused due diligence

Check-off on any material risks after focused and well-informed due diligence that allows us to substantiate that decision.

3

Identify risks for monitoring

Identify which risks require monitoring, post close, to give us comfort through the life of the investment that the risk is being effectively managed by the company. We rely on the relevant data (more on some potential data metrics below) to 'early-warning flags' on whether the risk may materialize or increase in severity.

4

Escalate priority risks early

Narrow down risks that have not been check-off and, in addition to monitoring, escalate them early to the Investment Committee for deliberation and mitigation.

Our ESG risk prioritization is driven by two factors

The likelihood of the risk occurring	The severity of the impact if the risk materializes

> This approach encompasses the more modern view on integrating ESG analysis into investment, focusing on potential circumstances that may have unintended consequences on not only the financial performance of the company in the short term but also on its medium to longer-term value.

What is the likelihood?

In order for us to feel confident about assessing the likelihood of a risk occurring we focus on both the exposure the company has to the risk, and its capabilities to potentially manage it. The exposure of a company will be a function of how its core business model relates to the risk; for example, a business that lends to customers with low FICO scores as a target market has more exposure to financial customer protection risk. It could also be a function of other factors like proximity to the risk, frequency of activities that underpin the risk, or scale of output that may trigger the risk. Simultaneously, we assess the capabilities of a company to not only manage the risk as it exists, but also mitigate the risk from escalating. Our view on a company's capabilities includes, but is not limited to, its culture, its governance structure, its policies and procedures as well as its resourcing, internal training/skills, and leadership awareness. A company that has safety certifications, tested or audited protocols, transparency, leadership oversight, and clear governance checks and balances on hazardous waste disposal methods indicates a higher degree of capability to manage a potential environmentally damaging risk.

What is the potential severity?

When we want to assess the potential severity of the impact the risk could have, we include both the financial impact of the risk occurring as well as, and equally, the stakeholder impact it may have. The financial impact includes the monetary impact on the borrower, via change in revenue, increase in costs of capital and/or negative effect on ability to repay.

It may also include longer-term erosion of potential revenues, including but not limited to market or investor confidence or increased regulatory scrutiny. The potential impact on stakeholders takes into account the size and depth of potential negative consequences to people (e.g., direct effect on employee health), the environment (e.g., degradation of soil quality) and even broader society (e.g., misinformation affecting social welfare). Importantly, this factor allows us to give weight to potential inequalities where the depth of stakeholder impact is higher for 'vulnerable' stakeholders – i.e., those who have lower resilience or ability to recuperate from the negative shock, such as the lower-income, the elderly, or children. Negative stakeholder impact will inevitably have financial consequences, though it may not be clear what the associated monetary impact is. We account for this factor in our assessment proactively, with the knowledge that we may not have the ability to immediately (and directly) translate it into financial impact, but that we consider negative stakeholder impact as eroding the investment's medium to longer-term financial value.

Translating Assessment to Action

As our Direct Lending deal teams undergo this ESG assessment process, they are able to prioritize risks and map them to our suggested guidance on what actions, if any, to take.

Our ESG assessment process leads to 4 specific outcomes

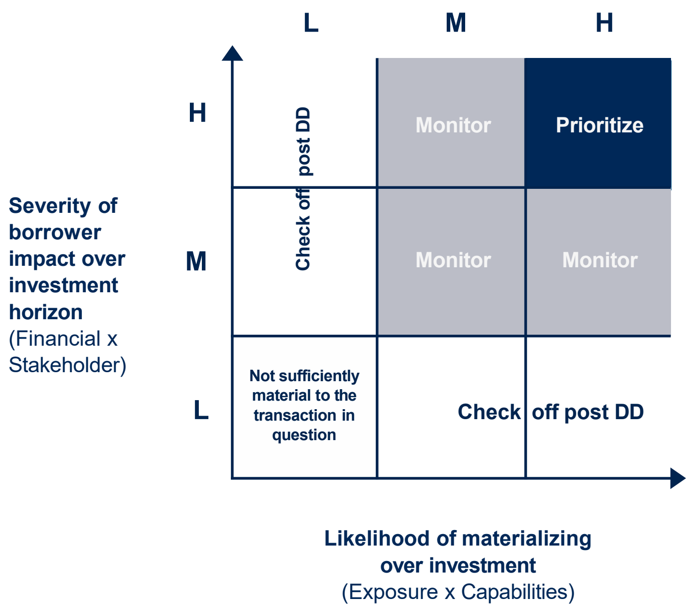
- The risk is not sufficiently material to the transaction in question.
- The risk has been checked-off post due diligence activities.
- The risk will need to be monitored through the life of the investment.
- The risk is significant and needs to be escalated to the Investment Committee early for deliberation.

Once risks have been deemed as not sufficiently material to the transaction in question, we encourage deal teams to document that accordingly and not assign further resources to the topic. This is the first step to eliminating irrelevant risks and narrowing our focus to where we can best use our resources at scale.

Checked-off risks will require deal teams to include substantive analysis in the IC memo. They are encouraged to conduct due diligence and describe the circumstances, features and characteristics of the transaction, the borrower, the industry, the product etc., that underpin the ultimate decision to check-off or get comfortable with the risk. We assume that this risk will then not need to be proactively monitored post-close and/or will not require any mitigation from us as the investor.

Risks that will need to be monitored more closely will be tracked via the portfolio management process. This more narrow and specific articulation of risks and their potential implications allows us as a direct lender to thoughtfully assess which metrics, KPIs and/or proxy variables are the most appropriate through the life of the investment. These data needs, including the frequency at which we require the data, should be agreed on before the transaction closes, allowing us to explore our options on data visibility. Options could include: using loan documentation to incorporate formal requests, agreement with management teams to give updates on specific topics as part of regular portfolio monitoring, collaboration with the sponsor or equity investor on data sharing, etc. Similar to risks that have been checked off, in the case of risks that require ongoing monitoring, we do not require any active risk mitigation efforts on our part as the investor.

Risks that need to be escalated early to the Investment Committee for deliberation and consideration will necessarily be the risks that are prioritized as being the most relevant, with the highest degree of likelihood and potential impact. It is these risks that will require us to make deliberate choices if we choose to proceed with the investment, including how we will mitigate the risk, how we may want the relevant risk profile to change or evolve over the life of the investment, and how we as a lender may be able to enable, support or affect that change. These more infrequent and focused circumstances allow us, as a non-control investor, to take additional action as needed if we choose to proceed, including for example, linking the loan to KPIs, creating pricing step-ups/downs, phasing disbursement to milestones, carving out use of proceeds, segmenting portfolios and exposures, proposing initiatives or business critical improvements, coordinating on syndications, etc.



How do we integrate this ESG assessment into our investment process?

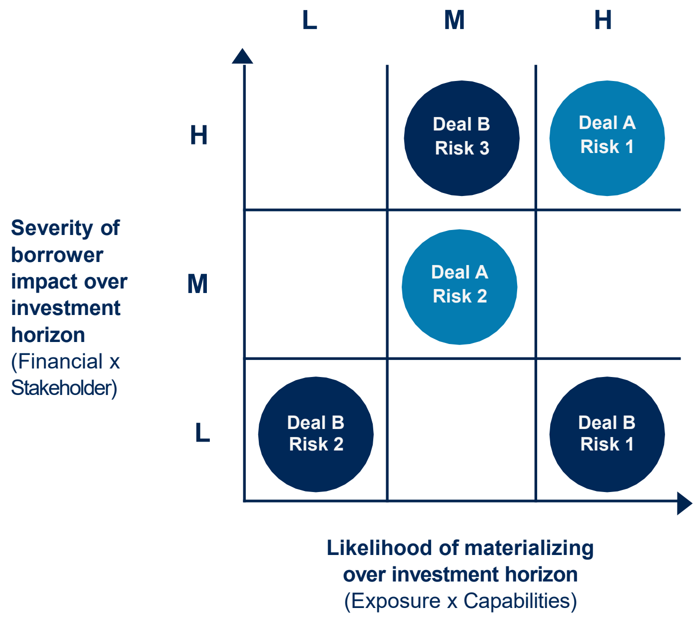
We broke it down by investment decision milestones and developed sets of proprietary tools[1] to support this assessment process in phases, during which we rely on our core principles to guide our approach.

We encourage our deal teams to use a customized tool to narrow down a long-list of relevant ESG risks for the transaction at-issue. This allows them to, among other things, make decisions on which risks may not be sufficiently material to the transaction in question. This tool incorporates guidance from global standards and frameworks such as SASB, GRI, TCFD, UNGC, ELFA, among others, allowing us to use a broad range of sources to help with an initial scoping of relevancy and materiality. The long-list of risks is then analyzed by utilizing our proprietary assessment tool. This second tool helps deal teams narrow down higher or lower priority risks – based on the severity of the potential impact and likelihood of materializing.

The tool then automatically plots each risk onto the matrix, enabling deal teams to substantiate decisions on which risks are most critical and \what course of action to take. Further or enhanced due diligence is conducted around the risks, and the tool is updated as more information is made available.

By the end of the investment underwriting process and before final investment committee vote, the deal team should be able to create an inventory of actions taken by each identified ESG risk, which allows them to have clear steps for portfolio management as needed.

Blue Owl's approach to integrating ESG assessments into its investment cycle aims to incorporate practical, scalable, and commercially-sound practice, which will continue to support our ability to effectively manage our portfolios while seeking to deliver attractive risk-adjusted returns to our investors.



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[1] *The development of the excel tools was supported by Close Group Consulting Inc.*

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