ALLEN & OVERY

Sustainability Linked Lending in the Leveraged Finance Market

ESG ratchets and related issues

1. Introduction

Environmental, Social and Governance (**ESG**) matters have long been a talking point in the leveraged finance market, but the end of 2020 and the first few months of 2021 have seen deal flow take off for transactions addressing these issues.

In our market, sponsors are driving inclusion of ESG terms in their debt documents, seeing them as key to good portfolio management and exit planning, and because of increased focus on ESG from LPs.

2. What are sustainability linked loans?

Sustainability linked loans aim to encourage borrowers to improve their ESG or sustainability performance through financial reward for complying with agreed targets. In the leveraged finance market, this is usually done by including an 'ESG ratchet' on the margin. This contrasts with the approach we're currently seeing in REF and infrastructure debt products, where, driven by lenders, the focus to date has been on ESG reporting requirements. Note that 'Green Loans' are a separate category of product, which drives ESG improvement by including use of proceeds criteria to ensure funds are applied in a particular way. This is not what we're generally seeing in leveraged finance (although see below under 'Emerging features and talking points').

3. What have we seen in leveraged finance documents to date?

There is not yet a standard approach adopted across the market, but there are some common features to ESG related terms in leveraged finance transactions.

Margin adjustment

- Most often, the margin ratchet is two-way, so that meeting the agreed sustainability performance targets results in a reduced margin, and not meeting them results in an increased margin. In some very recent deals we have seen sponsors seek (not always successfully) a downwards only adjustment.
- Mechanics are similar to a standard margin ratchet based on financial ratios, although adjustments occur annually rather than quarterly.
- In some cases the ratchet is subject to no specified Events of Default having occurred (or being outstanding) but this is not common.
- The range of adjustment is generally larger than is seen in investment grade ratchets. We see between 5-15bps in leveraged documents, whereas investment grade ratchets are typically around 5bps (and can be lower).

What ESG targets are measured?

- At least one ESG ratchet in the leveraged market uses as its basis an overall ESG rating provided by an independent third party. Others use more specific Key Performance Indicators (**KPI**s) – of which, examples seen so far in the leveraged finance market include:
  - greenhouse gas emissions
  - energy consumption
  - water quality
  - use of recycled materials
  - number of female managers
  - staff shareholdings
  - food waste

  As this list shows, the KPIs don't only relate to environmental issues, but can also address the 'social' and 'governance' elements of ESG performance. Other KPIs have been seen in the investment grade market, and the Sustainability Linked Loan Principles published by the LMA, LSTA and APLMA in 2019 (the **SLLP**) include further examples and guidance.
- In most ESG loans in the leveraged finance market to date, more than one KPI is used, with the ratchet applying based on how many of the targets are reached for each year.
- KPIs and targets are sometimes negotiated on behalf of the lenders by a Sustainability Co-ordinator or Sustainability Structuring Agent though this is not common in recent leveraged deals. This approach can offer more robust and consistent KPIs and methodologies for assessment. It is not, though, universal in widely held deals, and Direct Lenders in particular are less likely to use this process in our experience.

Reporting and verification

- Currently there is no standard measurement methodology for ESG criteria, and KPIs are specific to each borrower. This may change over time, with the EU taxonomy for sustainable activities and the Sustainable Finance Disclosure Regulation expected to have a particular impact.
- Generally in leveraged finance we are seeing sponsors take the view that management reporting is the most appropriate way to measure ESG performance against KPIs, although the SLLP does recommend that borrowers seek external review of their performance against their ESG targets. In some cases the 'baseline', day one position on a KPI is externally verified.
- The borrower does not usually represent that the information delivered to the agent and/or external provider is accurate.

What happens if the borrower fails to meet its targets, or doesn't report on its targets?

- If targets aren't met (or too few are met where there are multiple targets), normally the only consequence is that a higher margin (based on the ratchet) applies; generally there is no Default or drawstop.
- Failure to deliver an ESG compliance certificate, in general, does not result in a Default but does result in a higher margin (based on the ratchet).

Emerging features and talking points

- **Charitable donations** – Borrower agrees to donate an amount equivalent to any margin reduction to charity and/or lenders agree to donate an equivalent to any margin increase to charity.
- **Sustainability payments** – An amount equivalent to the margin reduction is directed towards the borrower's own sustainability objectives.
- **Borrower's choice whether to use ESG provisions** – In some transactions the borrower can opt out of setting annual targets or delivering ESG compliance certificates. In some cases where this provision is included there is no consequential margin adjustment.
- **Hybrid green/ESG provisions** – A recent leveraged deal features ESG specific pricing on the RCF which applies when the use of proceeds satisfies specified ESG criteria. The sponsor on that deal has reportedly said that it expects to replicate this structure.
- **Use of acquisitions and disposals provisions in leveraged documents** – How should acquisitions or disposals affect KPIs in leveraged deals? Some in the market include specific provision for targets and KPIs to be adjusted – others don't. How these adjustments work (and whether they are required) depends on the nature of the agreed KPIs.

Key resources for leveraged ESG loans

- Sustainability Linked Loan Principles (SLLP): global principles published jointly by the LMA, APLMA, and the LSTA describing a framework for companies raising ESG-linked finance without a specific "green" project to fund.
- Guidance on the SLLP: further guidance on the SLLP published jointly by the LMA, APLMA, and the LSTA
- Guide for Company Advisers to ESG Disclosure in Leveraged Finance Transactions: jointly published by the LMA and ELFA
- ELFA ESG factsheets: ELFA has published sector specific ESG factsheets as well as a general ESG factsheet.

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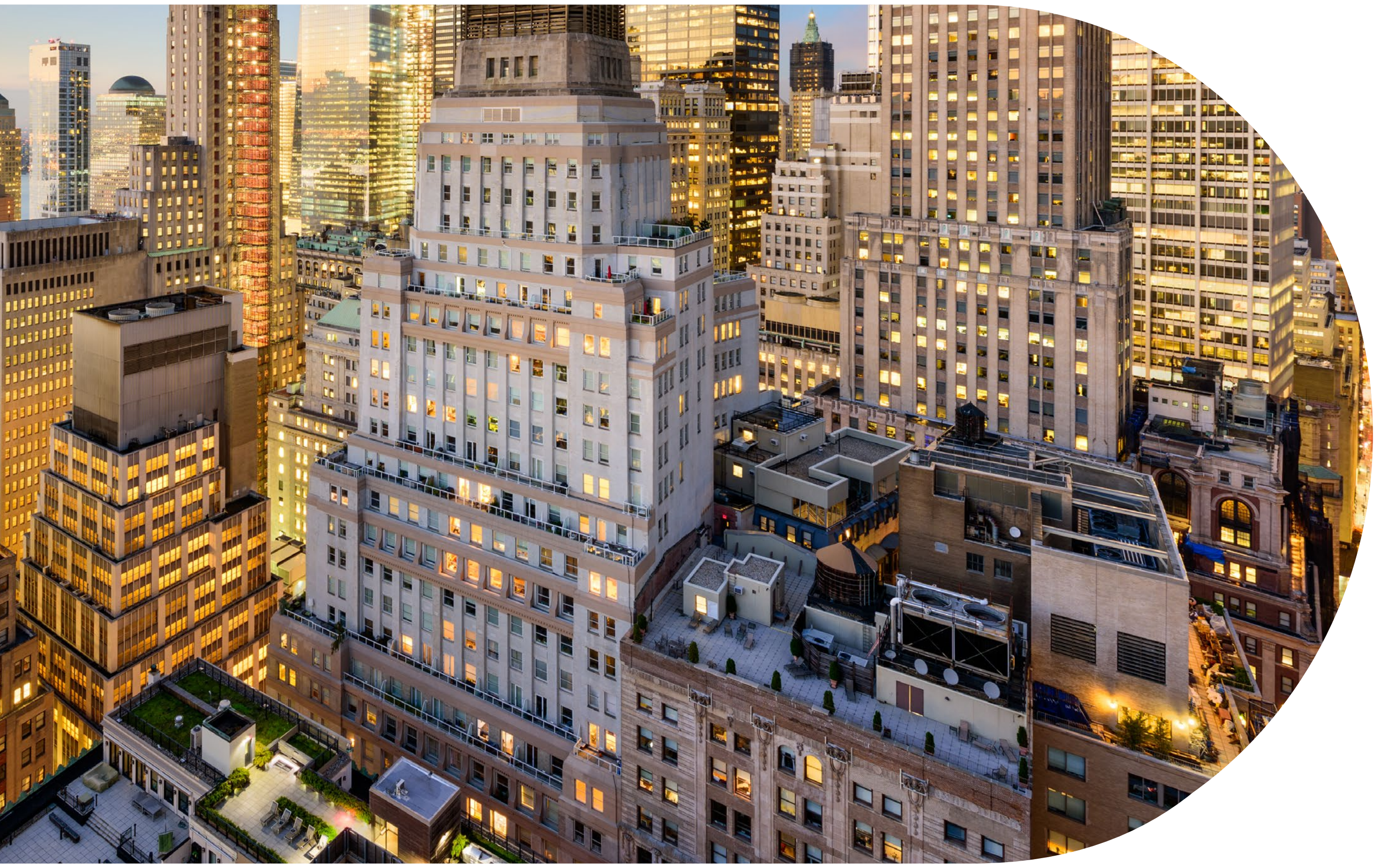

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