Investment Insight

Sustainability-linked LBO loans – fad or future?

Leveraged Finance Fund Management desk

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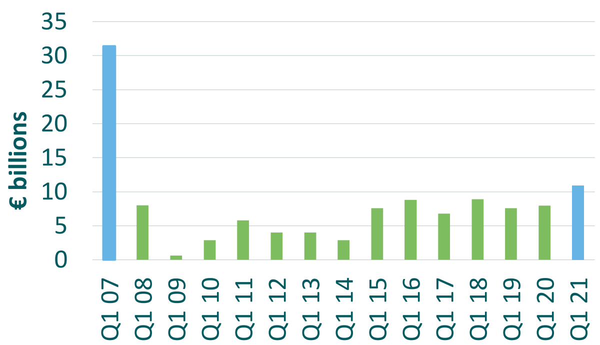
The 'green' finance revolution shows no signs of slowing down, with sustainable debt issuance continuing to set new records as sustainability becomes an increasingly critical factor for companies seeking to raise capital. More recently, there has been an explosion of new deals carrying sustainability-linked pricing in the European LBO market, in the form of Sustainability-Linked Loans (SLLs). In this paper, we explore some of the key features and terms associated with these deals, talk about the main challenges lenders may face when analysing deals and offer our views on what we think is necessary in a credible SLL.

ESG-linked pricing structures emerge in the leveraged finance market

The first quarter of the year was the busiest opening period for European leveraged buyouts (LBOs) since before the global financial crisis, according to S&P Global, amid renewed appetite for deal-making.

Figure 1. European Q1 buyout volume Q1 2007 to Q1 2021



Source: S&P LCD, as at 31 March 2021. Information is subject to change and not an indication of future results.

In Europe, there is growing use of sustainability criteria in leveraged loan structures too – an emerging trend that we noted in our recently-published '*Leveraged loan market outlook 2021*'. Around half of all leveraged loans issued so far this year have seen private equity (PE) sponsors introducing a sustainable element to an LBO loan backing their acquisitions in a diverse range of sectors.

While leveraged loan investors have been open to the idea of ESG-linked pricing structures as the loan market steadily embraces the adoption of better ESG disclosure and target-setting, given the growing awareness and enthusiasm among institutional investors around ESG and sustainability matters, there is understandable scrutiny from loan market participants on this latest evolution in documentary terms.

Does the increase in sustainability-linked LBO loan issuance signal a wider commitment by borrowers/PE sponsors to ESG disclosure and growing focus on sustainability matters or does it constitute a less credible development in the market and a device only to reduce financing costs?

What are sustainability-linked loans?

A SLL is a loan – whose proceeds may be used for general corporate purposes (unlike a more dedicated instrument like a Green or Social loan whose proceeds are ring-fenced for specific use) but whose margin may change, depending on the company's ability to meet (or otherwise) a pre-selected ESG metric or sustainability performance target (SPT), and an associated key performance indicator (KPI). Indeed, a company may choose to link its financing to more than one such measure.

Until 2020, SLLs had been solely the preserve of investment grade (IG) issuers and entirely provided by banks. SLLs first emerged in 2017 and predated their bond market equivalent, SLBs. More recently, the feature of linking a coupon to an ESG KPI has spread to the leveraged finance market, now accounting for more than a third of corporate loans in Europe. Unlike its bond market equivalent (whose coupon adjusts only upwards, should targets not be met), the SLL's interest rate is adjusted up, *or* down, depending on whether the borrower meets its specified target.

As we've noted, the crop of new deals carrying sustainability-linked pricing in the European LBO market is relatively new and largely bespoke, and there are, as of yet, few guidelines for such deals.

Let’s explore some of the key terminology associated with SLLs in the LBO world:

Margin ratchets: Often, the LBO loan includes an ESG margin ratchet, based on chosen KPIs, intended to incentivise the borrower’s achievement of ambitious, pre-determined sustainability performance objectives. For example, the pricing of loan transactions is directly tied to performance by the borrower against these specified targets, ie a margin ratchet could go up or down, by 2.5-15 basis points (bps). Depending on their structure, margin ratchets effectively reward borrowers for their achievements (margin decreases) and hold borrowers to account if progress reverses (margin increases). In some cases, sustainability-linked margin ratchets can be based on several KPIs with each KPI, in turn, having an independent margin ratchet that is tested annually and subject to the borrower delivering certain information to its lenders to show that the underlying KPIs/targets have been met, if specified in the deal terms. Due to the varied nature of this market, there is currently no standardised format for the manner in which sustainability ratchets can be utilised nor verified.

KPIs: Key performance indicators included in such deals can be focused on sustainable elements of pre-existing company targets, although have tended to be ‘green’ or environmentally-focused. That said, there have been instances of ‘social’ targets, with some deals having seen pricing directly tied to a company’s goals around diversity. A business could target a measurable reduction in CO_2 emissions for instance (eg building materials group, Stark), or have other selected KPIs, based on the sustainability objectives of the business and the industry in which it operates such as recycling targets, its role in the circular economy or its contribution to renewable energy. Earlier this year, the €965 million loan facility that backed Carlyle’s buyout of German mechanical drive systems business, Flender, included a margin ratchet of 5-10 bps that was linked to the power volume of new gearbox installations in wind turbines.

The fact that the ratchet is designed to work both ways, ie to penalise (as well as reward) if the company does not hit a KPI or does not provide the requisite information, is an important feature and will help to ensure that credibility and integrity around the use of sustainability-linked loan pricing ensues.

What we would expect to see included in such deals

It is hoped that the advent of SLLs in the leveraged finance market will herald a wider commitment on the part of the borrower/PE sponsor to ESG disclosure rather than be a ploy to reduce the costs of the transaction based on hand-selected, peripheral targets that add little to material risk-changing.

While the sustainability-linked LBO loan market is still in the early stages, around half of the loans that have been issued in Europe so far in 2021 incorporate this feature, some of it being without stretch goals, direct relevance or appropriate verification. In some cases, the motivation of PE sponsors is questioned, this being seen as a gimmick or pricing perk to knock another 5-10 bps off the financing cost of the transaction. There have been a handful of deal examples where the inclusion of ESG-linked contractual provisions, have already been called out by the market for lacking ambition, inviting broader concerns about greenwashing.

In the absence of appropriate verification through second-party opinion (SPO) providers (unlike the green bond market where most corporate issuers obtain a verified SPO), how are lenders able to determine whether the ambition or impact of a touted KPI is stretching enough? These challenges around transparency emphasise why vigilant lenders must remain alive to potential greenwashing risks when it comes to assessing loans.

The loan asset class is well adapted to engagement with borrowers/sponsors as the direct, contractual nature of the loan permits more frequent interaction between the parties, and there are certain things that lenders can look out for when performing due diligence and deeper evaluation of a borrower’s businesses prior to investment. Nevertheless, a lender must be able to carefully assess the KPIs to determine the expected impact of each, whether they are ambitious enough from the borrower (or would have been achieved anyway during the normal course of business) and are achievable in the right timeframe, as well as ensuring adequate oversight on KPI measurement and reporting. We believe this calls for greater, and more meaningful disclosure and data around KPIs and targets to be made available ahead of a deal being launched ideally, so that lenders have sufficient information and time to analyse and evaluate accordingly. Borrowers including ESG metrics in their loan facilities would be expected to be those already preparing sustainability reporting so that a track record in target-setting of relevant metrics could be seen.

We take a closer look at an example of a SLL issued this year, where the borrower set some clear sustainability goals and targets, which we would view as both meaningful and relevant in the framework of its business model. The company came to the market for a new c.€2 billion-equivalent term loan B facility, with loans linked to specific environmental and social indicators relating to reducing carbon emissions, improving resource conservation and increasing the amount of training for its employees.

Sustainability-linked lending in action: Delivering energy-efficient, safe and affordable housing – sustainably

Borrower overview: Xella is a leading building materials company in Europe, producing high quality wall building materials and insulation products. The company is also a solution provider for energy-efficient and cost-optimised construction and renovation.

Sustainability agenda: The company has set itself clear ESG goals and measurement frameworks, specifically around CO_2 emissions, resource conservation and diversity, against which to achieve and actively make a contribution to a more sustainable society and economy.

Here, we have highlighted some areas of focus and targets within its broader ESG strategy:

- **Carbon-emissions reduction:** The company has committed to improving the energy efficiency of its products and solutions in order to further reduce the CO_2 emissions in buildings: specifically aiming to reduce its CO_2-emission intensity by 30% by 2030 (vs. 2019 base year) (scope 1&2 CO_2), for example.

- **Circular economy capabilities:** The company has committed to further increase the use of recycled materials: by targeting >80% of input from recycled materials in glass wool production by 2030, for example.

- **Safety in the workplace and high-quality training for employees:** The company has set specific long-term goals relating to diversity and training and further education, including a 25% share of female managers and 10% increase in annual training hours per employee by the end of 2025. The company has also put targets around improving occupational safety.

For more information, please visit the sustainability section of Xella's website.

Market standards – incoming loan market ESG guidelines

The supply of sustainability-linked loan deals that have surfaced this year against a backdrop of incoming regulation, especially in Europe, has also led to some market self-examination of standards. The European Leveraged Finance Association (ELFA) and Loan Market Association (LMA) (with whom M&G enthusiastically works) have also called for the ESG targets contained in such loans to be both meaningful and suitably ambitious for a company, but also achievable. They also note that ESG targets should be relevant to the company's core sustainability and business strategy and address relevant ESG challenges of the industry sector, and verified by independent and external third parties.

The two major lobbying groups in Europe's leveraged-finance market are already working on bespoke guidance for the leveraged loan market on ESG factors and best practice recommendations for market participants, in a bid to help spur sustainability in the market and dampen fears of greenwashing. Their work will include practical guidance for borrowers around sustainability-linked debt. The Sustainability Linked Loan Principles (SLLP), which were developed by the LMA in conjunction with the Loan Syndications and Trading Association (LSTA) and Asia Pacific Loan Market Association (APLMA) in 2019, will be used as an underlying framework for this new guidance. M&G is involved with and supports such guidance.

M&G is very much part of this latest collaborative dialogue too, being supportive of the development of ESG linkage in the loan market, while wishing to further ESG disclosure and efforts via credible KPIs, based on valid and stretching company targets, being embedded into deal-terms.

Why are we seeing this development in the loan market now?

ESG in the PE spotlight

For some PE sponsors, who have fully embraced ESG over recent years and long advocated good disclosure across all ESG areas when it comes to their portfolio companies, ESG has become part of their ethos. Principles for Responsible Investment (PRI) membership pervades the sponsor universe just as it has become a *sine qua non* for the asset management community.

Many believe that the size of the PE industry, and the characteristics of its business model, mean that it has a clear role to play in influencing private companies towards the effective management of ESG issues.

Limited Partners (LPs) will continue to apply pressure to their General Partners (GPs) in this regard.

Figure 2. Private equity dry powder in Europe – buyout

Source: Preqin Pro, data as at 14 April 2021. Dry powder figures are buyout focused. Information is subject to change and not an indication of future results.

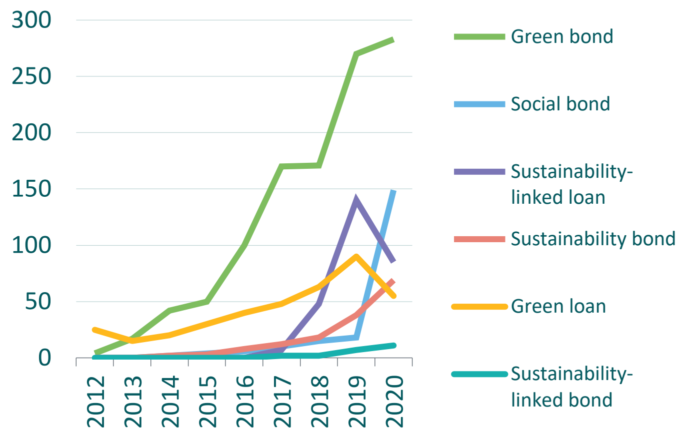
There is also suggestion that the leveraged finance market's increasing focus on ESG and sustainability may influence the type of buyouts that the market sees in the future.

The green finance revolution

There are potential opportunities to be gained from moving the dial on ESG and sustainability – not least to tap into the increasingly ESG-conscious capital markets and greater capital flows into ESG and sustainable investment strategies.

In fixed income, there have been many new sustainability-oriented finance structures and instruments that have emerged over the past five years in particular. The 'use of proceeds' bond format, of which 'green bonds', 'social bonds' and 'sustainability bonds' are examples of subsets, has been the result of innovation in traditional fixed income markets and driven by growing investor interest in sustainable investments. Those structures and formats are supported by the frameworks maintained by the International Capital Markets Association (ICMA) that recommend transparency, disclosure and reporting, albeit these guidelines are voluntary.

Figure 3. Green bond issuance far exceeds other sustainable debt instruments (in US$ billions)



Source: BloombergNEF, Financial Times, January 2021. Issuance by instrument type. Information is subject to change and not an indication of future results.

Sustainable debt issuance continues to set new records as sustainability becomes an increasingly critical factor for companies seeking to raise capital. In the first quarter of 2021, total global issuance of green, social, sustainability and sustainability-linked bonds (SLBs) amounted to US$225.4 billion (an increase of 235% in year-on-year terms), according to analysis by Italian bank, UniCredit based on data as of 6 April 2021[1].

There are newer concepts – like sustainability-linked bonds and transition bonds – that have emerged more recently but differ in their aims and objectives to some of the better-known and more popular formats. In the next section, we explore some of the main ESG bond formats that have proliferated in the market and see how they compare to the newer instruments we are seeing in leveraged finance market.

[1] UniCredit, "The Green bond and ESG Chartbook", published on 13 April 2021.

Sustainable debt market structures – an explainer

Green bonds

Green bonds (corporate and government) are specific types of debt raised where the issuer commits to use the proceeds from the issue to finance or refinance new and/or existing eligible environment-related or 'green' projects. These must align with the four core components of the Green Bond Principles (GBP), as developed by ICMA.

In the broader ecosystem that is the ESG bond market, green bonds have the highest market share, by far – with global borrowers selling close to US$300 billion of the debt in 2020 alone. While the 2020 tally of green bonds fell short of 2019's record, average transaction size was comparatively higher. Estimates from Swedish bank, SEB, suggest that governments and companies are expected to issue $500 billion in green debt in 2021[2]. Corporate green bonds are mostly IG-rated, although high yield issuers are increasingly making forays into the market.

Social bonds

Social bonds are specific types of debt raised where the issuer commits to using the proceeds from the issue to finance or refinance new and/or existing eligible social projects. These must align with the four core components of the Social Bond Principles (SBP), as developed by ICMA. The use of proceeds for social bonds are intended to benefit society and could be used for projects that provide or promote affordable housing, access to education or employment generation, for example. According to the IFC and in compliance with the SBP, social projects can also include COVID-19-related expenditures to counteract the effects of the pandemic, ie to increase capacity and efficiency in provisioning healthcare services and equipment, as well as tests, vaccines, and medication research and development.

Global issuance of social bonds surged eight-fold from 2019 to US$148 billion in 2020, according to BloombergNEF data[3] – with a significant step-up in issuance since September 2020. Estimates from Italian bank, UniCredit, suggest that issuance of social bonds could increase further this year, to around US$220 billion.

Sustainability bonds

These are another form of use-of-proceeds debt where the funds raised are specifically used to finance or refinance a combination of green and social projects. These must align with the four core components of both the GBP and SBP, as developed by ICMA, including efforts addressing COVID-19.

Sustainability-linked bonds

Sustainability-linked bonds (SLBs) are a type of sustainable finance structure that have started garnering attention, having first emerged in 2019, and it is important to note that these structures differ from the more popular green bonds as there is no requirement to spend the money raised on green projects and are for general corporate purposes. Instead, they are linked to the ambitions of a company and its ability to reach sustainability targets that it sets for itself, and are structured using a coupon step-up feature, ie by linking a bond's coupon to penalise borrowers for missing these targets.

SLB issuance reached US$9 billion in 2020, according to BloombergNEF data as cited in a Financial Times article[4]. Many market observers predict that SLBs will be a fast-growing part of the sustainable debt market this year, with issuance expected to far exceed its 2020 total, as a wider range of issuers look to adopt the more accessible format.

Sustainability-linked loans

Sustainability-linked LBO loans are issued typically to finance an acquisition. They carry sustainability-linked pricing provisions. Similar to SLBs, these loans are linked to pre-determined sustainability performance targets (SPTs), and associated key performance indicators (KPIs), and are structured by linking to a margin ratchet, ie a pricing lever (of X bps) which effectively rewards or penalises borrowers for reaching or missing these targets, not unlike the pricing mechanism contained in SLBs but incorporating a two-way feature.

Green loans

Like bonds, loans can be classified as 'green', 'social' etc. In contrast to sustainability-linked loans, there are spending restrictions attached to green loans. Green loans are any type of loan instrument, including term loans and RCFs, made to finance or re-finance new and/or existing eligible environment-related or 'green' projects. These must align with the four core components of the Green Loan Principles (GLP), as developed by the LMA, APLMA and LSTA. The GLP build on and refer to the GBP developed by ICMA, with a view to promote consistency across financial markets.

[2] Financial Times, "Analysts expect as much as $500bn of green bonds in bumper 2021", 4 January 2021.
[3] Bloomberg, "Social bonds propel ESG issuance to record $732 billion in 2020", 11 January 2021.

[4] Financial Times, "Analysts expect as much as $500bn of green bonds in bumper 2021", 4 January 2021.

Social loans

Social loans similar to green loans are any type of loan instrument, including term loans and RCFs, albeit are made to finance or re-finance new and/or existing eligible social projects. These must align with the four core components of the newly-published Social Loan Principles (SLP), as developed by the LMA, APLMA and LSTA, which build on and refer to the SBP developed by ICMA. Accordingly, the social loan market aims to facilitate and support economic activity which mitigates social issues and challenges, and/or achieves positive social outcomes.

www.mandg.com/institutional

Please note that this website has not been reviewed by the SFC and will contain information about funds that are not registered with the SFC.

Key risks associated with this strategy:

Credit risk: The strategy may be exposed to the possibility that a debtor will not meet their repayment obligations.

Liquidity risk: Where market conditions make it hard to sell the strategy's investments at a fair price to meet redemptions, we may suspend dealing in the strategy.

Prepayment risk: Loans may be prepaid by issuers at short notice, as a result it may be difficult for the strategy to locate and reinvest capital at an attractive price or at all, which may affect the strategy adversely.

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