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CLIENT ALERT

Private Lending and ESG. Time for Dirty Premium?

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The terms ‘ESG’ and ‘Green’ have become common in capital markets. They refer to improvements in a broad range of non-financial performance indicators or metrics spanning: (i) environmental issues such as climate concern and efficient use of scarce resources, (ii) social issues including job creation, labour standards, diversity and operating in high-risk areas, and (iii) governance considerations involving business ethics, independent oversight, executive pay and corporate social responsibility.

Export credit and international development banks have always applied ESG policies to their lending. But outside of a development context ESG features were originally associated with listed company debt issuers and expanded to syndicated loan markets. Both markets have established principles for “green” issuances and have effectively encouraged a “green discount” for businesses that are driving ESG improvements. However, those standards fall short of setting standardised metrics.

ESG principles and private debt

Non-bank lenders have traditionally financed medium-sized businesses looking to borrow outside of the public markets. It would be easy to assume that ESG considerations would be less relevant to private lenders. But, in fact, there is significant overlap in the investors funding both markets. Those investors are not only reacting to demands from their stakeholders to invest in ‘green’ enterprises but there is also evidence that companies which pay attention to ESG principles perform more strongly over the longer term.

It is now also accepted among private debt managers and investors that healthy ESG behaviors have risk mitigation potential. The analysis of ESG factors provides an additional level of risk analysis which helps to identify potentially material exposures. Since private debt funds typically invest larger stakes than traditional lenders and retain their holdings for the entire term of the facilities, they have a strong incentive to invest in companies with lowest risk.

Since investors are insisting that attention is paid to ESG factors, they are now being actively adopted into private lending processes and very much front of mind for private debt fund managers and investors. According to a recent study, the amount of capital allocated to private markets assets with a commitment to ESG has increased from

$128 billion in 2011 to $468 billion in 2020 and private debt was identified as the fastest growing segment. The global pandemic has only brought ESG considerations more into the spotlight.

However, integrating a "green discount" into private debt transactions is not straightforward as pricing is already fiercely competitive and many transactions already incorporate margin ratchets based on leverage.

ESG-linked terms in private debt loan documents

The greater flexibility of private debt funds to negotiate terms allows the parties to set project specific ESG standards or targets, or variable interest rates relating to specific ESG outcomes. This flexibility is very useful, given the lack of standardised ESG indicators or reporting for non-listed borrowers. Arguably it also avoids the borrower or issuer being effectively in control of setting their own ESG metrics.

Although there are currently no standard clauses or criteria for sustainability linked provisions in a loan agreement (whether syndicated, club or bilateral), private lenders have been able to negotiate ESG-linked terms in loan agreements tailored to both generic and project specific ESG standards or targets.

Approaches can vary, for instance:

- **ESG commitment** – some lenders have developed a standard ESG clause requiring the borrowers to acknowledge that they are committed to responsible investing and agree to deliver an ESG questionnaire and/or an ESG certification;
- **Minimum ESG requirements** – an alternative to more tailored metrics, ESG conditions may require the investee group to maintain certain standard practices. We have seen requirements to maintain: (i) an ESG policy that requires it to monitor ESG key performance indicators; (ii) net zero carbon dioxide emissions; (iii) an active equality and diversity policy; (iv) a system assessing the risk of human rights abuse, poor labour standards and modern slavery and throughout its supply chain; (v) participation in initiatives to improve its local community; and (vi) a corporate code of ethics;

However, typically when people refer to ESG-linked loans they are thinking of bespoke ESG conditions which will be reported on and tested against and drive a reduction in interest rate. These provisions essentially drive a discount to pricing based on meeting agreed targets, together with the mechanisms needed to demonstrate compliance. Lenders may also require that the proceeds of any discount achieved are applied towards agreed sustainability causes or towards ESG projects in the borrower group.

Recent transactions incorporating such a downward ratchet include the €183.5m acquisition financing for Talan, which included an ESG-linked downward ratchet mechanism for the unitranche piece, but we have also seen a ESG margin reduction trigger in a recent European financing which applied a downward only pricing adjustment of 0.5% to both the €153.8m facility B and the €50m acquisition/capex facility where specified ESG conditions were satisfied.

Metrics and standards

The metrics and standards to be used will be unique for each facility, investor and investee. The metrics are incorporated into documentation under the following types of clauses.

Compliance with agreed ESG metrics can be tested and monitored by a combination of reference points depending on the relevant trigger:

- **ESG questionnaire:** for more qualitative criteria or where interest reductions are not at stake, the borrower's self-certification may be sufficient provided that the borrower has adequate assessment methodologies in place or where the borrower reports that information publicly.
- **ESG certification:** Alternatively, lenders may require certification and supporting evidence from an appropriately qualified third party approved by the lenders. This will be appropriate for certain more quantitative conditions or

outputs, such as the net zero carbon dioxide emissions. Lenders and borrowers will need to be satisfied that reliable advisors are available which are able to report on achievement of sustainability criteria.

Dirty Premium

One of the key issues for the adoption of ESG-driven terms in facility agreement remains that pricing in debt market remains extremely competitive and, in any event, it is not obvious that investors should bear the burden of providing financing to a borrower who is ESG compliance or that a borrower who achieves an ESG-linked saving by achieving ESG targets should be required to invest that saving in ESG initiatives.

Arguably what is needed is for businesses who do not meet ESG principles to bear the burden of higher interest rates or penalties for failing to comply with ESG principles which can be invested in initiatives to improve that position.

As the market understanding of ESG principles develops and ESG factors become an integral part of credit decisions it is likely that this will occur. But this would only be assisted by a clearer consensus on what ESG standards should be adopted by businesses generally.

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