European Leveraged Loans Embrace ESG Features in 2021:

An Overview of ESG Provisions, Emerging Trends and Areas for Future Development

Transactions with ESG margin ratchets are gathering steam in the European leveraged loan market and are being embraced by borrowers and investors alike. ESG margin ratchets were seen in 40% of European syndicated leveraged loans in 2021 - a significant uptick from 2020 - in a diverse range of sectors. We noted the start of this trend in our review of the 2020 European leveraged loan market and, as has been reported, ESG margin ratchets have been found in deals from Stark Group, Elsan, Kloeckner Pentaplast, Ahlsell AB, and TeamViewer, to name a few. It is clear that ESG and sustainability-linked features are a priority for 2021.

The incorporation of environmental, social, and governance (ESG) standards into loans is a means to incentivize borrowers to improve their performance in these areas against pre-set criteria. Specifically, the incentivization comes in the form of pricing - a margin adjustment mechanic (often referred to as an "ESG margin ratchet") is built around certain criteria and the borrower's performance will result in either a reduction, or an increase, to the margin based on how well it meets the criteria.

Overall, this mechanism enables borrowers to reduce their interest burden while achieving sustainability goals and this in turn enhances their reputation and that of their sponsors. Meeting ambitious ESG goals could also feed into improving the credit quality of a company and may benefit both their cost of capital and access to capital. Encouraging ESG efforts may also satisfy the objectives of numerous investors in the current market.

ESG margin ratchet provisions in European leveraged loan documentation are in their infancy and are largely bespoke. No market standard has been developed for such provisions, and our research has shown that documentary approaches to determining ESG criteria, margin adjustment mechanics and disclosure processes remain disparate. While such variance is natural at this evolutionary stage, certain key themes are emerging. This report will examine the current approaches to ESG provisions, discuss the underlying elements of ESG margin ratchets, and consider other ESG-related developments in the broader market. As a greater number of lenders and borrowers incorporate ESG margin ratchets into their leveraged loans, we anticipate that the architecture of the salient clauses will evolve away from bespoke practices.

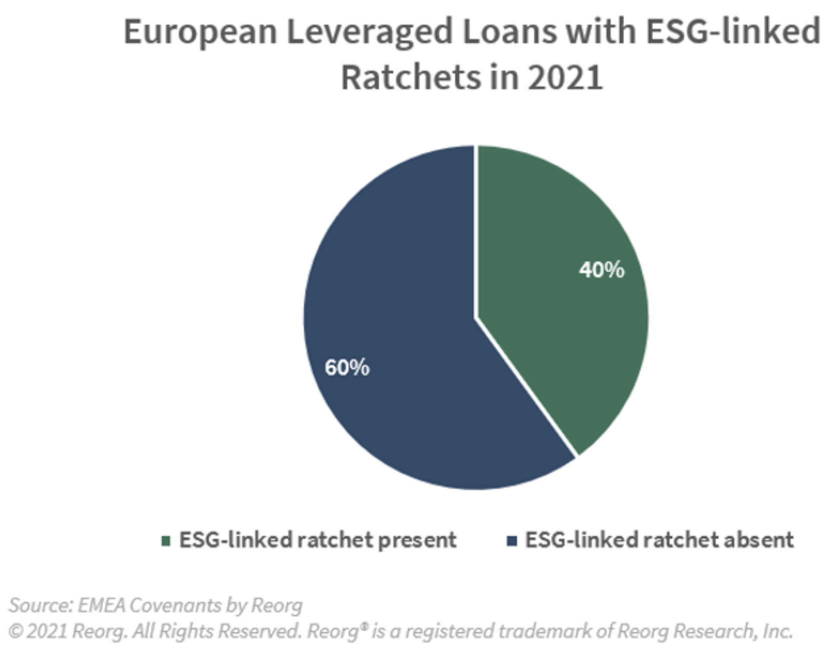
ESG Margin Ratchet Clauses

ESG margin ratchets operate in tandem with the borrower's ESG performance. Depending on whether the ratchet has a one-way or two-way function, the margin can decrease if the borrower satisfies the pre-set criteria and/or increase if the borrower falls short of the criteria or fails to provide the requisite information.

ESG margin ratchet increases and/or decreases are on an annual basis. To date, we have not seen a deal which allows quarterly adjustment under the ESG margin ratchet.

Ascertaining the relationship between the borrower's performance and the ESG margin ratchet is dependent on various features that are typical to a traditional leverage-based margin ratchet clause - how is the performance measured, how is the performance reported and verified, and what are the consequences of the performance on the margin? However, ESG margin ratchet provisions typically operate separately to leverage-based margin ratchet provisions. Borrowers will need to satisfy the requirements of both ratchet provisions if they wish to benefit from the maximum margin reduction that may be available to them at a given time, based on their performance at such time.

ESG margin ratchets have been seen in 40% of the 2021 European leveraged loans, comprising syndicated senior term and revolving credit facilities, reviewed by Reorg's EMEA Covenants team at term sheet or SFA stage (2021 ESG Deals). **Reorg collates data from senior facilities agreements relating to ESG criteria, the measurement and performance of ESG metrics, reporting and verification, calculation of ESG margin ratchets and consequences of non-compliance with ESG metrics.**



As the underlying objective of ESG margin ratchets is to incentivize borrowers to improve their ESG performance, most of the 2021 ESG Deals have adopted a two-way mechanism. A margin reduction is available on agreed sustainability targets being met and a margin increase results when the sustainability performance falls below agreed levels or if the ESG related disclosure is incomplete.

Measuring Performance - ESG Criteria

There are two approaches for measuring the ESG performance of a borrower:

- Third party ESG scores/ratings.
- Key Performance Indicators.

ESG Scores

The first approach bases performance on an overall ESG score/rating provided by a third-party ratings agency on the date of the loan agreement or the first utilization date. That initial score/rating is used as a baseline against which improvements in performance are annually assessed and provides a holistic view of a company's performance. If the overall ESG score improves above a threshold determined by reference to the baseline, the target is achieved. **Of the 2021 ESG Deals, only 7% were based on an ESG score/rating.**

Key Performance Indicators

The other, more commonly seen, approach measures ESG performance against key performance indicators (KPIs) or other specified targets. In deals which take this approach, the form, substance and quantity of KPIs/targets varies from deal to deal and reflects the underlying nature of the borrower's business and the industry in which it operates. Based on the 2021 ESG Deals, **the number of KPIs/targets included usually ranges from one to four.**

The actual measure of performance differs from borrower to borrower and from KPI to KPI. Most 2021 ESG Deals take a dynamic approach, requiring year-over-year improvements in performance in order for the margin reduction to continue to apply. A dynamic approach may require a certain percentage increase/decrease in the relevant KPI/target to be achieved each year, measured against an opening level often set out in a baseline report (discussed further below). Alternatively, the targets to be met may be set by reference to absolute, pre agreed, levels which must be achieved. In deals with multiple

KPIs/targets, a mixture of approaches may be found as the appropriate measure ultimately depends on the subject matter of the underlying KPI/target and how it can best be monitored.

As an example of KPIs, as reported by Reorg, the senior secured loans in French livestock biosecurity company Kersia's €520 million-equivalent financing package were linked to indicators on recycling, producing green products and increasing the percentage of employee shareholders. In the case of German packaging group Kloeckner Pentaplast, indicators in its new five-year €1.175 billion-equivalent term loan B included reducing greenhouse gas emissions, increasing the percentage of PCR content packaging and increasing the number of women in management.

From a practical perspective, the targets themselves will either be hardwired into the underlying SFA or will be incorporated by reference if they are contained in a side letter (which may need to be agreed prior to closing or by a certain date post-closing). It is not possible to determine whether there was any third party involvement in setting the targets from the underlying documents we have reviewed and we presume that the targets were agreed between the borrower and the arrangers in the ordinary course of negotiations. It goes without saying that the greater the degree of involvement from independent parties, the more objective the targets will be. In addition, independent involvement may result in more ambitious targets which have a greater ESG related impact.

Fundamental to assessing performance, is the baseline report, score, survey or other metric(s) against which ongoing performance will be measured. When negotiating an ESG margin ratchet, or assessing its merits, investors should be mindful of whether the baseline report, score, survey or other metric(s) have been, and will be, prepared by the borrower or an independent third party or prepared by the borrower and verified by an independent third party in some way. **The involvement of third parties in calculating KPIs/targets appears only in a small number of 2021 ESG Deals.**

For example, we have seen several healthcare deals contain a patient satisfaction target and the underlying patient satisfaction percentage will be as calculated and published by the E-Satis Survey, a French national survey for measuring patient experience satisfaction managed by the French National Health Authority. In addition, several deals (across multiple sectors) require a reduction in greenhouse gas emissions and, in at least one of the relevant deals, the baseline data was to be determined by the borrower in accordance with the relevant guidance, protocols and standards and reviewed by the auditors or such other person appointed by the borrower for the purpose of independently reviewing the emissions. Both of these examples provide more robust measures of performance than a KPI which requires, for example, an improvement in quality of work life balance, increase in the number of female professionals in the business or a reduction in waste products, as measured solely by reference to internal surveys/determinations.

During the life of the loan, there may be a need for the underlying KPIs/targets or calculation methodologies to change or for the KPIs/targets to be reset. This may be because the KPIs/targets are no longer appropriate for the borrower's business and/or because the borrower is unable to perform at the level anticipated. A handful of 2021 ESG Deals have contained specific provisions contemplating future amendments to KPIs/targets which are summarized below:

- Provisions permitting the borrower to elect to adjust or amend the targets if, in its reasonable opinion, they are required to maintain the equivalency of the targets with the levels set out at closing (or an alternative date) for any reason (including headcount / production capacity increases or decreases or regulatory changes) provided that an industry specialist or other independent firm elected by the borrower confirms that such adjustments or amendments maintain such equivalency.

- Provisions permitting target levels to be recalculated if an event (such as an acquisition, disposal or outsourcing initiative) occurs that, in the reasonable opinion of the borrower, is likely to affect the calculations and yield materially different results. Following notification by the borrower to the agent of the proposed adjustments, the agent is obliged to provide the same to the lenders for them to consider in good faith. If approved by the majority lenders, proposed adjustments will take effect.

- Provisions stating that amendments or waivers to the ESG margin ratchet provisions or KPIs/targets (together with all related definitions) shall only require the prior consent of the borrower and the agent (acting on the instructions of the majority lenders).

Of course, the absence of specific provisions does not preclude the borrower from approaching the syndicate for an amendment to the ESG provisions, but pre-agreed adjustment mechanisms may be simpler, quicker and ultimately cheaper for the borrower. In an ideal world, if the borrower was regularly hitting its KPIs/targets pre-agreed adjustment mechanisms could also work to increase the targets, thereby pushing the borrower to exceed the targets initially set. This could be a particularly useful tool if the KPIs/targets had been set by the borrower itself, by reference to an internally generated baseline report. However, such provisions may be too optimistic.

The ability to customize ESG goals is important for the borrower to successfully incorporate and, in turn, achieve its individual sustainability strategy, so as to positively impact future business. The need for this customized, flexible, and bespoke approach, coupled with the infancy of this field and lack of scrutiny, has made convergence and comparability of KPIs/targets difficult. An area for future standardization of KPIs/targets could be for businesses within the same sector, or for those that are not strongly predisposed to requiring bespoke standards. The door to standardization has been opened by the Sustainability-Linked Loan Principles (SLLP), a framework produced by a joint working party composed of the Loan Market Association, Loan Syndications and Trading Association, and Asia Pacific Loan Market Association. It aims to develop the characteristics of sustainability linked loans and offers voluntary guidelines to help practitioners best identify KPIs/targets for differing types of businesses.

The failure to achieve an ESG rating or meet at KPI will not lead to a default under the leveraged loan agreement, but could, depending on the structure of the ESG margin ratchet, lead to an increase in margin.

Reporting and Verification - Disclosure Requirements

A borrower will be required to deliver certain information to its lenders to show that the underlying ESG criteria have been met to trigger the margin ratchet. Such information is typically required to be **delivered annually.**

In the 2021 ESG Deals linked to an ESG score/rating, borrowers have only been required to provide agents/sustainability coordinators with a copy of the annual rating assessment from an ESG rating agency to show satisfaction of the underlying deliverable.

Similarly, 2021 ESG Deals based on KPIs/targets have only required borrowers to supply an annual compliance certificate and/or sustainability report, confirming whether (and the extent to which) the KPIs/targets have been met. **Only a small number of 2021 ESG Deals went further to indicate the level of information that should be provided, specifying the inclusion of reasonable details or calculations and/or supporting information.**

If an overall ESG score/rating is being used, the chosen ESG rating agency acts as an independent party to verify and disclose whether the absolute criteria has been met. If KPIs/targets are being used, the same external oversight is not naturally present unless, as mentioned above, the KPIs/targets are set by reference to an external score, survey or other metric. As such, investors should seek to ensure that the performance levels set out in the relevant compliance certificate are subject to independent external review or verification. To date, this has largely been negotiated on a case-by-case basis but **38% of 2021 ESG Deals set by reference to KPIs/targets included a requirement that some, or all, of the performance metrics provided by the borrower would be independently/externally reviewed, audited or verified by a qualified reviewer with relevant expertise (generally appointed by the borrower, at its sole discretion).** The remaining deals had no such requirement, meaning that self-reporting by the borrower would be sufficient to determine performance - a formulation which carries inherent risk.

The variation in disclosure requirements for individual KPIs and targets is another area lacking and in need of standardization. Debates over the need for third-party/independent verification in addition to internal reports will undoubtedly focus on the additional cost and administrative burden to the borrower but it is not unreasonable for lenders to expect a degree of comfort here, and we expect to see some movement in this area as the year progresses.

Margin Adjustments - Calculations

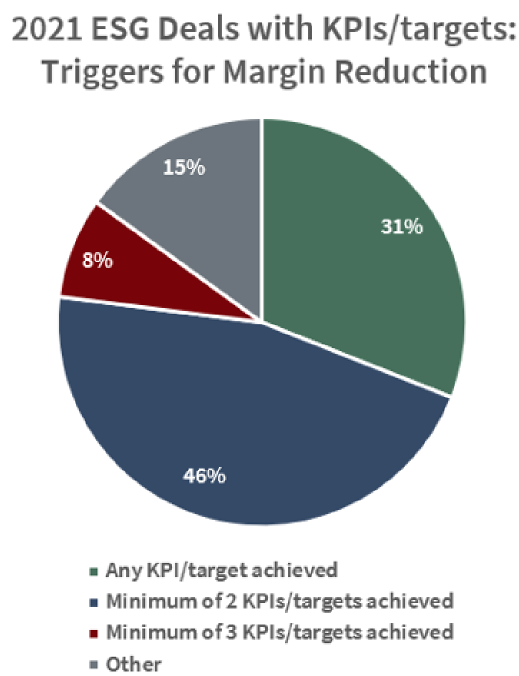
As mentioned, performance is typically tested annually and operation of the ESG margin ratchet may result in the reduction and/or increase of a margin.

If the underlying criteria are linked to an ESG score/rating, a margin reduction would typically be available to the borrower if the rating was the same as, or more favorable than it was on the reference date. If not, and the rating had become less favorable, a margin increase would be triggered.

The determination is often more nuanced where the ESG criteria looks at KPIs/targets. In 31% of 2021 ESG Deals linked to KPIs/targets, the reduction in the margin was tiered so that each ESG KPI/target achieved equated to an additional lowering (subject to a cap on the maximum reduction in most cases). Conversely in such deals, failure to meet the ESG KPIs/targets would result in an equivalent tiered increase to the margin (subject to a cap on the maximum increase in most cases).

A variation of this formula has been seen where satisfaction of more than one ESG KPI/trigger (out of a number of specified KPIs/targets) is required before a margin reduction can apply. **The need to satisfy multiple KPIs/targets to trigger a margin step-down has been more common, appearing in 54% of 2021 ESG Deals linked to KPIs/targets**. The minimum number of KPIs/targets needed to trigger a margin reduction has ranged from two to three and, in these deals, satisfaction of only one or two KPIs/targets respectively would either lead to a margin increase or would have a neutral impact.

The margin ratchet mechanisms in the remaining 15% of 2021 ESG Deals linked to KPIs/targets focused on growth levels of specific KPIs/targets, with each margin adjustment corresponding to a percentage of growth achieved (or not achieved), or were otherwise bespoke.



Source: EMEA Covenants by Reorg

Typically, a margin increase would be triggered if an ESG score/rating was not available or if the relevant KPI/target information had not been provided. This additional feature has been specified in 71% of 2021 ESG Deals. However, this may not be the case if alternative KPIs/targets or an alternative reporting regime (discussed above) was being negotiated at the time.

We also saw deals in the market last year which do not apply the ESG margin ratchet consistently to the term loan and the RCF. Specifically, these deals will not result in an increased margin for the RCF lenders, only the term loan lenders, and the reduction in margin will be significantly larger for the RCF lenders than in that for term loan lenders.

Given that ESG margin ratchets are included predominantly for the benefit of the borrowers/sponsors, it is common for borrowers to have discretion over whether or not to exercise them. In these cases, failure to deliver the relevant compliance certificate and/or supporting information will not trigger a default or event of default but, as mentioned above, will usually result in a margin increase.

Margin Adjustments - Consequences

In many deals, the amount saved by the borrower as a result of a margin reduction under the ESG margin ratchet provision may be retained by the borrower group. However, additional conditions may apply, prescribing how that saved amount should be applied. For example, the recent term loan B for Danish heavy building materials distributor Stark Group required that 100% of the savings from the margin reduction be reinvested into sustainability investments. Other deals have required that the full amount of the savings, or a portion of them (example at least 50%), need to be applied towards an ESG/sustainability investment within a specified time period. Of note, the reinvestment requirement may not be absolute, it may simply be a requirement for the borrower to "use reasonable endeavors" to reinvest (or apply) the relevant amount in the prescribed manner.

The condition to apply savings towards an ESG/sustainability investment has only shown up in a handful of 2021 ESG Deals to date and details of the ESG/sustainability investments are not always required to be disclosed (although in practice we presume that the borrower would be happy to provide such details to demonstrate compliance). While the reinvestment initiative contributes further to ESG aspirations, "soft" drafting may lack teeth and, nevertheless, negates the financial incentive for borrowers which can be significant in high value deals.

ESG Expansion

There are further innovations to ESG-linked financings beyond ESG margin ratchets in European leveraged loans.

An ESG/sustainability use of proceeds margin ratchet was reportedly included for the first time in a revolver in February 2021 in the buyout financing of Swiss precision manufacturer Groupe Acrotec SA by the Carlyle Group and is being considered by the Carlyle Group as a structure that can be replicated throughout the leveraged loan market. Unlike other deals so far, the use of proceeds ratchet adjusts the margin on the basis that the loan is drawn down to fund sustainable endeavors.

By opening the door to use-of-proceeds linked ESG ratchets in RCFs, Acrotec's deal underscores the array of innovative financings that are being used to address ESG concerns. Other financings that have been ESG-linked include unitranches, Schuldschein, and high-yield bonds.

Recently, Greek utility group Public Power Corp. launched one of Europe's first sustainability-linked high-yield issuances, providing for a single upwards adjustment to the coupon on its €500 million senior unsecured 2026 bond offering if it did not reduce its CO_2 emissions by the end of 2022 (measured against a baseline figure from the end of 2019). Constellium's new notes also feature an upward adjustment to its coupon if the issuer fails to meet its sustainability targets and Hapag-Lloyd has also recently issued €300 million of sustainability-linked senior notes which contain a step-up from a date in 2025 if Hapag-Lloyd fails to achieve an average efficiency ratio (in relation to carbon intensity) which is lower than or equal to the applicable sustainability performance targets for the calendar year 2024.

The ESG-linked pricing mechanisms seen to date in sustainability linked European high-yield bond transactions have been less complex than those seen in the European leveraged loan market. Time will tell whether they develop further, particularly in relation to floating rate notes which by definition have fluctuating coupons.

This year seems ripe for immense growth in ESG-linked loans. However, the mechanics and drafting of the underlying ESG margin ratchet provisions have a long way to go if they are to reflect a "market standard" in the European leveraged loan market in due course. In addition, it may be necessary for the pricing adjustments in ESG margin ratchets to become more significant if borrowers (and their sponsors) are to be encouraged to move beyond the ESG rhetoric. Borrowers may also agree to increased third party involvement at the baseline report stage, together with more burdensome ongoing reporting/verification requirements if greater margin reductions are at stake. Although the push for this will need to come from the lending community. Ultimately, the extent to which these provisions develop may depend largely on the requirements for the "saved" amounts to be reinvested. Our cynical view is that the overall cost of pursuing ESG goals will be a key factor for borrowers (and their sponsors).