European Leveraged Finance Association
LMA
INSIGHTS

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Are ESG margin ratchets saving the planet, or saving borrowers money?

2021 has brought on a period of rapid evolution in how ESG is incorporated into deal documentation in the European leveraged finance market. This comes at a time when leveraged loan investors, arranger banks, sponsors and also certain corporate borrowers are subject to an ever-greater mix of regulation, including the Sustainable Finance Disclosure Regulation (EU) 2019/2088 (partially in force since 10th March and applicable to investors) and the Non-Financial Reporting Directive 2014/95/EU (in force since 2018 and applicable to issuers over a certain size).

These regulations, as well as widespread societal support for improved ESG practices, are driving increased investor scrutiny in the leveraged finance markets. The growth of ESG investing has also led to new innovations in documentary terms.

Leveraged loan market participants have unique opportunities to lead the way in ESG:

- The asset class lends itself to close relationships between borrowers and lenders;
- Information reporting can be bespoke (unconstrained as it is by public securities laws); and
- Investors are already accustomed to performing “deep dives” into borrowers’ businesses.

However, loan investors also recognise the threats posed by “greenwashing” – indeed these threats are what the latest raft of European legislation explicitly sets out to prevent. Furthermore, for investments to be truly sustainable into the medium/long term, everyone needs to be clear on where they stand today – and what the future looks like.

The inclusion of ESG-linked contractual provisions in broadly syndicated loans is rapidly increasing, and investors are concerned that some of the provisions currently coming to market reflect “business as usual” and are conceived as a way to improve sponsor economics.

We believe the industry should remain cognisant of the spirit of ESG investing, and that benefits and risks cannot simply be divvied up. All stakeholders have an equal stake in getting it right, and share material risks of getting it wrong.

We also believe that the growth of ESG in the leveraged finance market presents real opportunities for businesses and lenders to work together toward a more sustainable future – for our markets, and for the planet.

To realise these opportunities, it is critical that corporate borrowers and their advisers determine at the outset of any such exercise the overall sustainability profile of the business, how this can be improved by actions with ambitious, objective, and measurable results, focusing on the metrics that will have the most impact.

The Current State of ESG-Linked Provisions

Loan investors must be mindful of achieving appropriate returns for their clients, whilst also taking into account factors which help to put investments on a sustainable footing. As such, the recent emergent trend of ESG-linked margin ratchets poses an interesting case study.

Margin ratchets reward borrowers for achievements (margin decreases) and hold borrowers to account if progress reverses (margin increases). Typically, these ratchets have been linked to leverage, in order to incentivise healthy de-leveraging. Recently, the European loan markets have seen ESG-linked margin ratchets appear.

The logic on paper remains the same – achieving sustainability targets ought to put the business on a more stable footing in the medium/long term, thus making it more creditworthy and therefore justifying margin decreases. However, to get this right in practice requires:

- The right targets or key performance indicators (KPIs)
- The right timeframe
- The right oversight

Most obviously, ESG targets should be relevant to the company. For example, carbon emitters should include a measurable target for emissions reduction in their ESG ratchets. Additionally, KPIs should be aspirational, which would rule out those that can be met on day one of syndication. For example, giving the borrower an economic benefit solely because it appoints someone to the board to be responsible for sustainability is not ambitious enough.

In addition, using ESG provisions as a lever for economics goes against the spirit of the provision and risks inviting scrutiny for "greenwashing". We believe it is inappropriate for KPIs to be loosened if the deal is syndicating well. The appropriate way to flex economics is by way of the coupon, not through ESG margin ratchets.

Finally, loan investors expect ESG targets to be well thought through, meaningful, and ambitious. As such, the structuring of these KPIs should take place well before the deal is launched such that as much information as possible can be disclosed in the Term Sheet (i.e., prior to commitments being due). Careful thought and planning should go into a borrower's ESG programme, and this thinking can feed into creating the right ESG KPIs for borrowers. This must necessarily take place before provisions are drafted.

There are meaningful opportunities to be gained from such an exercise. Capital is flowing in an increasing pace into ESG and sustainable strategies, and a carefully thought through ESG programme can attract investors and increase a borrower's access to these growing pools of capital.

The risks of getting it wrong are very real. If insufficiently ambitious, inappropriately structured ESG-linked provisions take root in Europe, the asset class faces the risk of losing credibility amongst investors, and will undoubtedly attract increased regulatory scrutiny in light of the explicit "anti-greenwashing" messages enshrined in recent legislation.

How can the industry respond?

Credit investors are supportive of the use of ESG KPI linked provisions as a means to encourage material improvements to ESG performance. The industry as a whole stands to benefit from a rigorous analysis of borrowers' ESG profiles, and fulsome reporting of these metrics (which we are seeking to support through the ESG Disclosure Initiative).

Once the exercise is complete, and the data is unlocked, there are tremendous opportunities for companies and their advisers in capturing value and potentially reducing costs as the borrower achieves meaningful, ambitious ESG KPIs.

The depth and breadth of the leveraged finance market means that it is uniquely positioned to aid the ESG transition journey for a large proportion of the corporate sector, from listed companies to medium sized enterprises. The ELFA and the LMA therefore believe it is imperative for all market participants to get ESG right in our market, and to do so from the start.

The road might be bumpy at the beginning, as we navigate new regulatory landscapes and challenges together, but it's a road well worth travelling, collaboratively, as ESG continues to influence the growth of the leveraged finance market. A common framework to evaluate ESG developments, like ESG ratchets, could assist lenders in formulating a common approach to integrating ESG into their investment process.

Next steps, and how to get involved

The ELFA and the Loan Market Association (LMA) are working together to produce best practice recommendations to guide market participants in structuring and drafting such provisions. The guidance will set out the factors that borrowers should consider when integrating ESG factors into loan agreements. The respective ELFA and LMA working groups are using the "Sustainability Linked Loan Principles"[1] as a base, with an aim to tailoring them to the leveraged loan asset class.

Working groups comprised of various leveraged loan market participants have already been created to discuss the matters presented in this Insights report, and the principles are taking shape. If you would like to join the discussions, please contact Sabrina Fox at the ELFA and/or Gemma Lawrence-Pardew at the LMA.

In addition, to assist the industry in thinking through best practices, the ELFA will shortly launch a survey designed to help us learn how investors think about ESG criteria, their ambitions in target setting and other elements that can make provisions that incorporate ESG considerations, like the ESG margin ratchet, useful ESG tools for borrowers. We urge market participants to share their views so that these can be reflected in our initial recommendations on the guidance.

[1] https://www.lma.eu.com/application/files/5115/8866/8901/Sustainability_Linked_Loan_Principles_V032.pdf

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