

KEY POINTS

- The leveraged loan market has seen a significant increase in the number of sustainability-linked leveraged loans issued since the beginning of 2021.
- Although the Sustainability-Linked Loan Principles (SLLPs) provide a voluntary framework for market participants to adopt, we are far from reaching documentary standardisation and drafting continues to be deal-specific.

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2021: the year of the sustainability-linked loan

In this Spotlight article, the authors discuss the recent updates to the Sustainability-Linked Loan Principles (SLLPs) and the way in which the newly published Best Practice Guide (Guide) complements them, before examining how the market has incorporated ESG provisions into leveraged loans and the related issues that borrowers and lenders will need to consider.

ESG IS EVERYWHERE

Such is the extent to which environmental concerns dominate the global agenda, that for some time now it has been impossible to open a newspaper and not find an article related to climate change or the transition to net zero. Greta Thunberg and Extinction Rebellion have become household names as awareness of global warming, carbon footprints and our impact on the planet has skyrocketed, meaning that you cannot avoid the E in ESG. Furthermore, after the tumultuousness of 2020, attention is by no means limited just to the environmental pillar. Events such as the global coronavirus pandemic and the Black Lives Matter movement raised issues relating to the social and governance pillars to the forefront and dominated headlines.

In a similar vein, it has also been impossible for market participants in the European leveraged loan market not to notice the momentum of ESG since the start of 2021. After a trickle of sustainability-linked loan issuances towards the end of 2020, suddenly, at the beginning of this year, the floodgates seemed to open. Almost overnight, everyone was an ESG expert and borrowers and sponsors were racing to join the cause by including an ESG-linked margin ratchet in their financings. In fact, such was the enthusiasm for sustainability-linked financings that in the second quarter of 2021 65% of European syndicated leveraged loans reviewed by Covenant Review contained an ESG-linked margin ratchet. This is a truly remarkable figure, particularly when you consider the fact that sustainability-linked loans (SLLs) accounted for just a 4% share of the market in the whole of 2020.

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Principles (SLLPs) and the way in which the newly published Best Practice Guide (Guide) complements them, before examining how the market has incorporated ESG provisions into leveraged loans and the related issues that borrowers and lenders will need to consider.

UPDATED SUSTAINABILITY-LINKED LOAN PRINCIPLES

In light of the staggering increase in the volume of Sustainability-Linked Loans (SLLs) and the rapid evolution in the incorporation of ESG principles into deal documentation, the APLMA, LMA and LSTA updated the SLLPs to reflect emerging market trends. This update, which also aligns the SLLPs with ICMA's Sustainability-Linked Bond Principles, was published on 27 May 2021. The SLLPs were originally published in 2019 with the aim of promoting the development and preserving the integrity of sustainability-linked loan products by providing a (voluntary) framework. The most significant change was to tighten up the process of selecting Key Performance Indicators (KPIs) and to introduce mandatory third party verification. In part, this was deemed necessary because of the perceived potential for greenwashing and the reputational risks for lenders and borrowers participating in SLLs where the targets were too easily achievable. Greenwashing is the practice whereby either a company overstates its green credentials to obtain better terms or where claims made in relation to ESG performance do not match reality.

LMA/ELFA BEST PRACTICE GUIDE FOR SLLs

On 28 July 2021, the LMA and ELFA published a best practice guide for sustainability-linked leveraged loans.

The Guide aims to steer market participants when applying the SLLPs to leveraged loans that seek to incorporate any kind of ESG factor or metric. The Guide addresses the following areas, some of which we will cover in greater depth later in the article:

- **Terminology:** the Guide cross-references to the LMA's Sustainable Lending Glossary, which was updated in August 2021, the aim of which is to assist market participants in the development of a common language;
- **Roles:** the Guide provides an explanation of some of the specialised roles that have developed, such as ESG Rating Providers, ESG Consultants, Sustainability Co-ordinator/Agent and External Reviewer;
- **Selection, disclosure and calibration of KPIs:** the Guide discusses requirements and timing relating to the selection of KPIs;
- **Reporting:** the Guide discusses the requirements relating to reporting on performance against the Sustainability Performance Targets (SPTs) and KPIs and the frequency with which it should be provided; and
- **Documentation:** although there is no standard drafting and documentation will need to be negotiated on a case-by-case basis, the Guide summarises certain considerations for documenting SLLs.

INCORPORATING ESG INTO FACILITIES AGREEMENTS

Various trade associations have produced a significant amount of guidance around SLLs, which is assisting in the adoption of ESG provisions by the leveraged loan market. The guidance, coupled with the SLLPs, has provided a skeleton of standards to which participants in a SLL should aspire and has highlighted issues to consider when drafting an ESG-linked facility. Standardisation is still a way off, however, and while some market precedent is beginning to form, varying approaches are still emerging. In the sections that follow, we consider some common features

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when documenting a SLL. It is worth noting, however, that as with all leveraged loans, the drafting will be deal-specific and negotiation will vary on a case-by-case basis.

THE ESG-LINKED MARGIN RATCHET

The ESG-linked margin ratchet works in a similar way to a standard financial ratio-based margin ratchet, but rather than adjustments happening on a quarterly basis, they are annual. The facilities agreement will usually set out that the relevant sustainability margin adjustment will be made within a certain number of business days following receipt by the agent of the borrower's sustainability certification, which is usually delivered alongside the annual financial statements, and the relevant adjustment will then apply for the financial year.

The ratchet is an area that has seen considerable development since the negotiation of the first SLLs. The early SLLs featured a one-way pricing adjustment that resulted in a discount, but nowadays, pricing adjustments tend to be two-way; either offering a discount on the margin if the borrower meets the relevant target(s) or imposing a premium on the margin when targets are missed.

Ratchet discounts (and premiums) in the leveraged loan market, although larger than those on offer in the investment grade space, are still minimal and typically range from 2.5 basis points up to a maximum of 15. We may, however, see these become more financially material over time as investors pay increased attention to ESG concerns.

SETTING TARGETS: KPI OR ESG SCORE?

One of the underlying decisions to be made when documenting a SLL is whether to tie the ESG-linked margin ratchet to performance against specific KPIs or to the borrower's ESG rating. To date, the market has favoured the use of KPIs, but we have seen some transactions incorporate performance against an ESG rating, whilst others have used a combination of both.

ESG Ratings

An ESG rating is determined by an independent, external ESG rating agency

who assesses the ability of the borrower to integrate and manage sustainability issues relevant to the particular sector in which it operates. The rating process will also consider the degree to which ESG risks are mitigated. The format of the score or rating varies by provider but can be either a numeric score (typically given as a score out of 100) or an alphabetical representation (often ranging from AAA for the best performing companies through to D for the worst performers).

In determining a borrower's score, ESG rating agencies will usually perform an annual evaluation of its performance against a number of ESG factors (sometimes as many as 200), which is verified and standardised according to the industry in which it operates. As part of the evaluation process, the ESG rating agent will usually collect publicly available ESG information, such as that disclosed in the borrower's Corporate Social Responsibility or Sustainability Reporting, as well as anything disclosed by the company on its website and any relevant information from other public sources. The ESG rating agent may also make contact directly with the company to request information. Once the ESG evaluation report has been prepared, some ESG rating agencies will give the borrower the opportunity to review, verify and comment on the ESG score and provide further data before the final report is published.

The use of an ESG rating can be advantageous for borrowers who are not ready to (or would prefer not to) have to invest in or upskill employees to create the in-house ESG expertise required to monitor and report against detailed KPIs. The downside, however, is that an ESG rating, whilst providing a holistic view of a company's ESG performance, is less bespoke to the borrower and the ESG rating result can vary depending on the chosen ESG rating agency and its particular methodology.

KPIs

The alternative to an ESG rating is to use KPIs to measure the borrower's performance against sustainability performance targets (SPTs), which can be external, internal or a

combination of both. The advantage of using KPIs is that they are bespoke and tailored to both the business' overall strategy and its ESG-specific aspirations.

The SLLPs emphasise that the credibility of the sustainability-linked loan market is intrinsically linked to the selection of robust and credible KPIs. To avoid allegations of greenwashing, it is essential that borrowers select KPIs that are ambitious and meaningful to the business and which address any relevant ESG challenges that the particular sector may present for the borrower. Furthermore, the KPIs should be quantifiable using a consistent and methodological process, and, where possible, capable of benchmarking against an external reference. Finally, as part of the recent update to the SLLPs, borrowers are now encouraged to seek external review of the KPIs to substantiate their appropriateness, which means that a requirement to provide a sustainability auditor's opinion on the KPIs can sometimes be included as a condition precedent to the SLL.

The number of KPIs against which the ESG margin ratchet is measured typically ranges from one to five, with three being the standard seen in SLLs in the year to date. The number of KPIs, however, should not be a driving factor when negotiating a SLL. In order to bolster the meaningfulness of KPIs it is important to ensure that the facilities agreement adequately defines the KPIs and sets out both the calculation methodology and any baselines, as well as any industry standards that will be used for benchmarking.

The use of KPIs, however, can present challenges to borrowers and sponsors, particularly in an acquisition scenario. First, in order to adequately monitor progress against SPTs and make appropriate disclosures on performance, suitable internal expertise is required and there may be a need to upskill employees. Second, it is necessary to consider how it is possible to meet the demanding requirements of the SLLPs in respect of meaningful and ambitious KPIs, presented alongside detailed, methodological processes for measuring performance when, prior to the acquisition, there may be

Bio box

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limited access to the target and the required information. The Guide referred to earlier states that the KPIs should be agreed upon before a deal is marketed for syndication and ELFA recommends that as much information as possible is disclosed at the term sheet stage. One suggested approach where there is limited access to the target is to set SPTs for year one that are based on historical data and allow for the Majority Lenders to agree further targets post-closing. Alternatively, one recent transaction started with a ratchet measured against the borrower's ESG score, but also included mechanics in the facilities agreement to allow for a smooth transition to KPIs at a later date.

UPDATING KPIs

Although the setting of ambitious KPIs is central to the SLLPs, equally important is that they remain ambitious throughout the life of the loan. Some early SLLs featured static SPTs, which effectively allowed the borrower's ESG efforts to plateau once the target had been achieved and the margin discount triggered. More recent SLLs include cumulative or dynamic SPTs that encourage continued endeavours by borrowers in relation to improving their ESG performance if they wish to continue benefitting from better pricing.

In order for KPIs to remain relevant and meaningful throughout the life of the loan, it is also essential that the facilities agreement allows for adjustments and/or recalculations to the targets or methodology. In order to achieve this, some SLLs have allowed for submission to the lenders of a written adjustment proposal detailing the necessary changes to calculations, whereas other SLLs allow the parties to enter into a period of good faith negotiations to agree any necessary adjustments, often following the occurrence of an "adjustment event". The requisite consent level for both of these options is usually Majority Lender and if no agreement is reached then any ESG-linked margin adjustments will cease to apply. Sometimes, documentation might require third party verification of either the need for the adjustment or the change to the target/methodology.

DISCLOSURE, REPORTING AND THIRD PARTY VERIFICATION

Transparency is essential in the SLL market as it helps to protect against greenwashing. It is important, therefore, that the borrower be prepared to provide the lending group with certain information relating to its ESG strategy and performance both at the outset of a transaction and throughout the life of the SLL.

As a condition precedent to the initial utilisation, the facilities agreement may require the provision of any of the following third party reports: sustainability vendor due diligence report, sustainability strategy, ESG rating report confirming the base ESG rating, or a sustainability auditor's opinion on the suitability of the KPIs and testing methodologies.

It is also common to require the provision of an annual sustainability report detailing the borrower's sustainability efforts, as well as a sustainability compliance certificate confirming whether the KPIs have been reached. A template certificate is often included in the schedules to the facilities agreement. Where the ratchet is measured by an ESG rating, there will be a requirement to provide annual ESG rating reports, as well as an ongoing obligation to notify any change in the ESG rating.

The updated SLLPs now require mandatory independent and external verification of the borrower's performance against the KPIs, which will usually be performed by a borrower-appointed sustainability auditor.

NO SUCH THING AS AN ESG DEFAULT

Given the nature of the current cov-lite, top-tier sponsor-driven market, it will come as no surprise that the consequence of failing either to meet the SPTs or to make the required disclosures is purely economic and does not result in an event of default or drawstop. As previously discussed, margin ratchets are typically two way with failure to meet a KPI resulting in the borrower paying a premium. Similarly, failure to deliver a sustainability report or compliance certificate will usually trigger a grace period after which the margin will increase until such time as the relevant document is delivered.

OTHER DOCUMENTARY CONSIDERATIONS

Finally, below are some concepts, which although not market standard, parties may consider including in the SLL facilities agreement.

Charitable or sustainable uses for margin savings

An increasingly common feature in SLLs is to require that margin savings be either partially (for example 50%) or entirely donated to charitable causes or reinvested in sustainable initiatives. Whether or not the borrower is required to demonstrate that the savings have indeed been donated/reinvested is a point for negotiation with some SLLs requiring the inclusion of a confirmatory statement in the annual sustainability compliance certificate. The consequences of failing to make the donation/reinvestment also varies between facilities and can range from a period of negotiation to agree on an extended period within which to comply, a financial penalty (the ESG margin ratchet ceasing to apply either on a temporary or permanent basis and/or repayment of the margin savings) or an Event of Default.

Severe sustainability controversy

Sometimes events (which may or may not be beyond the parties' control) can occur which have such significant detrimental ESG consequences that it is in everyone's best interests to disapply the SLL-related provisions altogether. For this reason, some SLLs in the year to date have included "Severe Event" or "ESG Controversy" drafting, meaning that should the Sustainability Coordinator (or sometimes Majority Lenders) deem that a severe event has occurred, the margin adjustment will be disapplied for as long as the event is continuing, even if the relevant KPIs have been met.

Further Reading:

- ESG factors in loan finance: moving the needle on sustainable finance (2019) 10 JIBFL 677.
- Comparing sustainable debt products and standards (2021) 4 JIBFL 296.
- LexisPSL: Banking & Finance: Practice Note: Sustainability-linked loans.