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Insights

European Leveraged Finance and Capital Markets Group

It's Easy, Being Green - The Development of ESG in the European Leveraged Finance Market

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Background and Rationale

In 2021, we saw ever-increasing volumes of ESG bonds and loans in the European leveraged finance market — particularly "sustainability-linked" high-yield bonds and syndicated loans. To put it in some context, in 2021 Reorg EMEA Covenants tracked approximately €49 billion of institutional loan transactions with a margin ratchet linked to ESG-related criteria (43% of the total leveraged loan market in Europe, up from 5% in the year before), and €25 billion of green, sustainability, and sustainability linked high yield bond issuances (18% of issuances).

The rise is driven by increasing demand on all sides — from institutional investors in the debt (who are integrating ESG into their overall investment strategies at a rapidly increasing rate) to the private equity sponsors themselves (whose LPs are pushing them more and more to consider ESG in their valuation and asset selection processes). This demand looks set only to grow in line with the changing regulatory environment — it is expected that more investors will start to integrate FSG requirements as they are required to comply with the new EU Disclosure Regulation (which requires financial market participants to publish their sustainability risk policy to explain how they integrate such risk into decision malting processes (irrespective of any stated ESG focus or strategy).

Types of ESG Finance – Key Differences

ESG finance is broadly understood to mean bonds or loans that have an "ESG" objective or are subject to "ESG" metrics – i.e.

- "Environmental" - promoting conservation of the natural world and seeking to combat measures such as climate change and carbon emissions, resource depletion, deforestation, waste management, biodiversity and pollution.
- "Social" - relating to the consideration of people and relationships, including matters such as gender/diversity, human rights, community relations and labour standards.
- "Governance" - involving the standards of running a company and relating to matters such as board composition, bribery and corruption, executive compensation, lobbying and donations.

There is no consensus on the exact scope of what can qualify as an ESG bond or loan. Having said that, there are two main and distinguishable types of ESG bond and loan product, each with the key characteristics as summarised below.

Bonds/Loans Tied to Use of Proceeds

Issuers/borrowers of these bonds or loans use the funds raised to finance or refinance eligible ESG projects. The main types of these bonds or loans are "green" bonds or loans, "social" bonds or loans, and "sustainability" bonds or loans. To date, in the sub-investment grade space, the focus has been primarily on the environmental aspects, with some ESG loans (rather than bonds) starting to introduce social and governance elements.

Green Bonds/Loans

Green bonds were the first ESG financing product to emerge in the debt markets, in 2007. There is no set definition of green bonds, but most issuances of green bonds in Europe are aligned with the ICMA "Green Bond Principles", which are voluntary guidelines that provide issuers with guidelines around transparency, disclosure and reporting, and which help investors assess the "greenness" of a bond. The Green Bond Principles themselves recommend that the label "green bonds" only be used for bonds that are aligned with these principles - and the use of such label means that the issuer has agreed to comply with fairly onerous disclosure, reporting and monitoring obligations.

While the green bond market has grown since 2007, it has done so relatively slowly in the sub-investment grade market. Bond proceeds in the leveraged finance market are most commonly applied for refinancings and acquisition financings, and generally involve very substantial sums (usually from €250 million and upward). Since the equivalent amount of all of the bond proceeds has to be allocated for green purposes under the Green Bond Principles, not all such issuers have been in a position to find a sufficient green pool of projects. The development of the high-yield bond green market thus naturally led to the development of green loans, with the first green loan being issued in 2014. Like green bonds, green loans are governed by a set of principles developed to guide investors in respect of the characteristics of green loans and clarify when a loan may be labelled as "green" – being the "Green Loan Principles" issued by the Loan Market Association, the Asia Pacific Loan Market Association and the Loan Syndications and Trading Association. Unlike green bonds, however, the loan market offers the advantage of less onerous disclosure and reporting requirements, more flexibility in terms of debt size, and lower transaction costs (and as a consequence the green loan market has grown at a faster pace than the green bond market).

The Green Bond Principles and Green Loan Principles each have four (similar) core components:

i. Use of Proceeds: amount equal to the net proceeds must be exclusively used to finance or refinance, in part or in full, eligible new and/or existing green projects which provide clear environmental benefits and contribute to environmental objectives (such as climate change migration, climate change adaptation, natural resource conservation, biodiversity conservation and pollution control).
ii. Process for Project Evaluation and Selection: an issuer/borrower is required to communicate to investors the process by which it determines how the projects fit within the categories identified in the use of proceeds requirement and the related eligibility criteria.
iii. Management of the Proceeds: proceeds (or amount equal to the net proceeds) must be ringfenced and placed into a sub account or otherwise tracked. For green loans, if the loan is part of a tranched facility, each tranche must be clearly designated and tracked. Green bonds must generally not be fungible with non-green bonds (in practice, trading under separate ISINs).
iv. Reporting: the Green Bond Principles provide that an issuer must make readily available and renew annually information on the list of projects and a brief description of them, amount of proceeds allocated and their expected impact; the Green Loan Principles provide for such information to be provided annually until the green loan is fully drawn (and thereafter to account for material developments only).

Both the Green Bond Principles and the Green Loan Principles recommend issuers/borrowers get a third party to verify that their bonds or loans are compliant (referred to as the "second party opinion" or "**SPO**").

A distinguishing feature of green bonds is that generally the application of the use of proceeds is not an undertaking in the indenture, unlike in green loans where the borrower will have an obligation to apply the proceeds for a specifically identified purpose. Equally, the reporting covenant in the indenture will not require a green bond issuer to comply with the ongoing reporting described above. Therefore, investors would have no contractual recourse against a green bond issuer that is no longer complying with the Green Bond Principles.

Green bond frameworks have been developed to be increasingly flexible, including allowing issuers to use the proceeds of the bonds for refinancings or other purposes while allocating an equivalent amount of the proceeds to green projects (past, present or future). Nevertheless, green bond issuers face some unique challenges, which also explains the recent rise in popularity of sustainability linked bonds (discussed below). For example, an issuer that issued green bonds and allocated an equivalent amount of proceeds to a specific green project may want to access the markets again by "tapping" the existing bonds in a fungible manner (i.e. issuing more bonds with the same ISINs which benefits the liquidity of both the existing and the additional bonds). Unless the issuer is able to find additional eligible green projects to which an equivalent amount of proceeds can be allocated, the additional bond will not be fungible with the existing bonds and, therefore, will be less attractive to investors.

Social/Sustainability Bonds/Loans

In recent years, there has been increased focus by both investors and companies on socially responsible lending and investing, and new categories of ESG bonds and loans have developed as a result — notably, "social" bonds or loans (which require that the proceeds be used for new or existing projects with positive social outcomes) and more recently, "sustainability" bonds or loans (which are designed with a hybrid set of objectives, bridging both green and social issues).

The Spanish Instituto de Credit° delivered the first formal "social" bond offering in January 2015, to help finance SMEs in economically depressed regions of Spain, which generate lower GDP per capital than the national average. ICMA in response published in 2017 the "Social Bond Principles" and "Sustainability Bond Guidelines", and, in turn, most recently in 2021 the Loan Market Association, the Asia Pacific Loan Market Association and the Loan Syndications and Trading Association together published the "Social Loan Principles".

Both the "Social Bond Principles", "Sustainability Bond Guidelines" and the "Social Loan Principles", cover the four components covered by the "Green Loan Principles" (as set out above), with the difference being the use of proceeds i.e. that a "social" bond or loan must be used to finance or refinance a social purpose or project (such as financing the building of affordable housing, employment generation, or increased access to education or healthcare), and that a "sustainability" loan or bond must be used to finance or refinance a combination of both eligible green and social projects.

The growth in "social" and "sustainable" finance has most recently been further fuelled by the recovery from the global COVID-19 pandemic – "social" bonds and loans in particular remain largely the remit of supranational and sovereign entities, and have grown as governments seek to stimulate economies and create jobs while committing to ambitious environmental targets. Nevertheless, to date there has not been any notable issuance of "social" and “sustainable” bonds in the leveraged finance market.

Sustainability Linked Bonds/Loans

What Are They?

Sustainability linked bonds or loans, by contrast to the "use of proceeds" bonds or loans described above, do not require the issuer/borrower to apply the proceeds for specific eligible ESG projects – the proceeds can be applied for any general corporate purpose. Instead, the focus of the sustainability linked bond or loan is to encourage the relevant issuer or borrower to improve their ESG performance by the setting of certain targets (which, if met, provide the issuer or borrower with financial benefit, usually a change to their margin ratchet as set out below).

The fact that the issuance of the relevant bonds or loans is not limited by the nature of the project it is intended to finance and the flexibility of the sustainability linked structure has led to a huge surge in sustainability linked bonds and loans in the European leveraged finance market, as companies from industries not typically considered "green" or those without specific eligible green or social projects are now able to access ESG related finance.

In contrast with green bonds and loans, sustainability linked bonds and loans have also been used in connection with notable leveraged buy-outs, with sponsors incorporating ESG into their M&A investment thesis by linking their LBO financing to specific ESG-related key performance indicators.

How Is ESG Performance Measured?

ESG performance is generally measured either by reference to "key performance indicators" ("**KPIs**") measuring whether or not it has achieved one or more agreed "sustainability performance targets" ("**SPTs**") or (more rarely and only in the loan market) against an ESG rating provided by an independent third party rating agency (which determines a score by reference to an annual evaluation of the borrower's performance against various ESG factors).

The leveraged finance market has focused mainly on the KPI approach, as reflected in 2020 and 2021 (as applicable) when the ICMA published the "Sustainability Linked Bond Principles" and the Loan Market Association, Asia Pacific Loan Market Association and Loan Syndications and Trading Association published the "Sustainability Linked Loan Principles", each setting out five core components for the relevant bonds or loans:

i. Selection of KPIs: should be relevant, core, and material to the issuer or borrower's overall business, measurable on a consistent basis and capable of being benchmarked.
ii. Calibration of SPTs: should be set in good faith, should be ambitious, and should be set based on a combination of benchmarking approaches (based on issuer or borrower's performance over time, their peers, and by reference to science based or official targets).Management of the Proceeds:
iii. Bond/Loan Characteristics: economic outcome is linked to whether or not the SPTs are met.
iv. Reporting: issuers or borrowers should provide noteholders or lenders (as applicable) with up to date information to enable them to monitor the SPTs (at least once a year), and are encouraged to publicly report information relating to SPTs.
v. Verification: at least once a year, an issuer or borrower should obtain independent and external verification of its performance.

The most significant development from the components set out above was the attempt to make the selection of KPIs more rigorous and to try to get third party verification of performance — in particular, to avoid any perception of "greenwashing" (where the issuer or borrower's claims of environmental benefit are unsubstantiated or illusory).

It remains the case that not all of the above is addressed in each bond or loan in the market, however, and the key areas of focus and/or negotiation in deals that have come to the leveraged finance market are set out below.

What Are the KPIs?

The number and type of KPIs against which performance and compliance with the SPTs will be measured depends on the nature of the relevant issuer or borrower's business. Publicly available examples from 2021 include matters such as the following (and some will have a combination of multiple KPIs):

- The increase in power volume of new gearbox installations in wind turbines;

- Reduction in greenhouse gas/carbon emissions;
- Improvement of the quality of care services for the elderly;
- Women’s representation in senior management;
- Increase in recycled aluminium input;
- Water saving processes; and
- Decrease in work accidents and occupational diseases.

How Are the SPTs Set?

Generally in the leveraged finance market, it is management of the issuer or borrower that sets the SPTs and, solely in the case of loans, sometimes the SPTs for future years are not set upfront (i.e. management will provide next year’s target each year on a yearly basis).

The question then remains for investors in the relevant bond or loan as to how they ensure that the SPTs set are objective, reasonable and not too easily achievable and/or not just in line with the issuer or borrower's already projected performance. Also note that setting the SPTs can be more challenging in the context of an LBO, when the financing is obtained prior to the closing of the acquisition itself.

The specifics will obviously depend on the KPI(s) being proposed, but generally investors have focused on (i) in loans, ensuring a baseline target or report is received and reviewed by investors (although it is not generally delivered as a condition precedent to commitment or funding) and (ii) in bonds, the inclusion of meaningful disclosure in the offering document relating to the timelines, methodology, the existing track record of the issuer and their plans to achieve the SPTs (and such disclosure also generally summarises the sustainability linked bond framework which the issuer has prepared together with an SPO provider who has also provided an SPO with respect to such framework). Investors will also expect that the initial SPTs (and future SPTs, if possible, depending on the KPI(s) involved) are then set upfront by reference to this objective baseline.

Going forward, investors are then typically focused on ensuring that management must use a similar methodology to the one described in such initial baseline report or else that management is required to meet some kind of objective standard that works for the KPI (e.g. that the SPT must always require a certain level or percentage of improvement on performance from the year before).

Timing also becomes an issue — some syndicated loan deals, for example, have even sought to get commitments from investors in syndication before the borrower has delivered sufficient information around the KPIs and SPTs and/or will permit the borrower to agree such levels with the facility agent in due course (without lender consent).

More lately over the course of 2021, banks in the leveraged loan market have been vying for the titles of "Sustainability Arranger" or "Sustainability Manager", with such appointment making them responsible for helping the issuer or borrower to structure the step-ups, review the disclosure and reports, and lead communication with investors on the ESG-related provisions.

How is ongoing compliance with the SPTs measured and certified?

In the leveraged loan market, compliance with the SPTs (as well as the setting of the SPTs per above) has most commonly been measured or certified by management of the issuer or borrower, through delivery of a yearly report and compliance certificate which confirm whether or not the SPT has been met for that year (which also (if applicable) sets the target for the following year).

Despite the "Sustainability Linked" bond and loan principles referred to above, a relatively large proportion of loans in the European leveraged finance market have not historically included a requirement for a third party advisor to verify compliance with the SPTs on a yearly basis — this looks set to be shifting, however, with Sustainability Arrangers pushing hard for inclusion of third party verification in the more recent deals in the market.

As regards bonds, whilst it is only recommended by ICMA's Sustainability-Linked Bond Principles, the involvement of SPO providers both at the time of the issuance and on a yearly basis is expected by the market. In addition, as is the case for green bonds, the sustainability linked bond reporting covenant does not include a requirement to report on a year basis to provide any disclosure and/or SPOs (but per below the failure to deliver the certification results in the pricing step up).

In sustainability linked loans, in the absence of a third party verifying compliance with the SPTs, it is incumbent on investors or the Sustainability Arrangers to ensure that (as well as ensuring the SPTs themselves are objective and not too achievable) there is some clear methodology in place to enable management to evidence whether or not the relevant SPT has been met — this is often achieved by a requirement that the yearly report provided by the borrower uses similar methodology as the baseline report initially provided to and reviewed by the investors.

What Are the Consequences?

In sustainability linked loans, the meeting or failure to meet the relevant SPTs by reference to the KPIs generally leads to a small change in the margin by use of the margin ratchet (with no other consequence i.e. it is not an event of default or a new money draw stop). In the simplest constructs, the margin will increase if the relevant SPT is not met and decrease if the SPT is met; in more complex constructs (where there are multiple SPTs), the margin will increase or decrease by different amounts depending how many of the SPTs are achieved. The changes in margin are generally small, ranging from 2.5bps to 15bps in publicly available loan deals in 2021. Increasingly, borrowers have been pushing for this to be entirely at their option i.e. a failure by the borrower to deliver the relevant annual report and compliance certificate confirming whether or not the SPTs have been met does not have any consequence except that there will be no adjustment to the margin - although in most transactions investors and (lately) Sustainability Arrangers have pushed to ultimately include an increase in the margin (as if the SPTs had not been met) in these circumstances.

Further, in the event that the margin does decrease because the relevant SPTs have been met, some recent loan transactions have also seen borrowers agree to donate any savings (within a certain period of time) they make from any such margin reduction towards ESG charities or towards their own internal sustainability initiatives.

Contrary to the position in sustainability linked loans, the margin in sustainability linked bonds only increases if the relevant SPTs are not met (and does not decrease if they are met). Such margin stepups vary from 12.5 bps to 75 bps per SPT, also depending on the number of such SPTs. Due to the requirement to have third-party certification, sustainability linked bonds tend to have only one or two SPTs each. In addition, SPTs are not necessarily measured the first year after the bond issue date — the first measurement date is frequently delayed by at least a couple of years. According to Reorg, the more commonly seen first measurement year for bonds issued in 2021 was 2024 or 2025. In certain top tier sponsor transactions, such measurement only occurs once in the lifetime of the sustainability linked bond.

A key area of focus in bonds is when the step-up takes place, with a dynamic interplay between the quantum of the step-up, which tends to be higher the later the certification date with respect to the SPT. In addition, unlike syndicated loans, bonds benefit from call protection. Therefore investors in sustainability linked bonds will be very focused as to (i) when the step-up kicks in and (ii) how it will affect redemption prices. The market has seen now a number of possible variations: (a) the step-up affects both the margin and the redemption premia; (b) the step-up only affects the margin; or (c) the step-up only affects the redemption premia. Choosing (b) over (c) depends on a number of circumstances and the resulting economic outcome for investors will vary depending principally when in the life of the bond the step-up occurs. There have been a number of issuances in the market where the step-up only applies to a handful of interest payments, all commencing after the call protection has already expired. As prudent issuers tend to refinance their bonds early, it is unlikely that some of the SPTs for some European sustainability linked bond issuers will ever be tested.

Other Developments

In 2021, we also observed some sponsors in the leveraged finance market include a "use of proceeds" margin ratchet on the borrower's revolving credit facility — this new structure allows a borrower to achieve a cost saving if it is drawing down on its revolver to use proceeds for a sustainable cause. This combines the "use of proceeds" model described above for "green" bonds or loans with the margin ratchet mechanism from the sustainability linked bonds or loans and has been an interesting development.

In addition, sustainability linked margin ratchets have also started to make their way into unitranche loan financings.

Conclusion

Looking forward into 2022, it is expected that ESG related finance continues to grow in the European leveraged finance space, and is generally considered a favourable development — although with fears of "greenwashing" and increased regulation in the area coming in across Europe it seems likely that the market will develop a more standardised approach to documentation and, in particular, there will be greater focus on obtaining third party verification of compliance with ESG linked terms.

It will also be interesting to see how ESG linked lending develops in the leveraged finance market in the USA, where to date it still remains a relatively uncommon feature, given asset managers are under regulatory pressure in justifying a "greenium" (an improvement in terms for borrowers/issuers when issuing/borrowing ESG instruments).

Milbank ESG Practice

Green and sustainable finance is an important tool for the transition towards a de-carbonised economy. Milbank has one of the strongest capital markets and leveraged finance practices in the market with unprecedented expertise in the disclosure of climate-related risks, sustainability-linked financing structure and green ratings.

We have assembled one of the finest teams of any international law firm to advise clients on a range of matters related to disclosure of climate risks, sustainability-linked finance structures and green ratings. Recent experience includes advising:

- The initial purchasers in connection with Zenith Finco plc's offering of £475 million 6.500% Green Senior Secured Notes due 2027 pursuant to their newly established green bond framework and related revolving credit facility.
- The mandated lead arrangers on the €500 million term loan B refinancing of Carlyle's portfolio company Saverglass.
- Citycon on Its €350 million Green Capital Securities Offering.
- Canary Wharf Group on its £906.3 million (equivalent) debut bond offering pursuant to their newly established green bond framework and related revolving credit facility.
- Public Power Corporation S.A., the biggest electricity company in Greece, on the first sustainability-linked high yield bond in Europe. This was the first European sub-investment grade sustainably linked bond.
- Globalworth Real Estate Investments Limited, a leading real estate company in Central and Eastern Europe, on its inaugural green bond offering and cash tender offer.
- The arrangers in relation to a new amendment for Portugal-based packaging firm Logoplaste, which created the first institutional term loan with interest payments directly linked to ESG factors.
- The initial purchasers in connection with a sustainability-linked bond financing of Apollo's acquisition of AS Graanul Invest.

- Lar España on two green bond issuances this year: its €400M Senior Unsecured Green Bond Offering and related tender offer and with its €300M Senior Unsecured Green Bond Offering.
- The underwriters and take-and-hold investors of the €1.32B (including a RMB tranche of the equivalent of EUR €80m) senior credit facilities with ESG-linked pricing in relation to The Carlyle Group's acquisition of all of the shares in Flender GmbH.

This article was co-authored by Alexandra Grant and Ana Grbec and published by Reorg (www.reorg.com). Reorg is a global provider of credit intelligence, data, and analytics.

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