Research Paper

The Use of Sustainability Linked Loans in the European Direct Lending Market

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1 INTRODUCTION

The integration of ESG topics into all business aspects has been one of the key trends in the financial industry over the last few years and also affects the way private debt managers conduct their business. Even though lenders do not control companies and therefore cannot directly change the ESG policy of borrowers, they nevertheless can set incentives via their loan agreements to encourage desired behavior.

This is already happening in the European direct lending market for the last two or three years. While we have a lot of anecdotal evidence for this trend from our conversations with private debt managers, there is still a lack of empirical data about the usage of Sustainability Linked Loans (SLLs). SLLs are defined by the Loan Market Association in its "Sustainability Linked Loan Principles" as: "Any types of loan instruments and/or contingent facilities (such as bonding lines, guarantee lines or letters of credit) which incentivize the borrower's achievement of ambitious, predetermined sustainability performance objectives. The borrower's sustainability performance is measured using sustainability performance targets (SPTs), as set against key performance indicators (KPIs), external ratings and/or equivalent metrics and which measure improvements in the borrower's sustainability profile".

Put in more simple terms, SLLs are loans that use ESG margin ratchets to promote certain sustainability targets. While the usage of SLLs is widely accepted by many market participants, a clear market standard for these loans has yet to evolve. It is the aim of this study to provide an overview of the current practices used by the relevant market players in the European direct lending market. Therefore, we have reached out to 64 fund managers that provide direct lending solutions to European companies and asked them to fill in a survey containing 26 questions. We are thankful for receiving answers from 27 fund managers, representing in total more than 120 funds and more than EUR 150 billion of committed capital.

The following results have to be interpreted with a grain of salt: while the absolute number of responding private debt managers and the number and amount of funds managed by them are impressive and signal a high degree of representativeness, it could well be the case that managers with higher ESG standards and an active ESG policy are more likely to participate in our study than managers that currently do not apply ESG standards for their investments.

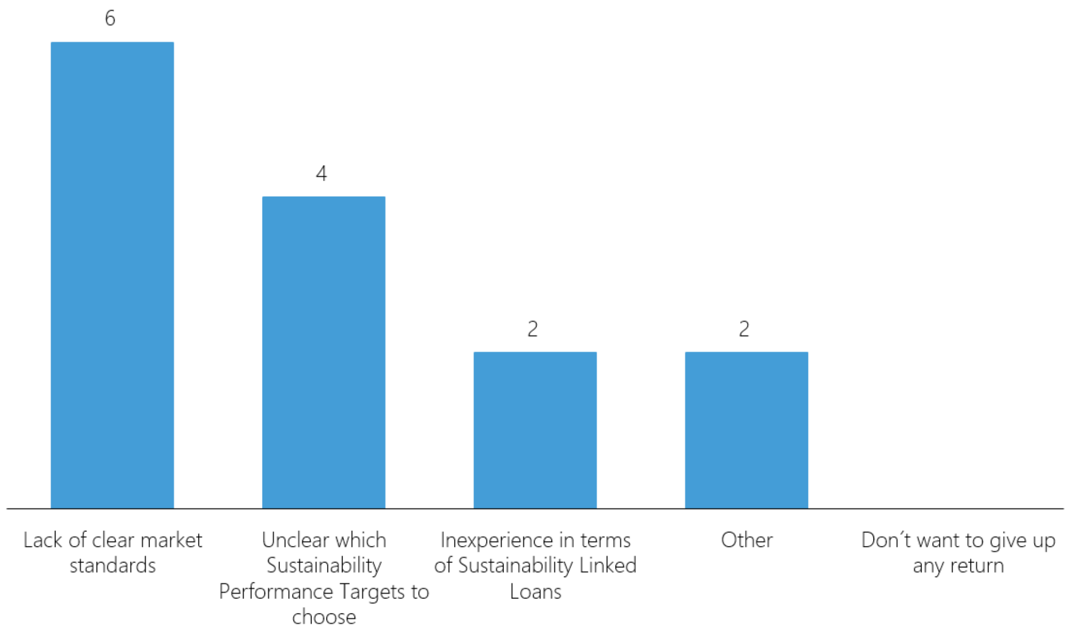
2 RESULTS

2.1 Use of SLLs in the European direct lending market

Out of the 27 participants, 20 are generally using SLLs, representing roughly 3 out of 4 funds. While a large majority of fund managers is already using SLLs, only seven are not. Of these, all but one cited the lack of clear market standards as the main reason for not using SLLs (see diagram 1). This stresses the importance of this study which will improve the transparency about the use of SLLs in the European direct lending market and may serve as a starting point for the further development of a market standard for measuring and influencing ESG performance.

Only two fund managers mentioned that ESG compliance is not part of their investment objective and that they fear that SLLs might be considered greenwashing rather than having an actual impact. It is noteworthy though, that while SLLs could lower the overall return, no fund manager indicated that giving up a small portion of the return is an obstacle to using SLLs.

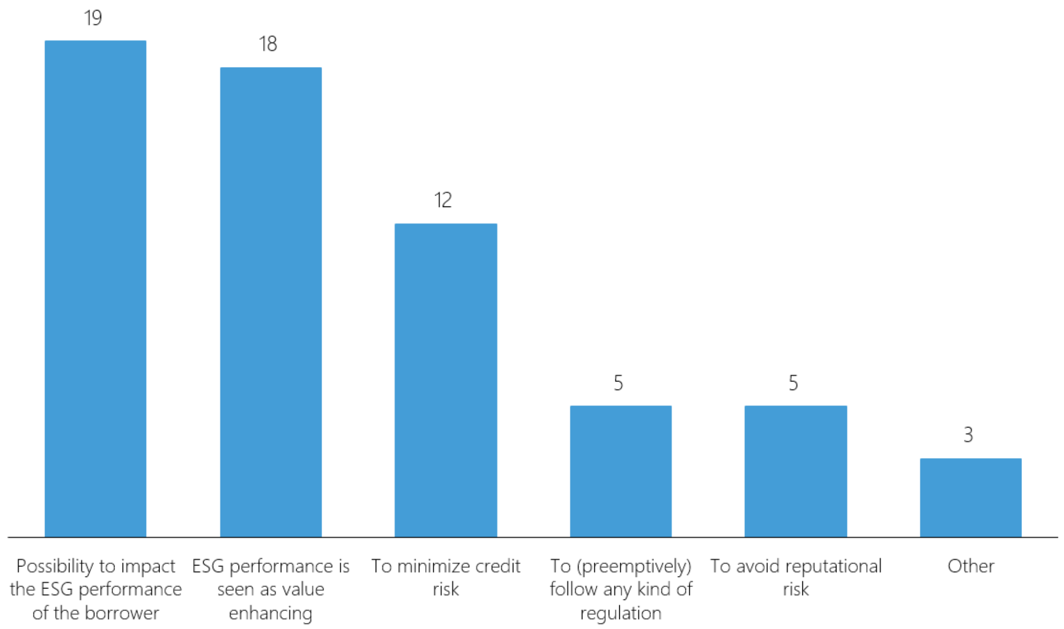
Diagram 1: Reasons for not using SLLs



Note: N = 7; Multiple Options possible

As diagram 2 below shows, out of the 20 fund managers that are using SLLs, almost all expect to be able to influence the ESG behavior of the borrower and see ESG performance as value enhancing. 12 respondents also mentioned reducing credit risk as another important reason. Interestingly, external factors like regulatory requirements and pressure from investors or other stakeholders to use ESG incentives ("to avoid reputational risk") were mentioned far less often, showing that fund managers are more intrinsically than extrinsically motivated to apply an active ESG policy.

Diagram 2: Motivations for using SLLs



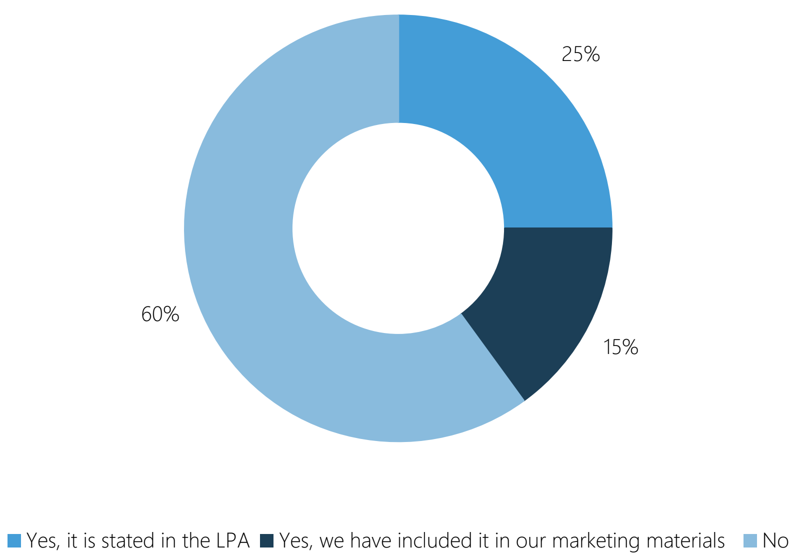
Note: N = 20; Multiple Options possible

Most managers do not make use of industry standards for ESG performance indicators. The ones who do mostly use the Loan Market Association/European Leveraged Finance Association's "Best Practice Guide to Sustainability-Linked Leveraged Loans" since it is seen as the easiest to use.

We next examined the extent to which managers make use of SLLs and if they have hold themselves to a target ratio which limits the voluntariness of using SLLs. As can be seen from diagram 3 only 25% of managers have a legal obligation to use SLLs to a certain extent, 15% have at least an intention to use it and mention this in their marketing documents, but a 60% majority does not want to be pinned down at present.

In addition to being obliged by the limited partnership agreement of their funds to use a certain portion of SLLs, the promotors of an active ESG policy also use incentives for their investment team like linking a portion of the carry to the extent SLLs are being used.

Diagram 3: Do you have a target ratio for SLLs in your current fund?



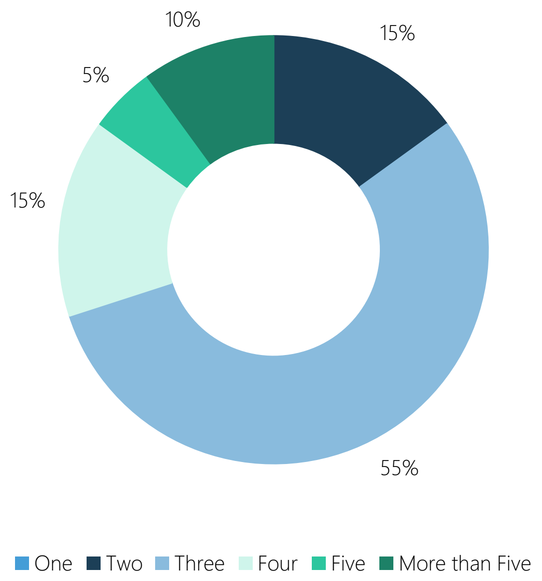
Note: N = 20

While this result clearly indicates that the use of ESG incentives in private debt industry is still in its infancy, there is a clear trend towards an increased use of SLLs. Already 37% of the investments in the most recent fund were classified as SLLs compared to only 23% in the predecessor fund, an increase by more than 60%. As we see more and more private debt funds that are currently in the fundraising process being classified as Article 8 funds under the SFDR (Sustainable Finance Disclosure Regulation) – instead of Article 6 funds under the SFDR – this number is expected to increase further in the near future.

2.2 Structuring of SLLs

Next, we examined in more detail how SLLs are implemented, i.e. which performance indicators or "Sustainability Performance Targets" are used by the fund managers. 85% of managers use three or more targets (see diagram 4) and the majority (60%) require the borrowers to achieve more than one SPT to trigger the ESG ratchet and lower the interest margin. However, it was never the case that all targets have to be met.

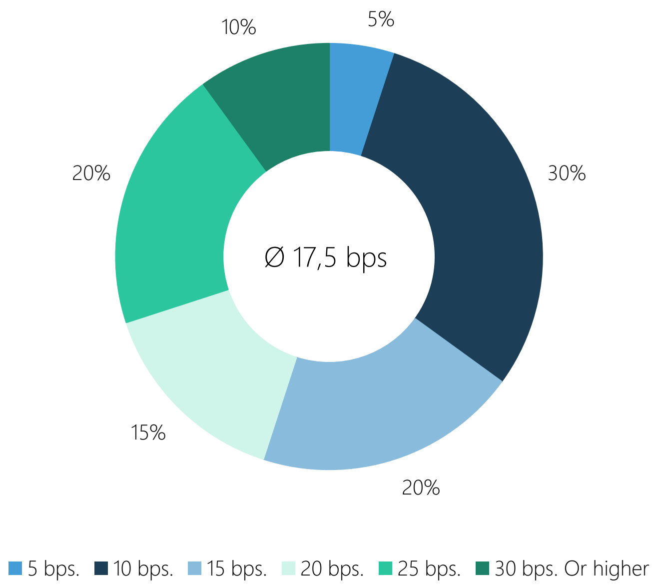
Diagram 4: How many Sustainability Performance Targets (SPTs) do you set on average?



Note: N = 20

The maximum extent to which a borrower can lower its interest margin by meeting the set targets varies between 5 bps and 30 bps as diagram 5 shows. Most managers (65%) not only reward borrowers for achieving their targets but also punish them via margin increases if they do not (but always with an upper or lower limit). However, there are still 35% of managers that only use asymmetrical ratchets that only lower the interest rate for the borrower but do not charge a premium.

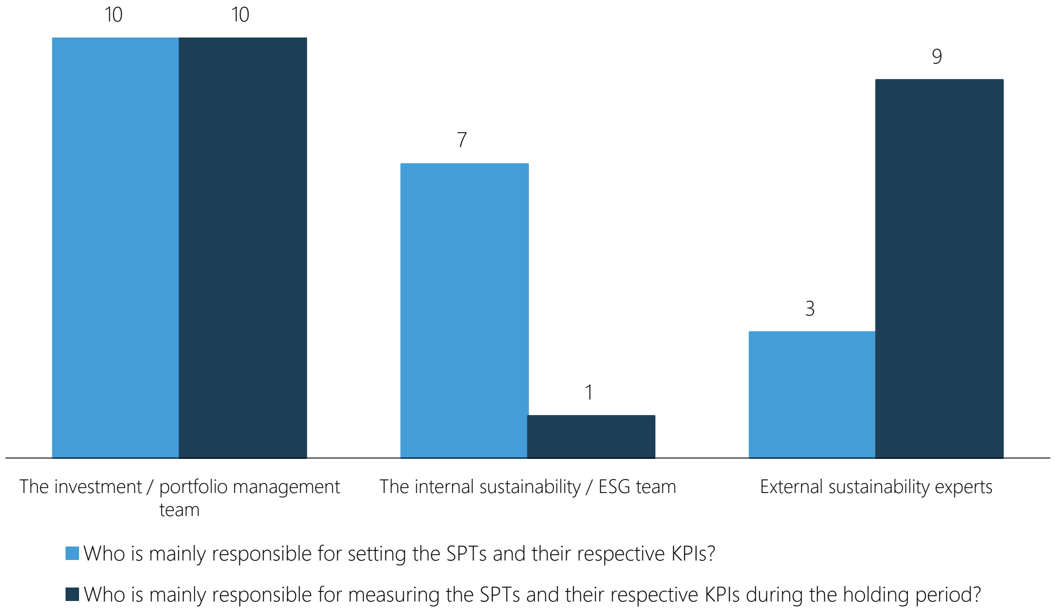
Diagram 5: Average margin reduction for meeting SPTs



Note: N = 20

The responsibility for setting SPTs and for monitoring them typically rests with the investment team or portfolio management team. Interestingly, if sustainability experts are used in this process, the internal experts are mostly in charge of setting the targets while external consultants are primarily used for monitoring the SPTs which also might be done for reputational reasons. Even if SPTs are set and monitored entirely internally, most managers have used specialized consultants in the first place to set up their ESG policy and get advice on which SPTs to use and how to operationalize them. An equal number of managers (although they are not necessarily identical) that use outside help also cite the cost involved for external counsel as one of the obstacles against a wider use of SLLs (see diagram 9 below).

Diagram 6: Who is mainly responsible for initially setting the SPTs and their respective KPIs and measuring them during the holding period?



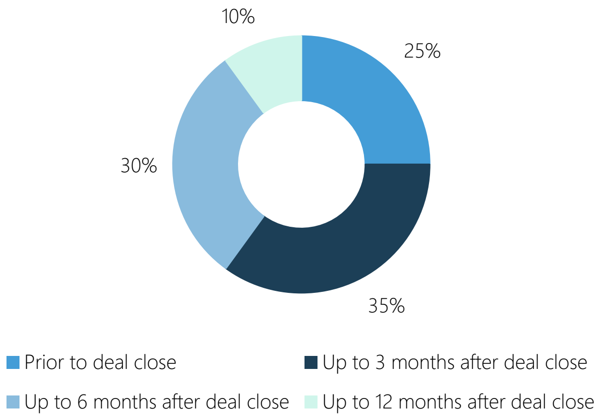
Note: N = 20

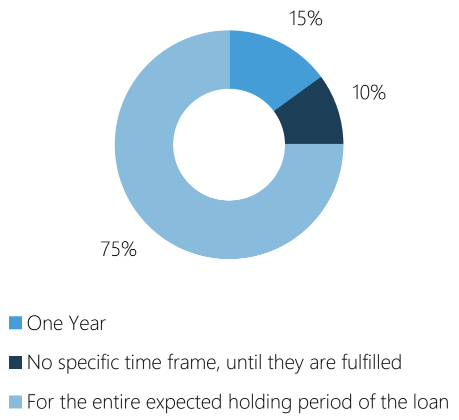
Most likely due to the typical time pressure in the closing process, only for 25% of the financings the SPTs are set before the loan is extended (see diagram 7 below). In some cases, there might also initially be a lack of specific knowledge of which level of information on ESG indicators the company can provide, and which targets can reasonably be achieved. However, in these cases there is typically an understanding that the loan agreement will be complemented by certain SPTs at a later point in time. Further standardization will definitely enable a smoother process for including SPTs in loan agreements in the future.

In 15% of the transactions the sustainability targets have to be achieved by the borrower within one year from closing or the margin ratchet is no longer valid. In the rest of the cases the margin decrease or increase can be achieved throughout the term of the loan and therefore provides a permanent incentive to achieve and maintain certain performance targets.

A dedicated ESG reporting from the borrowers is in most cases required only on an annual basis to keep the burden of gathering the information manageable. However, 15% of managers ask for a quarterly report on the defined KPIs.

Diagram 7: When are the SPTs set and for which time frame?

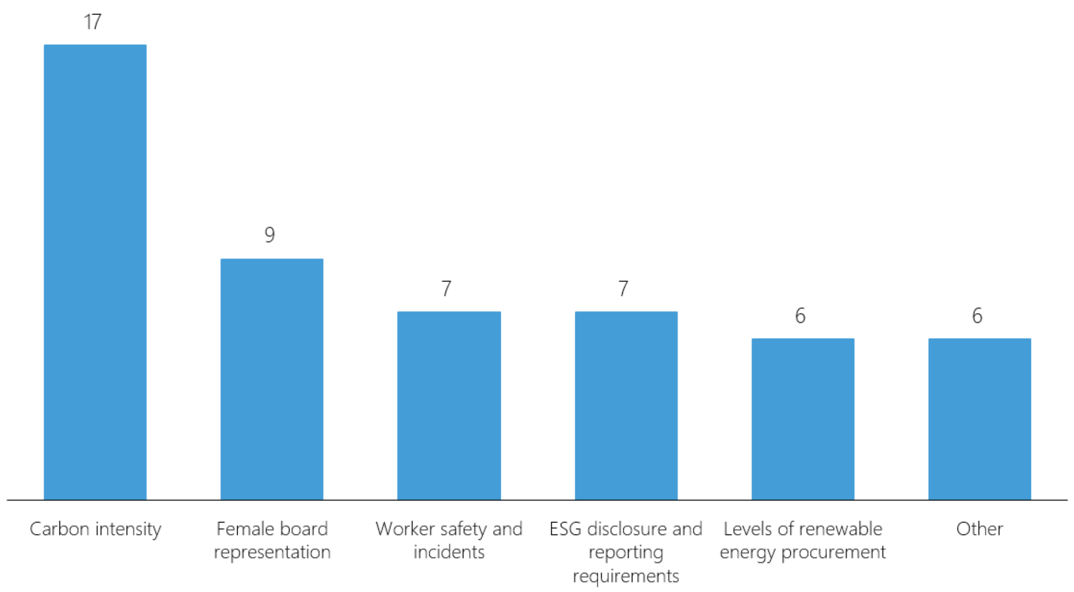




Note: N = 20

Given the lack of a common market standard yet, it is interesting to look at the topics that are most often addressed by SPTs. The predominant theme is carbon intensity which almost all respondents include as a KPI. The next most relevant topics concern female board representation and worker safety (which are also easy to measure), general ESG disclosure and reporting policies and renewable energy procurement.

Diagram 8: Which three topics are most often included in the SPTs?



Note: N = 20; Max. three options possible

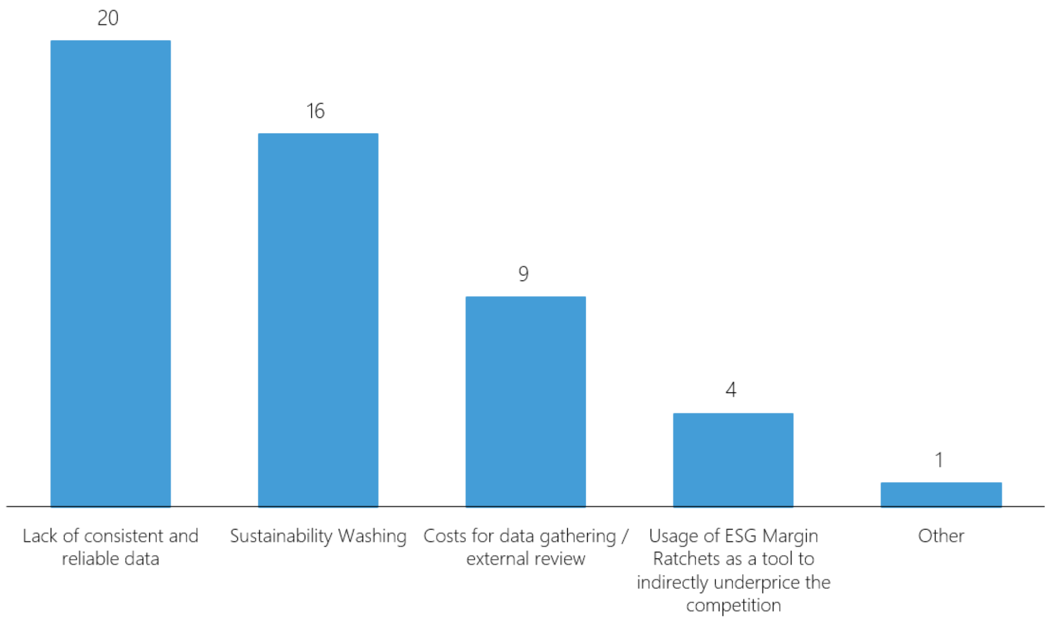
For SPTs to be effective, they have to be material and ambitious. Otherwise their broader acceptance by the different stakeholders will be very limited and companies run the risk of being blamed for greenwashing if the SPTs are considered to be ineffective or very easy to reach without a significant chance in the way a company conducts its business.

Since there is no common agreement so far what this actually means, managers use external tools like the SASB (Sustainability Accounting Standards Board, now part of the IFRS Foundation) Materiality Map or cooperate with specialized ESG consultants. Some even use an independent „impact advisory committee" which advises on the use of SPTs and approves them. Benchmarks are also a very important, but still underdeveloped tool for checking the appropriateness of the used SPTs.

2.3 Barriers to greater use of SLLs

Finally, we analyzed the barriers to a more widespread use of SLLs. Diagram 9 shows that the lack of standardization is the biggest problem for almost 75% of participants. This goes hand in hand with the fear of ca. 60% of respondents, that the individual measures used in the absence of a common market standard might be considered greenwashing by the wider public or at least the relevant interest groups, i.e. investors. While a third also mentions the high cost of data gathering and/or external consultants as a hindrance, only very few managers fear that ESG ratchets are used by the competition as a means to offer lower interest rates and underprice the market.

Diagram 9: Which are the greatest barriers against the wider use of Sustainability Linked Loans?



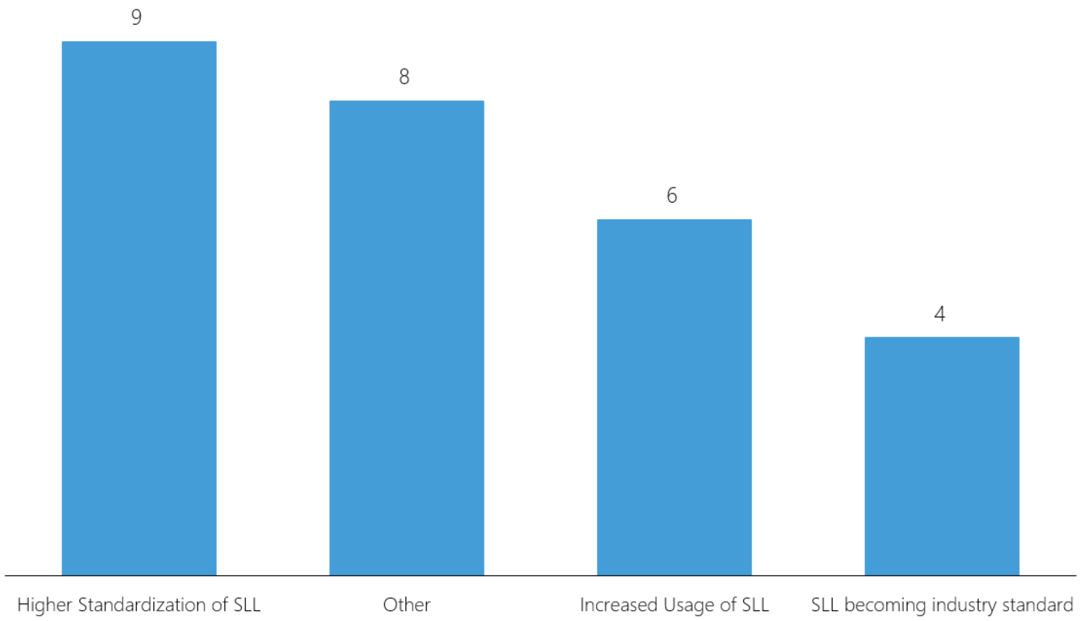
Note: N = 27; Multiple Options possible

2.4 The future of SLLs

Asked about their expectations for the future use of SLLs, most participants expect a higher degree of standardization and a more widespread use of SLLs. Among the answers mentioned in the "Other" category were: the increasing ESG maturity of private equity investors and portfolio companies, the increasing regulation around setting KPIs and validation of reporting KPIs and the growing scrutiny from LPs on the validity of Sustainability Linked Loans (specifically on whether SLLs drive meaningful change). Some also expect SLLs only to gain relevance, if more cost-effective third-party analysis tools to support the implementation, development and measurement of the relevant KPIs become available.

An interesting question is, if loans will have ESG covenants one day which is a much more powerful mechanism than increasing margins to effectuate the warranted behavior. While this is already discussed in the literature, it will be necessary to have broadly accepted market standards for measuring ESG-related KPIs before borrowers will accept these covenants in their loan documents.

Diagram 10: How do you see the development of Sustainability Linked Loans in the future?



Note: N = 18; Multiple Options possible

3 CONCLUSION

Our study aims to improve the transparency about the use of SLLs in the European direct lending market and hopefully can be another step towards a better understanding of SLLs and the obstacles that have to be solved before the widespread use of SLLs becomes market standard.

It is still early days for ESG related performance indicators to be formally incorporated in loan documents and trigger a lower or higher interest expense for the borrower. It may be argued that SLLs do not really have teeth, e.g. when only discounts to the initial interest rate after achieving certain KPIs, but no premiums for missing them are agreed (this was the case for 35% of managers in our study). In addition, the time period which is set to achieve the ESG targets is sometimes very flexible and does not put much pressure for action on the borrower.

On the other hand, a large number of private debt managers in Europe are already using SLLs and with further standardization and reduced cost for measuring, monitoring and reporting of the relevant KPIs there is no reason why loans with ESG covenants should not be the norm in the not too distant future. The development of a common market definition for SLLs and a framework for measuring ESG performance indicators will also remove the potential problem of greenwashing.

It is encouraging that the private debt industry – although sometimes being blamed as sitting in the back seat since managers do not control the companies they finance – has taken active steps ahead of regulatory action to find ways to incorporate ESG topics into their daily business. Our study found a high level of support for linking sustainability elements to corporate loans and we expect the private debt industry to continue to be an important element of a sustainable financial industry.

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