11 May 2021

Setting the ESG Agenda

Key takeaways of the inaugural ELFA ESG Conference

ISSUE #14

Exploring five key takeaways from the conference

- Materiality matters
- Environmental reporting presents both challenges and opportunities
- Industry initiatives to tackle ESG issues collectively are well underway
- There are significant benefits to capturing ESG data early
- Recent market developments, such as ESG-linked margin ratchets, further illustrate the acceleration of the ESG investing trend

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Key takeaways of the inaugural ELFA ESG Conference

Executive Summary

On 18 March 2021, the European Leveraged Finance Association (ELFA) held its inaugural ESG Conference, Setting the ESG Agenda, bringing together sub-investment grade corporate borrowers, private equity sponsors, banks, investors, lawyers and credit rating analysts. Part of the ELFA's ESG Disclosure Initiative, the event provided a forum for discussion on key issues facing market participants as ESG continues to play an important role in the leveraged finance market.

The conference attracted over 400 market participants, including panellists representing sub-investment grade corporate borrowers as well private equity sponsors. Together with partners Standard & Poor's, Hogan Lovells and Eigen Technologies, the ELFA was able to provide timely and practical insights into key ESG themes. The panellists and participants focused on how ESG is transforming the European leveraged finance market. Four break-out sessions were also hosted to provide corporate borrowers and private equity sponsors the opportunity to describe the trajectory of their ESG journey, during which they explained how they began collecting ESG data and the opportunities and challenges they faced. These sessions focused on specific sectors: paper and packaging, telecommunications, retail and software.

There were five key takeaways from the conference that we explore in more detail in this Insights report:

1. Materiality matters
2. Environmental reporting presents both challenges and opportunities
3. Industry initiatives to tackle ESG issues collectively are well underway
4. There are significant benefits to capturing ESG data early
5. Recent market developments, such as ESG-linked margin ratchets, further illustrate the acceleration of the ESG investing trend

1. Materiality matters

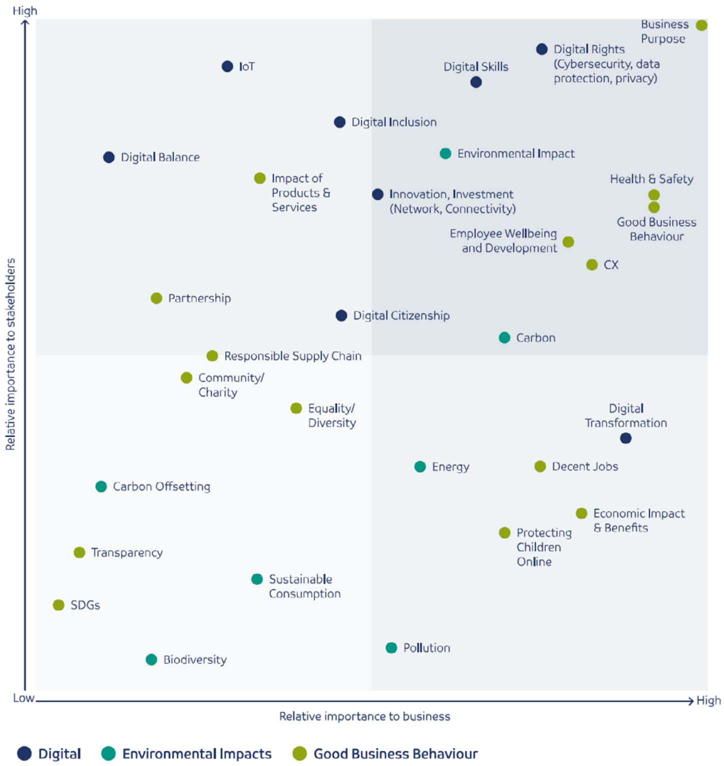
Conducting a formal materiality analysis, which is a method of identifying and prioritising the most important sustainability issues to a company and its stakeholders, was one of the first steps in the ESG journey described by corporate borrowers.

First, the company must identify the sustainability topics that are most likely to significantly affect the commercial success of the business. Once management has made this determination, it can take the next essential step – to evaluate the importance of each issue to its stakeholders, from employees and customers to suppliers and investors. To achieve this, the company might use surveys or organise interviews to ask stakeholders to score these sustainability topics in order of importance to them.

One potential output from this process could be a visual representation of topics that could be prioritised based on their significance to the company's success and stakeholders' expectations. This type of visual representation is called a materiality matrix. The top right-hand corner of the matrix shows the ESG issues that are both (i) material to the company and (ii) highly valued by stakeholders. Equipped with this analysis, companies can then look to create their long-term ESG strategy, determine targets and report meaningful data to stakeholders.

One borrower noted that their materiality analysis revealed an expectation by stakeholders that they go beyond providing their day-to-day telecom services by promoting digital citizenship and digital skills, helping the elderly benefit from technology, and keeping children safe online.

Example of a materiality matrix



Source: TDC Annual Report, 2019

Resources developed by the Sustainability Accounting Standards Board (SASB), such as SASB's Materiality Map, could assist businesses in carrying out this process. For each industry, SASB has identified ESG factors that are likely to significantly affect the financial condition, operating performance, or market valuation of companies. The ELFA has used SASB's Materiality Map, amongst other resources, to develop its ESG Fact Sheets which are specifically tailored to corporate borrowers in the European leveraged finance market.

"It's not only leveraged finance investors that are interested in ESG, but also employees (and future employees), especially the younger generation." – Corporate borrower

2. Environmental reporting presents both challenges and opportunities

The corporate borrowers participating in the event were all in different stages of environmental data collection and reporting. For many, the first area of focus has been collecting emissions data and comparing this with peers. Scopes 1 and 2 of greenhouse gas (GHG) emissions are most frequently tracked and disclosed to investors.[1] Some corporate borrowers are starting to consider measuring scope 3, which is inherently more challenging.[2] One borrower expects they will have to make certain assumptions to do this analysis, but they view it as essential to begin this process and learn along the way.

Although scope 3 measurements will require a dialogue with suppliers about reducing emissions, there are several benefits of going through this process. For many companies, a high proportion of their GHG emissions and cost reduction opportunities lie outside their own operations. For example, organisations can identify energy efficiency and cost reduction opportunities in their supply chain, improve their products' energy efficiency, and engage with employees to reduce emissions from business travel and employee commuting.

Companies explained that measuring GHG emissions is a laborious process that at times requires manual calculations. One borrower has an in-house environmental analyst and has engaged external parties. Another borrower, who does not yet disclose any environmental metrics, noted it is considering reporting this data in the future.

Another topic of discussion was the circular economy. A circular economy is based on the principles of designing out waste and pollution, keeping products and materials in use and regenerating natural systems.[3] Ultimately building sustainable and lasting products is the most powerful way to minimise waste. One borrower mentioned it has introduced circular economy principles into its business and is currently exploring re-designing products and increasing recycling of materials. Another borrower said that they are now focusing on less waste to landfill and seeking a second purpose for this waste – they stressed that cooperation with suppliers is essential.

One of the borrowers discussed the utility of product buy-back schemes. These can present an excellent opportunity to continue engaging with customers and to find out what happens to products after the sale, such as how long people are using them. Any valuable market insights can then feed into product and business model innovation.

"Companies need to be prepared with those [environmental] numbers, as investors will start asking this soon, if they haven't already." – Investor

3. Industry initiatives to tackle ESG issues collectively are well underway

Corporate borrowers discussed their involvement with various initiatives that support them in achieving their ESG objectives.

UN Fashion Industry Charter for Climate Action

The purpose of the UN Fashion Industry Charter for Climate Action is to achieve net-zero emissions by 2050, in line with keeping global warming below a rise of 1.5 degrees Celsius. It includes a target of 30% GHG emission reductions by 2030 and a commitment to analyse and set a decarbonisation pathway for the fashion industry, drawing on methodologies from the Science-Based Targets Initiative. The signatories and supporting organisations of the Charter work collaboratively, bringing together stakeholders and experts in the fashion and broader textile sector.[4]

Joint Audit Corporate Initiative (JAC)

JAC is an industry initiative comprised of 17 telecom operators with the common objective of raising social, environmental and ethical standards within the ICT supply chain. JAC members collaborate in engaging with their suppliers to promote transparency and raise sustainability standards. Each member company has the responsibility to lead a complete audit process of around five suppliers. Audit results are then shared with other JAC members. When a supplier has gaps in their policies or practices, JAC then works closely with the supplier to develop and implement a corrective action plan. As telecom companies usually have many common suppliers, the JAC initiative creates efficiencies in the industry as member companies can benefit from shared audit results.[5] The ELFA considers the JAC initiative to be a great programme, which can potentially be replicated in other sectors.

Global Enabling Sustainability Initiative (GeSI)

The GeSI initiative, representing around 40 ICT companies, is committed to sustainability within the ICT sector. It provides members with a forum in which to discuss ideas and share best practice, especially on environmental matters. Members and partners use their collective knowledge and experience to identify opportunities and develop sustainable solutions, for example improving energy and resource efficiency and reducing carbon emissions.[6]

[1] Scope 1 covers direct emissions from owned or controlled sources. Scope 2 covers indirect emissions from the generation of purchased electricity, steam, heating and cooling consumed by the company.
[2] Scope 3 includes all other indirect emissions in a company's value chain, such as business travel, employee commuting, waste disposal, use of sold products, as well as transportation and distribution (up- and downstream).
[3] https://www.ellenmacarthurfoundation.org/circular-economy/what-is-the-circular-economy
[4] https://unfccc.int/climate-action/sectoral-engagement/global-climate-action-in-fashion/about-the-fashion-industry-charter-for-climate-action
[5] https://jac-initiative.com/
[6] https://gesi.org/

UN Global Compact Principles and the OECD Guidelines for Multinational Enterprises

To be credible with its sustainability claims, borrowers mentioned that customers increasingly expect that a business commits to ESG and sustainable principles, requiring more transparency and often certification and external assurances of its policies and practices. Subsequently, more companies are signing up to The Ten Principles of the UN Global Compact and the OECD Guidelines for Multinational Enterprises. These are commitments to uphold ESG responsibilities, for example in human rights, labour practices, environmental sustainability and anti-corruption.

4. There are significant benefits to capturing ESG data early

Conference panellists agreed that bringing in new, good quality ESG information can lead to an improved understanding of a borrower's overall credit risk. Ultimately, investors would like to see dedicated ESG sections within deal offering materials. For this to happen, however, sponsors, borrowers and advisers must capture ESG-related information early on during the deal origination process.

Private equity sponsors shared their perspectives and experiences during the conference, noting without exception that more sponsors are actively embedding ESG factors into their investment decision- and value-creation processes. One sponsor mentioned that ESG was at the back of the slides in the investment presentation five years ago, where it did not receive much attention. Now, however, it has moved to front and centre in how they think about investing.

"Using an ESG lens, we are discovering ways to create additional value." – PE sponsor

Private equity sponsors are increasingly looking through an ESG lens when examining a new company. Their strategy is to identify gaps in a company's ESG/sustainability policies and practices and to then develop plans to address these. In this way, sponsors use ESG as a tool to increase the value of a company. According to one sponsor, a better ESG profile can lead to lower costs, improved cash flow, a lower risk profile, higher profitability and higher growth.

"The ELFA ESG Fact Sheets are very helpful, they kick-started [internal] discussions." – Corporate borrower

The ELFA acknowledges that it may be a daunting process for some borrowers to start collecting, tracking and disclosing new ESG data. Several sponsors and borrowers mentioned that they found the ELFA ESG Fact Sheets to be a helpful way to get started. However, we must emphasise that the ESG Fact Sheets are not viewed as a pass-or-fail test, and we understand that companies are at different stages in their journey to becoming more sustainable and some may have limited resources available.

One investor feared that a consequence of the EU's Sustainable Finance Disclosure Regulations (SFDR) would be that a borrower's failure to disclose adequate ESG information could raise the risk of it being excluded from a fund manager's investment universe. Such exclusion, in their view, would also be detrimental to the investor's portfolio, potentially excluding smaller sized companies with fewer resources and skewing it toward larger-resourced companies more capable of providing better ESG KPI information. On the other hand, being able to disclose ESG information adequately could potentially widen a borrower's investor base, according to the investor.

5. Recent market developments, such as ESG-linked margin ratchets, further illustrate the acceleration of the ESG investing trend

Since the start of 2021, loan investors have reported receiving over twenty European leveraged loans with an ESG/sustainability-linked margin adjustment embedded in the capital structure.

Some investors perceive this latest trend as a positive development as it may encourage companies to raise their ESG profile. However, the lack of a clear market standard has resulted in a wide range of features appearing in loan agreements and presents the risk of a lack of robustness in provisions.

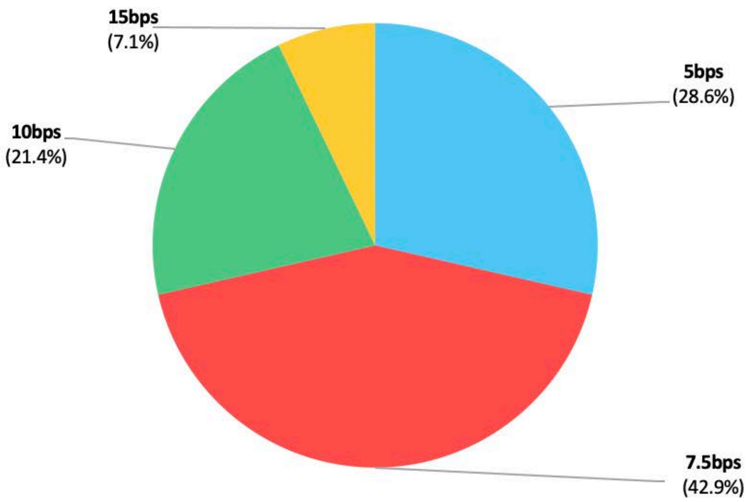
For example, according to a report by Xtract Research, in some deals a borrower can make an irrevocable election that the ESG-linked margin ratchet and related reporting will not apply from a specific date, potentially allowing the borrower to avoid a margin increase if it looks like it won't meet the specified KPIs.

According to a special report from our partners at 9fin, there has been significant variation in many other aspects of these provisions in the deals they have reviewed.

- Margin adjustments range between a maximum of 5bps-15bps, with an average adjustment of 7.8bps.
- Several instances were noted of step-downs based on multiple KPIs / target thresholds in increments of 2.5 to 5bps for each KPI / threshold achieved.
- Some loans refer to only one ESG KPI, whilst others use three or more (illustrated in the pie chart below).
- The criteria used for ESG-linked margin ratchets range widely - sometimes these are linked to external ESG scores, whilst others are linked to meeting ESG/sustainability KPI targets, including environmental KPIs related to recycling or GHG emissions reductions, social KPIs tied to gender diversity and employee work-life quality targets, and governance KPIs related to the presence of a sustainability board champion.
- Some borrowers set targets relative to a static baseline, whilst others are based on year-on-year improvement.
- Some loans provide that KPIs will be automatically adjusted each year, whilst others keep KPI targets static for the duration of the loan.
- Some borrowers are only required to deliver an annual ESG compliance certificate stating whether the KPI targets have been met, whilst others must obtain external verification, in some cases by way of an annual sustainability report delivered with an ESG compliance certificate, accompanied by a verification statement by auditors or another independent qualified reviewer.
- Some deals allow the KPIs to be adjusted for the impact of an acquisition / investment, or exclude their impact and calculate KPIs on a "like-for-like" basis.

Maximum ESG Margin Reduction, YTD April 2021

Source: 9fin.com



"We have declined some transactions that we believe are guilty of ESG-washing." – Investor

Investors, including those within the ELFA, have raised concerns about these recent developments and the potential for greenwashing or ESG-washing. Investors are looking to ensure that these KPIs are meaningful, sufficiently ambitious, objective and measurable targets relevant to the borrower's business. There is a broad consensus amongst investors that ESG KPIs should not be an afterthought or merely business-as-usual.

The ELFA, in collaboration with the LMA, has established a working group to study these practices and has launched a survey to gather investor views. Investors who wish to share their views can complete the survey by clicking here. The survey will close on 14 May at 7pm. We will use the feedback to develop guidance in this area over the coming months.

Conclusion & Next Steps

The ESG Conference was held during a time when the market's discussion about ESG was reaching yet another milestone within the leveraged finance market, with ESG contractual provisions appearing at an increasingly steady pace in leveraged finance documents.

Originators have been initiating discussions with investors about how to appropriately implement such mechanisms, particularly in bond indentures. Meanwhile, borrowers continue to collect and disclose ESG data to satisfy the analytical and regulatory needs of credit investors. In addition, investors are working with advisers and specialists to comply with the new requirements imposed by the SFDR.

The ELFA will continue to support the market by addressing emerging issues in these areas. Our ESG Committee has published nine ESG Fact Sheets as part of our ESG Disclosure Initiative, and will next focus on the healthcare and transport sectors during the ESG Workshop on 19 May, co-hosted with the PRI.

Our survey on ESG contractual provisions referenced above will inform our work with the LMA to develop guidance for the leveraged loan market, and will help us determine the best way to approach equivalent recommendations for the high yield bond market.

The trend toward more sustainable investment practices is transforming the leveraged finance markets at an ever-accelerating pace. Collaboration by market participants is essential to support borrowers and investors and their advisers in areas of data disclosure, ESG contractual provisions and compliance with regulatory obligations.

To refresh the perspectives received during our inaugural ESG Investor Survey from November 2019, we plan to conduct a second such survey later this year. In the meantime, if you encounter issues relating to ESG in your leveraged finance practice, you can contact the ELFA team, or the Co-Chairs of our ESG Committee, Malin Hedman and Tina De Baere.

About the ELFA:

The ELFA is a professional trade association comprised of European leveraged finance investors from over 45 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. The ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit the ELFA's website: www.elfainvestors.com.

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