

Best Practice Guide to Sustainability Linked Leveraged Loans

DILIGENCE

ESG SERIES

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Introduction

With the leveraged loan market increasingly looking to engage with sustainability linked financings, the European Leveraged Finance Association (ELFA) and the Loan Market Association (LMA) have worked with their respective committees to create this Best Practice Guide to Sustainability Linked Leveraged Loans (the “Guide”).

Leveraged loan market participants face unique opportunities to lead the way in sustainability: (i) the asset class lends itself to close relationships between borrowers and lenders; (ii) information reporting can be bespoke (unconstrained as it is by public securities laws); and (iii) investors are already accustomed to performing “deep dives” into borrowers’ businesses. However, loan market investors also recognise the threats posed by “greenwashing” and the need to promote transparency on any sustainability related features of a transaction.

This Guide seeks to provide practical guidance as to the application of the Sustainability Linked Loan Principles¹ (SLLP) to leveraged loans (herein known as Sustainability Linked Leveraged Loans or SLLs), setting out what borrowers, finance parties and their respective advisers should consider when looking to integrate sustainability factors into their facility agreements. For the avoidance of doubt, SLLs are not an asset class of their own. They are leveraged loans to which the SLLP have been applied. This Guide should be read in conjunction with the SLLP and Guidance on Sustainability Linked Loan Principles (SLLP Guidance)².

For the sake of clarity, this Guide is primarily intended for the leveraged loan market on a portfolio company level, and not the sponsor or fund level, where sustainability linked loans are also starting to gain popularity. In principle, the guidance in this document should provide similar support for such facilities; however, it is recognised that there will be differences to the relevant sustainability structure since concepts such as ‘materiality’ of the KPIs and ‘ambitiousness’ of the SPTs should be seen in a different context when at a fund level, where several portfolio companies are included, than on an individual company level. Fund-level loan agreements may also specify applicable ESG-related documentary criteria for financings at their portfolio level, which may impact on the terms of such financings.

Terminology

As with all areas of industry, there is a common language evolving in relation to sustainability. For those new to sustainability, this can seem daunting and act as a barrier to entry. For that purpose, the LMA has put together a Glossary of Terms³ common to sustainability lending products generally.

Roles

Transparency and integrity of the product are of utmost importance when applying the SLLP to any loan transaction. It is therefore no surprise that a number of specialised roles have arisen. In this section, we seek to highlight those roles that might arise in relation to a SLL throughout its life cycle. However, it should be noted that not all of these roles will be required in all circumstances. It will depend on the transaction at hand.

- **ESG rating providers**

Typically engaged by the borrower, possibly at the outset of the transaction, ESG rating providers are independent third parties who issue an ESG rating to the borrower. This rating sets out a borrower’s capacity to integrate and manage the key sustainability issues in its sector of activity, and indicates the degree to which ESG risks are mitigated. Commonly, an accompanying report sets out areas for improvement. An ESG rating provider will not typically provide advice to the borrower in relation to the setting of SPTs. It is for the borrower to share its ESG rating with the syndicate.

An ESG rating provider is likely to have an ongoing role post-signing in re-assessing the borrower’s ESG rating periodically (usually annually) where a KPI refers to the borrower’s external ESG rating.

¹ https://www.lma.eu.com/application/files/5115/8866/8901/Sustainability_Linked_Loan_Principles_VO32.pdf

² https://www.lma.eu.com/application/files/8915/9799/8238/SLLP_Guidance_VO5_pages1.pdf

³ https://www.lma.eu.com/application/files/6016/1192/3656/LMA_Green_Lending_Glossary_VO7.pdf

- **ESG Consultant**

Also known as a sustainability consultant, the borrower may appoint a third party ESG consultant to provide a second party opinion regarding the selection of the borrower's KPIs and how far the borrower is capable of improving its ESG performance. This can help the borrower to identify KPIs which are material to its business and to ensure that it has set suitably ambitious SPTs, thereby ensuring the integrity of the sustainability linked loan product is maintained.

- **Sustainability co-ordinator**

See section 3.C.I Sustainability co-ordinator or sustainability structuring agent of the SLLP Guidance.

- **External Reviewer**

An external reviewer will be appointed by the borrower and will be an independent third party with appropriate expertise and qualifications, such as an auditor, environmental consultant and/or independent ratings agency, which will review the borrower's performance level against each SPT for each KPI. The reviewer will have an ongoing role in the transaction post-signing as reporting and testing of the borrower's performance level assessment against each SPT for each KPI is typically required to take place at least once a year.

Selection and Disclosure of KPIs

Pertinent ESG information should be provided to the prospective lenders by the borrower in disclosure and any relevant marketing materials. This helps the company to demonstrate a pre-existing and meaningful commitment to ESG prior to entering the transaction.⁴ Such disclosure might include provision of an existing ESG report, historical data (if available), third party reports, such as by an independent ratings agency or a consultancy, or internal reporting provisions that can be benchmarked against regulatory standards or taxonomies.

- During the underwriting phase of a deal, there may be instances where flexibility on timing is required. For example, if the financing relates to an acquisition bid the parties, especially target management, may be reluctant to make the investment to agree deal specific KPIs (both from a timing and cost perspective) until there is certainty of the bid outcome.
 - The position may be different if the transaction relates to a refinancing and there are sustainability linked provisions in the existing financing documentation and/or if the target already has KPIs in its existing financing documents.
- It is recommended that KPIs, and the associated SPTs, should be communicated ahead of, or at the time of, marketing the deal for syndication, to allow sufficient time for the prospective syndicate to fully review and, where appropriate, challenge the proposed KPIs, and associated SPTs.
 - Not only is this essential in affording prospective syndicate members time to make an informed investment decision before taking a commitment, but also in ensuring that proposals are robust and ambitious enough to guarantee the integrity of the product and limit greenwashing risks.
- Importantly, the borrower and its advisors should not rush to structure a sustainability linked loan until the company is ready to do so. As required under the SLLP, SPTs must be set before or concurrently with the origination of the loan. If this is not possible, an amendment could be sought at a later date to include the SPTs when ready (subject to e.g. Majority Lender consent).

Market participants should refer to the "Selection of KPIs" section of the SLLP for additional guidance on this point.

⁴ Sustainability linked leveraged loans can be undertaken by companies starting out on their sustainability journey. However, additional time should be built into the transaction timetable to allow for the necessary sustainability strategy discussions, agreeing on the third party scope of work (if applicable), and the planning of deal appropriate KPIs and associated SPTs to take place.



Calibration of SPTs

A borrower's sustainability performance is measured using predefined SPTs, by reference to predefined KPIs. As noted in the SLLP, the "SPTs should be ambitious" and the "KPIs should be material to the borrower's core sustainability and business strategy and address relevant ESG challenges of the industry sector."⁵ In order to ensure that these ambition and materiality criteria are strictly adhered to by market participants, the SPTs set should:

- represent a material improvement in the respective KPIs, focusing on those KPIs which impact the company most, and be beyond a "Business as Usual" trajectory;
- where possible be compared to a benchmark⁶ or an external reference;
- be consistent with the borrower's overall sustainability / ESG strategy⁷;
- be discussed and devised with assistance from a sustainability co-ordinator(s) and an ESG consultant (where appointed); and
- be determined on a predefined timeline, set before or concurrently with the origination of the loan.

Market participants should refer to the "Calibration of SPTs" section of the SLLP for more guidance on this point.

Reporting & Verification

As explored more fully in the SLLP, borrowers should, where possible, make and keep readily available up to date information relating to their SPTs (such as any external ESG ratings), with such information to be provided to those institutions participating in the loan at least once per annum.

Further, borrowers must obtain independent and external verification of the Borrower's performance level against each SPT for each KPI (for example, limited or reasonable assurance or audit by a qualified external reviewer with relevant expertise, such as an auditor, environmental consultant and/or independent ratings agency), at least once a year. Market participants should refer to the "Reporting" and "Verification" sections of the SLLP for more guidance on these points.

Documentation

There is currently no template wording available for use in sustainability linked loan documentation due to the varied and precedent-based nature of this market and, as such, a case-by-case approach will be required. However, there are some important considerations which should be kept in mind when documenting sustainability linked leveraged deals.

Term Sheet

- **Market flex** – ESG provisions should not be subject to any market flex. To allow otherwise would undermine the validity of targets set within the deal, and could result in allegations of greenwashing.

Loan Facility

- **Sustainability-linked margin ratchet** – SLLs typically include a margin ratchet, which is linked to the performance of the borrower against predetermined KPI(s). Generally, the borrower will obtain a premium or a discount to the margin based on its performance against the predetermined KPI(s). Ratchets may include a margin premium if a target is missed or there is backsliding, and the trigger for the margin premium should be set at a suitably ambitious level to avoid a situation whereby there is no realistic prospect of such margin premium ever being triggered.

⁵ SLLP.

⁶ For example, benchmarked against the performance of the borrower's peers; the borrower's own historic performance measured (where possible); regulatory standards or taxonomies in the choice of relevant KPIs; or from goals and objectives set in international agreements, such as the Paris Agreement (countries' nationally determined contributions and the 1.5°C or 2°C temperature rise objective) or the 2030 Agenda on Sustainable Development (Sustainable Development Goals).

⁷ The SPTs should be set based on the sustainability strategy of the entire borrowing group, where applicable. When ESG lending is sought at the fund level, relevant material KPIs might include, but are not limited to, governance topics on the fund owned companies.



- **Fallbacks** – parties may wish to consider including fallback mechanisms in case SPTs cannot be calculated or observed in a satisfactory manner. Parties may also wish to consider whether provisions are required to govern what happens in exceptional events, such as a significant change in parameters through material M&A activities or extreme events, including drastic changes in the regulatory environment that could substantially impact the calculation or scope of the KPI or SPT.
- **Breaches** – whilst there is currently no established market standard in relation to what will constitute a “sustainability” breach, this should be clearly documented in the facility agreement in respect of each deal. Whilst a failure to meet the SPTs does not typically constitute an event of default under the facility agreement, an economic impact could result, e.g. a margin premium. Inaccurate reporting (or failure to deliver information) on the borrower’s SPTs might constitute a breach if not remedied within a set period of time and may, in some cases, give rise to an event of default. Whether delivery of inaccurate information results in an event of default is, however, typically left to the interpretation of the standard reporting representations and covenants in the facility agreement, although it should be noted that inaccurate reporting will not always be a consequence of a failure to meet the SPTs.

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.

About the LMA:

The LMA is the trade body for the EMEA syndicated loan market and was founded in December 1996 by banks operating in that market. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 750 organisations across over 65 jurisdictions and consists of banks, non-bank investors, law firms, rating agencies and service providers. The LMA’s overall mission is to act as the authoritative voice of the EMEA loan market vis à vis lenders, borrowers, regulators and other interested parties. www.lma.eu.com

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