European Leveraged Finance Association

INSIGHTS

7 July 2021

The Emergence of ESG Provisions in Leveraged Finance Transactions

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Inside this issue...

ESG Provisions in High Yield Bonds and Leveraged Loans

Investors' Views

Forthcoming Guidance on Sustainability-Linked Leveraged Loans

Next Steps and Request for Feedback

7 July 2021

The Emergence of ESG Provisions in Leveraged Finance Transactions

Executive Summary

- Provisions linking a borrower's performance on environmental, social and governance (ESG) factors are increasingly appearing in high yield bonds and leveraged loans.
- As part of our mission to support strong market practices in disclosure, transparency and engagement, the European Leveraged Finance Association (ELFA) has been working with members and other market participants, including the Loan Market Association (LMA), to examine this nascent trend.
- In this Insights report, we describe emerging trends in key features across both high yield bonds and leveraged loans, in particular with respect to Sustainability-Linked Bonds (SLBs) and Green/Sustainable/Social (GSS) Bonds and ESG-linked margin ratchets in leveraged loans.
- We conducted a survey of credit investors on ESG provisions in leveraged finance transactions in order to identify areas where we could support best practice.
- The survey revealed a number of important issues, including a divergence in opinion amongst investors on the justification for greeniums, their views on the sufficiency of current coupon step-up levels and the need for strong reporting and verification of ESG key performance indicators (KPIs).
- We plan to use the survey results to support continued engagement on these issues with relevant market participants, industry bodies and regulatory agencies.
- We also summarise the key points covered in our forthcoming guidance developed with the LMA on sustainability-linked leveraged loans (SLLLs), which is designed to support the growth of ESG investing in the leveraged finance market whilst guarding against potential greenwashing risks.

Introduction

The leveraged finance market is undergoing a seismic shift in approach to ESG and sustainability. Appearing first as a result of end-client demand and emerging regulatory requirements, the trend has seen an increased focus on analysing credit risk through the lens of ESG factors, which we have reviewed in our previous Insights reports on the topic.

We used responses to our first ESG Investor Survey in November 2019 to guide our work in this area, initially focusing on the lack of relevant data and disclosure by leveraged finance borrowers in collaboration with the Principles for Responsible Investment (PRI).

During a series of ESG workshops, conducted with the PRI as part of their Credit Risk and Ratings Initiative, we discussed material ESG risks with borrowers, credit analysts and credit ratings agencies on a sector-level basis.

Over the course of three workshops covering 12 sectors and attracting hundreds of participants, together with the PRI we published sector-specific ESG Fact Sheets to guide company disclosure on ESG topics.

The resulting increase in ESG datasets has precipitated the emergence of leveraged finance provisions that financially incentivise borrowers to improve their sustainability profiles – a trend that we explore in this Insights report.

To gather more information about credit investors' experience with these provisions, we recently conducted a survey that received over 170 responses from across asset allocators, ESG specialists and others in the high yield bond and leveraged loan market. The results reveal a number of interesting issues that we summarise in this report. We will use the survey results to guide our continuing work in this area.

Finally, we also summarise the key points covered in our forthcoming guidance on SLLLs, developed with the LMA. The guidance will support best practice amongst market participants looking to employ ESG provisions in SLLLs, including how to calibrate SPTs that are ambitious and material, when and how to disclose the borrower's proposals in deal documentation, and why readily available, up-to-date and externally verified information on SPTs is critical to guarantee the integrity of the product and limit greenwashing risks.

7 July 2021

ESG Provisions in High Yield Bonds and Leveraged Loans: A review of key features and emerging trends

High Yield Bonds – Sustainability-Linked Bonds and Green/Social/Sustainable Bonds

Genesis

Sustainability-Linked Bonds ("SLBs") first appeared in the bond market in September 2019, pioneered by Enel, an investment grade rated Italian provider of electricity and gas. At the time, Green/Social/Sustainable Bonds ("GSS Bonds") were growing in popularity amongst investors due in large part to transparency conferred by the requirement that proceeds be applied directly to GSS projects.

While this feature provided greater transparency to investors, borrowings tied to specific projects or capital expenditures restricted the use of GSS bonds to companies with sizeable enough capital requirements for green or social activities. Another problem for sustainable bond investors was that while GSS bonds might promote sustainability at the project level, they do not necessarily engender accountability for an overarching sustainable corporate strategy.

Theoretically, SLBs are structured in a way that overcomes these hurdles – rather than being tied to specific projects, they financially incentivise issuers to achieve greater sustainability at the corporate level by imposing an increased coupon ("coupon step-up") should the borrower fail to achieve Sustainable Performance Targets ("SPTs") set at issuance.

Enel issued its inaugural US dollar-denominated SLBs in in September 2019 and then followed with three euro-denominated tranches in October 2019. These latter euro-denominated SLBs maturing in 2024 and 2027 were issued with 0% and 0.375% coupons, respectively, and included a 25 basis points (bps) coupon step-up triggered by failure to reach a renewable energy installed capacity goal measured in December 2021.

Most recently in June 2021, Enel came back to the market to issue three more euro denominated SLBs with a consistent 25bps coupon step-up. In the event that Enel missed all of its targets across their SLBs, the annual interest expense on these bonds would increase by approximately 28%, which creates a financially material incentive for Enel to achieve these sustainable targets, thereby increasing management's accountability to its sustainability commitments.

KPIs and Target Levels

Despite the rapid emergence of SLBs, just eight deals have been printed in the European high yield market so far this year. Given the infancy of the market, KPIs and financial conditions are continuing to develop. We have summarised below the key features of the SLB market to date.

Type of SPTs: Although the most common criteria relate to greenhouse gas (GHG) or waste reduction, other conditions like an increase in the use of recycled products have also been used as SPTs.

Number of SPTs: Most companies have come to market with one or two criteria.

Target levels: Most deals contain a midterm sustainable target set for 2030. However, given the call schedule of high yield bonds, SPT test dates are set from one year to four years to match the typical call structures and maturities of the debt issues. While many issuers are taking the initiative to provide a science-based 2030 target verified by a third party, it still remains to be seen whether the SPT test dates, which are set at the issuer's discretion, are truly sustainable milestones or merely easy-to-achieve targets.

Impact on SLB Economics

Range of economics: Five deals have come with as low as 12.5bps per SPT to one deal extending to 50bps. Most deals provide for a par plus 50% step-up coupon if the issuer fails to meet the SPTs or if the SPT date falls after the first call date.

Mechanics: If the issuer fails to meet its SPT by a specified date, the coupon will increase or step-up.

Most deals provide for the SPT test date to be close to the first call date; however, some deals also provide for an SPT date that falls after the first call date. Unless the call price is set at a materially higher level, this undermines the SLB structure completely.

Same credit risk, tighter pricing: Market conditions have resulted in another economic benefit of SLBs for issuers, as coupons are being set 10–25bps inside the existing curve due to investor demand outweighing current supply. This results in guaranteed lower cash interest expense regardless of whether the sustainable target is met.

Other Provisions and Considerations

Verification and reporting: Most issuers plan to report yearly as part of their annual sustainability report. However, we note that there is an absence of reporting covenants tied to SPTs. Therefore, issuers lack the contractual obligation to report SPTs.

Default provisions: So far, failure to meet an SPT will not trigger a default.

Use of proceeds: The issuer's use of the funds is not required to relate to the sustainability target. Many issuers have used proceeds from SLBs to redeem existing debt or for general corporate purposes. We have even seen an instance where proceeds were used to pay dividends to shareholders.

SLBs vs GSS bonds: As noted above, SLBs are arguably better suited to the high yield market than GSS bonds, which contain size and capex constraints that pose challenges for smaller companies and those operating outside of the power and energy sectors.

Accountability: The shift in SLBs from the investment grade to the high yield universe also presents opportunities for utilising covenants in order to increase accountability for achieving the sustainable targets. However, SLBs are difficult to structure due to the shorter tenors and callability of high yield bonds.

Leveraged Loans – ESG-linked Margin Ratchets

Genesis

While the first ESG/sustainability-linked margin ratchet appeared in the syndicated leveraged loan market in MásMóvil's May 2019 deal, the trend firmly took hold at the end of 2020. Supported by investors' increasing focus on ESG, this can be seen as a natural next step for the leveraged finance market following the emergence of Green Bonds and SLBs.

KPIs and Target Levels

The recent focus on these provisions has led to a range of different KPIs and financial conditions coming to market. We summarise some of the key themes below:

Type of KPIs: Although the most common criteria relate to GHG or waste reduction, we have seen other conditions such as an ESG rating or having female representativeness at management or board level as well as patient satisfaction, encompassing all of the E, S and G aspects.

Number of KPIs: So far, most companies have come with a set of two to four criteria, with targets to be achieved over five to six years. Few borrowers have come with a criterion that is static or binary such as the publication of an ESG report (only one has appeared so far).

Target levels: Again, given recent focus and nascent market, it is difficult to properly assess and compare levels of ambition, although we note some of the target levels have already been achieved in the past or have flat-lined after two years, as opposed to demonstrating year-on-year improvement.

Impact on Economics

Range of economics: Depending on the number of criteria achieved, in a similar way to a traditional margin ratchet, the company is granted a premium or a discount to margin, ranging from +/-2.5bps to +/-15bps. Again, no standard has been established and we await harmonisation.

Mechanics: The application of such premium/discount to margin can differ significantly, and this may depend on the number of KPIs to be achieved. For example, to achieve a margin reduction of 7.5bps, a borrower may be required to meet all four KPIs, but the margin is not increased by 7.5bps unless none of the targets are achieved.

Some more complex structures include specific adjustments for each of the KPIs – for example, applying a premium but no reduction with respect to one KPI, whilst others are set to go both up and down depending on whether the trigger is met.

Other Provisions and Considerations

Verification and reporting: The vast majority of the ESG/sustainability-linked margin ratchets require the release of an ESG report to the lenders (as a condition precedent to the adjustment of the margin rather than as a KPI). These sometimes include a third-party review of the targets by an ESG expert.

Default provisions: Unlike the typical margin ratchet, this feature has not yet been introduced.

Use of interest savings: So far, one-third of borrowers have endeavoured to apply interest savings to ESG projects.

Timing of KPI disclosure: Whilst most of the targets are presented at term sheet stage of deal syndication, some borrowers have not provided sufficient information, including KPIs and related levels, before investors must commit to the deal. Some will even permit the borrower to agree KPI levels with the agent (not necessarily the lenders) after syndication.

Investors' Views: ELFA Investor Survey on ESG Provisions in Leveraged Finance Documents

The ELFA recently conducted a survey of credit investors in Europe to gather their views on the emergence of ESG provisions in high yield bonds and leveraged loans. The survey sought investors' views on determining ESG KPIs, which parties should be involved in setting them, and how investors and borrowers should think about measurement, disclosure and verification of KPIs, among other important issues.

More than 170 participants took part in the survey with the vast majority (85%) being asset allocators (portfolio managers/research analysts). Half of the respondents cover both leveraged loans and high yield bonds and most respondents (90%) currently own instruments that incorporate ESG provisions.

We set out below some of the key themes that emerged from the survey.

7 July 2021

High Yield Bonds

Diverging Views on Greeniums

Respondents have diverging views on whether "greeniums" are justified in SLBs and GSS bonds – around half of respondents believe that they are justified if the structure and targets are robust and credible. Fifty-one percent of respondents believe greeniums are justified in GSS bonds and nearly 55% believe that a similar premium is justified for SLBs.

Interestingly, 13% of those answering that they believe greeniums are justified in GSS bonds answered that they do not believe a premium should be applied to similarly robust and well-structured SLBs.

One respondent commented that "most companies seem to be issuing SLBs to refinance other debt using the 'greenium' benefit ... the connection to new sustainability targets and/or going beyond what is already being done is tenuous."

"We run a number of ESG mandates, none of which give any credit to sustainability linked bonds. It's the firm's ranking across E, S and G that determines an investment's eligibility. There is no extra credit for issuing a green bond or SLB."

Coupon Step-up – 25bps Is Not Enough

Whilst the current market standard for a coupon step-up is 25bps, 75% of survey respondents do not believe this is high enough. Using the proportion of the coupon step-up to the coupon as a gauge of financial materiality, at this level it is as low as 5% and only reaches 15% at its highest, compared to the 28% seen in Enel's original investment grade SLB. Despite this comparatively low level of financial materiality, 25bps is the coupon step-up used in seven out of eight SLB deals in the European high yield universe.

Out of our survey respondents, 39% answered that a coupon step-up of between 25–50bps is appropriate whilst 30% answered that it should be larger than 50bps or equivalent to 20–50% of the final coupon.

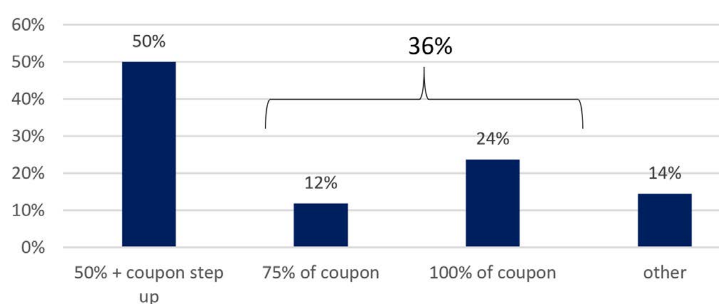
It is clear from the survey that investors believe 25bps is not sufficient – how much higher the step-up should be is an ongoing debate.

"The step-ups have been too low. SLBs are being used by "polluting" companies to reduce cost of funding and attract investment, they need to be more impactful to cover for the fact that they screen badly on coal, emissions, etc."

Gaming KPI Testing Whilst Reaping Greeniums?

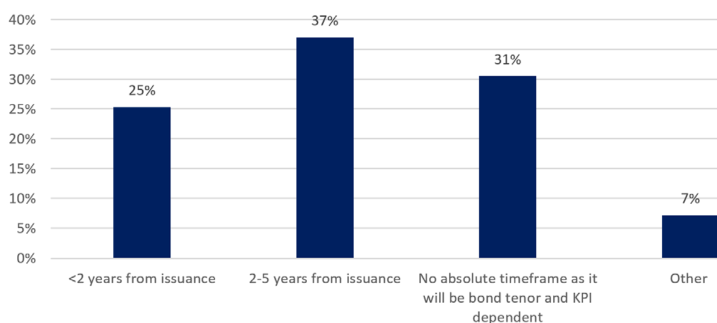
The survey responses suggest concern among investors that some companies may be able to reap the benefit of greenium-style interest savings whilst still avoiding meeting, or even testing, KPI targets by issuing bonds that are callable before the KPI target date.

When asked what the cost of calling the bond should be if the non-call period ends before KPIs must be tested, half of respondents chose 50% plus the coupon step-up. Thirty-six percent of respondents chose a call price of either 75% or 100% of the coupon, whilst nearly 15% chose the "other" option.



Despite these concerns, investors do appreciate that this will be case dependent. Indeed, 37% of respondents answered that two to five years is an appropriate timeframe for a borrower to test KPIs, with 25% choosing less than two years (which would almost certainly fall within the non-call period) and just over 30% choosing "no absolute timeframe as it will be bond tenor and KPI dependent".

"Pricing needs to be more aggressive (make it material for borrowers). Timelines need to be much more actionable (2–5 years). And reporting needs to be robust (at least annual and methodology in detail)."



External Verification and Robust Reporting Desired

The survey responses highlight that robust reporting and external verification are important to investors.

Asked if external verification on KPI selection and targets should be required pre-issuance, 72% of respondents chose yes, whilst 26% of investors would go without as long as there is strong disclosure on the internal expertise and methodologies used to arrive at the set KPI target.

Almost all respondents (96%) answered that issuers should report their progress on KPI targets at least annually, with some commenting that reporting should be made with the same frequency as a borrower's financial reporting. This may be a cause for concern for issuers – many currently report ESG information only once a year, or even less, and highlight the time-consuming nature of ESG-related KPI data collection.

Investors clearly want issuers to be accountable under their covenants for reporting on SPT targets – 95% of respondents answered that SPT reporting should be linked to reporting covenants, with less than 3% answering that this should be at the issuer's discretion.

"If ESG KPIs can impact coupon, then it should be linked to externally-audited data that is included in annual reporting."

Effective Engagement – Asking the Right Questions

With ESG provisions appearing more frequently in fixed income instruments, 96% of our survey respondents agree that a standardised questionnaire (similar to the ELFA's [New Deal Disclosure Questionnaire]) would support discussions with borrowers about provisions in green/sustainability/ESG-linked products.

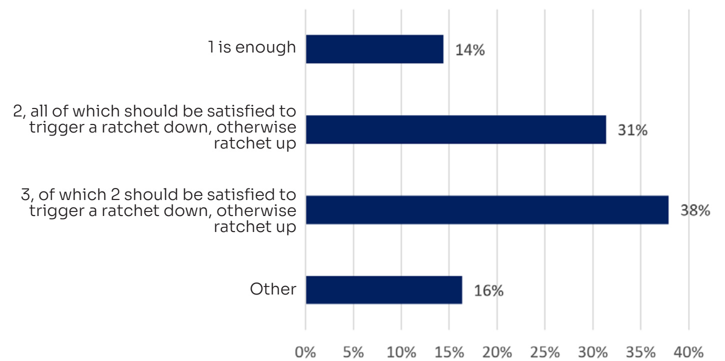
We are in the process of drafting a resource to support strong engagement on ESG provisions in both high yield bonds and leveraged loans.

Leveraged Loans

Structuring Margin Ratchets

There is a preference amongst survey respondents (63%) for ESG-linked margin ratchet provisions based on a relevant set of KPI as opposed to 30% who prefer for these to be linked to third-party ESG ratings.

Asked how many criteria should be contained in an ESG-linked margin ratchet provision, less than 15% answered that one is enough. The remaining responses were split between two and three KPIs, with nearly 70% answering that at a minimum two should be satisfied to trigger a margin reduction.

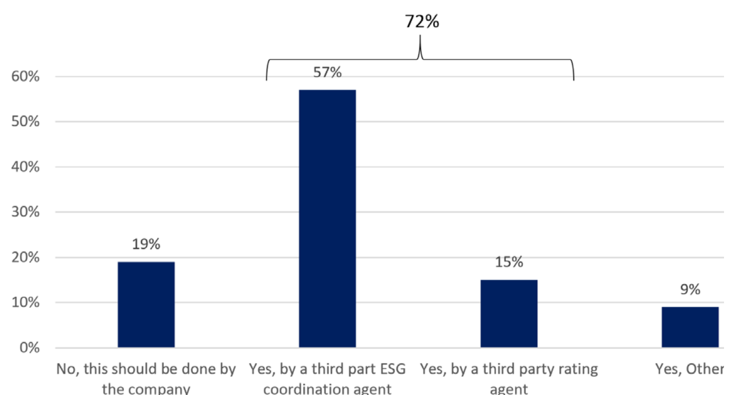


Setting, Verifying, and Reporting KPIs – Investor Engagement and Verification Are Key

Given that ESG criteria and KPIs are at a relatively early stage of evolution, some investors are ready to roll up their sleeves and provide feedback to companies setting targets.

Thirty-two percent of respondent believe that investors should have the opportunity to input on relevant KPIs before committing to a deal, with almost 37% answering that "investors should, at a minimum, be involved by way of a call with the borrower's head of ESG/sustainability coordinator". On the other hand, 32% believe that this is the job of the arranger/sustainability coordinator.

Overall, more than 70% of respondents agree that a third party (56% choosing an ESG coordination agent and 15% choosing third party rating agent) should be involved in setting KPIs initially.



An even higher percentage (87%) would like to have KPIs audited by external parties annually.

Regardless of who is choosing the KPIs, 70% of respondents answered that targets should be meaningfully higher than historical levels, with just 22% answering that this should be based on the last achieved number.

Further, respondents believe borrowers should be held accountable for not providing reporting or third-party verification: 82% of respondents think a margin step-up should be applied if a company does not provide an ESG/sustainability report or third-party confirmation.

"I think going forward, it's crucial to see targets that fall outside of the business plan scope. The KPIs calculation should be provided to investors. The failure to report these KPI targets should be subject to a margin step-up. Savings for these margin ratchet should be fully reinvested in ESG efforts."

Using Cost Savings – Invest in Sustainability or Leave it to Company's Discretion?

The majority of respondents believe savings should be reinvested in sustainability. Asked what should be done with savings obtained through margin ratchet step-downs, 66% of respondents believe that proceeds should be at least partially reinvested into ESG-focused projects, whereas 28% believe that this should be left to the company's discretion.

Investors Agree – ESG KPIs Should Be Disclosed Before Investors Commit, and ESG Provisions Should Never Be Flexed

When asked whether all relevant KPI information should be determined and disclosed before investors commit to a deal, 96% of respondents answered yes. This confirms our view and will be reflected in guidance designed to support best practice in this rapidly evolving market that we have been developing with the Loan Market Association over the past few months, described further below.

In addition, almost 90% of respondents said that it would not be appropriate to flex ESG KPIs in the event that a deal has strong demand.

Forthcoming Guidance on Sustainability-Linked Leveraged Loans

Working groups within the ELFA and LMA have been collaborating on guidance to support best practice amongst market participants when incorporating ESG provisions into leveraged loan agreements, referred to as "Sustainability-Linked Leveraged Loans" or SLLLs. We are in the process of finalising this guide, which will cover terminology (cross-referring to the LMA's Green and Sustainable Lending Glossary of Terms), roles, selection and disclosure of KPIs, calibration of KPIs, reporting and verification, and documentation.

The best practice guidance sits underneath the recently-updated Sustainability Linked Loan Principles (SLLP) and related Guidance.

The guidance will describe a number of specialised roles that have emerged, including ESG rating provider, ESG consultant, and sustainability co-ordinator. In addition, with respect to selection and disclosure of KPIs, the guidance will recommend that pertinent ESG information be provided to prospective lenders in deal disclosure and marketing materials. This would provide sufficient time for the prospective syndicate to review and engage with the borrower on proposed KPIs. This approach will facilitate informed investment decisions by investors before they commit, and also help to ensure that the borrower's proposals are robust and ambitious enough to guarantee the integrity of the product and limit greenwashing risks.

The guidance will explain how to calibrate SPTs that are ambitious and material to the borrower's core sustainability and business strategy, in line with the SLLP. In addition, the guidance will encourage borrowers to make and keep readily available up-to-date information relating to their SPTs so that this can be provided to lenders at least once per annum. Borrowers are also required to obtain independent and external verification of their performance level against each SPT for each KPI, at least once each year.

The ELFA and LMA also plan to update their Guide to ESG Disclosure in Leveraged Finance Transactions to reflect this guidance along with recent market trends and key considerations relevant to the chapter covering ESG contractual provisions.

Next Steps and Request for Feedback

We will continue to work with our members, trade associations and other market participants to publish resources that will support best practice as the leveraged finance market continues to borrow principles from sustainable finance.

We would like to hear feedback from the market. If you have experience with these instruments and would like to share your input, or would like to get involved in these projects, please contact our CEO, Sabrina Fox, at sfox@elfainvestors.com.

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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