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The Disappearance of ESG-Linked Margin Ratchets – Will They Return?

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Executive Summary

- The European leveraged finance market has observed the ESG loan margin ratchet trend fade as A&E execution has taken precedence.
- Covenant Review's data indicates that through the first half of 2023, an environmental KPI remained the most common form of test, with a focus on greenhouse gas emissions; the services sector – a large cohort within the European borrowing base - saw the greatest proportion of leveraged loans including a KPI ratchet, at 50% of ESG-related loans.
- The report highlights the lenders' qualms about the value of ESG-linked ratchets, as well as the tightening standards from industry bodies that also contribute to the trepidation of borrowers and lenders about disclosure and the perceived threat of litigation.
- It further explores issues relating to the KPI-linked ratchets and the likelihood that ratchets will reappear as dealflow recovers.

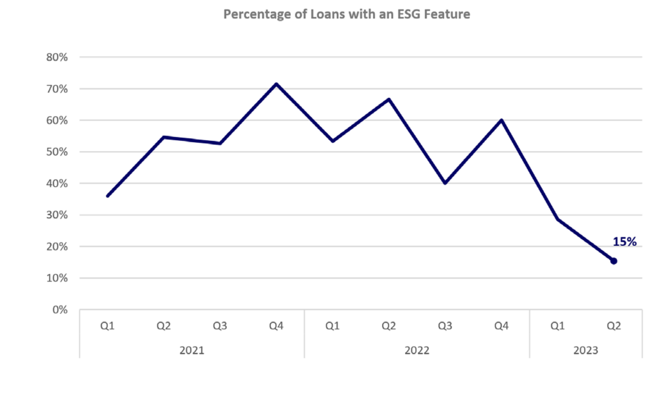
Introduction:

2023's deal flow has been heavily dominated by amend to extend (A&E) requests, with A&E and refinancing facilities making up 78% of loan issuance in H1 2023, and the second half starting off along similar lines. With a scarcity of fresh deals, and with the focus on execution against a tough economic backdrop, KPI-linked margin ratchets have been scarce, giving lenders space to consider their future purpose. This report focuses on trends across the KPI-linked ratchets in the past deals set against greenwashing fears and the newer requirements under CSRD.

ESG loan margin ratchet trend fades as A&E execution takes precedence, giving lenders space to debate their future purpose

European investors have seen fewer deals with explicit links to ESG targets so far this year, compared with recent years when enthusiasm for linking financing costs with responsible corporate behaviour was in its first flush.

Only 15% of loans tracked by Covenant Review in the second quarter of 2023 had an ESG margin ratchet, down from 29% in the first quarter and sharply lower than the 50-70% recorded in nearly every quarter in 2021 and 2022.



Source: Covenant Review, A Fitch Solutions Service

This raises the question of whether the step-back points simply to a hiatus or a change of direction.

The evidence of H1 2023 suggests that lending activity specifically linked to ESG targets is still enmeshed with market conditions, rather than existing on its own merits.

Industry experts note that the quick execution of a transaction is often the dominant concern when markets are volatile, taking precedence over the time-consuming and highly-involved process of developing ambitious KPIs for sustainability-linked loans.

2023's deal flow has been heavily dominated by amend to extend requests, with A&E and refinancing facilities making up 78% of loan issuance in H1 2023. The second half has kicked off with more of the same.

This has taken the place of the previously flourishing and borrower-friendly LBO scene, in which deals were based on newly-minted and innovative documentation terms. However, as the A&E trend got underway, there was considerable anxiety about how these borrowers would fare in the face of a shrinking pool of active CLO buyers.

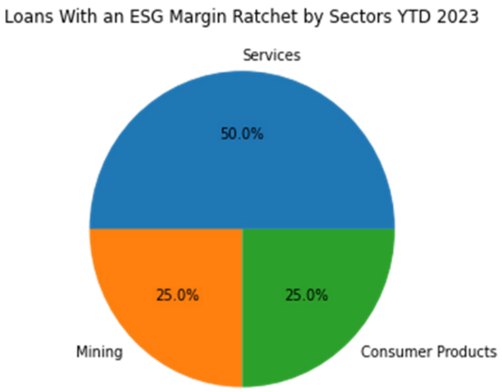
Arching over all this, inflation and rising rates have made the economic backdrop generally unfriendly. Liquidity is tighter, debt is expensive, and the technical bid for floating-rate paper has not been well supported by fresh CLO issuance.

This has left arrangers and sponsors extremely wary of botching a transaction, and consequently market participants report that sustainability-linked features have moved down the priority list.

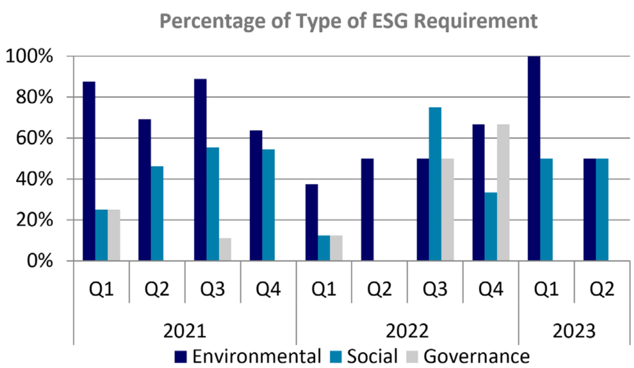
Borrowers are understandably focussed on inflation and energy costs to the exclusion of sustainability topics. For lenders, this is unfortunate as ESG can be useful for companies by helping their bottom line.

What's in, what's out

Albeit with a limited number of deals including an ESG-related feature, Covenant Review's data indicates that YTD 2023, the services sector saw the greatest proportion of leveraged loans including such a feature, at 50% of ESG-related loans. Of course, this also reflects the large proportion of service-based leveraged loan borrowers in Europe more generally.

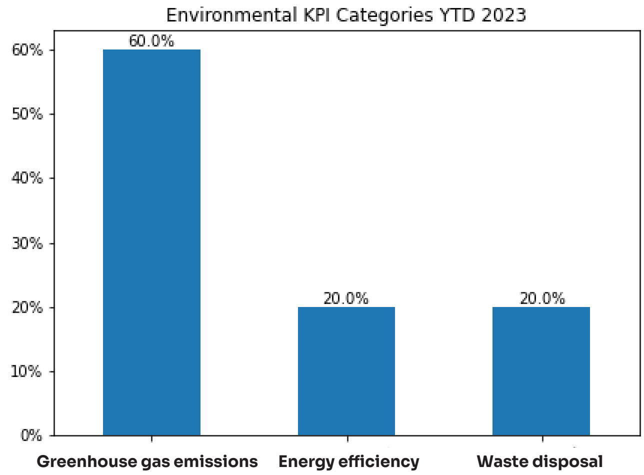


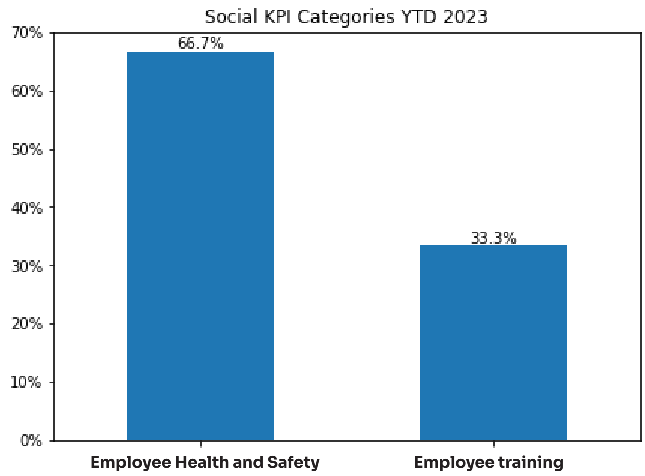
An environmental KPI remains the most common feature, where 2023 has seen the disappearance of a governance-based KPI – perhaps deemed to be the pillar the most sensitive to perceived greenwashing since proper governance is generally considered to be in the ordinary course of any good business.



Source: Covenant Review, A Fitch Solutions Service

Across the environmental KPIs, a reduction in greenhouse gas emissions remains the most prevalent, representing 60% of environmental related KPIs, with an environmental KPI tied to an improvement in energy efficiency the next most common. KPIs related to social targets have largely been tied to improving employee health and safety standards. Thereafter, and in line with the services-heavy European borrower market, increasing hours of employee training has been the most frequent KPI.





Pushed back

In a small number of instances this year, private equity sponsors attempted to include new ESG-linked language in the documentation of loans they were extending, and in some cases lenders took a dislike to the terms and pushed back.

Even before this year, lenders were jaded by borrowers proposing light-touch ESG targets that are too easy to hit. They found that pushing back on these in the face of a heavy technical bid was difficult - but that's no longer the case.

Now when a deal is labelled ESG or sustainable, it must make sense. Fund managers have noted that in the last 24 months a number of deals included KPI ratchets that were considered unsuitable and as such lenders dropped out of deals if the sponsor was unwilling to amend terms.

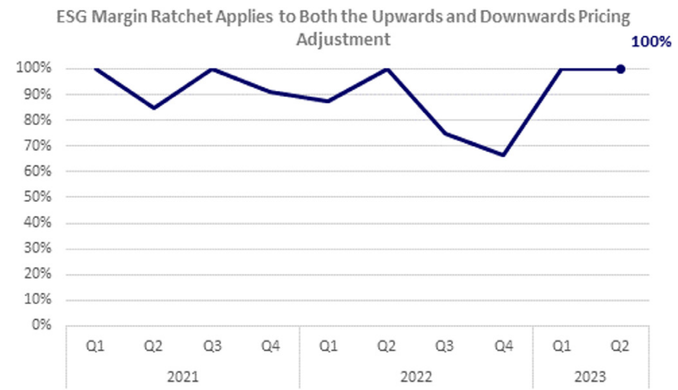
Resistance to meek targets goes beyond lenders simply feeling short-changed: there is a risk of reputational damage over potential greenwashing, undermining the whole concept of responsible lending.

Tightening standards from industry bodies also contributes to the trepidation of borrowers and lenders about disclosure and the perceived threat of litigation.

While market participants feel strongly about greenwashing risk, investors in the high-yield market had a comparatively mild reaction when an issuer announced earlier this year that it missed an emissions reduction target. This came in the shadow of the energy crisis triggered by the war in Ukraine.

At the time, Fitch Ratings described this as a "limited impact" on the debt cost, and added that it expects investors to take the view that it is unrelated to the issuer's "operating performance, a change of strategy, or a weakening of its sustainability focus." The missed target triggered a 50bps step-up in its coupon to 4.375%.

In terms of penalties, Covenant Review data shows that all H1 2023 loans with ratchets will penalise a target missed, as well as rewarding a target hit. The data is thin, but that hints at a shift from last year when there was a creep in the second half of the year towards ratchets that moved only one way.



Source: Covenant Review, A Fitch Solutions Service

Some investors welcome missed targets as well as achieved targets, since the former could indicate such targets were indeed set at ambitious levels and not merely selected as low-hanging fruit. Such events bring credibility and integrity to ESG-linked structures.

KPI-based ratchets: a red herring or a red flag?

Going forward, there is a school of thought among some investors that margin ratchets linked to KPIs are not the right way to corral borrowers into sustainable and responsible behaviour.

Some view KPIs as a bit of a red herring, as they may distract borrowers from the broader issues, instead forcing them to pick two or three things that are not as effective at supporting sustainability as a comprehensively considered ESG strategy would be.

Having been a good way of focusing attention on ESG principles initially, now the expectation around the disclosure of information is that adherence to regulation has taken over as the driving force, and it's this that will enable lenders to assess the ESG qualities of their portfolios.

Funds complying with Europe's Sustainable Finance Disclosures Regulation (SFDR) under Articles 8 and 9 must include transparent sustainability indicators, with some opting to use the principle adverse impact (PAI) indicators. Borrowers have to follow the Corporate Sustainability Reporting Directive (CSRD) in disclosing sustainability data. The latter was signed in January, and EU member states have until June next year to sign it into their national laws.

For the time being, there is no expectation among market participants that loan documentation will mandate ESG disclosure, aside from that relating to KPIs, or that failure to disclose sustainability data would be a possible event of default trigger. This may be in part due to existing and emerging regulatory requirements mandating such disclosure.

Per Covenant Review data, no deals to-date have included a separate default trigger for the specific failure to provide sustainability-related reporting, although of course, to the extent that a sustainability report (and/or audit) is included as a provision under the Information Undertakings of the credit agreement, then like any failure to provide reporting on time and subject to a grace period, a default could arise. In that respect, Covenant Review has seen a borrower seek to amend its contractual reporting requirements to ensure that the failure to provide sustainability related reports will not inadvertently trigger a default.

In light of private equity's ownership of many leveraged finance issuers, any company looking to become publicly listed should conform to public company requirements well in advance.

In a move towards framing how sustainability and lending should intersect, the Loan Market Association in May published model provisions for sustainability-linked loans, as a basis to support negotiations around an SLL.

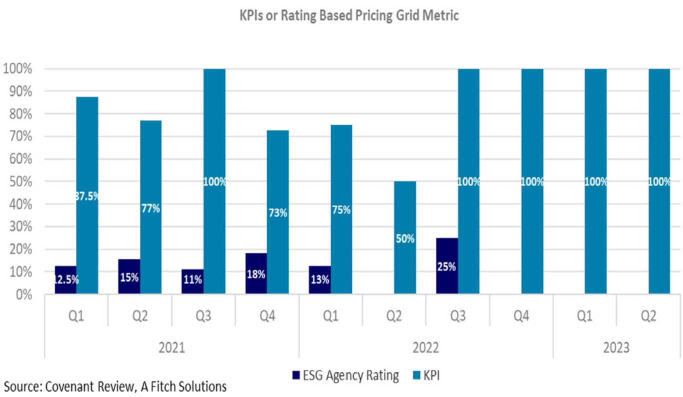
Ratchets return

But while KPI-linked ratchets have been flawed in the past, some market players expect them to reappear when primary deal flow brings more M&A financing.

This is in part due to lenders' appetite for the concept, which triggers information flow in respect of covered ESG topics. However, lenders note that targets must make sense in the context of the borrower's business, and the market is moving away from negative screening to positive screening.

As regulators and supranational bodies develop their approaches to sustainability, more widely-accepted standards should emerge. For instance, the establishment of the Science Based Targets initiative (SBTi) may improve the credibility of a borrower's chosen environmental KPIs.

Covenant Review's data indicates that where targets are being placed within the finance document, KPIs remain almost universally favoured over rating-based targets (again, bearing in mind that new deal flow is very thin on the ground).



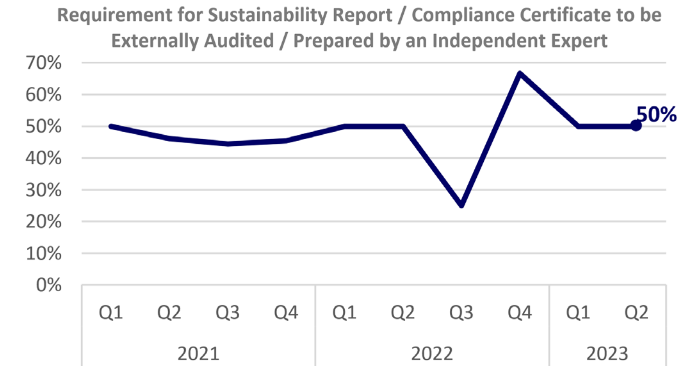
Source: Covenant Review, A Fitch Solutions

Advisers also see ESG-linked ratchets reappearing as the pipeline strengthens.

Disclosure continues to be critical for trade bodies and regulators, and the expectation is that economic penalties and rewards will return as a primary feature of the SLL market, particularly following publication of the LMA rider.

Among the small number of ratchets appearing this year, there already seems to be a tougher attitude towards how information is provided. In a change from last year, all of 2023's KPI-linked loans carry an automatic pricing increase if the borrower fails to meet reporting/ certification obligations, and all require an initial and annual sustainability report/certificate – although still only half from an external body.

Source: Covenant Review, A Fitch Solutions Service



Source: Covenant Review, A Fitch Solutions Service

But, in themselves, increased regulation and tighter KPIs don't necessarily bridge the gap between box-ticking and properly fulfilling the principles of sustainable lending, according to market participants. Lenders now require targets that are relevant and material created in the context of the borrower's overall sustainability strategy, alongside robust reporting and transparency.

About ELFA:

ELFA is a professional trade association comprised of European leveraged finance investors from over 60 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 ELFA's website: www.elfainvestors.com.

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