

Best Practice Guide to Sustainability-Linked Leveraged Loans

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Introduction

With the leveraged loan market increasingly looking to engage with sustainability-linked financings, the European Leveraged Finance Association and Loan Market Association (LMA) have worked with their respective committees to update this Best Practice Guide to Sustainability-Linked Leveraged Loans (the Guide). Since the first publication of the Guide in June 2021, the Sustainability-Linked Leveraged Loan market has grown significantly. We are publishing an update to this Guide in line with the market development to uphold best practices.

Leveraged loan market participants face unique opportunities to lead the way in sustainability: (i) the asset class can lend 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 SLLLs), setting out what borrowers, finance parties and their respective advisers should consider when integrating sustainability factors into their facility agreements. For the avoidance of doubt, SLLLs are not an asset class of their own. They are leveraged loans to which the SLLP, and the five core components of (i) Selection of Key Performance Indicators (KPIs); (ii) Calibration of Sustainability Performance Targets (SPTs); (iii) Loan Characteristics; (iv) Reporting; and (v) Verification, have been applied. This Guide should be read in conjunction with the SLLP and Guidance on Sustainability-Linked Loan Principles (SLLP Guidance).² All loans originated, extended or refinanced after 9 March 2023 should fully align with the revised version of the SLLP, if they are to be classified as a SLLL.

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 the ‘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 criteria for financings at their portfolio level, which may impact 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 generally common to sustainability lending products.

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 several specialised roles have arisen. In this section, we highlight those roles that might arise in relation to a SLLL 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.

- **Sustainability coordinator**

A sustainability coordinator can play a key role in assisting parties looking to align a SLLL transaction to good market practice. On a SLLL, the sustainability coordinator is appointed by the borrower and will generally assist the borrower in selecting and negotiating the relevant KPIs and the related SPTs during syndication of the SLLL.

¹ https://www.lma.eu.com/application/files/9216/8192/1243/Sustainability_Linked_Loan_Principles_23_February_2023_v.2.pdf

² https://www.lma.eu.com/application/files/5916/8192/1243/SLLP_Guidance_23_February_2023_v.2.pdf

³ https://www.lma.eu.com/application/files/1416/3092/3134/LMA_Sustainable_Lending_Glossary_VIII.pdf



Whilst the role of the sustainability coordinator is typically fulfilled pre-signing, there may be occasions where not all of the KPIs/SPTs can be agreed pre-signing or the loan is to be converted into a sustainability-linked loan post-origination (see ‘Calibration of SPTs’ below for further information), or where the KPIs/SPTs need to be recalibrated during the life of the loan. In these circumstances, it is possible that the sustainability coordinator may be involved in the transaction post-signing to (re) negotiate the KPIs and (re)calibrate the related SPTs.

However, there is often significant variation in the terms of a sustainability coordinator’s appointment (often included as part of the engagement of the arrangers of the leveraged loan) and the scope of the role and responsibilities from transaction to transaction and across different institutions and regions. See Guide ‘An Introduction to the Sustainability Coordinator Role’⁴ for more information on this role.

- **Second Party Opinion (pre-issuance verification)**

As part of the sustainability-linked structuring process, the borrower may appoint a second-party opinion (SPO) provider, an independent reviewer whose role is to opine on the alignment of the proposed sustainability-linked structure with SLLP, in particular regarding the materiality of the KPIs selected and the ambition of the related SPTs. The delivery of the SPO provides the lenders with further assurance on the quality of the sustainability-linked structure of the loan and on its coherence with the underlying sustainability strategy of the borrower and the ESG stakes in its industry.

- **External Reviewer (post-issuance verification)**

An external reviewer, appointed by the borrower, 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 at each observation date. 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 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.⁵ It should, however, be noted that the notion of materiality is multi-faceted and can be understood from different vantage points: (1) an economic or a strategic planning exposure;⁶ or (2) a sustainability standpoint⁷

- During the underwriting phase of a deal, flexibility on timing is generally required. For example, if the financing relates to an acquisition bid, the parties, especially target management, may be reluctant to agree on deal-specific KPIs (both from a timing and cost perspective) until there is certainty of the bid outcome and until data on the target needed to set suitable SPTs has been received. In this instance, a reference to SLL provisions will be made in the underwriting term sheet, with actual KPI and/or SPT selection and calibration being negotiated with lenders for inclusion in the long form documentation.
- 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 making a commitment, but also in ensuring that proposals are robust and ambitious enough to guarantee the integrity of the product and limit greenwashing risks.

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

⁴ <https://www.lma.eu.com/download?p=384448463-6796>

⁵ SLLPs can be undertaken by companies starting 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.

⁶ i.e. the E and/or S and/or G issues captured by the chosen KPIs are the ones that have the greatest impact on the relevant activity, strategic orientation and the borrower’s operational and potentially financial performance.

⁷ i.e. where the ESG issues captured by the KPIs have the highest impact on the environment and/or society whether to external stakeholders or internally.



Calibration of SPTs

A borrower's sustainability performance is measured by applying predefined SPTs to predefined KPIs. As noted in the SLLP, the "SPTs must be ambitious" and beyond "regulatory required targets" and the "KPIs must be relevant, core and material to the borrower's overall business, and of high strategic significance to the borrower's current and/or future operations; measurable or quantifiable on a consistent methodological basis; and able to be benchmarked, i.e. as much as possible using an external reference or definitions to facilitate the assessment of the SPT's level of ambition."⁸ To ensure these criteria are strictly adhered to by borrowers, the SPTs set should:-

- represent a material improvement in the respective KPIs, focusing on those KPIs which impact the company most, and be both beyond a "business as usual" trajectory and regulatory required targets;
- where possible be compared to a benchmark⁹ or an external reference;
- be consistent with the borrower's overall sustainability strategy;¹⁰ and
- be determined on a predefined timeline, set before or concurrently with the origination of the loan.

Focusing on timing, the borrower and its advisors should not rush to structure a SLLL. Where a borrower is not ready to set SPTs before or concurrently with origination of the loan, then the loan should not be communicated or referred to as a SLLL. In exceptional instances, and where the borrower already has a clear sustainability strategy in place, parties may agree to include the mechanics of a SLL within the SLLL documentation, with these mechanics to be switched on when the SPTs are agreed post-origination, typically with a 12-month deadline. In such instances, the borrower should have a clear sustainability strategy in place and parties must ensure that the SPTs undergo the same scrutiny and attention as they would have had they been proposed at the outset of the transaction, with appropriate levels of lender consent being expressly provided for in the loan documentation.

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, as least once per annum, provide lenders of record with:- (1) up-to-date information relating to their SPTs; and (2) a sustainability confirmation statement with verification report attached.

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), for any date/period relevant for assessing the SPT performance leading to a potential adjustment of the SLL economic characteristics, after the last SPT trigger event of the loan has been reached. Market participants should refer to the "Reporting" and "Verification" sections of the SLLP for more guidance on these points.

Documentation

There is template wording available for use in sustainability linked loan documentation. In May 2023, the LMA published its model provisions for sustainability-linked loans,¹¹ which look to provide a proposed form of draft sustainability-linked loan provisions for inserting into loan documentation,¹² and which are aligned with the SLLP and accompanying guidance. These provisions are intended to be used as a starting point only and transaction-specific customisation and negotiation will be required.

In addition, the APLMA published a Term Sheet (with Sustainability-Linked Loan Appendix)¹³ in September 2022 and in February 2023, the LSTA published Drafting Guidance for Sustainability-Linked Loans.¹⁴

⁸ SLLP.

⁹ For example, benchmarked against the borrower's own performance over time; the borrower's peers; and/or reference to the science, or to absolute levels, or to official country/ regional/international targets, or to recognised best-available-technologies or other proxies to determine relevant targets across ESG themes.

¹⁰ Where a sustainability strategy applies on a group wide basis, it is likely that any such strategy will cover and be relevant to the borrower as well, although care should be taken to ensure this is the case. 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.

¹¹ <https://www.lma.eu.com/sustainable-lending/documents#draft-provisions-for-sustainabilitylinked-loans222>

¹² The model provisions were drafted by reference to the LMA's senior multicurrency term and revolving facilities agreement for leveraged acquisition finance transactions (senior/mezzanine) incorporating backward-looking compounded rates and forward-looking term rates with rate switch provisions (with option for lookback without or with observation shift), but can be adapted for use in conjunction with the LMA's other recommended forms of facility agreement.

¹³ <https://www.aplma.com/microsites/categories/3/pages/14>

¹⁴ <https://www.lsta.org/content/drafting-guidance-for-sustainability-linked-loans-feb-17-2023/>



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. 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.

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.

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