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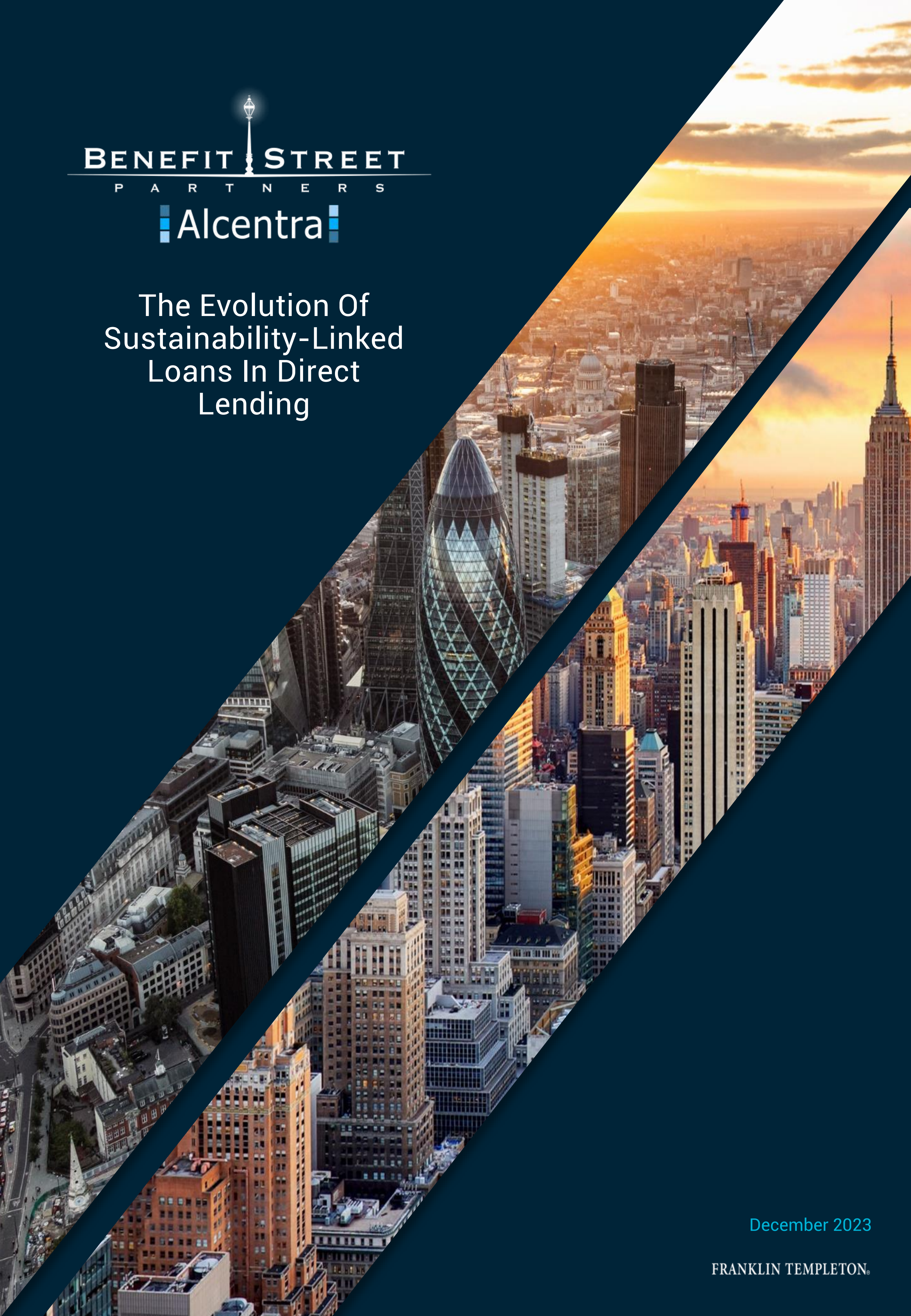
Alcentra

The Evolution Of Sustainability-Linked Loans In Direct Lending



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Franklin Templeton

Introduction

The direct lending market is undergoing a shift in its approach to Environmental, Social, and Governance (ESG) factors and sustainability, driven by both increased regulation and investor demand. In tandem with this, lenders are exploring how they can use their sphere of influence in the investment space to actively contribute to positive change. One of the primary ways that lenders like Alcentra are integrating ESG into their investment universe is through sustainable finance, and the provision of sustainability-linked loans.

In 2022, 50% of European leveraged loans included sustainability-linked features, this continues the upward trajectory from 44% in 2021. Despite the slowdown in primary issuance during 2023 due to the geo-political landscape and challenging macroeconomic backdrop, ESG remains at the forefront of developments in the European leveraged loan market.

At Alcentra, we have taken a proactive approach in shaping the Sustainability-linked Loan (SLL) market according to best practice and have used our expertise to help borrowers and investors understand how to effectively structure SLLs.

This whitepaper will provide an insight into our learnings on the key features of SLLs and will use both market data and case studies to explain how the SLL market has evolved.

Sustainability-Linked Loan (SLL) Background

WHAT ARE SLLs?

SLLs are loan facilities that incentivise companies' sustainability performance by linking the interest margin to the improvement of tailored ESG Key Performance Indicators ("KPIs"). The loan's coupon will either increase or decrease, by a pre-determined amount, based on whether or not the company is able to achieve a particular set of Sustainability Performance Targets ("SPTs") for each KPI. The adjustment to the margin is known as the margin ratchet. The Loan Market Association ("LMA") has launched a set of guiding principles which provide a framework on how to structure an SLL according to 'best practice', allowing for increased consistency and harmonisation across the market (collectively called the "SLL Principles" or "SLLPs"). Aligning to these principles is what separates SLLs from ESG-linked facilities. We encourage borrowers to structure SLL facilities rather than ESG-linked provisions as they are regarded as more robust and credible by market participants.

	ESG-LINKED	SLL
Margin benefit for meeting KPI	✓	✓
Annual Reporting	✓	✓
Material KPIs chosen	?	✓
Externally verified	?	✓
Data calibration / Benchmarks	?	✓
Two- way ratchet	?	✓

A GROWTH STORY

SLLs have gained considerable interest from borrowers and investors since their 2017 market debut.

Cumulative global sustainable lending totaled $308bn at the end of September 2023, this represents a 1.5x increase compared Q1, with SLL currently accounting for 86% of total sustainable lending volumes.

One of the factors contributing to the growing proportion of SLLs is the fact that these facilities are now spreading to other areas of the debt market.

SLLs are now reaching mid-sized corporates, and we are seeing deals being structured for companies with earnings of £100m or less.

The growing significance of sustainability and ESG is shared across all sectors in Europe, where we have witnessed smaller corporates creating and defining their sustainability strategies in order to gain access to the sustainable finance market and investment opportunities.

EVOLUTION OF THE SLL MARKET

2017

MARKET INCEPTION
Debut of SLLs in sustainable finance market. Market is largely undefined and undeveloped

2019

LAUNCH OF SLLPs
The LMA publish the SLL Principles, bringing structure and standardisation to the market

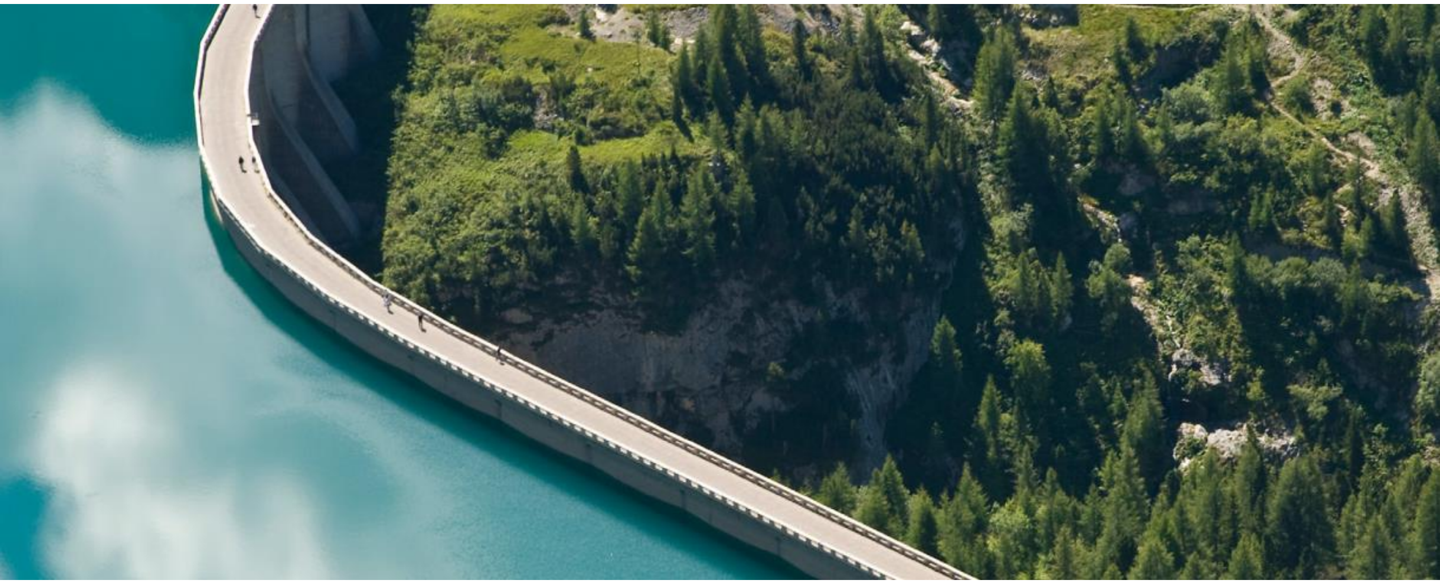
2021

MARKET BECOMES ESTABLISHED
Loans enable borrowers to credibly signal their ESG commitments to external stakeholders resulting in sustained growth in the market

2023

SHIFT IN PLAYERS
Sustainable finance expands into the direct lending and mid-market space, driven by investor demand, reputational benefits for corporates and regulatory requirements

Transaction Timeline



SLEEPING SLL TIMELINE

We understand that the leverage loan deal process can be constrained by time pressure, making it difficult to agree KPIs from the outset.

In order to overcome this, we can support clients by structuring 'Sleeping SLLs', which are usually activated 6-12 months after completion.

Sleeping SLL → Select KPIs → Establish SPTs → Amend Docs → Switch On

INSERT "SLEEPING SLL" LANGUAGE INTO DOCS

The majority of loans will start as 'sleeping SLLs'. This means the transaction has completed and the draft SLL language has been inserted into the Facility Agreement but, usually because of time constraints, KPIs and SPTs have not been finalised.

SELECT KPIs

Identify the material ESG challenges impacting the business and the sector. Determine appropriate KPIs which are deemed ambitious and stretching.

ESTABLISH SPTs

Calibrate targets to span the term of the loan. SPTs should be benchmarked to industry standards, historic or peer performance and should be stretching (go beyond the regulatory requirements / "business as usual" trajectory).

AMEND DOCUMENTATION

Once full diligence of the proposed KPIs and SPTs has been completed and the loan adheres to the SLLPs, the Facility Agreement is amended to document the full details of the KPI suite.

"SWITCHING ON"

The SLL mechanism has been "switched on" through the amendment to the documentation meaning the transaction can now be marketed as an SLL and the borrowers loan repayments will be subject to the margin adjustments.

Our Learnings On SLLs

SELECTING KPIs AND CALIBRATING TARGETS

We believe the simplest way to ensure the credibility of an SLL is to pick strong KPIs. When structuring SLLs, we encourage our borrowers to select KPIs that are relevant, core and material to their overall business. Not only will this enable the borrower to align themselves to the principles set out by the LMA, we believe that performing against KPIs with high strategic significance will also result in more tangible benefits for the company.

For example, if a water-intensive firm, such as a data centre, which consumes a significant amount of water to cool the servers, were to set a KPI which aimed to increase their proportion of recovered/recycled water, they would ultimately benefit from cost savings to their utilities in the longer term.

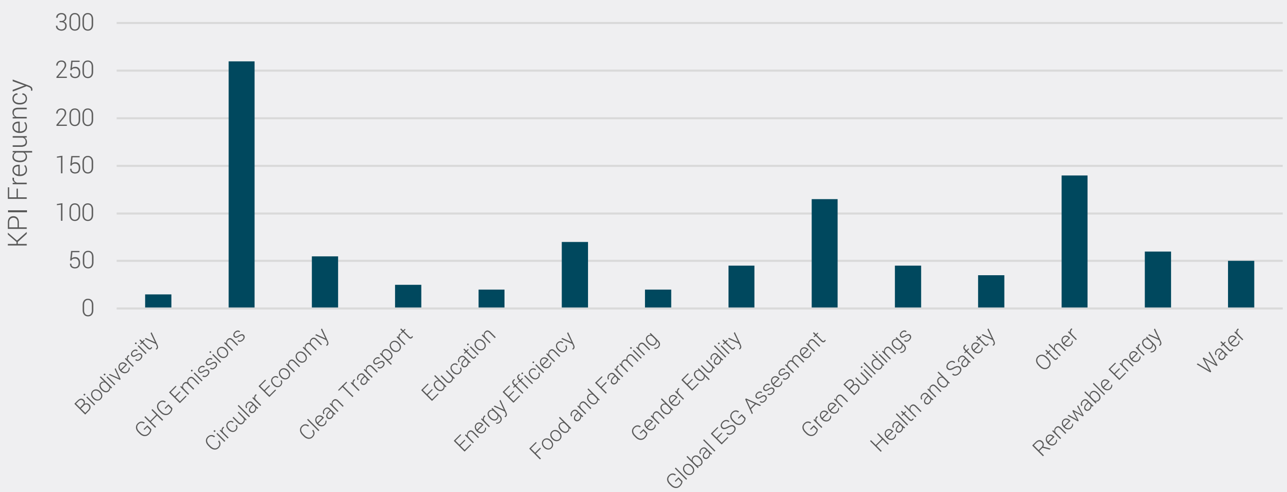
Once the KPIs have been selected, we will then support borrowers or sponsors in calibrating annual targets for each KPI. From our previous experience in structuring SLLs, we believe targets are most robust when they are assigned for each year of the loan, go beyond 'business as usual', and are aligned to a benchmark, such as historic company data, an external benchmark or peer performance.

When thinking about KPIs and targets, we encourage all parties to reflect whether they are:

Material	Stretching	Quantifiable	Timebound

MARKET INSIGHTS – SELECTING KPIs AND CALIBRATING TARGETS

Market data suggests that borrowers and lenders typically set their margin adjustments based on achieving between one to three KPIs, with three KPIs being the most common. The graph below shows the frequency of KPI themes and highlights the prevalence of emissions-based KPIs over 2022. More recent data suggests that social KPIs are becoming increasingly popular in European leverage loan structures.



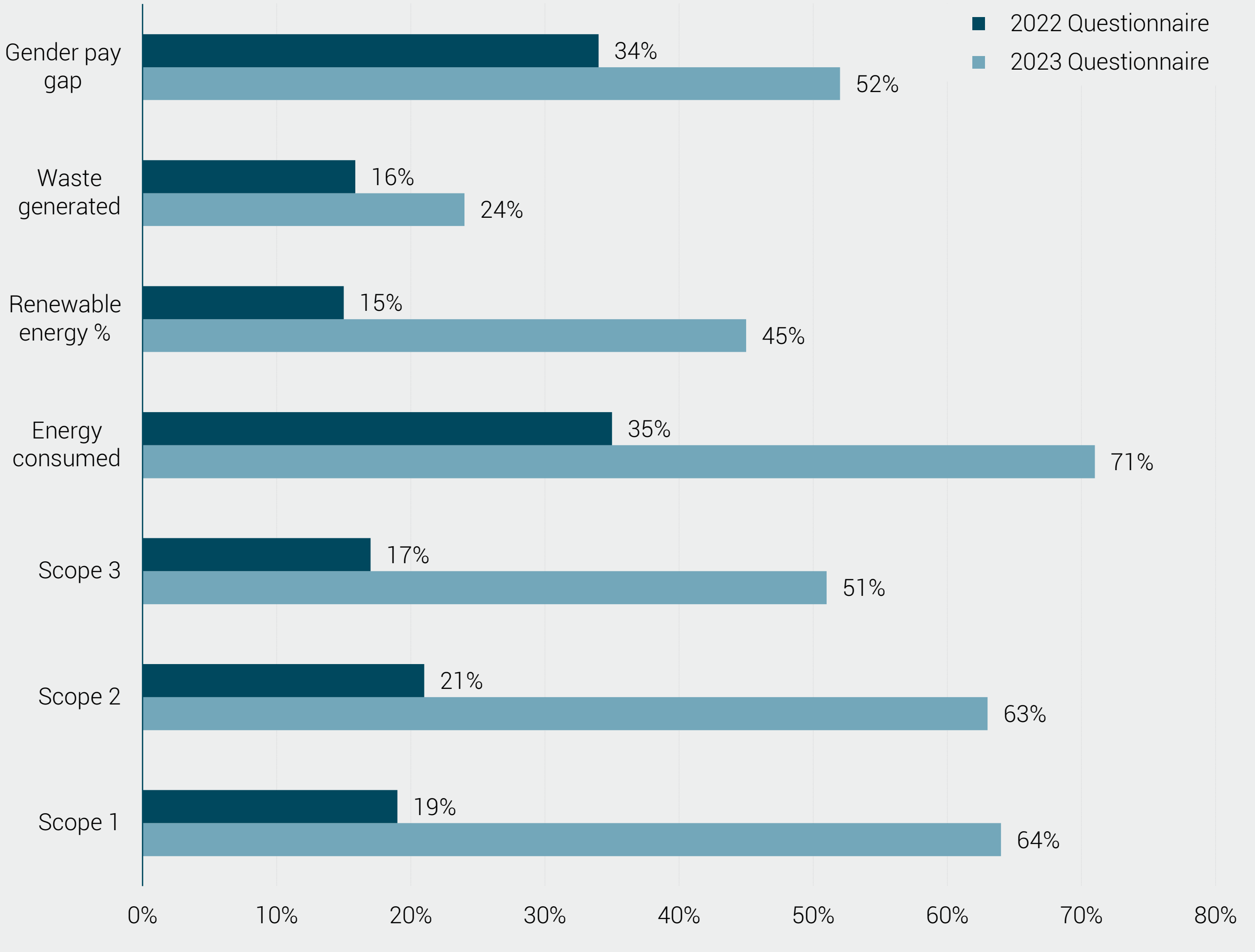
Our Learnings On SLLs

THE IMPORTANCE OF DATA

We believe that one of the most crucial elements of setting robust KPIs and targets comes from ensuring that they are backed by data. Through our experience we have seen that strong KPIs are most often measurable and quantitative rather than process-driven or qualitative. As a precursor to this, the best way that companies can prepare for structuring data-driven KPIs is through understanding their current base-line metrics and building out their current disclosures. For example, a company can start the process of calculating its emissions data or their gender pay-gap data to provide a base-line for future GHG or diversity KPIs.

Through our own ESG questionnaire and engagement with portfolio companies, we have seen a significant year-on-year improvement in the number of companies disclosing quantitative ESG data, particularly carbon emissions. This highlights the value that data brings for borrowers and its ability to drive financing opportunities, enhance decision-making, and foster long-term value creation.

MARKET INSIGHTS – IMPROVEMENTS IN ESG DATA DISCLOSURE



Our Learnings On SLLs

LOAN CHARACTERISTICS

The primary method of incentivising companies to improve their sustainable performance within an SLL structure is through a margin discount or penalty which is applied if they meet / do not meet their KPI targets.

The ratchet is an area that has seen considerable development since the negotiation of the first SLLs. Early SLLs typically featured a one-way pricing adjustment that resulted in a discount upon meeting the targets, nowadays, pricing adjustments tend to be two -way; either offering a discount on the margin if the borrower meets the relevant targets or

imposing a premium on the margin when targets are missed. Two-way ratchets are considered more robust and better aligned with the SLL Principles as they offer no 'free-option' for not meeting the targets.

Whilst we understand there is no strict standardisation when it comes to negotiating the margin structure, we are seeing a fair degree of convergence in the market around the range and nature of the margin ratchet, which we have detailed below.

MARKET INSIGHTS – LOAN CHARACTERISTICS

The majority of ESG margin ratchet step-downs and step-ups among 2022 SLLs were set within the range of 7.5 basis points to 10 basis points, with 10 basis points being the most common. The tighter distribution of margin adjustments and the convergence around 10 basis points, compared with 2021, suggests that the market is moving towards a standardised ESG margin ratchet within SLL structures.

Two-way ESG margin ratchets continue to be most common in 2023, with 77% of European SLLs having both step-up and step-down mechanisms .

We view this as a positive market development as we expect that the investor community will push back on the limited application of one-way ratchets in order to maximise the impact and credibility of SLL provisions.

DISTRIBUTION OF MARGIN ADJUSTMENT

	2021	2022
Step-up and step-down adjustment of 2 bps	3%	0%
Step-up and step-down adjustment of 5 bps	11%	0%
Step-up and step-down adjustment of 7.5 bps	47%	24%
Step-up and step-down adjustment of 10 bps	32%	63%
Step-up and step-down adjustment of 12.5 bps	3%	0%
Step-up and step-down adjustment of 15 bps	4%	1%

Our Learnings On SLLs

REPORTING AND VERIFICATION

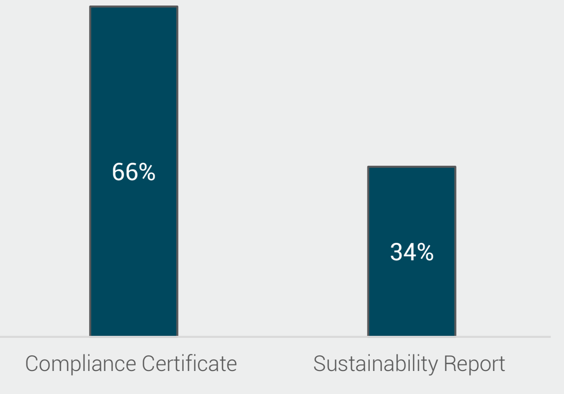
A key component of an SLL is the need for borrowers to report on whether they have been successful in meeting the targets set for the year. From our experience, we have seen that reporting often takes the form of a compliance certificate submitted on an annual basis. In sponsor-backed deals structured as SLLs, sponsors may suggest that management reporting is the most appropriate way to measure ESG performance against KPIs. In order to enhance the integrity of the SLL market, we encourage our borrowers to have their performance verified by an external party, aligning to best-in -class market practice.

We see the requirements for third party verification of SPTs and the requirement to deliver sustainability reports as a positive market development. However, we understand hurdles remain in obtaining external verification and in ESG data standardisation, and we will therefore work closely with our borrowers to support them in aligning with the SLL principles, as far as possible.

MARKET INSIGHTS – REPORTING AND VERIFICATION

Sustainability reports were delivered on around a third of SLLs, with compliance certificates delivered on two-thirds. Both forms of reporting are intended to provide lenders with a more fulsome set of information (e.g., how calculations have been made; adjustments made to the KPIs/SPTs). Positive market movements have been seen in the use of external verifiers to provide statements of assurance as to the borrower's performance on SPTs, which featured in 58% of 2022 SLLs.

METHODS OF REPORTING IN 2022



Best Practice Case Study

OVERVIEW

Company X, a professional service company, secured a sustainability-linked loan, maturing in 2025, to finance the next phase of growth and to advance their sustainable strategy. Three material, stretching KPIs which were linked to the margin of the loan were agreed. The KPIs were based around reducing carbon emissions from air travel, increasing the diversity of the new partners intake, and increasing staff involvement in volunteering programmes.

The company assigned increasing, annual targets to each KPI, which spanned the term of the loan. The targets were benchmarked against peer performance and historic data, with an agreed two-way margin ratchet of 10 bps. The company provided an annual sustainability compliance certificate which confirmed their performance and, in line with best practice, an external auditor provided limited assurance on the accuracy of the data.

STRUCTURING STRENGTHS

1. Robust KPIs and Targets

KPIs adressed the most important environmental, and social challenges faced by the borrower.

Targets were benchmarked and were aligned to the length of the loan.

Targets stretched the company to go beyond a 'business as usual' trajectory and exceeded all regulatory requirements.

2. Two-way ratchet

Two-way ratchet ensures the credibility of the SLL, no 'free option' for not meeting targets, bringing the SLL in line with the investment grade and syndicated market.

10bps margin adjustment aligns to current direct lending market standard.

3. Verified performance

Performance was verified by a third party with appropriate credentials, protecting the integrity of the SLL.

The verification enabled data integrity and reliability and was mutually beneficial to both us as the lender, the sponsor and the company.

Glossary

COMPLIANCE CERTIFICATE

A borrower may have its sustainability linked loan or associated sustainability linked loan framework certified against an external sustainability assessment standard. An assessment standard defines criteria, and alignment with such criteria is tested by qualified third parties/certifiers.

GREENWASHING

Greenwashing refers to the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact it does not meet basic environmental standards. In the context of green loans, greenwashing is a term that has been used to describe situations where a borrower or project is held out to have green credentials but where these claims are, in fact, misleading, inaccurate or inflated.

KEY PERFORMANCE INDICATORS (KPIs)

A measurable value that demonstrates how effectively a company is achieving key business objectives. They are critical (key) indicators of progress toward an intended result. KPIs provide a focus for strategic and operational improvement, create an analytical basis for decision making, and help focus attention on what matters most. Select KPIs are often used in the context of sustainability linked loans to measure improvements in the borrower's sustainability profile.

MARGIN RATCHET

The margin ratchet is a mechanism whereby the initial margin is reduced or increased when the company meets / does not meet their pre-determined sustainability performance targets. A one-way ratchet will simply decrease the margin if the target is met, with no penalty if the target if not met. A two-way ratchet will both increase and decreased according to performance.

SLEEPING SUSTAINABILITY LINKED LOAN

In the event that timing issues prevent the structuring of an SLL but some relevant ESG information is made available, market participants may opt for a sleeping SLL structure. These are loans which "switch" on the SLL label after signing once full diligence of the proposed KPIs and SPTs is completed and provided that the loan adheres to the SLLP and related guidance at the time it is activated.

SUSTAINABILITY LINKED LOAN (SLL)

Sustainability linked loans are any types of loan instruments and/or contingent facilities which incentivise the borrower's achievement of ambitious, predetermined sustainability performance objectives. The borrower's sustainability performance is measured using SPTs (as defined below). Sustainability linked loans are commonly aligned in the market with the Sustainability Linked Loan Principles (defined below).

SUSTAINABILITY LINKED LOAN PRINCIPLES (SLLP)

The SLLP are intended for broad use by the market, providing a framework within which the flexibility of the sustainability linked loan product can be maintained. The SLLP provide a high-level framework, enabling all market participants to clearly understand the characteristics of a sustainability linked loan. The SLLP will be reviewed on a regular basis in light of the development and growth of sustainability linked loans.

SUSTAINABILITY PERFORMANCE TARGETS (SPTs)

SPTs include KPIs, external ratings and/or equivalent metrics which measure improvements in the borrower's sustainability profile.

Why work with Alcentra?

Expertise

Our dedicated ESG and Investment teams combine deep experience in structuring sustainable finance products across many sectors with expertise and awareness to help clients make the right decisions for their firms and the environment.

Insight

We understand the challenges facing our borrowers as markets and regulators respond to climate change. Our insights are curated to provide you with the updates that matter most to your business.

Choice

Through the development and provision of sustainability-related products, we provide our clients with a wide range of choices when it comes to structuring their loans, which can be tailored to align to the sustainable strategies of our borrowers.

SOURCES

2022 European Sustainability-Linked Loans Wrap: Sustainability-Linked Loans Continue to Gain Prominence in 2022 but Margin Adjustments Remain Modest (reorg.com)

ELFA-Best-Practice-Guide-to-Sustainability-Linked-Leveraged-Loans-1.pdf (elfainvestors.com)

Sustainability Linked Loan Principles (SLLP) – LSTA

Overview - SASB

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