Demystifying Sustainability Linked Financing
Podcast transcript

Robert Byk	Welcome to the latest in our podcast series where Jess O'Sullivan, one of our senior associates and I will be looking at sustainability linked loans. An important subject and we'd love you to engage in this podcast. There will be an opportunity, hopefully at the end, to contact us, but also to engage in the overall topic. We thought it would be really helpful today to take stock of the features we are seeing in these type of loans and the current trends in the market. Unlike green loans, which are purpose driven use of proceeds, i.e. using the proceeds for a green purpose, sustainability linked loans, which is a mouthful – we might refer to as SLLs, but that's even more of a mouthful – contain performance related sustainability metrics or KPIs (key performance indicators) and they are typically, as we are seeing today, built into the pricing mechanisms. So our focus today is on the loan market, although we are seeing an uplift in issuance of SLLs in bonds as well, and a more general trend towards sustainability being factored into key investment decisions in every company, so some of what we will come on to talk about will be equally relevant to bonds and loans. So as part of our conversation we will take a look at why these types of loans are increasingly popular, what the features are that make a loan sustainability linked and what parties, most critically you guys in the market, should be thinking about when putting one of these in place, and who is accessing these type of loans. So Jess, much more interesting to hear you speak, but why are we seeing more of these types of loans?
Jess O'Sullivan	Well first I think it is important to highlight that for many of our clients, sustainability is one of the first issues that lenders are raising when corporates are looking to refinance. Now that may some of our listeners by surprise, sustainability is obviously quite a key focus for many businesses at the moment, though many probably don't expect it to be such a high priority in a financing context. But it is and that has been a big driver as to behind the why. Saying that though, as you said, KPIs are linked to pricing so there is an attractiveness element here as well for borrowers. At the moment, as you said, margin adjustment seems to be the normal way to be doing this and it's normally between two and a half to five basis points on investment grade deals, and we are seeing slightly more, so five to seven and a half basis points on leverage deals.
Robert Byk	That's a really interesting point isn't it, the margin adjustment has been the mechanism to reward because as more sustainability linked loans come to the market, we are also seeing parties take a step back and say, is it actually right that pricing is the driver here, or indeed put it a different way, is it right that if I don't do well on sustainability, actually I end up paying more to a lender for the loan. Could it be the case, and this has been discussed and beginning to be discussing more in the market, that if money goes back to a lender, shouldn't it have to be used

	by that lender for an ESG purpose, or indeed given towards a charitable initiative related to ESG. So we are seeing some borrowers beginning to insist and have the conversation of a reinvestment back into the business, on a sustainability basis, or apply generally to charitable initiative for sustainability if those goals are not met.
Jess O'Sullivan	And the pricing too doesn't just need to be linked to the margin adjustment, and while we are not seeing too much of it yet, as the market develops we may see impacts on other elements of the loan such fee reductions or a relaxation of covenants which as you say, allows the borrower then that flexibility to reinvest money back into the business to achieve its sustainability goals. So in a sense this is quite an exciting shift into how green finance can help borrowers and corporates with the transition to a net zero economy. I suppose then the next question is if borrowers do go down the route of putting one of these in place, is what KPI should they be looking at, and how do they then determine the targets, which Robert I think you've probably got some good insights on that.
Robert Byk	That's a very important point because actually the key point is the KPIs need to be relevant to the particular sustainability objectives of the borrower. They are after all focused on what that business is seeking to achieve. If the company has published its sustainability targets or goals, those are very likely and will be the best starting point for formulating the KPIs. Of course you may not be at that stage. For companies who are not so advanced in their thinking, their lenders or even lawyers, may be a valuable resource in offering suggestions as to the type of KPIs that we are seeing, or they are seeing, on other deals. However, it is important, and this is sort of stating the obvious, to say that these are not prescriptive – they need to be tailored to the borrower. What will be appropriate for one type of business may not work for another. So, for example, if the company has a limited physical footprint, a KPI linked to waste reduction may not be relevant. For one of our clients involved in the construction industry KPIs have been included that relate to the proportion of power consumption from green energy in cement and other references were included to reducing the negative impact of deforestation. In both those cases, those ambitions were relevant to the very specific targets and specific purposes that the business and its corporate purpose and operations had put in place. And it's really exciting because one of the key features of this type of product is its inherent flexibility. In theory, any objective that addresses an ESG criteria, and that's not just 'E', that social and corporate governance as well, can be developed into a KPI. So the key takeaway here is number 1, business focus, but that means that discussions between Treasury and the Board and the sustainability portion of the business need to be established at a very early stage in order to work out what criteria are necessary for the loan.

Jess O'Sullivan	And the same goes too, I think, for the actual targets themselves. So once you've determined your KPI, you need to break it down into targets and it's those targets that then trigger the margin adjustment. So on the one hand you don't want that to be a hair trigger, but on the other hand it also needs to be something that is achievable. So again, discussions with lenders can be quite a good resource as you say, in determining that the market seems to be, or is seeming to be, I should say, to be ambitious enough in this space. However, one size certainly doesn't fit all, and like the KPIs themselves, it needs to be considered in the context of the business and its ESG strategy.
Robert Byk	I mean, it's an obvious example but let's take the example of greenhouse gas emissions. In some cases you would have a target which was an absolute reduction year on year. In other cases you might frame that target by reference to your previous or past activities, which pre-date the facility but you compare to the progress that you have made in previous years. Equally, duration is important. The business might be focusing on targets, say for greenhouse emissions, in line with the Paris Agreement. However, the timescale in the Paris Agreement is likely to be longer than the timescale of the facility, so when you take those KPIs you then need to translate them into the term of the facility, what is achievable within that, and although they are linked to the Paris Agreement, they need to be tailored to the duration of the overall loan.
Jess O'Sullivan	And we should highlight there again, as you said before Robert, it isn't all about the 'E' so while those examples are quite environmentally focused, we have also seen KPIs linked to other things such as the company signing up the particular frameworks such as the UN backed Principles for Responsible Investment and we have also seen companies include KPIs around having a certain proportion of the female staff in senior management positions. So the KPIs in this context can be sustainability linked in that broader sense rather than just green.
Robert Byk	And I think that's a very, very vital point to remember. ESG is much more than just environment, it could be modern slavery, it could be all sorts of criteria, again relating back to what the business is saying. So once the KPIs have been set, the parties then need to think about how they are then monitored during the life of the loan. On the one hand the lenders will need comfort, they are potentially giving margin back or indeed changing a fee or changing a basket, so they need comfort that the KPIs are being met. On the other hand the borrower wants simplicity, and how closely the lenders will look at the company's progress and how the company will demonstrate its performance, are important decisions that have to be made at the outset of putting in to the loan.
Jess O'Sullivan	They are exactly, and this is one of probably the bigger discussions points we are seeing in deals at the moment because there has been a

	fair bit of variation. So for borrowers it can be quite helpful to maintain control over the process and therefore self-certify that their KPIs are being met, but in deals where third party verification has been required, we are seeing variation there too. So for instance, on some deals we're seeing a specialist ESG verification expert coming in and verifying the KPIs but then on other deals, what we are seeing is the company's auditors taking on the role of being a sustainability auditor. And that approach in particular has the benefit of, if the KPIs and the ESG strategy are in the company's annual reports, say, that verification process is then only being done once, and it helps streamline the process internally for the corporates. But obviously with these different options, there's a lot of factors to consider, and one of those factors is the KPIs themselves, because obviously, what may be appropriate to some KPIs, may not necessarily be an appropriate level of oversight for others.
Robert Byk	And in relation to all of those KPIs it doesn't mean that the same testing has to occur in relation to each one. KPI that measures gender diversity in senior leadership roles may simply not require the same degree of external oversight, compared to an environmental KPI that measures a reduction of greenhouse gas output or electricity generation. Another factor to think about, is the external reporting obligations of the corporate, going to your point Jess about efficiency, it makes absolute sense to leverage off the existing processes the borrower already goes through, whether regulatory or voluntarily in order to report on climate related disclosures or other ESG areas. If in fact those are already in place and these external obligations will of course evolve over time, that is absolutely where the borrower should say the starting point should be for measuring these KPIs.
Jess O'Sullivan	And slightly tangential to that, taking your point about the fast developing nature of this area, that's obviously one thing that makes it so exciting, but it is also something that borrowers should be thinking about from the outset that KPIs may change over time, and the business priorities may change over time, and so you need mechanisms up front that allow borrowers to do that. So usually in loan agreements, an amendment process will be embedded into the documents and that will usually require a specified level of lender consent. Parties should be having a discussion around whether that is equally appropriate in the context of reconfiguring KPIs and what the consequences are, say, if one lender doesn't give its consent to a reconfigured KPI or if the parties just don't reach an agreement.
Robert Byk	And equally may be this is an area where a borrower can say, look these are my KPIs, this gives me a benefit and actually I need to monitor these, number 1, but number 2, if it's not appropriate for my business over the course of the loan, I can actually determine to remove one or more of those KPIs, something that we are seeing more and more. Now

	before we wrap up and give you back your ears, so to speak, we should make a few observations about the jurisdictions and sectors in which these products are proving popular, and the type of borrowers accessing them. And it's fair to say I think, until quite recently, the sustainable debt market was really focused on Europe. However, borrowers in other jurisdictions are increasingly engaging with ESG and sustainable financing and I think that relates back to a point you made Jess, really near the beginning, which is more and more the lenders are bringing this on the table as the first conversation, or one of the first conversations, that the borrower needs to have in looking at the structure of their loan. CEMEX is a great example of this. Based in Mexico but they are a worldwide cement company, we recently advised them on the amendment and restatement of their existing facilities agreement, which built into it sustainability linked metrics which aligned with both the company's climate action strategy and their ultimate vision for a carbon neutral economy.
Jess O'Sullivan	And that's particularly interesting because companies like CEMEX in the construction industry or the aviation and other heavy sectors like that, have often found it difficult in the past to access green finance, whereas because sustainability linked loans aren't purpose driven and instead have this KPI mechanism, it does allow companies in a broader range of sectors, to access this market and reflect their sustainability commitments in their financing, and I think as we see more of these products come online and investors becoming increasingly comfortable assessing the long term sustainability strategies of corporates, we will see even more companies being able to access these sorts of products.
Robert Byk	And that links into the range of credits within the space. I think it's no longer true that this is the preserve of the investment grade corporate borrower. Other credits, other areas of the credit spectrum, are able to successfully build ESG mechanics and indeed are doing it on a corporate basis, so of course logically, can build those into their facilities and that's something that we have seen emerging in the leverage space, in TLB, etc. So in terms of where the market is at the moment, sustainable finance is an increasingly popular option on both the issuer and borrower side. It's an important discussion that occurs very much at the front of the loan process with the lenders; it requires Treasury to really be linked into the business, to understand what those KPIs and possibilities are, and it's becoming a more and more significant part of the market place. We have only had a swift opportunity to talk to you about this topic. We'd love to engage with you further, whether that be through LinkedIn or emailing us, or whatever it might be. Talking in a vacuum like this is bizarre, it's a bit like being on a desert island and sort of seeing no one else, but that's what we've been doing anyway for the past year or so. We would love to engage; we'd love to have a further

	chat and we really look forward to hearing from you on this topic and engaging on all the other topics as more of our podcasts come out.