Debt capital markets update
The dawn of ESG in private debt markets

SUMMER 2022

Sustainability in action

In recent years, it has become commonplace for lenders to agree environmental, social and governance (ESG) performance driven margin ratchets in their facility agreements. Ranging from 5bps to 50bps, borrowers must achieve pre-determined ESG-based KPIs in order to benefit from subsequent price reductions, with the size of the ratchet typically determined by a combination of the opening margin of the loan, and the extent of the potential ESG targets.

Some lenders have introduced upward ratchets alongside the downward ones, providing borrowers with a stick as well as a carrot. This drive from both funds and banks, which in turn comes from LPs and shareholders, has seen major financial institutions signal a genuine intent to develop the success of sustainable investing, with more lenders expected to follow suit in coming years.

Critics of ESG ratchets typically focus on the often modest quantum of the ratchets, the quality of the KPIs selected, the cost of monitoring KPIs and how the KPIs are measured. Generally speaking, most ratchets sit in the 5-10bps range, an amount judged by some to be too modest and insufficient to drive real change in investment direction. The use of the savings made by the ratchets has also attracted some negative attention, the argument being made that the interest saved, although attained via achieving ESG-specific KPIs, could then be spent on things which are not ESG-friendly. The solution to this has been to seek undertakings from borrowers that the savings from reduced interest payments will be invested into ESG-friendly projects. A recent example of this would be Ares' landmark financing of RSK, which required RSK's ratchet savings be put toward sustainability-related initiatives or charitable causes, a requirement matched by Ares in the event they received any additional interest.

Similarly, due to the wider market's desire for the system of ESG ratchets to be a success, some KPIs are being set in such a way that borrowers are achieving them without straying too far from what their plans would have been without them. The process of verifying a company's performance against these KPIs, which in the past has often been undertaken by the company themselves, has also faced challenges, with critics arguing there is insufficient transparency in the measurement process, and that external parties should be more closely involved to ensure accuracy.

To emphasise their commitment to quality and verifiable KPIs, some large investors have hired individual specialists to sit on their credit committees to help determine challenging, yet achievable KPIs, often chosen ex-post to ensure selection is not rushed. Some funds have partnered with ESG-specialist agencies such as EcoVadis to assist them in "scoring" a target's ESG credentials, against which they base their

"ESG incentives are becoming increasingly common in the debt market but remain a work in progress. While their application, scale of benefit and monitoring regime are all evolving, they are a step in the right direction and are set to become a permanent feature of the market."

ANDREW SHELLARD,
MANAGING PARTNER, UK

ANDREW LYNN,
PARTNER, UK

KPI targets. Some direct lenders have even looked to set up entire funds with an ESG-focus, such as Kartesia's Impact Fund. Whilst sending a strong statement of intent and undoubtedly a force for good, such funds will have to compete with the mainstream for deal flow which may ultimately put pressure on qualifying criteria.

ESG-ratchets shouldn't be seen as a bad thing. They may not be the finished product nor the sole answer to responsible investing, but they do give borrowers a financial incentive to better themselves across an array of ESG-metrics and allow lenders to help in directing the market towards more responsible practice. Naturally they should be complemented by other ESG mechanisms in the market, but should at the very least be viewed as a well-intentioned work-in-progress.

At Alantra we can help borrowers maximise the benefit of these features and navigate the ever evolving landscape they live within.

Should you wish to explore any aspects of this article or any other debt matters, we would be keen to discuss how we can support you.

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DEC 2021 charterhouse DEBT REFINANCING SLR	OCT 2021 Foster + Partners INVESTMENT Hennick & Co	AUG 2021 aryza REFINANCING Pollen Street	JUN 2021 MML Return on Ideas DEBT REFINANCING Roboyo
JUN 2021 Livingbridge BUY-SIDE ADVISORY semafone securing data - protecting reputations	MAY 2021 Sovereign Capital Partners BUY-SIDE ADVISORY Aquaq Analytics	MAR 2021 Inflexion Private Equity BUY-SIDE ADVISORY Medik8 Pangaea	MAR 2021 Inflexion Private Equity BUY-SIDE ADVISORY digital wholesale solutions
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