PRIVATE EQUITY NEWS

The evolution of ESG provisions in the private debt market

Over the course of 2021, environmental, social and (corporate) governance (ESG) aspects of private debt grew exponentially and now feature in most deals. The fundamental reason behind this is that it has become more important for investors to build ESG factors into their investment thesis because of the general desire for financings to flow to businesses that are more sustainability conscious.

The incorporation of ESG-related provisions into private debt loan documents has generally followed what has been seen in the syndicated term loan space. It is designed to incentivise companies to improve the performance of certain areas of the business.

Economic incentive

The biggest incentive to companies and their sponsors remains the economic one, where the introduction of an "ESG margin ratchet" is now commonplace in private debt deals. Where borrowers hit certain metrics, a small reduction in the margin is available. The level of reductions (or uplift) varies from deal to deal. In some cases, a tiered approach can be implemented which allows for companies to hit multiple metrics, the result of which is cumulative reductions. It will be interesting to monitor whether documents start stipulating what should be done with the proceeds of such interest savings.

It is not always the case that ESG criteria are agreed at the outset of the deal. Agreeing on what the key performance indicators (and/or ESG scores) can sometimes be the hardest part of the process. Given increasingly truncated deal timetables, there is an ongoing trend to include terms that allow for the lender(s) and borrower to work together post-closing of the transaction to establish the key performance indicators. Term sheets can be quite general and simply include the concept of the ratchet. Naturally, some sectors lend themselves better to be able to draft KPIs such as industrials and consumer but the concept as a whole has appeared across the board.

For those deals where day one indicators are to be included, many companies are having to rely on fairly generic metrics, mainly focused on the "G" of ESG. The social aspect often focuses on equality and diversity and may include certification as to positions on modern slavery, human rights issues, and labour standards. Other criteria include actively requiring the company's employees to participate in local community projects or internal training.

Mitigate greenwashing

The approach to validating these metrics varies and as the market evolves more sophisticated solutions to mitigate greenwashing will develop. Some credits allow for internal confirmation, whilst others argue that for true objective validation, the appointment of a third party to audit goals achieved should be required. An extension of this is the requirement, sometimes seen, for a third party to help set the KPIs initially.

In terms of timing for reporting, the market is generally working off a 12-month look back. If the relevant confirmations can be given off the previous 12-month period (either based from closing or per financial year) then any positive (or negative) effects on the margin will become effective for the next 12 months.

One school of thought is that for the ratchet to have real teeth and act as a true incentive for borrowers to improve on ESG, it needs to be a two-way ratchet. Where the agreed metrics are not met, a small increase in pricing would kick in. Some deals may include a margin uplift for failure to deliver the relevant ESG reporting documentation. That said, private debt funds are still willing to offer one-way economic incentives as a driver for companies to make substantive change.

To date, many private debt deals have static KPIs. As the market develops, we expect KPIs to become more dynamic and for loan agreements to allow for adjustments to targets or methodologies over the life of the loan and as companies grow.

Proactive approach

In addition to economics, some investors are taking a proactive approach and including other reporting requirements in the documentation, such as an obligation to complete ESG questionnaires on an annual basis. Often the form is shared with the borrower prior to close to help give comfort as to what they are signing up to.

Alternatively, a borrower may provide lenders with a questionnaire/report in line with what they are required to deliver to their own owners and investors. In such cases, lenders will want to ensure that all key reporting requirements from their perspective are included. There is still a fair amount of borrower apprehension as to setting hair triggers for defaults in the documents so in some cases, the obligation to provide additional reporting may be carved out from the event of defaults.

Given the lack of conformity around reporting requirements and the contents of such reports, it is not surprising that such provisions have not made their way into loan documents as regularly as the ratchet. However, as both borrowers and lenders continue to focus on sustainability, we expect a greater alignment of interests.

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Mark Fine, McDermott Will & Emery

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