The rise and rise of ESG-linked lending

ESG-linked subscription lines are becoming more common, with the market evolving quickly on both sides of the Atlantic, says Claire Coe Smith

Ever since the first ESG-linked subscription line facilities started to emerge in Europe in 2020, fund managers have been keen to incorporate environmental, social and governance mechanics into their borrowing, and lenders have been working to keep up with demand.

EQT was one of the first private equity managers to sign up to such an arrangement, when its €2.3 billion subscription line facility in June 2020 included a margin adjusted based on performance against ESG key performance indicators. The mechanism on that deal looked to incentivize the setting of ambitious ESG targets at portfolio companies, gender equality at each portfolio company board, and a transition within the portfolio towards renewable energy.

Since 2020, the market has evolved quickly on both sides of the Atlantic and these types of ESG-linked subscription lines are becoming more common.

Vicky Du, global head of fund finance at Standard Chartered, says: "In the last two years we have done a lot more transactions that are ESG subscription finance facilities. When we did those first ones, we took a view as an institution not only to provide these structures to our clients but also to be involved in the market development, so we are doing a lot of knowledge sharing with the market and with industry groups to talk through how we think about these structures."

She says things have moved on from a focus on just simply including ESG features on deals. "People are getting a lot more thoughtful about the KPIs that need to be included and there is a lot more complexity around the structures. We just did a deal with a carbon credit element, for example, so that if the fund does not meet its carbon targets, it can purchase carbon credits."

For lenders, the growth of the market requires further development of their infrastructure behind these products, to build out knowhow on the specific requirements and the necessary governance processes. Anastasia Kaup is a partner with Fund Finance Partners, an advisory firm helping fund sponsors access and utilize fund financing to achieve their objectives. She says there is a lot of demand coming from borrowers: "Many sponsors have realized that if they are not already in on this, they want to get in on it. Incorporating ESG metrics into fund financing makes a lot of sense for fund sponsors that are astute users of debt financing and pursuing their own ESG goals."

> *"Incorporating ESG metrics into fund financing makes a lot of sense for fund sponsors"*
>
> **ANASTASIA KAUP**
> **Fund Finance Partners**

Such demand is driven in part by limited partners that are focused on encouraging GPs to do more, while sponsors themselves are also looking to improve their ESG approaches. A subscription line facility with an ESG focus institutionalizes the importance of ESG, and borrowers can sometimes benefit from a margin adjustment of five to 25 basis points if objectives are met.

"One of the biggest challenges for fund sponsors is finding a lender partner that is experienced in this area," says Kaup.

"You really need to find the right lending partner that can understand and accommodate the goals, specific compliance set-up, reporting set-up, and individualized needs and capabilities, of the sponsor. Every fund sponsor has different ESG goals and different capabilities around tracking and reporting against those."

Bridgepoint Credit, whose parent

company Bridgepoint is owner of *Private Funds CFO* publisher PEI Media, was one of the first debt funds to enter into ESG-linked subscription lines for its credit funds last year, having already started to introduce ESG margin ratchets for its own borrowers in direct lending and credit opportunities.

Katie Cotterell, ESG manager at Bridgepoint Credit, says: "From our perspective, we are asking all our portfolio companies to improve on sustainability outcomes and as much as possible have ESG-linked margin ratchets in place that drive that motivation to hit ESG targets. So, it makes sense for us to be embracing that ourselves and demonstrating our own commitment to accountability."

The Bridgepoint Credit facility measures success against three KPIs, developed alongside lenders, focused on improving diversity and inclusion within the team, increasing the number of ESG-linked loans in the portfolio, and securing external recognition through a top score against the UN Principles for Responsible Investment.

Cotterell says: "One of the great advantages for us is that so often within ESG as an industry we talk about fairly long-term commitments, like achieving gender diversity in the investment teams or company boards, or reaching net zero. What these ratchets and facilities are able to do is break those long-term goals down into short-term actions that are ambitious, achievable and measurable."

As the market has developed, a lot of attention has been paid to ensuring KPIs are both sufficiently meaningful to stretch borrowers to go beyond what they might otherwise be doing, and quantifiable in a way that can be tracked and reported on. Du says the number of KPIs in facilities has inched up over time, with four or five now being typical, rather than two or three a year ago. In real estate funds, KPIs might focus on the percentage of the portfolio that is classified as being green buildings or cutting emissions, while in private equity, diversity and inclusion and social impact often features.

"One of the biggest challenges right now is that there are just so many different reporting standards out there," says Du. "There really hasn't been a unified approach, so the lender needs a lot of experience and expertise to review the fund's reporting standards and investment criteria in order to have the confidence to know what sensible metrics might be.

"Another issue is that sometimes people design KPIs that fit the facility at the start of a fund but as they start to make investments, things change or different investment opportunities come up that don't necessarily match those KPIs."

Lenders are also increasingly calling on borrowers to accept some level of third-party validation of the reporting that they are doing against the ESG metrics in their facilities.

Kaup says: "I am certain we are going to see exponential growth in this area. We are excited to speak with our fund sponsor clients about these ESG facilities, and to lenders who can provide flexibility and creativity to align their interests with these clients' goals and interests. We can expect a lot more innovation here in the coming years." ■

Using KPIs to drive DE&I

Fund managers are using ESG-linked loans as a means to encourage diversity, equity and inclusion

One example is Bridgepoint Credit's ESG-linked subscription line which includes a metric driving the firm to improve diversity and inclusion within its team, and especially the investment team, over the next five years. There are role-specific targets that go up incrementally year-on-year, and Katie Cotterell, ESG manager, says that means regular reporting to both investors and lenders on diversity KPIs. "Those metrics reflect what we are asking our portfolio companies to do as well, where it is typically about the percentage of women on boards and in management," she says.

Standard Chartered's Vicky Du says that diversity metrics are more common at private equity funds than for real estate and infra funds. "We are still a bit too early on this journey to judge how effectively those KPIs are really performing," she adds. "But we are definitely seeing these facilities playing a key role in the development of diversity, equity and inclusion strategies and implementation for fund managers."