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Memorandum

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ESG and the Leveraged Loan Market

Investor attention to environmental, social and governance ("ESG") considerations has increased steadily in recent years. The leveraged loan market has largely escaped this expanding ESG focus, but leveraged loan investors increasingly are incorporating ESG factors into their credit investment analyses. In early February 2020, the Loan Syndications and Trading Association ("LSTA"), a trade association representing the $1.2 trillion leveraged loan market in the U.S., released its inaugural ESG Diligence Questionnaire to facilitate enhanced sharing of ESG information on the part of corporate borrowers. On the other side of the Atlantic, the European Leveraged Finance Alliance ("ELFA") is in the process of developing a standard set of material ESG disclosure topics on which borrowers and issuers can be expected to report publicly. Given the growing recognition that ESG issues can pose material risks to credit investments, corporate borrowers in the leveraged loan market should expect this trend to continue and be ready to provide lenders with more detailed ESG information going forward.

ESG and the Leveraged Loan Landscape

The last decade has seen the launching of a multitude of sustainable finance initiatives designed to encourage the integration of ESG factors into investment decisions and corporate behavior. A short list of some of these global initiatives includes the U.N. Global Compact, the U.N. Sustainable Development Goals, the European Commission Action Plan for Financing Sustainable Growth, the Equator Principles, the Sustainability Framework of the International Finance Corporation, and the Network of Central Banks and Regulators for Greening the Financial System. Significantly, there are now over 2,200 signatories to the U.N. Principles for Responsible Investment ("PRI"), an initiative comprised of asset owners, investment managers and service providers (including credit ratings agencies) agreeing to six voluntary principles to incorporate ESG criteria into their decision-making and investment practices. In 2016, PRI launched a credit risk and ratings initiative, which is supported by signatories with nearly $30 trillion of assets under management related to fixed income. As part of the initiative, PRI has published a number of guides regarding how investors can consider ESG issues when assessing fixed income instruments and their issuers.[1] More recently, in September 2019, over 130 banks launched the U.N. Principles for Responsible Banking to provide a global framework for a sustainable banking system and to accelerate the banking industry's contribution to achieving the goals of the Paris Climate Agreement and the U.N. Sustainable Development Goals.

In tandem with the proliferation in global sustainable finance initiatives, there has been substantial growth in the sustainable finance market, including green, social and sustainability-linked bonds and loans, as well as funds with ESG mandates. The LSTA, Loan Market Association and Asia Pacific Loan Market

1 *See*, *e.g.*, PRI Spotlight on Responsible Investment in Private Debt (2019); PRI Fixed Income Investor Guide (2014); PRI Corporate Bonds: Spotlight on ESG Risks (2013).

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Association have also collaborated to launch the Green Loan Principles and Sustainability Linked Loan Principles designed to promote consistency and best practices across green and sustainable loan products, therefore building investor confidence in such vehicles. In 2019, sustainable debt issued globally was approximately $465 billion (up from $261 billion in 2018).[2] The first green bond was issued in 2007; by 2019, the global market for green bonds was $271 billion (up from $182 billion in 2018). The first sustainability-linked loan was issued in 2017; by 2019, the global market for sustainability-linked loans was $122 billion.

Until recently, the growth in fixed income products with an ESG orientation has largely been confined to the investment grade market, as opposed to the leveraged loan market, which involves higher levels of debt, lower credit ratings and higher spreads, and often involves the financing of mergers and acquisitions and leveraged buyouts by private equity sponsors. In addition, unlike in the investment grade space, ratings based pricing is relatively uncommon in leveraged loans. Europe's first sustainability-linked leveraged loan (a margin ratchet based on an ESG rating as part of Masmovil's $1.7 billion debt package) did not occur until May 2019. The slow uptake of ESG in the leveraged loan market may result, in part, from the lack of ESG data on leveraged borrowers, which tend to be privately owned middle market companies. Historically, these companies have faced less pressure to collect and report ESG metrics, and may not have received the attention of ESG raters, such as MSCI.

The lack of ESG data for many leveraged borrowers has presented a challenge for credit investors conducting an ESG investment analysis in the leveraged finance market. An ESG investor survey conducted by ELFA in November 2019 found that while 72% of European investor respondents already address ESG considerations in their investment processes on at least half of their fixed income assets, 49% of investors believe there is insufficient data available on ESG factors for high-yield issuers and leveraged loan borrowers, particularly small-cap and privately owned companies not covered by external data vendors. Many of these credit investors are themselves the subject of pressure from their LPs to report on ESG issues associated with their portfolios. To fill the data gap, many credit investors attempt to conduct their own proprietary research or send bespoke ESG questionnaires to companies, potentially adding substantial work for both the credit investors and borrowers. Credit investors who use ESG criteria in their investment analyses are beginning to push for more standardized ESG disclosure.

Credit rating agencies have begun to take note of credit investors' demands for more ESG information. Approximately twenty credit ratings agencies (including Moody's Corporation and S&P Global Ratings) are signatories to a statement supporting PRI's credit risk and ratings initiative designed to enhance the systematic and transparent consideration of ESG factors in the assessment of creditworthiness. Moreover, in the past year both Moody's[3] and S&P Global[4] have acquired ESG-data companies in an effort to improve their abilities to provide ESG data to market participants.

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2 Veronika Henze, "Sustainable Debt Sees Record Issuance at $465Bn in 2019, Up 78% from 2018," Bloomberg NEF (Jan. 8, 2020).

3 In 2019, Moody's announced purchases of majority stakes in Vigeo Eiris, a provider of ESG research, data and assessment, and Four Twenty Seven, Inc., a California-based provider of climate risk data, and a minority stake in SynTao Green Finance, a China-based ESG data provider.

4 S&P Global acquired RobecoSAM's ESG ratings business in January 2020.

LSTA ESG Diligence Questionnaire

Given that the need for ESG information about borrowers is on the rise, the LSTA launched the ESG Diligence Questionnaire at the request of, and in collaboration with, its buy-side members in an attempt to standardize and streamline ESG disclosure in the leveraged loan market. In developing the questionnaire, the LSTA was mindful that (i) the questionnaire should be applicable to borrowers in any industry, (ii) many borrowers are just beginning their ESG journey, and (iii) the initial version of the questionnaire should be manageable in scope. With these considerations in mind, the ESG Diligence Questionnaire poses eight basic questions, including:

1. Do you have a formal ESG policy? If yes, please provide. If not, what are the intentions or concepts with respect to ESG that you have identified as relevant to your company?

2. Who has oversight of ESG issues at your company and what is the level of board oversight?

3. Is ESG a factor in management performance evaluation or compensation?

4. Do you participate in any ESG frameworks, such as the Global Reporting Initiative and the Sustainability Accounting Standards Board ("SASB") standards? If yes, please provide reports and scores.

5. How is your company addressing, tracking and measuring ESG issues? Please describe business issues relating to ESG, using the SASB Materiality Map[5] as a reference point for guidance on financially material business risks and opportunities by sector.

6. What is your company's approach to board, management and workforce composition, including the percentage of independent directors and female directors?

7. If you would like, provide additional information on your company's overall approach to ESG.

8. Provide the percentage of revenue derived from certain activities, such as businesses involving alcohol, tobacco, cannabis, gambling, thermal coal, controversial military weapons, guns, GMOs and private prisons.

The ESG Diligence Questionnaire, which is voluntary, is designed to be completed by the borrower during the diligence phase of the loan origination process and to be posted in the public side data room for review by prospective lenders. The LSTA also suggests that the completed questionnaire can be included in the Confidential Offering Memorandum.

ELFA Development of ESG Standard

ELFA, a trade association formed in 2019 for investors in the European leveraged finance market, has prioritized ESG data disclosure as one of its goals for 2020, and is in the process of developing a standard set of material ESG disclosure topics for use in leveraged loans. ELFA is engaging with issuers, private equity sponsors, deal arrangers and other stakeholders in a collaborative approach to develop practical standards. ELFA's engagement has been included in the UN PRI's initiative of ESG in credit risk and ratings. The Loan Market Association, a syndicated loan market association in EMEA, has

[5] The SASB Materiality Map is available at https://materiality.sasb.org/.

joined ELFA in the initiative, and the associations are planning to organize a roundtable with the PRI in London, with a follow-up session including credit ratings agencies later in the year.

Conclusion

At this early stage, it is unclear whether the LSTA ESG Diligence Questionnaire, the ESG disclosure standards being developed by ELFA or another more widely applicable ESG disclosure framework[6] will emerge as the primary ESG framework adopted by the leveraged loan market. Nonetheless, borrowers should expect the clamor for increased and standardized disclosure to continue. In particular, private equity sponsors should consider the need for an ESG component to their target diligence process in order to be prepared to provide ESG information that may be required by their lenders in connection with their acquisition financing efforts.

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6 For example, at the 2020 World Economic Forum in Davos, the International Business Council, which represents approximately 120 global companies and their CEOs, released a draft framework for ESG reporting aligned with the U.N. Sustainable Development Goals and supported by the Big Four Accounting Firms.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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