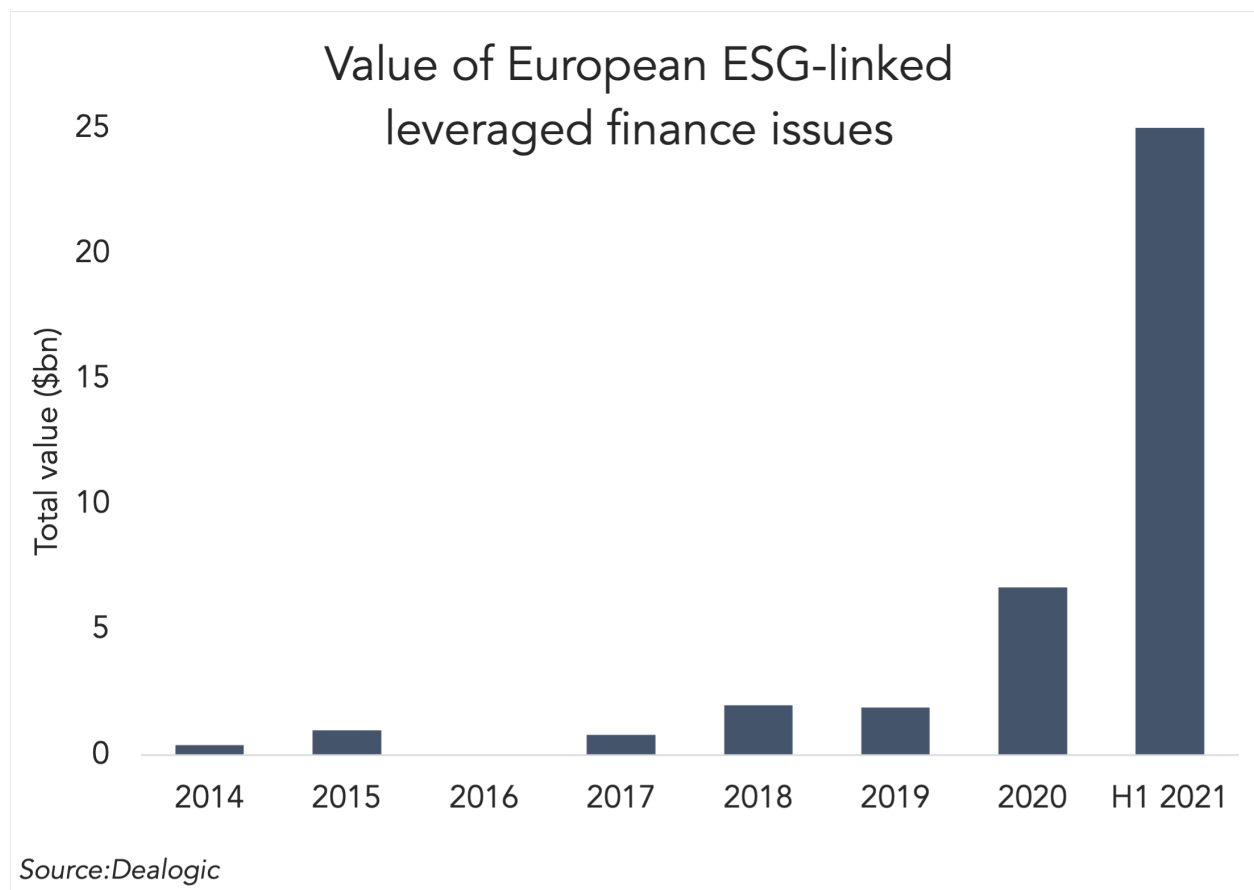


Ways through the ESG maze

PEI Private Credit | January 5, 2022



Europe has seen an explosion of loans encouraging better borrower behaviour in relation to ESG issues. We look at some of the key developments so far.

In the February 2022 issue of *Private Debt Investor*, we will be focusing on the rapid growth of ESG-linked loans in the European private debt market. As part of our research, we sought the views of leading investors about the way the trend has developed so far and what they expect in the future. Here are some of the takeaways:

1. The first steps towards private debt managers embracing ESG-linked loans were taken in 2020, but they really took off in 2021 (as can be seen in the chart above). Some in the industry think the pandemic made long-term strategic thinking a bit more urgent and brought ESG issues to the fore. Firms were forced to consider what they needed to do to make themselves relevant and sustainable in a changed world.

2. Most loans so far have involved margin ratchets, with the interest paid on loans decreasing if firms meet pre-set ESG targets. This is the “carrot” approach. However, there is a view that this may not be sufficient to improve borrower behaviour in a meaningful way. Some, therefore, are advocating more of a “stick” approach, perhaps making failure to meet targets a trigger for a covenant breach. There could be a sliding scale of

penalties, leading to a full-on default. As yet, this remains largely in the theoretical realm.

3. Some investors complain about a lack of transparency when it comes to the key performance indicators built into such loans – both in relation to exactly what the KPIs are, together with how much (and how clearly) they are a part of firms' reporting. Adding to the potential confusion, KPIs are often tailored to the type of business. For example, an industrial company may tilt its KPIs more towards environmental improvements whereas a software company may focus more on diversity improvements.

4. Thus far, ESG-linked loans have been largely in the domain of the bigger, brand-name managers. Although they are beginning to filter down to the smaller GPs, some say they lack the specialists within their teams who are needed to fully understand ESG and sustainability issues and price the risk accordingly. But it's something all managers will increasingly need to wrestle with, so solutions will have to be found one way or another.

(Past performance is no guarantee of future results.)