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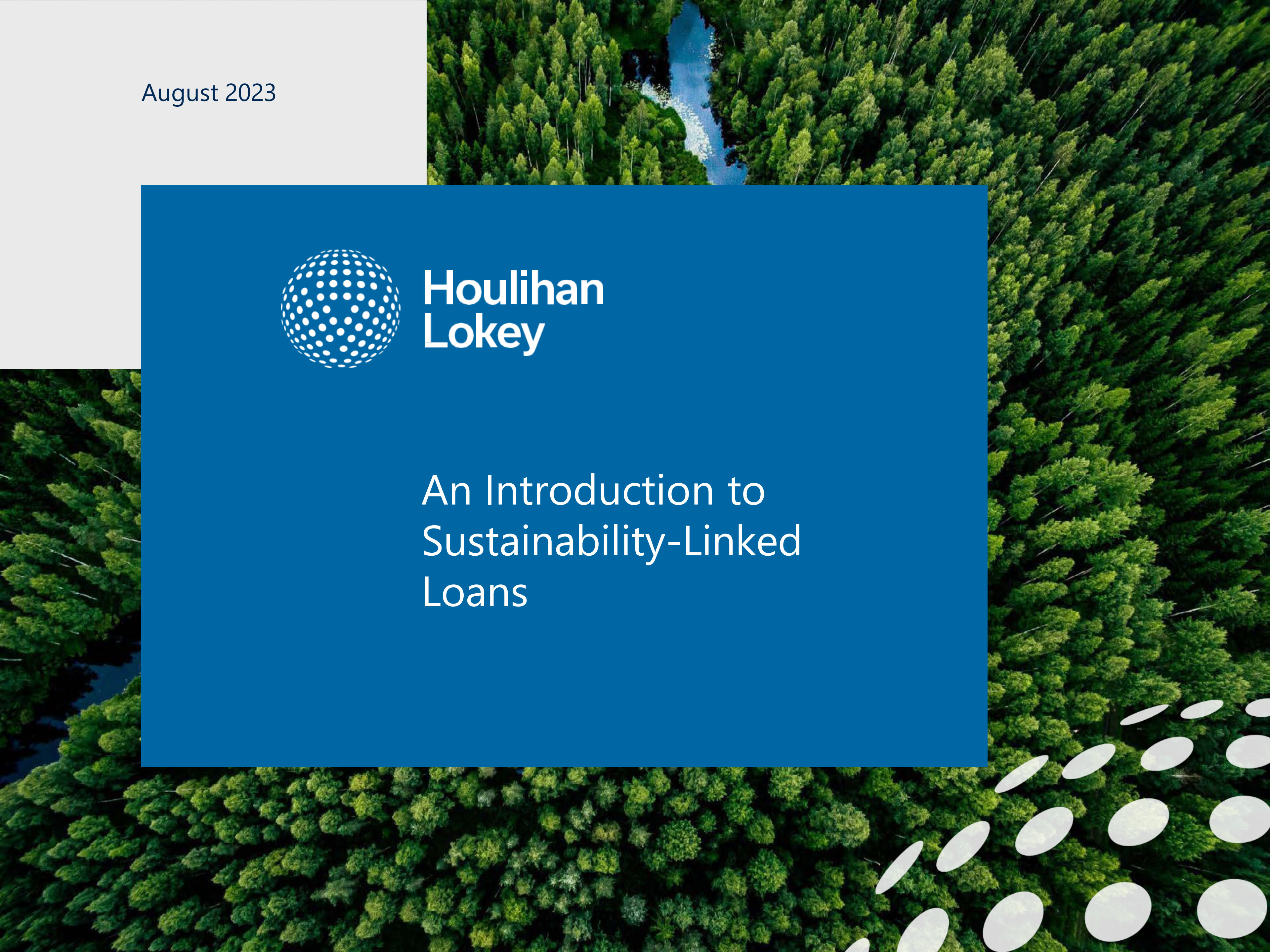
Houlihan Lokey

An Introduction to Sustainability-Linked Loans



01 INTRODUCTION TO SUSTAINABILITY-LINKED LOANS

What Are Sustainability-Linked Loans?

Introduction

Sustainability-linked loans (SLLs) are a relatively recent phenomenon but have become a topic of discussion from Wall Street to Main Street. With many organizations now required to report on sustainability, companies and lenders are also looking for ways to enhance both their financial and reputational position with investors and customers by capitalizing on the current focus on environmental, social, and governance (ESG) issues.

SLLs are loans where a portion of the interest rate margin is linked to the borrower's ability to meet predetermined sustainability performance targets (SPTs). Since the first issuances six years ago, the market for SLLs has grown exponentially from $4.8 billion in 2017 to $447.3 billion in 2022.(1) In its infancy, SLLs were issued in the syndicated loan market and concentrated mainly in the utility sector, consistent with green energy financing among European countries. However, in recent years, there has been an expansion of this financing vehicle to the North American private credit market and into other industries, including chemicals, energy, industrials, transportation, and logistics.

Oil and gas majors have also sought to issue sustainability-linked instruments, with Royal Dutch Shell in 2019 issuing one of the largest SLLs to date, tying interest and fees paid on a $10.0 billion revolving credit facility to its progress against a short-term net-carbon-footprint intensity target. Since the pandemic, there has been an increase in the number of companies utilizing SLLs as a financing vehicle, and this trend is expected to continue into the foreseeable future given the sizeable dry powder available from private funds—such as Blackstone Credit's Sustainable Resources Platform, which sees an opportunity to invest $100 billion in energy transition and climate change solutions over the next 10 years.

Energy transition presents a significant upside opportunity for the use of SLLs. The International Energy Agency estimates that annual clean energy investment worldwide will need to more than triple by 2030 to around $4.0 trillion to reach net zero emissions by 2050.

The Market for Sustainability-Linked Loans

$4.8B
in 2017(1)

$447.3B
in 2022(1)

(1) Bloomberg.

How Do SLLs Work?

SLLs contain a feature whereby the borrower's performance for predetermined metrics is measured against certain external SPTs, with that performance triggering certain outcomes. SPTs measure improvements in the borrower's sustainability performance that are generally tied to the interest rate margin on the loan. SPTs can be (i) internal and bespoke to the borrower's business; (ii) external and set against a borrower's ESG performance in relation to its peers, as determined by an external reviewer; or (iii) a combination of both.

Basic characteristics of SLLs include the following:

- There are no restrictions on the use of proceeds from an SLL—the issuer/borrower is not restricted to "green" expenditure and activities.
- The terms of an SLL (usually the interest rate) will vary depending on the performance of the borrower's business relative to pre-defined SPTs. The relevant metrics and SPTs (which should apply over the life of the loan) are negotiated and set between the borrower and the lenders, underscoring the collaboration across stakeholders in the SLL structuring process.
- Typically, there will be no other adverse contractual consequences (e.g., breach of covenant, event of default, etc.) if an issuer or borrower fails to achieve its SPTs. The only direct consequence of meeting or failing to meet SPTs or to deliver an SPT certificate is an adjustment to the interest rate margin.
- The type and level of the relevant SPT selected usually depends on the sector and business model of the borrower but should be ambitious, measurable, and aligned with the borrower's long-term sustainability strategy.
- KPIs include reduction of greenhouse gas emissions, utilization of renewable energy, water quality, use of recycled materials, percentage of women in senior management, employee training on diversity, anti-harassment, culture, workplace safety incidents, and provision of education and food waste, among many others.

Sources: Sustainalytics: "SLLs: A Bridge to Connect Sustainability and Finance," Sept. 2021. Vinson & Elkins: An Introduction to Sustainable Finance.

Process Roadmap for SLL Issuance

The Sustainability-Linked Loan Principles (SLLP) was developed by an experienced working group from the Loan Market Association and Loan Syndications and Trading Association, who set out a framework for issuing SLLs that enables market participants to understand the characteristics of a SLL. The five core components of the SLLP are shown below.

Selection of KPIs

KPIs must be relevant to the borrower's business and aligned with the sustainability strategy.

KPIs must be measurable or quantifiable on a consistent basis and able to be benchmarked to assess the ambition of the ESG goal associated with the loan.

Calibration of SPTs

The calibration of the SPTs per KPI is key to structuring SLLs, since it sets the level of ambition the borrower commits to.

It is recommended that an annual SPT should be set per KPI for each year of the loan term and be determined on a predefined timeline, set before or concurrently with the origination of the loan.

SPTs should represent a material improvement in the KPIs and be beyond both a "business as usual" trajectory and regulatory required targets.

Borrowers may seek input from an external party via a pre-signing second-party opinion that assesses, among other things, the robustness and reliability of selected KPIs, the rationale and level of ambition of the proposed SPTs, and the relevance and reliability of selected benchmarks and baselines.

Reporting

Borrowers must report at least annually to the lender on the progress toward reaching the SPTs.

The two parties must also decide whether the SPTs are still relevant and ambitious.

Information relating to the SPTs will often be included in a borrower's integrated annual report or sustainability report; however, a borrower may choose to share privately with the lenders rather than making this publicly available.

Loan Characteristics

An economic benefit should be provided if the borrower meets the predetermined SPT.

For example, the interest rate margin will often be reduced if the borrower satisfies a pre-determined SPT as measured by the pre-determined KPIs and vice versa.

Verification

The borrower's performance for each SPT and KPI must be independently reviewed by an external party at least annually.

Source: https://www.lsta.org/content/sustainability-linked-loan-principles-sllp.

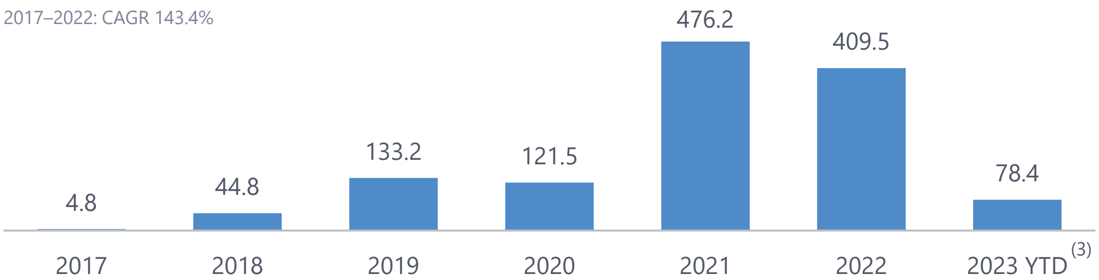
SLLs by the Numbers

The total dollar value of SLLs issued between 2017 and 2022 experienced a CAGR of 143.4%, while the U.S. market specifically achieved a CAGR of 128.8% from 2018 to 2022. Globally, the total number of SLL deals increased from 15 in 2017 to 895 by the end of 2022.

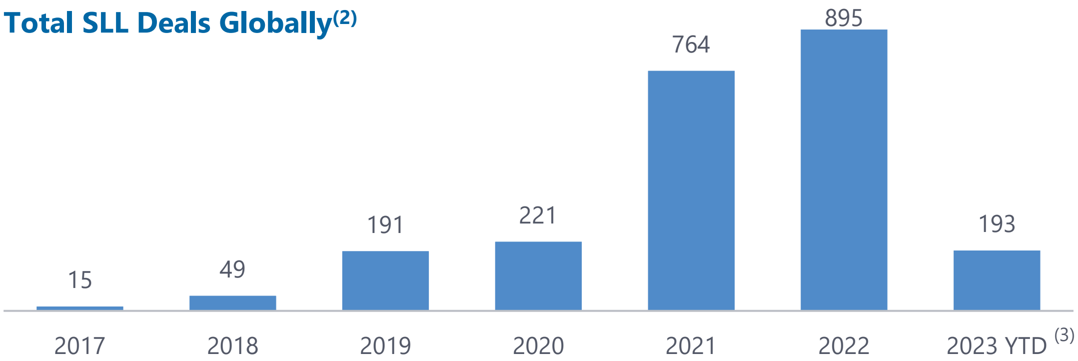
We note, however, that the volume of SLLs issued for the YTD period ended June 30, 2023, has declined precipitously as compared to the prior year, which is consistent with decline in the wider global debt market. New-issue volume in the global debt market for the YTD period ended June 30, 2023, is down 51% to $178.2 billion in 2023. The global debt market has been less active in the first half of 2023 as a result of tightening credit conditions, rising debt costs, and a more selective lender base. Despite the decline in SLLs, a recovery in the wider debt market should also result in a rebound of SLL issuances.[1]

Total SLLs Issued Globally[2]

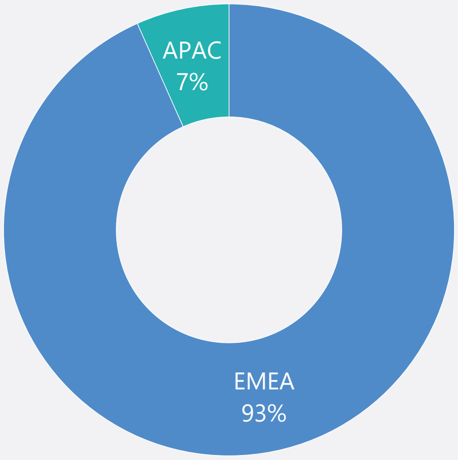
Amount in billions
2017–2022: CAGR 143.4%



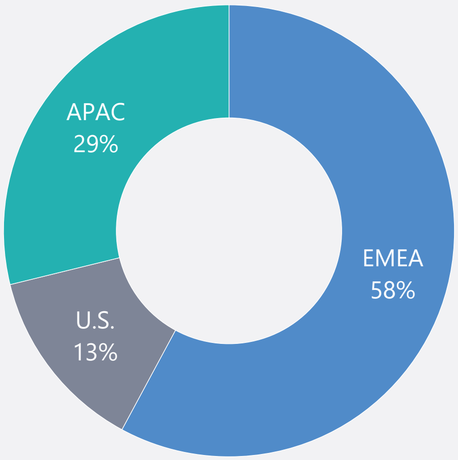
Total SLL Deals Globally[2]



2017 SLL Deals Globally[1]



2022 SLL Deals Globally[1]



(1) S&P LCD LoanStats.
(2) Bloomberg.
(3) Year-to-date information as of June 2023.

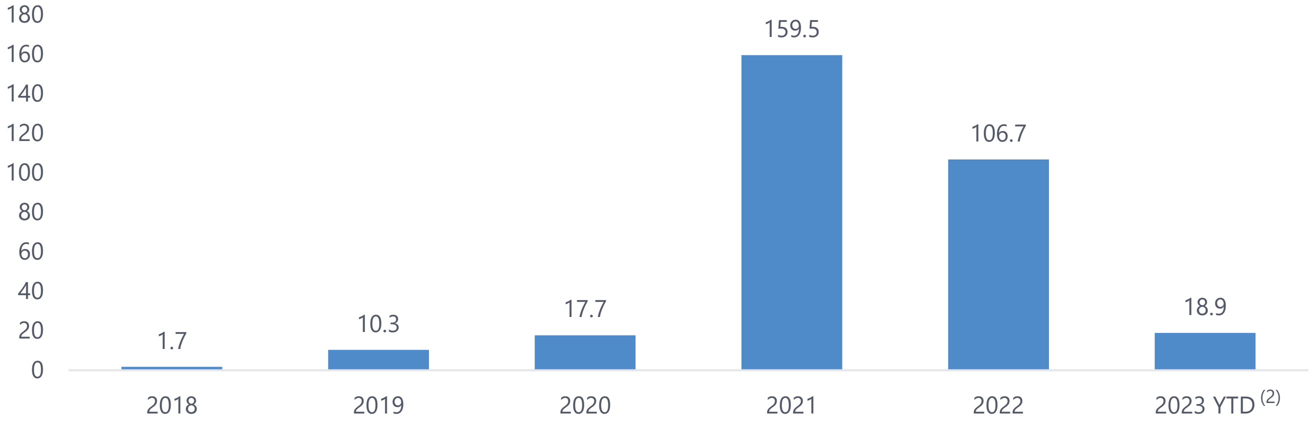
SLL Market in the United States

In 2018, CMS Energy issued the first SLL in the U.S., consisting of $1.4 billion of new credit facilities, with renewable energy generation as the SPT.(1)

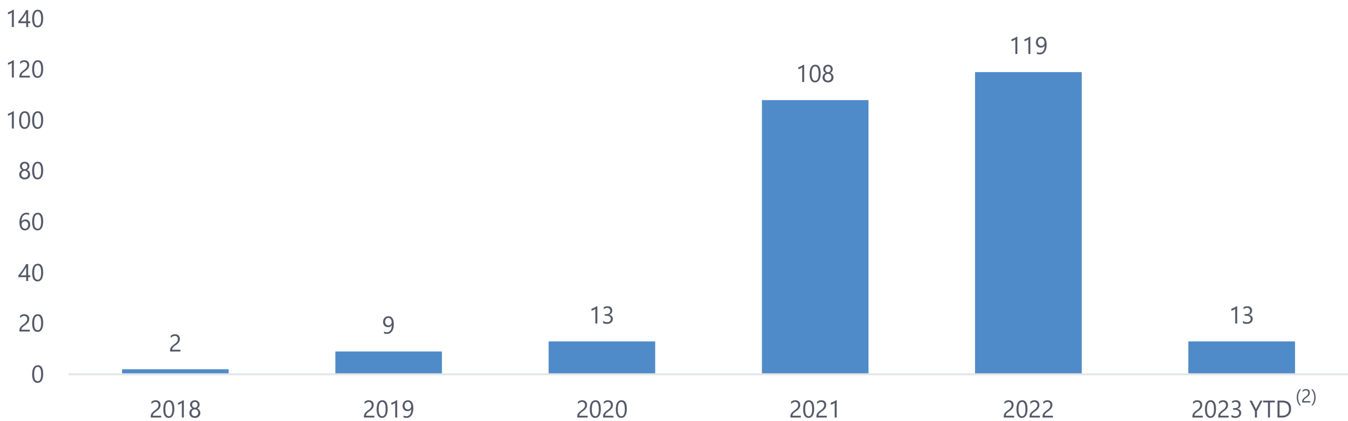
Total SLLs Issued in the U.S.(2)

Amount in billions

2018–2022 CAGR: 128.8%



Total SLL Deals in the U.S.(2)



(1) Bloomberg.
(2) Year-to-date information as of June 2023.

02 BENEFITS OF SUSTAINABILITY-LINKED LOANS

Benefits of Sustainability-Linked Loans

SLLs are an alternative to traditional capital raising that provide benefits to both corporate borrowers and lenders.[1]

Innovative Financial Instrument

- The concept of SLLs started gaining traction around six years ago, so market participants in this nascent debt instrument may be viewed as forward-thinking and potentially attract a diversified investor base.
- Interest rates are linked to agreed sustainability performance targets that allow borrowers to align financing sources with their wider sustainability plan.
- Lenders could benefit from a new revenue stream and develop a competitive advantage, particularly for funds focused on energy transition.

Different Credit Investment Strategies[2]

- The versatility of SLLs has resulted in the instruments expanding from the syndicated bank loan market to the private credit market, offering new investment strategies to private credit funds.
- Increasing appetite across energy and infrastructure credit investments.
- SLLs provide an opportunity for investors to make bespoke interventions in a portfolio company's sustainability strategy without taking a control position.
- Any type of loan financing can be used as an SLL (including revolvers, term loans).

No Requirement for Proceeds Use[3]

- SLLs are agnostic as to loan purpose—unlike green bonds, which mandate the use of proceeds to predetermined sustainability projects.
- Funding can be used for business expansion, loan refinancing, or any other corporate purpose.
- SLLs are accessible to companies operating in sectors traditionally not considered "green."

Accomplishment of Sustainability Objectives[1]

- SLLs incentivize companies to improve their sustainability while realizing tangible savings from lower interest costs.
- The issuance of SLLs demonstrate to stakeholders that the borrower is committed to sustainability targets and helps to reinforce alignment across segments for business leaders.
- SLLs enable lenders to leverage their capital and resources to strengthen businesses and support the lenders' sustainability initiatives.
- SLLs can play a key role in helping companies transition energy sources in alignment with the broader global energy transition.
- Interest rate savings linked to the ESG targets attracts borrowers to consider an SLL.

(1) Sustainalytics: "SLLs: A Bridge to Connect Sustainability and Finance," Sept. 2021.
(2) Ares: "Sustainability-Linked Loans in Private Credit," Case Studies pages 9–12, Dec. 2022.
(3) Norton Rose Fulbright: "The Rise of Sustainability-Linked Loans," Sept. 2022.

03

SELECTED RECENT SLL ISSUANCES IN THE ENERGY AND INFRASTRUCTURE SECTORS

Selected Recent SLL Issuances in the Energy and Infrastructure Sectors

Date Announced	Type-Maturity	Borrower	Business Description	SLL Value ($M)	SPT	Actual Interest Rate	Interest Rate Adjustment
3/1/2023	RCF - 5 Years	Xylem Inc.	Water Technology	$1,000	• Reduction in GHG emissions • Percentage of global supply chain spend (in $)	SOFR +1.125%[1]	(+/-) 0.33 bps
11/23/2022	RCF - 2 Years	Consumers Energy Co.	Power Generation and Distribution	$250	• Renewable energy generated/ purchased of total energy	SOFR +0.850%	(-) 2.5 bps and 5 bps[2][a][b] (+) 2.5 bps and 5 bps[3][a][b]
11/9/2022	RCF - 5 Years	Oncor Electric Delivery Co. LLC	Electric Utility	$2,000	• DART rate[4] • Partial electrification bucket trucks target	SOFR +1.000%[5]	If DART rate > DART rate threshold; (+) 2.50 bps[6] If partial electrification bucket trucks < partial electrification bucket trucks threshold; (+) 2.50 bps[6]
9/10/2022	RCF - 5 Years	Portland General Electric Co.	Electric Utility	$650	• Non-emitting generation capacity • Management, diversity, and inclusion rate	SOFR +1.250%[7]	(-) 5 bps
4/8/2022	RCF - 4 Years	Oceaneering International Inc.	Oil and Gas	$215	• ESG targets	SOFR +2.250%[8]	(+/-) 5 bps

(1) Based on current credit rating of BBB by S&P.
(2) If sustainability percentage ≥ baseline sustainability percentage (9.23%) AND;
(a) Sustainability amount ≥ 105% of baseline sustainability amount (3,299 Gwh).
(b) Sustainability amount ≥ 110% of baseline sustainability amount (3,299 Gwh).
(3) If sustainability percentage < baseline sustainability percentage (9.23%) AND;
(a) Sustainability amount ≤95% of baseline sustainability amount (3,299 Gwh).
(b) Sustainability amount ≤95% of baseline sustainability amount (3,299 Gwh).
(4) DART rate refers to a recordable workplace injury or illness that results in days away from work, restricted job roles, or an employee's permanent transfer to a new position.
(5) Based on current credit rating of A by S&P.
(6) No reduction in interest rate adjustment provided.
(7) Based on current credit rating of BBB+ by S&P.
(8) Interest rate is based on a consolidated total net leverage pricing schedule.

Selected Middle-Market SLL Issuances in the Energy and Infrastructure Sectors

Issue Date	Borrower	SLL Value ($M)	Industry	Rate (bps)	SPT	Interest Rate Adjustment[(1)]
5/25/2022	Company A	$400	Water Infrastructure	S+550	• Transition to lower-carbon fuel in equipment fleet • Increase in renewable energy consumption • Reduction in total recordable incident rate	(+) 25 bps
3/9/2022	Company B	$35	Transportation Services	S+900	• Number of apprenticeships added	(+) 25 bps
12/10/2021	Company C	$163	Utilities	L+650	• Renewable energy procurement • Emissions reduction • Workplace diversity	(+/-) 5 bps
11/22/2021	Company D	$20	Environmental Services	L+800	• Pollutant removal capacity	(+) 50 bps
6/30/2021	Company E	$50	Water Infrastructure	S+850	• Volume of water spillage	(+) 25 bps
3/31/2021	Company F	$105	Water Infrastructure	S+600	• Pump usage percentage	(+) 25 bps

(1) Tested annually, and failure results in adjustment to margin.

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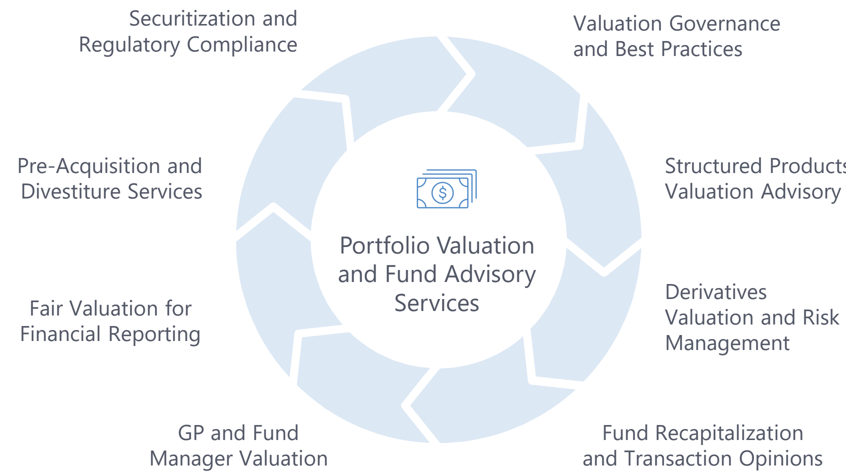

Global Recognition

The HFM Services Awards named Houlihan Lokey "Best Valuations Firm for Hard to Value Assets" in the U.S. in 2018–2022 and in Europe in 2020–2023, and it was named "Best Valuations Firm" in Asia in 2020–2022. Houlihan Lokey has now won these awards in all three geographic regions for three consecutive years!

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