SOARING ON SUCCESS:

The Growth of Sustainability Linked Loans

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In the wake of increased demand for sustainable finance products, sustainability linked loans (SLLs) have emerged as a rapidly growing segment of this diversifying market. More than USD 180 billion worth of SLLs have been issued since the first deal in 2017, with a 168% year-over-year growth in 2019 for an annual volume exceeding USD 122 billion.[i]

What is a Sustainability Linked Loan?

While green loans, much like green bonds, finance specific green projects or activities through clearly defined use of proceeds, SLLs, also known as ESG linked loans, broadly incentivize positive sustainability performance. The premise of the SLL is that by linking loan terms (namely interest rate margins) to pre-determined sustainability performance targets (SPTs) such as ESG ratings, the borrower receives a discount or premium on the interest rate based on their SPT performance.

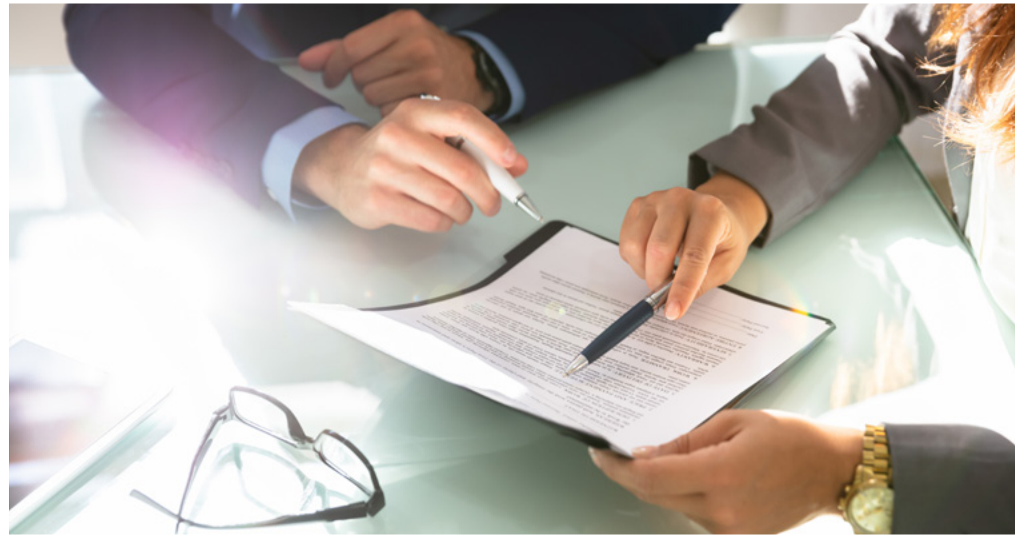
SLLs fall under the broad lending category of "general purpose loans" which provide flexibility to borrowers in terms of how they use the funds.[ii] This flexibility is one of the primary reasons for SLLs' rapid acceleration since their introduction in 2017, exceeding the market share of green loans in 2019. Additionally, the introduction of the voluntary Sustainability Linked Loan Principles in early 2019 reflects market acceptance of this new financial instrument, triggering greater uptake of SLLs.

Operating under the premise that there is a clear correlation between improved sustainability performance and lower cost of capital, SLLs provide clear benefits to both borrowers and lenders. Borrowers are incentivized to improve their sustainability performance and demonstrate this commitment to key stakeholders such as investors, while accessing preferential interest rates.

Aggregate Volumes of Announced Green & Sustainability Linked Loans, 2014–2019 (USD$bn)

Source: Bloomberg

For lenders, SLLs represent a structured way to expand their lending portfolios and apply ESG considerations in a systemic way. By using SLLs, commercial investment banks can benefit from competitive differentiation by enhancing their value proposition to customers while strengthening their position as sustainable finance leaders. By directing capital to companies with long-term commitments to sustainability improvement, lenders may also mitigate exposure to material sustainability risks and leverage exposure to sustainability opportunities.



How Are Loans Being Linked to Sustainability Performance?

With the aim of aligning financing and sustainability objectives, borrowers and lenders usually work together to set SPTs over the lifetime of an SLL. Typically, the loan margins are quite modest; in the case of ING, discounts and penalties on these loans vary between 5% and 10% on the interest rate margin, depending on the cost of capital.[iii]

Banks like ING, BNP Paribas, BBVA and Natixis, recognized by Global Capital as leading arrangers of green and ESG-linked loans in 2019,[iv] are among those at the forefront in the SLL market acting as structuring agents and sustainability coordinators in most deals to date. Corporate clients have come from a variety of sectors including utilities, financials and industrials. Notably, SLLs are accessible to borrowers from sectors that may not be considered "green" and may otherwise face barriers to accessing green finance.

Borrowing costs are often linked to external ESG ratings from a credible third party like Sustainalytics. In addition to their appeal as an independent assessment, ESG ratings cover a variety of ESG parameters and are considered a holistic representation of corporate sustainability performance.

ESG Ratings as a Sustainability Performance Target:

Poor ESG performance by a company can oftentimes result in negative financial impacts which can erode its credit worthiness. Thus, assessing the ESG performance of companies in a lending portfolio may help commercial investment banks to reduce their risks. Sustainalytics' ESG Risk Ratings have been used as SPTs for many sustainability linked loans in the market today because they are recognized and trusted by banks and corporate issuers alike.

Updated annually and covering more than 12,000 companies worldwide, Sustainalytics' materiality focused ESG Risk Ratings provide a broad assessment of a company's exposure to ESG risk as well as how well it manages those risks.

SPTs are also being linked to specific performance indicators, ranging from internally tracked corporate metrics to credible external metrics such as science-based targets or UN Sustainable Development Goals (SDGs).[v vi] When using specific performance metrics, borrowers may demonstrate the credibility of their approach by soliciting an opinion from third parties, such as Sustainalytics, to attest to the materiality of the selected SPTs. Best practices entail selecting metrics which directly and meaningfully align with the borrower's core business model and/or sustainability strategy. The most common metrics applied include carbon intensity and share of renewable energy.

Sustainability Performance Targets: ESG Ratings vs Internal Metrics

ESG RATINGS	INTERNAL BORROWER METRIC
• Independent • Credible • Holistic representation of corporate sustainability • Year-over-year comparability • *For lenders:* Allows for the systemic roll-out of SLLs across the lending portfolio	• Based on company's own reporting (thus third-party verification/audit required) • Metric may be company specific • Improvement on specific metrics not necessarily indicative of overall sustainability improvements

As a recent example, in December 2019, the biggest SLL deal to date worth USD 10 billion, was issued to Royal Dutch Shell targeting its most material ESG impact. The revolving credit facility (RCF) linked interest and fees paid on the facility to the company's progress towards reaching its short-term Net Carbon Footprint intensity target.[vii] Other notable examples are Nokia's EUR 1.5 billion SLL based on science-based targets and Pearson's USD 1.19 billion SLL considering SDG4, universal access to education, as the key target.[viii ix]

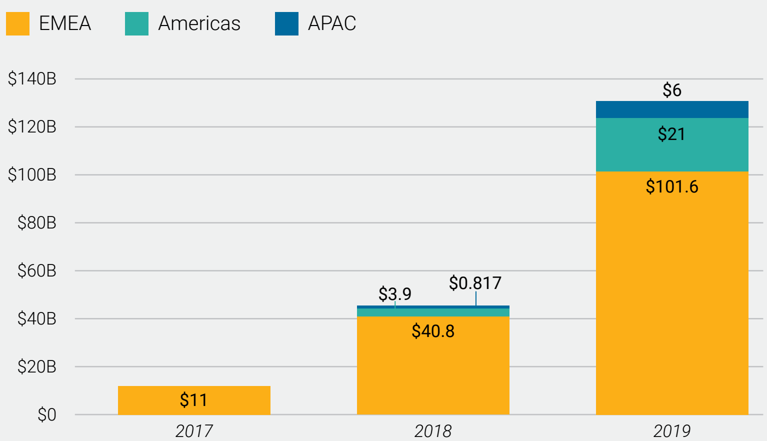
Some innovative deals include a mix of both ESG ratings and specific metrics in the loan terms:

In February 2018, Danone was among the first to link combined SPTs to its syndicated EUR 2 billion RCF with BNP Paribas acting as agent. This deal indexed a portion of the financing costs on ESG ratings, including Sustainalytics' overall rating, and on the percentage of consolidated sales by Danone's certified benefit corporation (B-Corp) subsidiaries. Danone's performance on its SPTs is measured and annually tracked to determine the discount or premium on the loan margin[x] Ultimately, even if Danone saves a small share on the loan margin, the annual savings for the company could still amount to several million dollars available for allocation towards its sustainability commitments, among other general uses.

Ranked among the world's largest SLLs, COFCO's USD 2.3 billion agreement with a consortium of 20 banks led by ING was the first SLL in China, and largest for a commodity trader globally.

The facility's margins are linked to SPTs such as i) year-on-year improvement of COFCO'S ESG Rating by Sustainalytics and ii) specific key performance indicators involving traceability of agri-commodities, with a focus on directly sourced soy from Brazil.[xi] The loan's margin offers as much as five basis points of incentive or premium depending on whether targets are met. COFCO estimates savings of about USD 1 million a year by meeting its targets.[xii xiii]

ESG Linked Loan Issuance



Source: Bloomberg

Growth of the SLL Market – Key Trends

In the wake of a major push to galvanize sustainable economic growth, SLLs are expected to make up an increasing portion of global sustainable debt. In 2019, SLL volumes exceeded USD 122 billion[xiv] with an overall borrower count exceeding 120, almost tripling 2018 volumes of USD 46 billion with 50 borrowers.

Some key trends in the market related to this growth are as follows:

Standardization and Transparency:

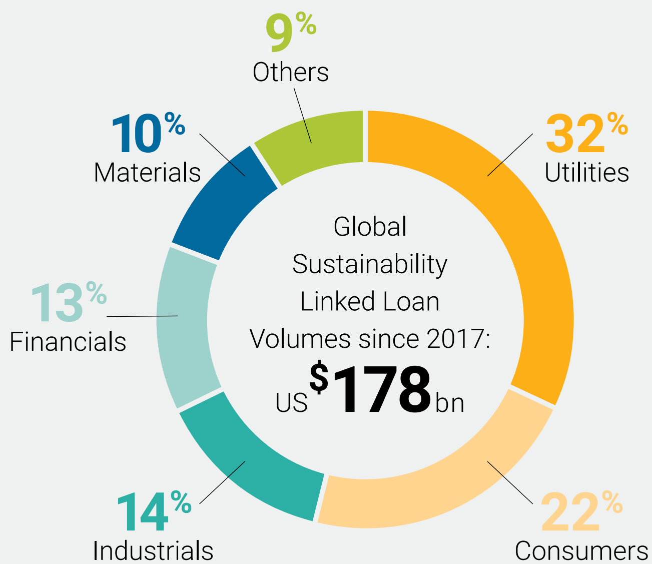
The rapid growth of SLLs got a boost in March 2019 with the release of the Sustainability Linked Loan Principles by three global loan trade odies, Europe's Loan Market Association (LMA), the US Loan Syndications and Trading Association (LSTA), and Asia Pacific Loan Market Association (APLMA).

The voluntary principles provide a high-level framework focused on improving transparency and disclosure related to criteria for loans linked to sustainability performance. Transparency remains a hallmark of the sustainable finance market and is reflected in one of the most important components of the Principles – reporting. Normally, companies and banks do not disclose the pricing details of their green and ESG facilities. While lenders often issue press releases announcing such loans, the details on the sustainability criteria on which the interest rate hinges can be vague. The Sustainability Linked Loan Principles are expected to bring consistency and transparency to future deals.[xv xvi]

Regional Spread:

While SLLs have gained considerable momentum globally, Europe has been at the forefront of this growth, capturing 81% of the SLL deals in 2019. Recent figures show that USD 21 billion of sustainable loans were signed in 2019 in the Americas, compared to more than USD 100 billion in EMEA. However, APAC is the region where considerable growth is expected in the coming years, with major SLL deals in 2019 amounting to USD 5.7 billion, including Wheelock, Sydney Airport and COFCO International.

Aggregate Volumes of Sustainability Linked Loans by Borrower Industry, 2017 - 2019



Source: Bloomberg

Diverse Range of Industries:

SLLs' general purpose financing provides access to capital to a wider range of corporations, in terms of size and industry, than sustainable bonds which require a substantial amount of green assets to finance. Their appeal to a diverse range of industries including, utilities, telecom, real estate and retail, is expected to grow. Following Royal Dutch Shell's recent high-profile deal, SLLs are expected to gain traction among browner industries seeking finance to support their transition to a low-carbon economy.

Sustainability Linked Loans Sees Activity From Across Sectors

Steel
voestalpine
EUR 1 billion[xvii]

Airports
Sydney Airport
USD 1 billion SLL[xviii]

Oil & Gas
Royal Dutch Shell
USD 10 billion RCF[xix]

Education
Pearson
USD 1.19 billion RCF[xx]

Hospitality
Accor
EUR 1.2 billion RCF[xxi]

Real Estate
Wheelock
HK 2 billion SLL[xxii]

Retail
Carrefour
USD 4.41 billion for two lines of credit[xxiii]

Telecom
Nokia
EUR 1.5 billion RCF[xxiv]

Utilities
CMS Energy
USD 1.4 billion SLL[xxv]

RCF = revolving credit facility

The Path Ahead:

SLLs have emerged as a flexible and scalable instrument to align financial priorities with sustainability objectives. As the market matures, we can anticipate further standardization and rigour with respect to the selection of performance targets. Moreover, the appeal of the instrument's flexibility seems to inspire further innovation in the sustainable finance industry. Enel issued the first general-purpose SDG-linked bond in 2019 and Sydney Airport issued a sustainability-linked bond in 2020, where the coupon will increase or decrease based on their ESG Rating from Sustainalytics.[xxvi] [xxvii] Building on the growth and success of the SLL market throughout 2019, there is clearly an appetite for such instruments in the sustainable finance toolkit.

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About Sustainalytics' Sustainable Finance Solutions

Sustainalytics is a leading global provider of environmental, social, governance (ESG) research, ratings and analytics. For over 25 years, Sustainalytics has been at the forefront of developing innovative solutions to meet the evolving needs of investors. Today, we support hundreds of the world's leading pension funds and investment managers who incorporate ESG and corporate governance insights into their investment processes.

Sustainalytics' Sustainable Finance Solutions support the growing demand for green and sustainability themed finance instruments in debt capital markets. The firm's Sustainable Finance team work with issuers and underwriters to provide second-party opinions on bond frameworks aligned with leading global Principles and Guidelines. Sustainalytics also offers corporations the option to license its ESG Risk Ratings, which can be used for sustainability-linked loans and for other capital raising activities.

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