October 5, 2021

RESPONSIBLE INVESTING

ESG-Linked Fund Finance: Two Most Prevalent Structures and Challenges With Use (Part Two of Two)

By Helen Kim, *Private Equity Law Report*

Subscription credit facilities have become a standard part of the PE landscape, with little in the way of contention after years of market participants working out terms. With the intense interest and focus on environmental, social and governance (ESG) principles, however, lenders and borrowers have begun to incorporate ESG targets and metrics into facilities, partly to demonstrate their commitment to ESG goals. The result is that the industry has adopted two types of approaches – performance-based and use-of-proceeds – that each weaves ESG into the subscription facility framework.

This second article in a two-part series describes the two main facility structures currently in use and certain challenges with linking ESG targets to financing, such as the difficulty of putting an internal ESG program in place and avoiding abuse through greenwashing. The first article outlined the trend generally and how ESG-linked fund financing differs from traditional fund financing, including the role of an ESG coordinator in the negotiation process and requirement of tracking ESG performance.

For more on alternative financing facilities, see "How Management Company Facilities Offer Liquidity for Sponsors' Working Capital Needs" (Apr. 28, 2020); "Streamlined Borrowings and Longer Loan Durations With Hybrid Facilities" (Mar. 3, 2020); and "How GP and Co-Investment Facilities Increase Sponsors' 'Skin in the Game'" (Feb. 11, 2020).

Two Types of Financing Structures

The two ways in which ESG-linked facilities are currently being structured are use-of-proceeds and performance-based facilities. "The market is still in the very early stages," noted Cadwalader partner Wesley A. Misson, who led the team that advised Bank of America on the Carlyle Group's $4.1-billion ESG-linked credit facility that closed in February 2021 (Carlyle Facility). "In terms of what's being done today, however, those are the two ways of structuring financing with ESG components."

Both types of structures have similar tenors to typical subscription lines, falling between one and three years on average, according to Misson. For both structures, tracking and reporting on key performance indicators (KPIs) are key obligations.

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Use-of-Proceeds ESG-Linked Facilities

Use-of-proceeds facilities require the borrower to use all loan proceeds for investments that qualify under agreed ESG criteria. "The main focus is whether the loan proceeds are going to be used to make ESG-qualified investments," explained Simpson Thacher partner Julia Kohen, who worked on the revolving credit facility for KKR's $1.3-billion Global Impact Fund, which closed in June 2020 and featured the first use-of-proceeds ESG facility in the U.S.

"The key takeaway is that the manager needs to make sure the asset class and investment strategy of the borrower sync with the agreed use of the loan proceeds," Misson agreed. "Otherwise, the facility simply does not work."

For ESG Funds Only?

Use-of-proceeds facilities are often used for funds aimed at a specific ESG goal, such as clean energy, renewable energy or climate change. "A use-of-proceeds facility lends itself naturally to an ESG-focused fund because the purpose of the fund and the nature of the investments are already linked to ESG," Kohen noted. "It would be very difficult to set up a use-of-proceeds ESG facility for a non-ESG fund."

A use-of-proceeds facility could potentially be used for a fund that is not solely focused on one ESG asset class if it were tranched, Misson commented. "A fund can set up a sustainability tranche, for example, in which 100 percent of use-of-fund loan proceeds must be applied to sustainable assets," he explained. "At the same time, the fund could set up a regular corporate or other investment purpose tranche where loan proceeds can be used for assets that would not qualify under the agreed ESG criteria."

Dividing a use-of-proceeds loan into tranches could be a way for the market to make it more flexible, Kohen mused, although separate loans could also be used in that situation.

KPIs and Targets Should Follow Internal Standards

For the borrower, it is important that the obligations under the use-of-proceeds ESG facility match those under the limited partnership agreement (LPA) without surpassing them. "Deals involving use-of-proceeds ESG facilities should tie the terms of the facility to the fund's organizational documents," Kohen elaborated. "If the fund has agreed with LPs that it will be making certain types of investments, then the obligations under the credit facility should not be more onerous than those negotiated with the investors."

Negotiating KPIs for a use-of-proceeds facility should be a straightforward process because an ESG-focused fund should already have KPIs, metrics and reporting obligations in its organizational documents, Kohen stated. "Performance targets and KPIs in the financing should piggyback off the negotiations the sponsor has had with LPs. The bank should not be in a position to impose additional compliance obligations."

See "ESG Risk Alert: Inadequate Controls, Policies and Procedures Concern SEC About ESG Practices Inconsistent With Disclosures (Part Two of Two)" (Jun. 15, 2021).

Tracking and Reporting Should Follow Internal Policies

An ESG-focused fund should already have processes and procedures in place to measure, verify and report to its LPs, including auditors and third-party opinion providers. "Setting up

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an ESG-focused fund requires a high level of sophistication," Kohen noted. "It requires resources to conduct the appropriate audits, perform due diligence, create the right system and prepare detailed reporting." Compared to a performance-based facility, it is easier for a bank to verify results.

Reporting and verification obligations may be the most strenuously negotiated points. Credit agreement reporting obligations should be tied to the reports the fund is already providing its LPs; borrowers should not have to provide more information about the fund or investments than they provide the LPs, Kohen advised.

If the lender does require additional audits, verifications or other obligations beyond what is required for LPs, however, the borrower must consider the cost of those additional requirements, Kohen said. "Borrowers want to ensure the cost of meeting lenders' additional obligations does not outweigh the economic incentive of putting the facility in place."

Once the lender has received the borrower's reports, it must be able to audit them if there is a perceived mismatch between the stated goal and the results reported, Kohen continued. Borrowers may want to limit how often the lender can verify the report to once a year, for example, or only when an event of default occurs.

Guidance

The most relevant guidance for use-of-proceeds ESG facilities is the Green Loan Principles (GLP) and accompanying guidance published jointly by the Asia Pacific Loan Market Association, Loan Market Association and the Loan Syndications and Trading Association (Lending Authorities). The GLP applies to a variety of loan instruments, including revolving credit facilities and focuses on environmentally sustainable economic activity.

The core GLP components are:

1. use of proceeds;
2. process for project evaluation and selection;
3. management of proceeds; and
4. reporting.

See "Emerging Trends in LP Demands for Standardized ESG Reporting and How GPs Have Attempted to Comply" (Jul. 20, 2021).

Performance-Based ESG Facilities

Experts agreed that performance-based ESG facilities are more flexible than use-of-proceeds facilities. "Performance-based facilities can be structured for any type of fund with any asset class," Misson noted. "Unlike a use-of-proceeds facility, it is not necessary for the fund investment strategy to align 100 percent with the ESG goal. The flexibility is the reason why we have seen more performance-based facilities to date than use-of-proceeds facilities."

Performance-based facilities can also be set at different levels of a fund structure – management, fund or portfolio-company level, Misson said. In Europe, ESG-linked fund financing has been happening at the portfolio company level for some time. In the U.S., the trend appears to have begun at the fund level but is starting to move into the acquisition level.

"We are now finding that we can get preferential financing pricing based on ESG metrics in connection with LBOs in the U.S., and it is going well beyond just fund-level financings, green bonds, etc.," observed

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Latham & Watkins partner Manu Gayatrinath, who led the finance team that advised Carlyle for the Carlyle Facility.

See "Adoption of ESG Voluntary Standards By Fund Managers to Overcome U.S. Regulatory Shortcomings and Bolster ESG Defensibility (Part Two of Two)" (Jun. 1, 2021).

Any Type of Fund

The flexibility of performance-based facilities extends to the types of managers, assets and funds to which they can apply. As long as the manager has an ESG policy and interest in finding a way to measure ESG performance at the investment, fund or management level, then a performance-based facility can probably work, Misson said.

The ability to monitor and report on KPIs may be the most significant gating item for funds that wish to put an ESG facility in place. "There is no particular type of fund that is better suited for a performance-based facility than another," Gayatrinath noted. "Any fund that has the capacity to do the reporting and tracking of metrics can potentially set up a performance-based facility, subject to the underlying investment thesis of the fund, of course."

See "Five Steps for PE Sponsors to Establish ESG Policies at Their Portfolio Companies to Suit the Present Moment" (Nov. 17, 2020).

Documenting a management-level ESG facility is similar to documenting a fund-level or portfolio company-level facility. "There isn't a ton of difference in the drafting, but there will be differences in how targets are established and how KPIs are structured," Misson said. "That will flow through to reporting and verification on reporting."

Guidance

The Sustainability Linked Loan Principles (SLLP) and accompanying guidance published by the Lending Authorities are the main tools used in creating performance-based ESG facilities.

"If the facility will be broadly syndicated within the market, most folks use the SLLP because the Lending Authorities are widely respected," Misson explained. "Using the SLLP enhances the marketability of a deal to other lenders and lends credibility to the structure because it follows what most in the market recognize as the authoritative and accepted guidance."

Excluding the cover page, the SLLP is five pages long. "It lists the key issues to consider while still providing a lot of flexibility," commented Latham & Watkins partner Benjamin Berman, who worked on the Carlyle Facility. The SLLP provides a definition of sustainability-linked loans and sets out a framework of five core components:

1. selection of KPIs;
2. calibration of sustainability performance targets (SPTs);
3. loan characteristics;
4. reporting; and
5. verification.

See our two-part series on the E.U. sustainable finance initiatives: "Preparing to Apply the Taxonomy Regulation and Other Proposed ESG Regulations" (Oct. 27, 2020): and "Exploring the Different Application Levels of the SFDR Based on a Firm's ESG Practices" (Nov. 3, 2020).

KPIs and Targets

Negotiating KPIs in a performance-based facility may not be as straightforward as a

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typical use-of-proceeds facility because if the fund is not focused on ESG, then it may not have ESG metrics or reporting obligations in its fund documents. “The targets are set up in the credit agreement as opposed to the LPA,” Kohen said. KPIs, however, are typically hammered out by the ESG specialists on either side of the table before legal teams come into the deal, Misson said.

According to the SLLP, the borrower’s performance is measured using predefined SPTs, as measured by predefined KPIs, which can include external ratings or metrics. Targets should:

1. represent a material improvement in the KPIs, beyond business as usual;
2. be compared to a benchmark or external reference where possible;
3. be consistent with the borrower’s overall ESG strategy; and
4. be determined on a predefined timeline, set before or concurrently with the loan origination.

According to the SLLP, KPIs should be:

1. relevant, core and material to the borrower’s overall business, and of high strategic importance to the borrower’s operations;
2. measurable or quantifiable on a consistent methodological basis; and
3. able to be benchmarked.

Comparative Popularity

At the moment, use-of-proceeds ESG facilities appear to be less popular than performance-based ESG facilities, in part because the number of ESG-focused funds remains relatively low. According to Misson, however, looking at pipeline and existing deal work, the two types of structures appear largely balanced in terms of prevalence.

A performance-based facility can be equally as rigorous as a use-of-proceeds facility, but the latter tends to be more complicated than the former because ESG funds already use a complicated set of ESG metrics. “A fund that isn’t set up to make ESG-qualified investments will likely prefer to look at performance-based metrics,” Kohen suggested. “Those facilities have very different metrics, covenants and reporting obligations.”

As more ESG-focused funds come to market, experts expect growth in use-of-proceeds facilities. “The vast majority of LPs are looking for ESG-linked investment opportunities. That will lead to changes in how sponsors select assets, fundraise and set up their funds,” Kohen noted. “In the future, we will see more demand for funds that are better suited for a single ESG purpose and therefore better suited for use-of-proceeds facilities,” Misson said.

Challenges

Creating the Internal ESG Program

For a borrower, one of the greatest challenges to setting up an ESG-linked facility is fully developing its own priorities, including what metrics it wants to track, Berman said. “Once the manager is able to develop its ESG program, it’s not terribly difficult to transfer those priorities into a piece of financing. Coming up with the priorities is not always easy, however.”

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Approximately 70 percent of fund managers have ESG policies or are working on establishing them, Misson observed. "When setting up an ESG-linked facility, the facility's goals should be consistent with the borrower's overall sustainability and ESG strategies."

One logistical hurdle is coordination between the ESG specialists who work for the fund and the financing professionals. "The people at the fund who are, for example, tracking emissions at a portfolio company or diversity at the fund level are rarely involved in the financing process," Gayatrinath said. "That coordination is something new that needs to be worked out."

Mitigating Greenwashing Concerns

Set Ambitious Standards

"Broadly speaking, the biggest challenge is ensuring ESG-linked facilities are actually accomplishing their purpose," Misson observed. To prevent greenwashing, facility terms need to address transparency and accountability in reporting and include ways to measure change, he continued. "We need to make sure we are not simply slapping labels on something that would have been achieved in any case."

The ESG linkage in a subscription facility needs to be more than just window dressing, Kohen agreed. "Change represents a material improvement in the respective KPIs and goes beyond the business-as-usual trajectory of the borrower," Misson explained. "It's something that would not have been achieved without the parties coming together, setting the goal and working toward achieving it."

See "Adoption of ESG Voluntary Standards By Fund Managers to Overcome U.S. Regulatory Shortcomings and Bolster ESG Defensibility" (Jun. 1, 2021).

Guidance suggests that, when possible, borrowers should compare their goals with benchmarks or other external references. Targets should be measured based on benchmarks from the borrower's prior track record, Misson recommended. "Measure targets over a set time period (*e.g.*, quarterly, biannually or annually) and then report back to see if the KPIs are actually being met."

Use Third-Party Verifiers

Another way to prevent greenwashing is to employ third-party verification. The May 2021 version of the SLLP actually requires third-party verification when putting a sustainability linked loan together, Misson pointed out. Previously, it was simply a recommendation.

Third-party verification may come from a qualified auditor, rating agency or consultant that reviews the borrower's reporting to ensure the underlying assumptions and benchmarks are reasonable. ESG officers housed at the lender also review reports.

"Experts at the borrower, experts at the lender and third-party specialists all look to ensure the goals are indeed ambitious and meaningful, as well as that the borrower is achieving the progress the parties set out to accomplish," Misson summarized. Lenders then take that verification into account when judging whether the targets or KPIs were satisfied.

See our two-part series on mitigating climate risk: "Mitigating Climate Risk: Advantages to PE Firms Pursuing Climate Risk Programs and Pitfalls to Avoid" (Jun. 30, 2020); and "Solutions for PE Firms to Develop a Physical Climate Risk Program" (Jul. 14, 2020).

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