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FUND FINANCE FRIDAY

A Guide to ESG Preparedness

November 12, 2021 | Issue No. 152

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When surveying the finance market landscape over the last couple of years, one thing is certain: ESG has been on the rise. Few topics have trended as hotly in recent memory, and our expectation is that environmental, social and governance dealmaking will only continue to grow in the year to come. Driven by investor advocacy and supported by enhanced outcomes when structured properly, it is increasingly important for fund finance practitioners to be well-versed in ESG. We regularly receive questions on what individuals and organizations need to do to be prepared for the long-term opportunities and challenges that ESG presents. This is your guide to ensure that you and your teams are ready for your first (or next) ESG deal.

Expectations

Before diving into the specifics of ESG preparedness, it's important to recognize the current state of play in our industry. The global pandemic has accelerated the adoption of ESG in fund finance. Market forces are driving the change, as investors and funds shift their focus to greener investments with positive impacts on people and planet. Banks have taken to the cause to book sustainability-linked loans, as industry pressure on reputation, compliance and financial risks grows. Studies have shown that companies that integrate ESG meaningful to their business perform better financially and create more long-term value than firms that don't. Some pundits predict that ESG will soon become part of the fabric of all fund finance deals, with credit facilities incorporating some form of values-based metrics and compliance generally. In an era when funds and banks are seeking to set themselves apart from competition, true ESG preparedness can be a real differentiator.

Evaluation

ESG preparedness in fund finance is about more than merely being able to negotiate key performance indicators (KPIs) or uses of proceeds (UoPs) in a credit agreement. It's about incorporating environmental, social and governance practices into your DNA and the DNA of your organization over time in a way that meaningfully moves the needles toward improved outcomes.

To initiate ESG integration, whether individually or into your team structure, we recommend starting with an evaluation of where you are currently. This assessment can be broken down into the following categories: ESG policy, credit facility documentation, data monitoring and collection, data analysis and literacy, disclosure and reporting, avoidance of sustainability washing and continued readiness by monitoring trends. You can incorporate additional items or swap out any inapplicable elements based on your or your organization's values and directives.

For proper evaluation, assess what factors you would need to enhance your capabilities in each category. For each domain, this would begin by considering what it will take to achieve basic results, such as putting an ESG policy in place, having a working knowledge of the pricing mechanics in ESG facilities or implementing procedures for data reporting and analysis. It could also include tangential components that broadly impact ESG competence, like investing in sustainability training, technology solutions, hiring subject-matter experts and related risk management. Seek open dialogue and honest input from others in your organization to appropriately appraise your present proficiencies.

By benchmarking to your current status on these various items, you'll determine existing strengths and weaknesses, and key areas for improvement. This can aid in goal-setting across ESG preparedness factors. We then suggest developing a timeline for periodic reevaluation of your progress. Initially, you might reassess monthly or quarterly. Once you discern sufficient strides toward your ESG targets, moving to a less frequent review could make sense.

After you've established the baseline of your ESG know-how, you're ready to develop your ESG preparedness in earnest. To do so, we recommend below a number of tools and practices to have all of your ESG bases covered.

Policy

Policy guides practice. As such, we suggest starting with a deep assessment of your values and objectives to craft policy that informs decision-making. This can be a living document that evolves over time. Good ESG policy should consider your approach to identifying and administering ESG matters and the standards you'll use to quantify them. Great ESG policy is shaped by your overall strategy to drive value creation and risk mitigation in a way that can be integrated in your daily routines. You may want to formally adopt a set of published ESG industry standards and actively participate in pushing for ESG adoption in fund finance. You'll want to routinely review your ESG policy with key stakeholders to ensure that it lives up to your mission and standards.

To pivot from policy to practice, you should implement systems that operationalize your policy. ESG-focused hiring, training and technology can help. If implementing it in your organization, determine who has ownership of ESG oversight and accountability. Look for opportunities to not only do ESG-linked financing deals, but also for you and your constituents to engage with others in the fund finance market on sustainability and green issues.

Facility Documentation

Without a rock-solid knowledge of how to document ESG in fund finance facilities, you won't be playing with a full deck of cards. A good place to start would be our prior articles: **ESG Loans – The Next Big Wave in Fund Finance**, **Top 10 Items to Consider When Structuring Your ESG Facility**

and The ABCs of ESG. Each provides tips, tricks and tactics that are immediately actionable for your next ESG deal.

As a basic primer, the LSTA, LMA and APLMA have published Sustainability Linked Loan Principles (SLLP) and Green Loan Principles (GLP) that will assist in your structuring of ESG deals. Depending on the aims of the fund and its ESG capabilities, the parties may use KPIs or UoPs as the fundamental factors underpinning the ESG methodologies in a credit facility. The basic mechanism in our transactions is a pricing toggle. After the borrower and lender set KPIs or UoPs, the applicable margin for pricing the loans is adjusted downward, upward or both. Recently, we're seeing a move to a two-way ratchet, which gives both parties skin in the game depending on whether the fund hits its preselected ESG targets.

The specifics of each deal will depend on the ESG philosophy and strategy of the borrower and the lender. The policy considerations listed above will influence those. But every ESG-based fund finance facility will require some form of monitoring, data literacy, reporting, regulatory guidance and sustainability-washing prevention. Our ESG preparedness suggestions for those are highlighted below.

Data Collection

Data collection begins with investment due diligence. The fund will want to ensure its chosen portfolio aligns with its ESG edicts under the credit facility. It will also want information to be collected via means that ease communication of the data to the lender. The sponsor may conduct its initial review via a third-party service provider, with a focus on maintaining compliance and mitigating any associated risks of the investments. To enhance its data collection, the fund should either be intricately involved in this process or, better yet, lead the upfront ESG due diligence. Data inputs should include what opportunities the investment elicits for value creation, material impact on selected goals and long-term sustainability. Data collection considerations may be included in investment committee or credit committee criteria.

Data collection also includes ongoing information-gathering over the course of managing each investment. Rather than being solely reactive to issues that arise, proper ESG monitoring requires systematic processes from investment inception to sale. Quarterly, semiannual and annual reviews by the fund can coincide with reporting under the credit agreement, with KPI or UoP compliance being the cornerstone of the diligence. To collaborate on this, the borrower and the lender might think about preparing a due diligence matrix or questionnaire that provides the framework for continued data calibration.

Data Analysis

Data collection begets data analysis. The borrower and the lender should each develop capabilities and methodologies for quantifying and assessing data. The critical component is materiality. The evaluator needs to understand which ESG risks are relevant to the fund's sector and to its global operations. This materiality assessment should uncover the issues that are most central to the KPI or UoP outcomes.

Data analysis should also be tailored toward the borrower's and the lender's respective risk appetites. If using KPIs, the data analysis should include both quantitative and qualitative metrics, where applicable. These may comprise statistical and regression analysis to

understand the strength of the relationship between ESG variables, as well as predictive models of future success. If using UoPs, the data analysis is much simpler, as the rubric is merely tied to whether loan proceeds were used for ESG investments.

Disclosure

Disclosure is also part of fund finance ESG's core. It first flows from data collection and analysis. With KPIs, at minimum, this will include basic reports of whether the fund met its measured targets and be delivered with the fund's quarterly financial statements. Better KPI disclosure combines quantifiable measurements with narratives, examples and case studies of investment success, including linkage to the borrower's chosen ESG policies and principles. With UoPs, reporting should occur with each borrowing if the related investments are then known, or once the use is certain if that's at a time subsequent to the loan. In negotiating the credit facility, it can be helpful for the borrower and the lender to settle on exactly what information should be provided in the compliance certificate.

Disclosure should also encompass incident reporting for any unusual or deleterious events. This will be required for KPI or UoP breaches. Outside such breaches, reporting of other circumstances that are materially adverse to the fund's ESG protocols can foster open communication and transparency between the parties. The borrower and lender can discuss at the outset of the facility what types of incidents may rise to this level. When disclosing these occurrences, the borrower can not only detail the event, but also explain how the situation is being resolved and what the fund plans to reduce repetition in the future.

Regulatory

As well-detailed in the **ESG: Regulatory Reform on the Horizon?** article by our colleague Katie McShane, Europe is now subject to an ESG regulatory regime, the Sustainable Finance Disclosure Regulation (SFDR). Fund finance practitioners located in or that do deals in Europe will want to learn the inner workings of SFDR to prevent any violations. There are no equivalent statutes or rules in the United States or Asia yet. It's left to be seen if and when any governmental reforms will be coming.

Sustainability Washing

The other side of the ESG coin is protecting against sustainability washing (also known as "greenwashing"). This can occur when a market participant exaggerates its ESG claims or provides inaccurate or misleading information. It can be implicitly encouraged if a lender does not insist on adequately ambitious and meaningful ESG goals by the fund. While noncompliance with ESG covenants and failure to meet sustainability goals can lead to unfavorable outcomes under the credit facility, greenwashing poses reputational risk that would be far worse. Moreover, if sustainability washing were to grow, it could pose an existential threat to the advancement of ESG in fund finance.

To avoid greenwashing, KPIs and UoPs that are material to the fund's business and meaningful to its mission should be selected and tightly overseen. By following the above guidelines on policy setting, data analytics, reporting and regulatory compliance, the parties can further ring-fence ESG in their deals from sustainability washing.

Trends

With online information at our fingertips, there is no excuse today for being ESG-naive. The LSTA, LMA and APLMA regularly publish updates on the evolution of ESG loans. ILPA has developed a framework and roadmap to advocate ongoing ESG initiatives between LPs and GPs. The UN's Sustainable Development Goals are intended to be reached by 2030. Government entities and other industry working groups are proactively promoting sustainability causes.

To be truly ESG-prepared, it is imperative to watch for related trends. We recommend attending fund finance roundtables, listening to industry podcasts, and participating in trade groups to stay apprised of the latest and greatest. Of course, we'll be keeping our pulse on ESG developments so we can bring them to you in our *Fund Finance Friday* pages.

Conclusion

Whether you're just starting your path on sustainability in fund finance or you're a seasoned player in the ESG space, preparedness will enhance your ability to increase value and drive long-term, socially beneficial results. By using the above as your guide, you'll be prepared to influence ESG as we enter the next phase of sustainability growth in our industry.