Partners Group
REALIZING POTENTIAL IN PRIVATE MARKETS

PRIVATE DEBT
Q&A

Sustainability-linked loans: A new engagement channel in private debt

Q&A with Aurélie Madé, Senior Portfolio Manager, and Gerald Tee, Member of Management, Private Debt Europe

Aurélie Madé, Senior Portfolio Manager

Gerald Tee, Member of Management, Private Debt Europe

As ESG and sustainability continue to climb up debt investors' agendas, so sustainability-linked loans are increasing in popularity both for limited partners (LPs) seeking ESG-compliant investments and for company management teams looking to improve their ESG performance. From a standing start just a few years ago, the sustainability-linked loan market grew to USD 600 billion globally in 2021, 3.5 times its value in 2020, according to LSTA figures.

Here, Aurélie Madé and Gerald Tee explain Partners Group's systematic approach to these loans and how the market is developing.

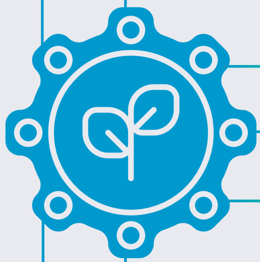
Sustainability-linked loans are relatively new to the market. How do they work?

Aurélie: These are standard loan instruments, but they incentivize sustainability improvement through a set of pre-agreed KPIs related to a company's ESG performance. There is a margin ratchet tied to these KPIs, and, depending on how well a company has performed against these objectives, the loan costs for the borrower can either step up or step down. Usually, the first reporting date on these KPIs is set to a year after the close of the investment.

Given this is such a nascent market, we've not yet reached that point with many of our sustainability-linked loans, but by way of example, for the first report we received back, the company had reached some of its targets, but not all. Overall, this equated to a small reduction in borrowing costs for the company – 25% of the maximum reduction possible – linked to the improvement of its sustainability profile.

How are sustainability-linked loans being incorporated into Partners Group's private debt business?

Partners Group's Sustainability-Linked Loans Operating Principles



Purpose	Improve our portfolio companies' ESG performance and accountability
Coverage	Offer ESG margin ratchets for all new investments
KPIs	Define material KPIs based on company size and sector, with a focus on climate change and D&I
Margin ratchet	Provide margin incentive to spur achievement of ESG KPIs
Material validation	Strive for companies to have third-party assurance
Ownership	Define clear ownership of KPIs at every level
Training	Educate investment teams on our Operating Principles

Aurélie: Sustainability-linked loans are a big topic for us. Our aim is for these loans to be an integral part of our direct lending strategy going forward. We are offering a margin ratchet on all of our financing and try to have the majority of our new investments in Europe include ESG margin ratchets, with the US following behind as the market there evolves. Over the last 12 months, we have deployed EUR 750 million in sustainability-linked loans across our European lending activities.

We have spent a lot of time ensuring the investment team understands the process, how to present the idea to company owners and how to ensure they are aligned with us. If you are going to work with private equity firms for these loans, they need to have the same philosophy or it won't work.

In collaboration with our ESG & Sustainability team, the investment team has also developed a set of Sustainability-Linked Loans Operating Principles to align our aims for the use of these instruments. These principles outline recommendations for investment teams, including focusing on material ESG topics, setting ambitious targets and recommending the use of third-party assurance to ensure reliable KPIs. It is also worth noting that every investment we make includes an ESG assessment during the investment process, meaning these factors are always considered regardless of whether the loan includes a sustainability-linked feature or not. Our ESG assessment during the due diligence phase can also form the basis of the KPIs that will be measured post-closing.

How open are company owners and management teams to sustainability-linked loans?

Gerald: This is still a developing field and the mechanisms are still evolving, but when we talk to company owners and management teams about this in Europe, most are open to discussions around the concept. That has been a shift over recent times – there is willingness on both sides to engage on ESG. LPs are partly driving this, but there is also rising regulatory pressure in Europe for investors and companies to focus on sustainability progress and reporting. These factors are changing mindsets and the incorporation of ESG targets in the documentation is an illustration of this.

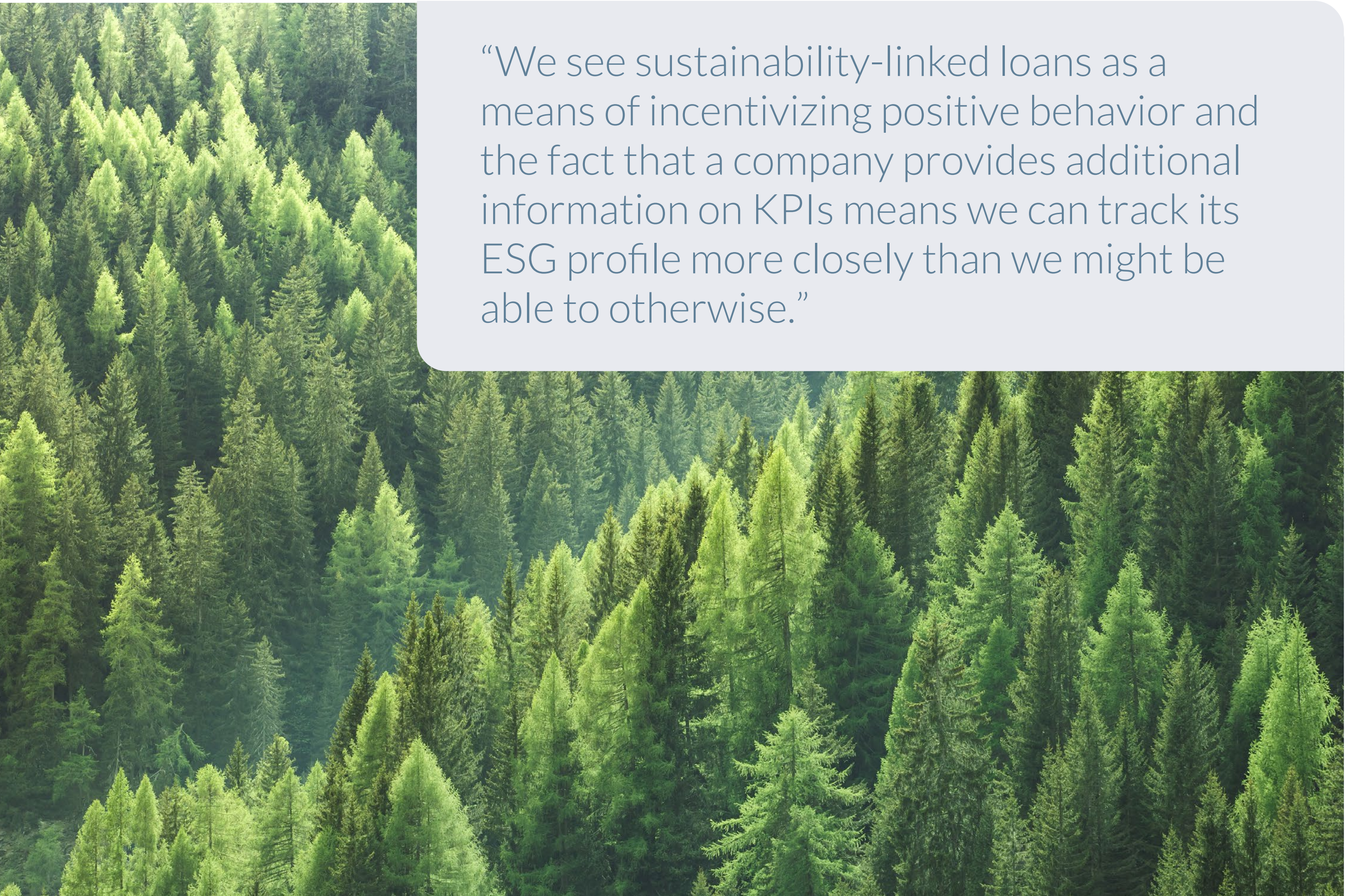
How do you set KPIs and how do you ensure they are meaningful while also being achievable and avoid the risk of greenwashing?

Aurélie: There is no real standard on KPIs as it really depends on the company, its stage of development as far as ESG is concerned, and what ESG topics are material to its activities. Most KPIs tend to be linked to the environment, but there are also KPIs related to D&I and other social factors. One way to help identify and set appropriate targets is ensuring the investment team collaborates closely with our in-house ESG & Sustainability team and, where necessary, with external independent advisors. We recommend that the company's performance is verified by a third party, but at the moment this is not always the case.

Gerald: Getting this right means working closely with the company's owners and, to an extent, the company's management team. For example, when a private equity firm acquires a business, it's down to them and the company's management team to develop the ESG path and, as Aurélie says, that varies according to the company. In companies that are further along the curve, the private equity owners and the management teams may already have a defined view and may have identified what the relevant KPIs could be and which targets they should adhere to. In these cases, we then use these as a basis for discussion. If the company is less developed that's where external consultants may be brought in to develop a framework and advise on KPI selection and targets. We recognize that these businesses will take longer to implement ESG initiatives and so our documentation reflects this.

If you are offering a reduction in margin for good sustainability performance, are you not giving up returns as a lender? And, on the flip side, doesn't that mean that your incentive is for companies not to reach targets because you can charge a higher margin?

Aurélie: We don't see it that way. Sustainability-linked loans are a key engagement channel with portfolio companies on ESG topics across our private debt portfolio. Lenders don't usually have the same level of influence as equity owners and so it can be difficult to be impactful.



"We see sustainability-linked loans as a means of incentivizing positive behavior and the fact that a company provides additional information on KPIs means we can track its ESG profile more closely than we might be able to otherwise."

We see this as providing companies with a real incentive to make ESG improvements in general. It can be burdensome for some companies to implement, measure and report on ESG progress. By offering a reduction in loan costs as an encouragement, we can help them put in place the systems needed to collect information, understand their current position and ability to make strategic changes, and therefore make progress on sustainability. This should improve the profile of the company and is likely to make it more valuable in the future.

As a lender, you are also heavily focused on risk and downside protection. If a company performs well on sustainability, your lending risks should reduce, which in turn should also improve risk-adjusted returns. It is also important to note that ESG margin ratchets are negotiated separately from a loan's initial pricing and that these mechanisms do not supersede sound underwriting. Hence, we typically have ESG margin ratchets in the +/- 5bps-10bps range.

Overall, we see sustainability-linked loans as a means of incentivizing positive behavior and the fact that a company provides additional information on KPIs means we can track its ESG profile more closely than we might be able to otherwise.

Can you give us an example of how this works in practice?

Gerald: A software company which we financed with a sustainability-linked loan in 2020 is a good example. The ESG targets that were set for it include appointing a person responsible for the company's ESG strategy at board level; increasing its share of green energy; and increasing its proportion of women on the board. The targets were set so that they would each cover an E, S, and G dimension, address areas in which we believed the company could improve its ESG performance, and contribute to Partners Group's focus on issues related to climate change and D&I. The targets were set starting from 2022 up to the maturity of the loan.

How do you see sustainability-linked loans developing over time?

Gerald: These loans will likely become more commonplace. Currently, Europe is ahead of the US in terms of engagement on this topic. However, we're already seeing a shift in this direction among US private equity firms. We have been in conversations with a US private equity firm acquiring in Europe, for example, and when we have raised the idea of sustainability-linked loans, they have been open to a dialogue about ESG. As more of these loans are arranged and as more data starts to come back, we will see practice evolve – we are only just starting to see information come through.

We actively look to bring up the topic of sustainability-linked loans in all of our European control transactions. LPs and regulators are asking for greater transparency on ESG across private markets, including private debt, and our approach with sustainability-linked loans is helping us to engage further and align with portfolio companies, sustaining their strategy and collecting sustainability information.

Partners Group is a leading global private markets firm. Since 1996, the firm has invested USD 185 billion in private equity, private real estate, private debt, and private infrastructure on behalf of its clients globally. Partners Group seeks to generate strong returns through capitalizing on thematic growth trends and transforming attractive businesses and assets into market leaders. The firm is a committed, responsible investor and aims to create sustainable returns with lasting, positive impact for all its stakeholders. With USD 131 billion in assets under management as of 30 June 2022, Partners Group provides an innovative range of bespoke client solutions to institutional investors, sovereign wealth funds, family offices and private individuals globally. The firm employs more than 1,600 diverse professionals across 20 offices worldwide and has regional headquarters in Baar-Zug, Switzerland; Denver, USA; and Singapore. It has been listed on the SIX Swiss Exchange since 2006 (symbol: PGHN).