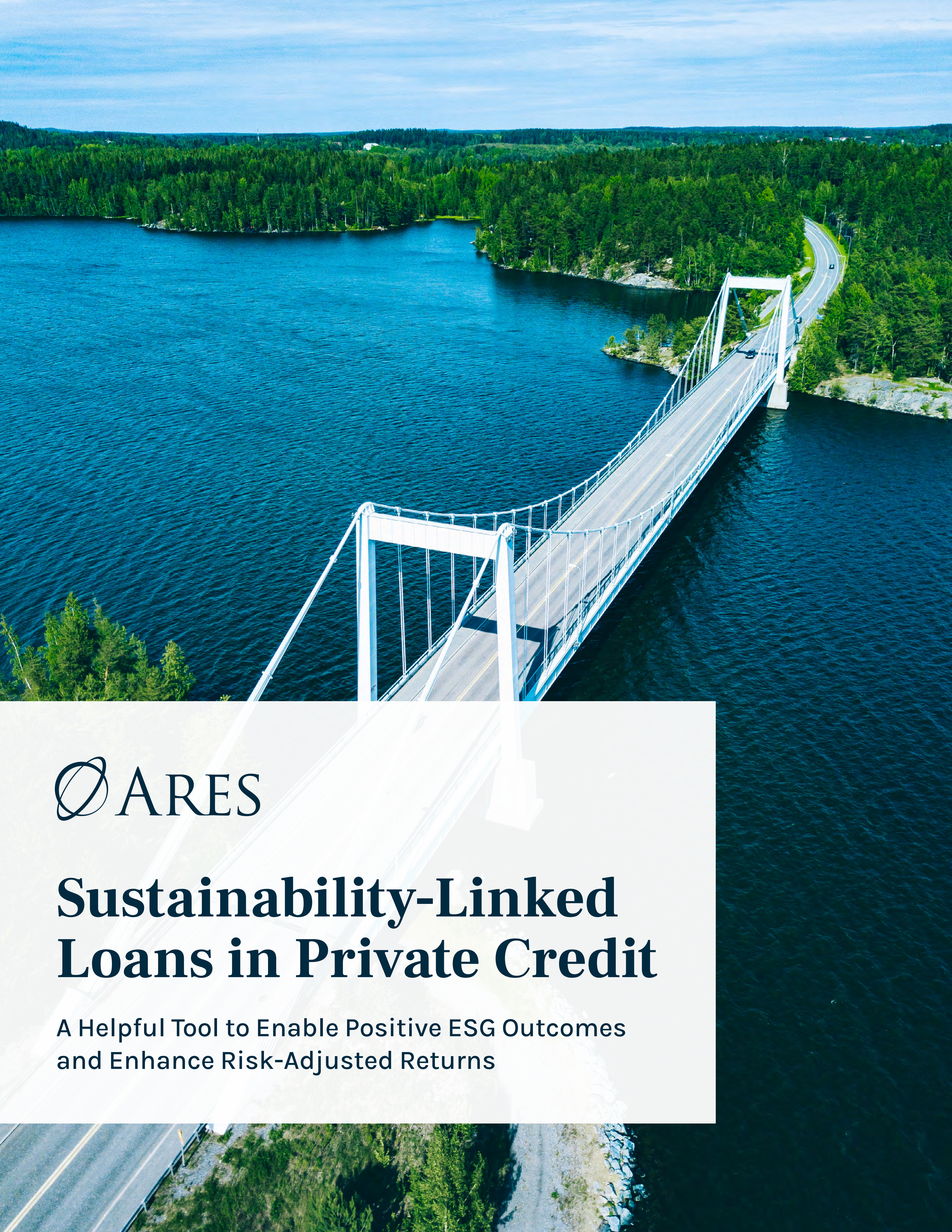

Sustainability-Linked Loans in Private Credit

A Helpful Tool to Enable Positive ESG Outcomes and Enhance Risk-Adjusted Returns

A systematic approach to structuring Sustainability-Linked Loans in private credit can enable enhanced ESG performance of portfolio companies, help improve risk-adjusted returns and forge deeper relationships with private equity sponsors and management teams alike."

Blair Jacobson
Partner and Co-Head of European Credit at Ares Management

Introduction

Sustainability has become an increasingly consistent focus area for companies around the world and across industries. Building on this, lenders have been actively seeking ways to move beyond negative screenings for ESG factors in potential investments and toward using their influence to support and effect changes in borrowers' sustainability practices. Ares highlighted this trend specifically in direct lending in our whitepaper "**Direct Lending's ESG (R)evolution**," published in April 2021. As Chair of the UNPRI Private Debt Advisory Committee[1], Ares believes private credit lenders are well positioned to influence portfolio company governance and decision making. Particularly when compared to liquid credit markets, **private credit is distinctly positioned to accelerate these efforts for two main reasons:**

1 Investments are sizable and for the long-term

Private credit providers support borrowers typically with significant long-term capital on a take-and-hold basis. This can represent as much as 50% of companies' overall capital structure. In many cases, private credit lenders may also have board representation, providing stronger potential to influence and effect change in portfolio companies.

2 ESG resource gap

In Ares' portfolio, we have observed that as many as 30% of companies do not have an internal ESG function, and approximately 20% of private equity sponsors do not yet have capabilities to shape long-term ESG strategies tailored to the individual companies[2]. Sophisticated and scaled private credit providers can lend both capital and resources to portfolio companies and sponsors to help drive a company's ESG maturity and establish tangible sustainability targets that are aligned with the overall business strategy.

Evolving from these advantages, Sustainability-Linked Loans ("SLLs") are increasingly utilized by private lenders as a tool to effect positive change on the broader sustainability agenda. SLLs are designed to create economic incentives for companies to improve across a set of pre-defined Sustainability Performance Targets ("SPTs") that are tailored, tangible and measurable. The SLL structuring process is a collaborative effort and requires significant input from management teams, investment teams and often equity owners. This collaboration can lead to deepening of relationships with — and of commitments to sustainability by — both portfolio companies and their owners.

At Ares, we see the benefits of SLLs across the private credit investment universe, from direct lending to infrastructure and real estate credit. Additionally, having structured SLLs across three continents to-date, we believe SLLs can be suitable for companies globally and that they will become increasingly common.

To support investment professionals across investment strategies to structure SLLs and enable an appropriate governance mechanism, Ares has established a global SLL council that comprises investment professionals across our global private credit platform. In its first initiative, the global SLL council has developed an early framework for SLL structuring, which we anticipate will be continuously refined based on our investment teams' experiences and market developments.

This whitepaper sets out this framework and seeks to address the most relevant elements for private credit investors looking to better understand and more effectively structure SLLs.

We discuss

1

Ares SLL structuring framework to ensure these financings are fit-for-purpose

2

How the SLL process can build stronger relationships with borrowers, their management teams and owners as key stakeholders, and can achieve better ESG outcomes

3

Our global perspective on how asset managers can harmonise their approach to SLLs

4

Ares' view on the future of SLLs in private credit

Ares SLL Framework

The basis of Ares' framework and best practices stem from the Loan Market Association ("LMA") and Loan Syndications and Trading ("LSTA") Sustainability-Linked Loan Principles ("SLLPs").

We review these continuously and update them to reflect our ongoing experiences, and we hold training sessions for our investment professionals across the Ares global credit investment platform.

Exhibit A – Ares SLL Framework

Set Relevant Sustainability Performance Targets (SPTs)

We believe the most important aspect of SLL structuring is to identify the SPTs that should be tested over the life of the loan. This is a collaborative, and often iterative, process between the lender, portfolio company as well as the owner to agree on the main objectives the portfolio company is facing from an ESG perspective and the measurable targets that could be set to promote better ESG outcomes.

In order to stay true to the core intention of an SLL, all parties involved have to be focused on identifying SPTs that are material, meaningful and relevant. They subsequently should seek to ensure the SPTs are sufficiently ambitious to promote continuous improvement. For example, a company whose mission is to improve social welfare of their employees may identify one SPT tied to enhancing the employee satisfaction score. To achieve this, an actionable plan might be developed that includes enhanced career development and social mobility opportunities.

Having structured Ares' first SLL nearly two years ago (see RSK case study on page 9) and many more since, we have found the five principles below can support positive outcomes, and we use these for training Ares investment professionals.

Achieving the SPTs could bring tangible benefits to the company, ranging from improving reputation (e.g. as a more attractive employer or supplier or customer) to direct cost-savings (e.g. reduction in energy consumption). We believe these benefits would also strengthen the credit profile of the company, and therefore offer the potential to improve the risk-return of an investment.

Exhibit B – Sustainability Performance Targets (SPTs) Principles

Be core to business operations	SPTs should reflect ambitions that are pertinent to the business' purpose so that they advance the overall strategy.
Support action beyond business as usual	Ambitious, relevant SPTs should motivate businesses to do more rather than reward normal business activities. For example, requiring faster timeframes or higher standards for achieving objectives.
Be evidence-based	The most transparent targets are rooted in long-term data that can be measured against industry benchmarks. Where such data isn't readily available, collecting baseline measurements is essential to providing context for targets.
Be timebound	SLLs most often deploy annual SPTs. There should be a longer- term vision within which annual increments that are sensible and can be tracked should be identified.
Be verified	Each objective should be accompanied by a clear methodology that can be measured and assessed to see progress and/or setbacks. Factors that are assessed or calculated internally should be verified and audited by a third party.

NOTE: These represent our beliefs regarding our approach to structuring industry leading SPTs and SLLs. Not all SLLs will include each part of the approach shown above.

The SPTs could span across each of Environmental, Social and Governance factors; however, we do not put requirements to include or exclude targets relating to any single ESG category. The SLLPs provide some guidance on example targets[3], and the SASB's Materiality Map[4] is another helpful resource to identify suitable SPTs for different industries.

Ensuring that targets remain relevant throughout the life of the loan is important, and our principle is that targets should be dynamic and showcase ongoing improvements at the company year after year. However, there are circumstances where particular SPTs may lose relevance (e.g. following significant M&A activities); therefore, there should be a mechanism to adjust the SPTs over time to ensure they remain appropriate.

We recognize that establishing appropriate SPTs is an iterative, collaborative process that takes some time to get right. As such, lenders may include the SLL features into the facility documentation at the outset and insert SPTs at a later stage – generally within a pre-agreed time period after closing. At this point, the loan becomes an active SLL. New owners may prefer this practice to allow additional time to shape or further assess the ESG agenda of the company before establishing relevant SPTs.

CASE STUDY

Ares worked with a portfolio company in France to structure an SLL containing three SPTs across the environmental and social domains.

One SPT is linked to Science-Based Target Initiative (SBTi) for carbon emissions reductions in line with best practice Net Zero guidelines. Another SPT is linked to improvements against the Pénicaud Index, a multi- faceted approach to tracking wage and workplace inequalities linked to gender. The final SPT is linked to a company-specific recycling target.

CASE STUDY

Ares provided an SLL to a portfolio company in the Netherlands that runs day-care centres.

The SLL contains three SPTs aimed to improve ESG value creation while supporting core business activities. Each of these activities serve a core purpose relating to the expansion, quality improvement and reputation of the firm. One SPT is linked to an increase in the number of day-care centres with a special designation for children with disabilities. Another SPT is linked to an improvement in the Dutch Municipal Health Scores. The final SPT is linked to a reduction in carbon emissions.

Agree on Margin Implications

It is important to any SLL to create economic incentives for the company to achieve the established SPT(s). Tying performance of SPTs relative to the interest margin under the facilities underpins the risk-reward relationship.

Ares follows the principle that the margin should have the potential for both upwards and downwards adjustments and should not be viewed as a "free option" for companies to obtain margin savings. In our view, a "free option" runs the risk of threatening the credibility of the SLL and undermines its purpose.

Wherever possible, we strive to document that the potential margin savings are either partially or entirely re-invested into sustainable initiatives or ESG training or, alternatively, in certain cases, donated to charitable causes. This has the potential to create a virtuous cycle, originating from the SLL and yielding additional positive impacts in addition to achieving the various sustainability targets. Many of the companies and sponsors with which we work share our enthusiasm for this as well.

We also acknowledge that there is no recognized, or standardized, market practice on how to strike the right balance between target fulfillment and margin adjustments. As such, we have developed some guiding principles we strive to follow when negotiating the margin impact, as illustrated in the below tables showing our general approach to i) multiple SPTs and ii) single SPT.

The below framework has been developed to serve as a starting point for discussions between lender, portfolio company and owner; however, it will ultimately vary on a deal-by-deal basis.

In these indicative formulations, in case of **Multiple SPTs**, the margin ratchet could either have each SPT valued individually or collectively and with or without incremental margin adjustments. In case of a **Single SPT**, the margin ratchet could either be adjusted based on SPT achievement (yes or no) or determined by the level of performance.

Exhibit C – Example Illustrative Margin Ratchets

	# SPTs Achieved	Margin Δ Examples		
3 SPTs	3 SPTs	(- [7.5-15] bps)	(- [7.5-15] bps)	(- [7.5-15] bps)
	2 SPTs	(- [2.5-5] bps)	(- [5-10] bps)	+ / - 0 bps
	1 SPTs	+ [2.5-5] bps	+ [5-10] bps	+ / - 0 bps
	0 SPTs	+ [7.5-15] bps	+ [7.5-15] bps	+ [7.5-15] bps

	OPTION 1		OPTION 2	
	SPT Achieved?	Margin Δ Example	SPT Performance	Margin Δ Example
1 SPT	Yes	(- [7.5-15] bps)	[High Overperformance]	[(- [10-15] bps)]
	No	(+ [7.5-15] bps)	Overperformance	- [7.5-12.5] bps
			In line with plan	+ / - 0 bps
			Underperformance	+ [7.5-12.5] bps
			[High Underperformance]	[+ [10-15] bps]

CASE STUDY

RSK Group ("RSK") is a leading UK-based global environmental consultancy business.

Ares has been the sole lender to RSK since Q3 2018, having provided ~£1 billion of available debt facilities as of November 2022. In Q3 2021, to support the next phase of growth for the company and driven by a mutual interest in improving ESG-related outcomes, Ares and RSK worked together to structure a refinancing of RSK's existing facilities with ESG-linked objectives. The SPTs are broadly focused on carbon intensity reduction and continual improvement to health and safety management and ethics. RSK has committed to donate a minimum of 50% of margin benefits toward sustainability-related initiatives or charitable causes. At the time of financing, we believe this was the largest private-credit SLL.

Incorporate into the Facility Documentation

Whilst no accepted market standard legal wording currently exists in the market for SLLs, the SLLPs provide guidance on a number of important base considerations for lenders to take into account when drafting the facility documentation. These include, among others, i) clear definitions of SPTs and the methodologies based on which the SPTs are to be calculated, ii) operating mechanics of the ESG margin ratchet; and iii) the conditions borrowers are required to meet to demonstrate compliance which may include a requirement for the SPT outcomes to be verified by a qualified third-party.

We recognize however that each SLL possess a varied set of distinct characteristics not least driven by their bespoke set of SPTs and linked financial incentives. Therefore, in our view, it is important that private lenders take a long-term view when drafting facility documentation and allow sufficient flexibility to adjust the SLL mechanics to cater for potential changes in the business profile. This is particularly relevant for middle-market companies, as we see many portfolio companies undergo significant M&A activities, which have potential to transform the business during the term of the facility. Even if certain SPTs could be linked to revenue or asset base to account for business growth, there may be circumstances where the business profile has changed to render the targets less relevant, at which point the involved parties should undertake a new materiality assessment.

Ongoing Reporting

Inherent to an Sustainability-Linked Loan ("SLL") is the need to report on results that indicate whether the company is meeting its Sustainability Performance Targets ("SPTs"). Any potential margin adjustment is based on the sustainability compliance verification, typically by way of a certificate, which is submitted to the facility agent on an annual basis. To protect the integrity of the SLLs, the performance should be verified by a third party with appropriate credentials to the extent possible. Such verification may be easier to argue in favor of for certain SPTs (e.g. environmental targets such as CO_2 emissions), compared to other SPTs that are internally collected (e.g. data from employee- or customer surveys). For such targets, the verification should focus its review of the systems in place for accurate data collection and reporting, as well as detail the robustness of the methodology or calculations. This kind of verification enables data integrity and reliability and should be mutually beneficial to both lenders and the company.

As traditional audit firms are increasingly building out their sustainability practices, it is often appropriate for the company to commission their auditor to undertake to perform the necessary verification. However, in some cases it may be appropriate for a specialist firm to undertake this assignment. We have found this especially helpful in cases that include carbon footprint exercises, for instance, as companies often use a third-party specialist to support in establishing baseline calculations.

We do recognize that this verification comes at a cost, which sometimes companies, especially middle- market companies, are reluctant to bear. This is especially true in the scenario where a margin premium would be applied. This is a challenge facing middle-market SLLs, for which there is no obvious solution. Where appropriate, lenders may seek to net-off the cost to verify SPTs against any margin discount or premium applied. We do however welcome further discussion amongst market participants on this topic, as we do not wish the cost to verify the SPTs to be a hindrance for further market growth.

Enhanced Engagement to Achieve Better ESG Outcomes

"

This financing demonstrates our deep commitment to driving sustainable business practices not just within our clients' businesses, but also within our own. We look forward to continuing the great relationship we have with the Ares team."

Alan Ryder
Chief Executive Officer of RSK Group

The relationship effect

In our view, the process of structuring an SLL can deepen relationships between the lender, portfolio company as well as its ultimate owner through the enhanced engagement it provides. The conversations usually take place at multiple levels inside the company, promoting information exchanges between different teams to form a view on material ESG topics. It also raises the sustainability conversation to the table of investment professionals and equity owners. In our experience, collaboration across stakeholders and teams on these topics have been overwhelmingly positive.

Private lenders benefit from scaled ESG functions and a position to accumulate knowledge from dozens up to hundreds of portfolio companies across multiple sectors at various points of their sustainability journeys. This position allows them to acquire and distill a comprehensive understanding of and approach to SLL structuring best practice overtime. Scaled private lenders can therefore offer the necessary toolkit and insights to enable a broader range of portfolio companies to accelerate progress earlier in their sustainability journeys and better realise their ESG goals.

We are cognisant that to achieve real change, these dialogues between companies, their owners, and financiers often takes time. Nevertheless, such investments made by all parties can build lasting relationships, trust and understanding and when fostered by a mutual desire to achieve good outcomes, it can reinforce a positive cycle of engagement.

The Global Perspective

SLLs have global reach

The first SLL was structured in the European bank market in 2017[5] before making its way into the private credit market three years later. It has not only been used with increased frequency in Europe, but SLLs are becoming increasingly structured in other geographies where they are equally suitable.

SLLs can be structured across different credit investment strategies

Given the versatile nature of SLLs, these are suitable for more than just corporate credit investment strategies. We are noticing an increasing appetite across real estate and infrastructure credit investment strategies to structure SLLs where SPTs, for example, could be linked to energy efficiency improvements of the buildings/locations, increases in affordable housing units developed or health and safety metrics.

Private credit investors should consider establishing a governance mechanism

As private credit providers embark on their SLL journeys across different investment strategies and geographies, we believe a degree of oversight is required. This can help ensure a consistent approach to structuring SLLs based on best practices and latest market developments, as well as provide sufficient training to investment professionals.

As mentioned in the introduction, a governance mechanism that we have applied at Ares is our establishment of a global SLL council. It consists of a broad range of investment professionals across the global credit investment platform that meet on a regular basis to provide case studies of closed SLLs, share updates on market developments and discuss potential challenges that have surfaced. The added benefit of a governance mechanism is the opportunity to drive synergies across the investment platform and enhance collaboration.

CASE STUDY

Ares structured the first Sustainability-Linked Loan in Australia for a portfolio company that provides waste management, procurement, and collection services.

Three SPTs were selected, across social and governance domains. The first SPT is linked to the appointment of a Group ESG manager and completion of an assessment into ESG gap together with an agreed action plan. The other two SPTs are linked to enhancement in employee training and specific governance practices.

CASE STUDY

EdgeConneX is one of the largest private owner-developers of data centers globally.

In June 2022, Ares Infrastructure Debt provided a Sustainability-Linked Holdco Facility to EdgeConneX in support of its growth strategy under EQT's ownership. Ares worked closely with EdgeConneX and EQT to devise a set of SPTs that align closely with the business's long-term ESG goals to become a carbon-, waste- and water-neutral data center provider by 2030, to be 100% renewable energy powered and industry-leading in terms of workplace safety.

The Future of SLLs in Private Credit

The number of SLLs executed in the private credit market have increased significantly in recent years, and, as the market continues to mature, we believe there are several developments that are likely to take place.

A well-structured SLL can provide benefits to key stakeholders, and we encourage lenders to remain vigilant in structuring them to avoid accusations of greenwashing that may risk undermining the tool in the long-term. To build on the existing foundation and further accelerate the adoption of SLLs in the private credit market, we encourage lenders to continue working together with portfolio companies and their owners to focus on ESG topics and emphasize the importance of increasing ESG maturity.

Exhibit D – Potential Future Developments in Private Credit SLLs

Documentation Guidelines

Template for including SLLs into facility documentation provided by LMA/LSTA

Due to the tailored nature of SLLs, the LMA or the LSTA have not yet published recommended legal wording for inclusion of SLL-related provisions into credit agreement templates. As these templates are used as a basis for lending transactions across multiple sectors and geographies, we expect that LMA and LSTA together with market participants will develop recommended wording, to further standardize the SLL market. In our view, this should also cover a recommended form of sustainability compliance certificate and outline the preferred format for independent third-party verification.

Increased Transparency

Investors likely to require additional reporting on agreed SLL features

We expect investors in private credit funds, as well as investors in the broader syndicated loan market, to require additional information regarding selected SPTs and agreed upon margin adjustments. This could include i) details on the materiality assessment driving the SPT selection and how SPTs were calibrated to establish yearly targets that are sufficiently ambitious, iii) margin ratchet dynamics and iv) SPT performance audits.

Enhanced Sophistication in SPT Selection

Promoting holistic assessment of ESG performance

As more SLLs are structured in the private credit market, we anticipate the level of ambition in selecting appropriate and meaningful SPTs will increase. This could be expressed through future requirements to include both internal metrics that are specific to an individual company, as well as external metrics that could be benchmarked against industry standards or peers. This would allow for comparability and an increasingly sophisticated assessment of the portfolio companies' ESG outcomes.

Applications of Margin Discounts/Premiums

New ways to enhance sustainability performance

As our fundamental thesis for structuring SLLs is to help drive enhanced ESG performance and seeking to increase risk-adjusted returns, we believe the SLLs may continue to develop in such a way that potential margin discounts received or premiums paid are re-directed towards investments into the business itself. An example could be for lenders to re-invest margin premiums received into sustainability initiatives within the company.

Conclusion

As discussed, we expect the number of SLLs to continue to rise in the private credit industry. We see them continuing to penetrate across different types of debt investments, given their structuring flexibility and increasing ESG maturity of private credit investors, private equity investors and portfolio companies.

However, efficient SLL structuring does not come without challenges, and it can be time-consuming for the parties involved to achieve the desired outcomes. Given the level of commitment required, we expect to see more talent dedicated to these efforts, which could engender even greater personal investment from the parties involved and hopefully yield clear, material results.

In our position as chair of the UNPRI Private Debt Advisory Committee, we consciously look to initiate further conversations between private credit providers to exchange experiences and lessons learned from structuring SLLs. By doing so, we hope to drive a greater number of increasingly sophisticated SLLs that can propel new advancements in ESG and sustainable business practices that have measurable and meaningful impact on the world.

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Endnotes

[1] Current chair as of date of this paper. The chair may change in the future.

[2] Based on internal analysis of Ares European direct lending's current portfolio as at September 30, 2022.

[3] Sustainability-Linked Loan Principles, Appendix 1, March 2022 (https://www.lsta.org/content/sustainability-linked-loan-principles-sllp/)

[4] SASB's Materiality Map (https://materiality.sasb.org/)

[5] https://www.sustainalytics.com/esg-research/resource/corporate-esg-blog/demystifying-sustainability-linked-loans-leverage-your-esg-rating

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