Commercial Insights

The Expanding ESG Wave

By The Numbers: ESG Growth

Financial activity with an ESG focus is on the rise in several sectors

- **$20.6 billion:** New money invested in sustainable funds in 2019, nearly four times the amount invested in 2018 *(Source: Morningstar)*
- **$255 billion:** Total global green bond and loan issuance in 2019, a 50% increase from the previous year *(Source: Climate Bonds Initiative)*
- **$143 billion:** Global sustainability-linked loan volume in 2019—nearly triple the $49 billion value from 2018 *(Source: Bloomberg)*

The growing importance of the Environmental, Social, and Governance (ESG) movement across the financial markets is undeniable—and it is now making its way into commercial lending in a new and impactful way. Public and private companies are starting to take a position in driving diversity, sustainability, and strong governance in order to ensure long-term business value, and they want their corporate financing vehicles to reflect these commitments. Currently, these companies and their banking partners are looking to determine the best ways to act on this evolving trend and its initial applications in corporate finance. In order to move toward implementing a structure involving ESG in a future round of financing, companies are launching internal ESG initiatives, searching for like-minded financial partners, and monitoring similar transactions in the marketplace to better understand their structure and benefits.

Once only the dream of lofty idealists, the notion that the economy should not only function successfully but also be sustainable, transparent and socially just has trickled down into the mainstream. Over the past decade, investing in companies that give credence to Environmental, Social, and Governance factors—known as ESG—has become increasingly popular, driven by a shift in consciousness that has heightened the roles we expect companies and their financial services providers to play.

Millennials, in particular, have helped bring to the forefront the idea that businesses must embrace practices and principles which safeguard the wellbeing of the planet and encourage the elevation of humanity. In turn, companies have been eager to position themselves as socially and environmentally conscious both to satisfy consumer demand, and as an employee recruitment and engagement tool. Corporate executives and business owners now firmly believe these principles help to drive long-term business value. Indeed, 53 percent of executives surveyed recently by Greenwich Associates say they consider ESG important for managing long-term strategies for their business, and more than one-third of respondents indicated they think it will grow in importance over the next five years.

There is ample evidence showing that companies focused on improving their environmental and social performance generate positive returns and stable cash flow. In an Oxford University data meta-analysis, 88% of the studies reviewed found that companies adhering to social or environmental standards showed better operational performance, while 80% of studies showed a positive effect on stock price performance. Executives, again, are confirming this notion: 76% of CEOs surveyed by McKinsey say they believe that strong sustainability performance contributes positively to their businesses in the long term. This growing inventory of data and interest underpins the development of risk rating models and consulting activity by third party providers.

Corporations are also putting their commitment to these ideals front and center. Just recently, for instance, global toy manufacturer Hasbro appointed a Chief Purpose Officer to oversee efforts the company calls "critical to advancing Hasbro's positive impact around the world" and which include corporate social responsibility, sustainability, ethical sourcing, and philanthropy and social impact.

Preparing For the "Wave"

With the next wave of the Environmental, Social, and Governance (ESG) movement hitting the commercial lending segment, it's important for businesses and their financial services partners to collaborate on the best path toward integrating an ESG approach into existing financial strategies. If sustainability-linked loans are a goal for an upcoming round of funding, what can you do right now to be prepared?

- [ ] Set and implement measurable ESG targets that are appropriate for your company. There is no one-size fits all approach, so simply start by establishing a strategy. Metrics around the "E" criteria have historically been adopted early (goals like reducing greenhouse gas emissions and carbon footprint, obtaining LEED certifications, etc.), but the COVID-19 pandemic is creating a newfound surge in "S" targets. It's important now to think about who your stakeholders are and where their goals lie. Ask questions like, What will the end result of our ESG efforts look like? What are our current challenges in these areas? How does sustainability create value for our organization?
- [ ] Begin exploring how you might implement a structure involving ESG in your next loan. Work to determine how your company can position itself to capture the growing pool of ESG-dedicated capital from investors and partners who are incorporating ESG metrics into the lending process.
- [ ] Monitor similar transactions in the market. Keep an eye on peer activity to stay abreast of how others in your industry are incorporating ESG financing strategies. If your direct peers/competitors are incorporating ESG metrics into their overall strategy, they may be receiving better terms/structuring on credit facilities as well as new capital investors to support long-term targets. Understanding where your industry is heading will help you best position your company for the future.

THE EVOLUTION OF ESG

With the accepted idea that companies embracing these philosophies deliver positive long-term performance, investors have flocked to ESG-focused funds over the last decade or so, leading many big-name asset-management firms such as BlackRock and Vanguard to publicly amplify their focus on ESG companies. The COVID-19 crisis has further driven home investors' desire to focus on companies with "do good" records, with CNBC reporting that U.S.-listed sustainable funds have seen record inflows during the pandemic.

Research from data provider Morningstar, which looked at the long-term performance of a sample of 745 European sustainable funds, indicates that the majority of these outperformed non-ESG funds over one, three, five, and 10 years. And U.S. sustainable funds comfortably outperformed their peers in 2019, according to Morningstar, with 35% of sustainable funds generating returns that placed them in the top quartile of their respective categories, while the returns of only 14% of sustainable funds placed in the bottom quartile.

For larger companies, ESG has also played a role in the bond markets, with "green bonds," or bonds that are tied to specific environmental municipal initiatives such as energy efficiency, pollution prevention, sustainable agriculture, clean transportation, and sustainable water management, among others. These securities are used to raise capital for specific projects in the above categories. According to the Climate Bonds Initiative (CBI), global green bond and loan issuance climbed by nearly 50% in 2019 to a record high of almost $255 billion; the group expects total 2020 numbers to range between $350 billion and $400 billion.

Though less common than green bonds, social-impact bonds are also growing. Currently popular in European markets, these conscious-investing vehicles are structured as private-public partnerships and are aimed at funding effective social services through performance-based contracts. According to S&P Global Ratings, social bond issuance quadrupled through the first half of 2020. Morgan Stanley reports that $32 billion dollars of social and sustainability bonds were issued in April 2020 alone, with the pandemic as a major driving factor. Volume so far in these instruments has come primarily from financial institutions, as their involvement in social bonds helps to strengthen their own corporate ESG programs.

THE RISE OF ESG IN CORPORATE FINANCE

A more nascent market is also emerging for corporate and commercial loans which directly link credit pricing indices to performance on ESG goals. This trend is expected to have an impact on the way many companies obtain financing in the future. Banks and other lenders may structure these loans tied to a company's overall ESG rating—which is determined by a growing number of ratings agencies focused on measuring these outcomes—or to particular ESG targets.

The draw of such loans is that firms can potentially lower the cost of borrowing by working with banks that integrate sustainability performance into the lending criteria. In essence, if the loan recipients hit their key performance targets, they receive lower loan pricing. For example, the bank could create a pricing grid or pricing incentives for achieving stated targets, not dissimilar to a pricing grid based on credit performance. The net result? Both a financial win and an ESG win.

The risks and opportunities associated with a company's ESG practices now play a larger role in their overall corporate rating, and ratings agencies are more focused than ever on integrating these criteria and metrics. KPMG estimates roughly 30 significant ESG data providers around the world, including big names like S&P Global, along with independent firms such as Sustainalytics and Vigeo Eiris, and the ESG arms of bigger groups, including index providers MSCI, Refinitiv, and FTSE Russell.

Currently, there is no single, accepted methodology for calculating the ESG ratings upon which many of these loans are structured, which has caused some confusion among corporations and lenders. Experts predict there will be more clarity around ratings over time, and expect these ratings to overlay on to the pricing matrix for ESG in much the same way as more traditional metrics like leverage and cash flow coverage have been embedded for the same result. Recent partnerships and working groups have included major accounting firms, industry forums and even the World Economic Forum, and can be seen as a further step in that direction. One such collaboration announced a framework for global ESG standards, outlining 21 nonfinancial metrics on issues ranging from gender pay gap to environmental protections.

While ESG's role in corporate finance is still in the early stages, global numbers tell a compelling story for the growing importance of these principles in the commercial lending arena:

- Companies around the globe have raised almost $275 billion of loans with interest rates tied to their sustainability performance since the first such deal in 2017.
- Global sustainability-linked loan volumes almost tripled in 2019 to $143 billion, and jumped ten-fold to $49 billion in 2018 from a mere $5 billion in 2017.
- The number of companies using this funding mechanism has grown to 265 worldwide from just eight in 2017. As of October 2020, 98 issuers had tapped the sustainability-linked loans market, compared with 128 in 2019 and 45 in 2018.

(Source: Bloomberg)

U.S. COMPANIES PICKING UP THE PACE

ESG-linked commercial lending has been most prevalent so far in Europe, and has initially been focused on the "E" portion, as environmental targets—such as reducing greenhouse gas emissions or water consumption, increasing the use of recycled materials, or a global assessment of overall environmental initiatives—are easier to quantify and design KPIs around than the "S" and the "G" portions. For the latter, indicators such as corporate diversity policies, racial and gender diversification among executives and/or the corporate board, human rights and child labor policies, and employee safety ratings, among others, are being used.

U.S. companies are starting to pick up the pace on securing these types of loans. The commercial lending market is now seeing U.S. borrowers seeking general-purpose corporate and syndicated loans that have ESG targets within them. So far, the early-adopters of these ESG-linked loans have tended to be in sectors such as industrial, utilities, and energy. According to Refinitiv, the utilities industry took the lead in ESG loan issuance last year, with more than $17 billion of volume coming to market through August 2020—most of which are tied to environmental targets.

Here are some recent examples:

Georgia Renewable Power closed the first green loan in the US institutional leveraged loan market in the summer of 2020. The $525 million term loan B conforms with the Green Loan Principals developed by the Loan Syndications and Trading Association. The terms indicate that Georgia Renewable Power must ring-fence the proceeds under the outlined green principles, and it must also conduct regular reports on the development of the power plants to ensure renewable energy practices are upheld.

Johnson Controls became one of the first industrial companies to link a revolving credit facility to specific sustainability metrics in the U.S. syndicated loan market in December 2019. The ESG metrics are aligned to greenhouse gas emission reductions the company is able to achieve from energy efficiency and renewable energy customer projects, and the greenhouse gas emissions reductions the company is able to achieve from its internal operations. Safety metrics that help to protect Johnson Controls employees were also factored into the loan terms.

Aligned Energy, a Texas-based US data center operator, signed a $1 billion senior secured loan in September 2020 with margins linked to the company's ESG goals. The financing, which is the first US data center sustainability-linked loan, provides Aligned Energy with additional capital to accelerate corporate, customer, and community-related sustainability initiatives as well as short and long-term growth objectives. Margins are tied to its core ESG KPIs, which include matching 100% of annual energy consumption to zero-carbon renewable energy by 2024, a commitment to transparency and the continuous improvement in sustainability reporting, and a commitment to workplace safety. Earlier in the year, Aligned Energy increased its commitment to environmental sustainability by matching 100% of the IT loads across its data center portfolio with certified renewable energy.

When utility company **Avangrid** came to market to amend and extend its 2018 credit facility, it was only the second company in the United States with a loan pricing mechanism that adjusted the interest margin on draws based on its annual sustainability performance. Avangrid's Sustainability Report is certified annually in a formal compliance certificate, and lenders receive a third-party opinion to validate the company's performance. At the time of the transaction, Avangrid's generating portfolio was among the cleanest in CO2 emissions in the country, and the company's objective of reducing CO2 emissions was directly aligned with an opportunity to reduce the company's borrowing costs.

Deals such as these show the increasing prevalence of ESG-linked corporate lending among U.S. companies. Firms in industries like heavy manufacturing, transportation, logistics, and commercial real estate are expected to be among the next wave to seek ESG-linked corporate financing.

The continuing pressure on companies from consumers, investors, competitors, and government to keep ESG factors front and center tied with the mounting evidence that effective management of ESG risks helps drive superior long-term performance is a powerful combination in favor of the expansion of these types of financial instruments. Add in the ongoing pandemic, mounting social and racial justice concerns, and a new presidential administration that has already indicated its strong focus on environmental issues, and it is crystal clear this type of investing is here to stay. ■

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