An ESG journey still in its infancy

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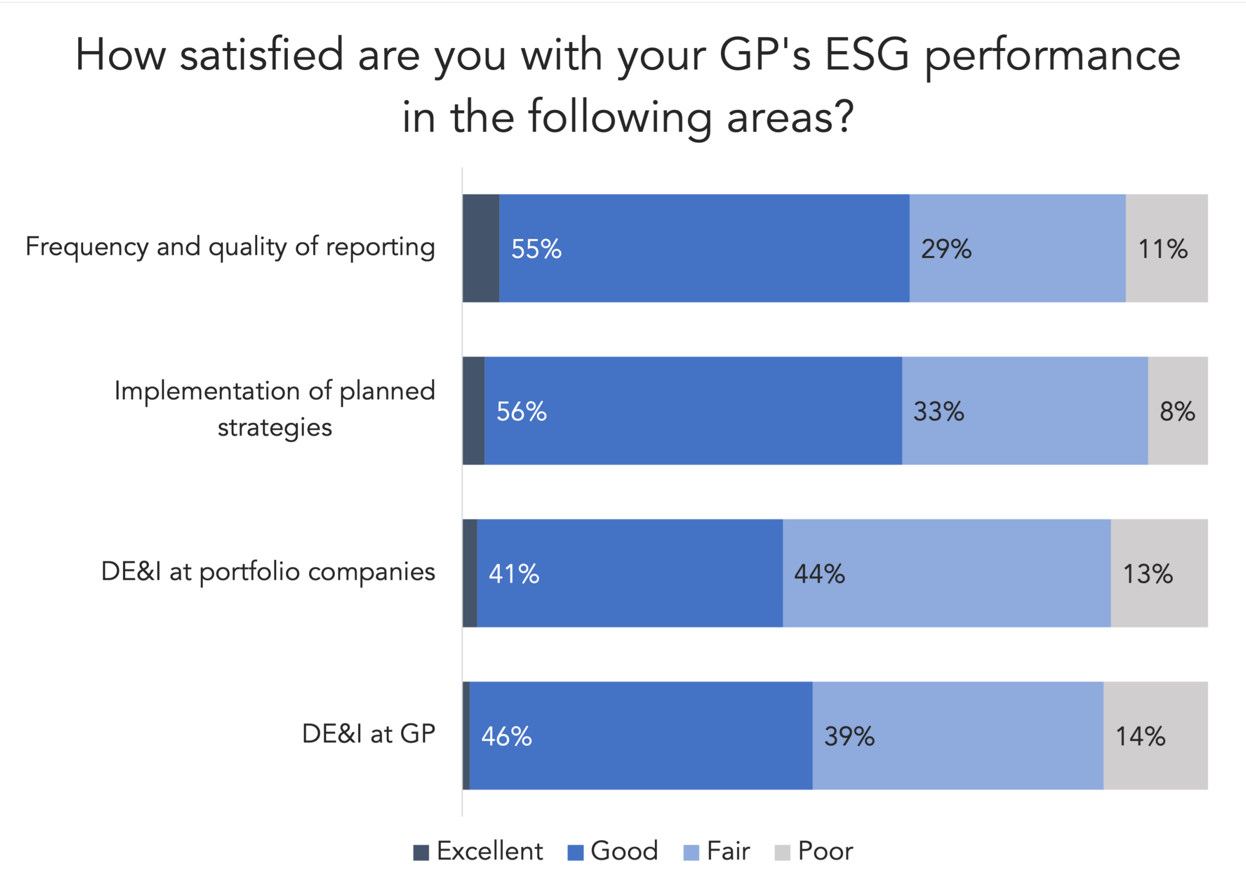

Private debt and ESG don't have a long history together, but there are signs of much-needed progress being made.

Long gone are the days when lenders were commonly described as the back-seat drivers in private equity-sponsored transactions. While equity financiers market themselves on their ability to bring operational skills to bear, ESG is just one area where they would be swift to acknowledge that debt providers have much that they can bring to the table as well.

For some lenders, evaluation of ESG is fundamental to decisions taken at the credit or investment committee level – they will contemplate withholding loans to companies that are not giving E, S and G (yes, all three – not just the E) sufficient priority. But the most common manifestation of lending engagement with ESG is in the sustainability-linked loan, and specifically the margin ratchet.

This has become an area of controversy, since there is a view that lenders have not yet achieved an optimal way of rewarding good behaviours and punishing bad. But it's important to note that this is a relatively young and evolving area, and solutions are being found. For example, in response to the claim that a typical 10-50 basis point ratchet was insufficiently incentivising, one fund manager we spoke with this week said their ratchet was instead based on up to 10 percent of the cost of financing – which “starts to become quite significant” according to the manager in question.

Meanwhile, a lawyer said that while a borrower being rewarded for performing well against its ESG KPIs seemed appropriate, he questioned the notion that a lender should benefit from a more favourable margin when targets are not achieved. This source suggested a better way may lie in a recent deal witnessed towards the end of last year, in which missed KPIs resulted in payments which ultimately took the form of charitable donations. Although this was a transaction that involved commercial bank lenders, the source saw no reason why it could not migrate to the private debt world.

(Past performance is no guarantee of future results.)