Episode 4 - Sustainability Linked Finance: No Pain No Gain

Introduction

This is the fourth episode in our series of podcasts so if you've missed the first few then make sure you go back and check those out. As you may have seen earlier this year we published the results of our sustainability research survey where we spoke to over 1,000 business and finance leaders across the UK and Europe. You can find these over on the sustainability page of our website.

Today we're going to be touching on the theme of No Pain No Gain. Businesses may need to put themselves through a little bit of pain in order to implement and progress their sustainability strategies, but we have seen evidence that a well-considered and well executed strategy may result in net gain in the end.

In this episode we'll be hearing from Kate Lawlor, CEO at Bruntwood SciTech and Jayne Cottam, CFO at Assura who will be able to give their perspectives on what it takes to implement a sustainability strategy and obtain sustainability linked finance. We'll also be talking to Radi Ivanova from Barclays and Alison Barry and Vaughan Tyrell from HSBC, who will be providing a bit of colour around what is involved in the bank process when it comes to sustainability linked loans.

Question 1

The coronavirus pandemic has caused huge disruption to businesses and the wider economy over the last 18 months and as a result we've seen a tension between achieving medium to long term sustainability goals and short term economic survival. 82% of the financial community believe that businesses are still prioritising financial performance over sustainability impact. With sustainability linked loans, businesses can focus on their sustainability strategy whilst also taking advantage of the financial benefits that such products bring.

Jayne Cottam, the CFO at Assura, a listed real estate business specialising in medical centres, gave her views on the importance of balancing both economic success and sustainability progress.

[JAYNE COTTAM – EPISODE 4, QUESTION 1][1]

[We haven't actually done any lending on the sustainable side, we've done it on the social, however, I have looked in detail at green and sustainable lending. It's quite challenging because to get the metrics that will work for the banks can be quite difficult. I can see how businesses would definitely, particularly coming out of the pandemic, those who've been hit economically, they are going to look at their financial stability and you know getting out of what's been a terrible 12 – 18 months over and above sustainability but I think if the banks can be supportive or their lenders because it's not just the banks, can be supportive, then actually there is no reason why you couldn't do the two together as they are coming out of this. I think the idea is is to set simple straightforward and achievable objectives and metrics because if this is the direction of travel for your business, if I look at our business, this is the direction of travel, this is what we're looking at, we set our social impact strategy before the pandemic so this was always our direction of travel so why not continue with that along with the lending so when we're looking at borrowing any additional funds we make sure we dovetail the two together but I can see how other businesses would find it challenging because the banks you know they've got some fantastic knowledge and experience but I think sometimes it can sometimes feel a little overwhelming for the company when you have these experts spouting lots of sustainability things and metrics to you whereas actually in reality if you peel back the layers and you push back a little bit and you think about your own sustainability plans, there is usually a middle ground where you can actually get things moving forward.]

[1] Jayne Cottam – between 14.00 and 16.15 mins [1:53 – 3:36]

Question 2

After speaking with Assura, we also wanted to find out about the experiences of a business that have recently gone through the process of obtaining sustainability linked finance. We spoke to Bruntwood SciTech, the UK's leading property provider to the science and tech sector, who recently put in place their sustainability linked loan with a syndicate of banks. Whilst this is only one example of many transactions where sustainability linked loan has been put in place, we wanted to get the views of Kate Lawlor, the CEO, on whether she thought the borrowing process was more onerous compared to non-sustainability linked finance.

[KATE LAWLOR – EPISODE 4, QUESTION 1][2]

[That was evidenced by virtue of the fact that we ended up having to separate the two, so we negotiated our finance on the basis that the sustainability piece would follow because they couldn't, they just couldn't get there in the timescales that we needed and whether that's down to them still being on the learning curve or them just wanting to get it absolutely perfect because you know they are still relatively few and far between in the market so it's almost as if every single one that comes forward they want to make it the exemplar, example of a sustainability linked loan product, but do I think it was more onerous? Yes without a doubt and I think there is a lot for them to do to make it slicker.]

We're seeing more and more of these types of products in the market and as experience develops, processes are becoming more streamlined.

Moving on to another potential area of concern, if you are a business coming out of the pandemic and thinking about your future finance options, you could be forgiven for thinking that a sustainability linked loan will impose significant measuring and reporting obligations on your business than if you were to go down the route of non-sustainability linked finance.

Kate Lawlor actually found that the structure of a sustainability linked loan has helped Bruntwood to focus on its sustainability strategy and will enable the company to benefit from favourable pricing if it meets its specified sustainability targets. We asked Kate how onerous she has found measuring and reporting against sustainability targets so far.

[KATE LAWLOR – EPISODE 4, QUESTION 2][3]

[Not very, I think- we've been doing it for some time anyway and it's becoming just such a bigger part of our business with sustainability a really key part of what we're trying to do right down to the grass roots of the business so we’ve already got our own targets, we're already looking to report against them, the sustainability linked loan helped us to sort of hone those targets down and really focus on, sort of give us a need to develop those year on year targets but I think we're still, I don't see it as being something that's particularly onerous because we're sort of already on that path anyway.]

Question 3

It appears that, from a borrower's perspective, the measuring and reporting requirements aren't unduly onerous. We wanted to find out from the lenders whether there are material differences to their internal credit processes when offering sustainability linked loans.

We asked Radi Ivanova in the Sustainable Product Group whether the Barclays credit process was any more difficult than the process for standard lending.

[2] Kate Lawlor – between 18.00 and 20.00 mins [4:10 - 4:45]
[3] Kate Lawlor – between 19.15 and 20.00 mins [5:31 – 6:03]

[RADI IVANOVA – EPISODE 2 QUESTION 1][4]

[So at Barclays, our sustainability review process which is an approval process we go for, for any sustainability link transaction is very much integrated with the capital committee process that we need to go through anyway so the answer to that is no. Where we see a bigger demand on time is probably in advance of that process or before the borrower kind of goes to the stage of credit and pricing approval with the bank or banks. So we tend to engage with borrowers in advance of that to agree the metrics, the targets, calibrate and have that discussion so that the borrower is ready to go when it comes to the capital and credit approval stages and we find the earlier we engage, obviously the better and direct dialogue with ESG contacts within a company really provide us with the best result and the quickest execution from that point of view.]

Vaughan Tyrell and Alison Barry of HSBC also spoke to us about their internal processes and documentation when offering sustainability linked loans.

[HSBC – EPISODE 2 QUESTION 1]

[It will often run alongside the credit process and add no additional time. In a similar way to a credit committee, HSBC have a sustainable finance forum that will include representatives from across the bank. The forum is not held to review the credit quality of the business or consider its financial performance. Its sole focus is to consider a sustainable finance proposal, whether it meets the banks strict criteria and is aligned to the LMA's principles. The sustainable finance team will work alongside the relationship team to ensure that the correct people from the business are engaged and that no time is lost in the agreement of sustainable performance targets. Where there are multiple banks involved it is often seen that one will take the role of sustainable co-ordinator and manage the process of agreeing suitable metrics with the borrower before engaging with other banks to agree relevant term sheet points and moving to full documentation.][5]

[Speaking from experience, enormous strides have been taken in terms of the standardisation of document terms and principles over the past three years. When Green and SLL loans were merged in 2014 before the LMA principles were launched, the volume of these loans were relatively low. Now SLL loans in themselves account for a third of corporate loans in Europe. We and our clients have come on quite the journey. I worked on one of the first loan deals that closed in 2018 following the launch of the Green Loan principles in March that year. This was the £400m financing of Argents Development of Facebook's new UK headquarters in Kings Cross. We served as Green Loan co-ordinator. The green principles helped us to effectively execute the transaction. As these did not include a lot of drafting we did spend some time with counsel coming up with fair and balanced drafting.

Similarly, we closed a deal for Derwent in 2019. This was the first UK REIT facility for a green RCF for yet another great client. As this was the first RCF with more reporting requirements, I remember being at an all parties where we turned the pages of the green principles in minute detail. It is fair to say that we have since closed a number of other transactions including two more with Argent. It is clear that lawyers, clients and transaction management teams are more and more comfortable with the terms.

I should touch briefly on the SLL principles. This is a growth area for banks and currently SLL loans are beginning to outstrip green loans. For example, we closed Bruntwood this year and I know you will be speaking to Kate at Bruntwood about that transaction. The key considerations to be aware of are firstly reporting information should be provided to the lenders annually so that we can be confident that the sustainability strategy is being complied with. Secondly, declassification. Our view is very much that if information is not delivered or if an SPT is breached in addition to a marginal penalty, the loan should also be declassified and this is something we do for the best interests of the customer also as we think

[4] Radi Ivanova – between 16:14 and 17:10 [6:24 – 7:10]
[5] HSBC Part 1 - Vaughan Tyrell – between 16:15 and 17:20 mins [7:20 – 8:12]

it is in the best interests of all parties that the loan is publicised properly. Finally, I just want to touch on our client considerations. Clients are always keen to ensure that the reporting requirements are not onerous and we appreciate that and work with them to ensure that that is not the case. We also make it clear that we will not declassify a loan without a proper discussion and an opportunity to replace the SPTs and finally and most crucially for many of our clients they want it to be made clear that if a loan is declassified as SLL that this is not a default or an event of default and that is pretty much the industry standard][6]

Lenders are now well ahead of the curve in terms of the process of putting a sustainability linked loan in place. As we've heard from both Barclays and HSBC, the sustainability element of the process is now embedded within the standard procedures that they follow. Borrowers can take comfort from the fact that lenders have done this multiple times and should be well versed in guiding borrowers through the sustainability linked finance process.

<u>Question 4</u>

We all know the issue of sustainability is quite rightly here to stay. How a business examines its ESG credentials and addresses any shortcomings is going to be in the spotlight more and more as time goes by. If a business wants to be an attractive prospect to potential lenders and investors, they need to ensure they are taking clear, well thought out and meaningful steps to becoming more sustainable. We wanted to get the views of lenders on whether they thought that sustainability and ESG considerations will play a key role going forwards in a lender's decision making process when a business is seeking any type of finance, not just sustainability linked finance.

[HSBC – EPISODE 2 QUESTION 3]

[Considering the impact that ESG is expected to have on the future prospects of every business, I expect that this will become a much larger consideration for our credit committees, especially where there is a notable impact from the operators of the borrower or indeed their historic performance. It has already been taken into consideration and this focus is only likely to increase. One of the main jobs of the bank is to consider risk and the impact of climate change and societal adjustments are both significant challenges in this area.][7]

[RADI IVANOVA – EPISODE 2 QUESTION 3]

[I definitely think that is the direction of travel. There is already a lot of data around the impact on infrastructure or asset values from climate related risks for example thinking about also bio diversity and [12.38 will discuss] there is an impact on companies access to raw materials on the companies cost base from that perspective so I think the tangible impact of the sustainability issues are coming to the forefront of banks and investors' minds and certainly the availability of data and track record of data is what will help us understand better and embed these considerations into credit models. I think it is definitely just a matter of time for that to happen more consistently because obviously there is some mandatory disclosure requirements now coming to market in the next 4/5 years and that will help accelerate that transition. If we look at what the approach for credit agencies for example is they already incorporate ESG considerations in their credit ratings some of the analysis is still qualitative because of that lack of consistent data but that is definitely changing.][8]

<u>Question 5</u>

[6] HSBC Part 2 – Alison Barry – between 01.20 and 05.10 mins [8:13 – 10:53]
[7] HSBC Part 1 – Vaughan Tyrell – between 25:50 and 26:45 [11:53 – 12:22]
[8] Radi Ivanova – between 20:49 and 22:06 [12:23 – 13.26]

Finally, we wanted to explore one of the main issues of sustainable finance - green washing. Green washing refers to a company publicising misleading information in an attempt to inflate the outside perception of their environmental impact or sustainability credentials. Lenders risk being complicit in green washing if they fail to properly interrogate a borrower's sustainability claims and monitor progress towards material, stretching and measurable targets.

We wanted to know how Barclays ensure that a lot of what is being done doesn't end up as being green washing. Here is what Radi had to say.

[RADI IVANOVA – EPISODE 2 QUESTION 2]

[Yes, absolutely, I think that is a key objective for the banking sector, but I think the existing standards that we have in terms of the sustainability linked loan principles published by the Loan Market Association, those principles really provide us with a robust framework from metric selection to target calibration, to the verification and reporting side so there is some very clear guidance around what good looks like. To an extent different banks would have different criteria around, you know what that structure should look like, but I think as disclosure and compatibility improves those standards will converge as much as possible and the risk of green washing happening would definitely reduce significantly. From a Barclays point of view we have definitely spent a lot of time with borrowers to understand why a particular set of metrics and how they would get to the targets they set under them and these are the two key questions we discuss with borrowers in a lot of depth and it is probably worth mentioning that some borrowers also look at engaging with external sustainability agencies as well who can provide them with a second party opinion on the framework that they have put together, whether that is aligned with the sustainability link on principles or not but lenders play a key role in terms of establishing the stretching nature of the goals under an agreement and we spend a lot of time with borrowers and ESG teams to discuss that.] [9]

<u>Conclusion</u>

Proactive sustainability strategies and initiatives are bringing immediate financial gain as well as assuring an organisation's longer-term success. Whilst businesses have responded to COVID 19 with clear reprioritisation towards sustainability, many business leaders also report that juggling the priorities of short term financial results is still a key obstacle to fully addressing sustainability issues. Those that have the greatest momentum have shown already that stronger sustainability commitment boosts performance.

Sustainability is good business. Our research has shown that having a more sustainable business can be cost-neutral and even create net gain. Take the plunge and get started on your sustainability journey sooner rather than later. After all, no pain, no gain.

Thanks for listening, we've been Nick Parkin and Emma Whitehall. Tune in to the final episode of our sustainability series when we'll be discussing whether sustainable finance is a flash in the pan or if it's here to stay.

[9] Radi Ivanova – between 17:27 and 19:05 [13:58 – 15:19]