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Investing with 'carrots' and 'sticks': generating maximum impact through ESG-linked loans and ESG covenants

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When we write about financial markets we often think of the traded debt and equity of large publicly quoted corporations. An equally important part of the financial system are the private equity and lending markets.

These private markets are different due to low liquidity, closer client relationships and more concentrated ownership of both debt and equity. These characteristics change the power balance between companies and their debt and equity investors. This can be particularly true of direct investments into physical 'real assets' such as infrastructure and real estate. This closer relationship can be a significant benefit when it comes to investing for impact and sustainable transition.

In this paper **Stanley Kwong** from **Aviva Investors** explains different approaches in the form of incentives and deterrents. This form of financing is still developing and has the potential to inspire new templates for investing and lending in public markets.

The year 2015 saw two critical milestones in the fight to tackle climate change. The Paris Agreement added fresh urgency and clear targets, with a key outcome to limit global temperatures from reaching dangerous levels, so that they remain "well below" two degrees Celsius above pre-industrial levels.

Separately, the 2030 Development Agenda was ratified, which outlined 17 Sustainable Development Goals (SDGs).

Real assets should have a vital role in tackling climate change by supporting the transition to a low or zero carbon economy. As governments demand a greater pipeline of sustainable real estate and infrastructure, there is an increasing recognition for the need to develop more pragmatic environmental, social and governance (ESG) investment approaches to climate transitioning assets.

Whilst there has been much focus on classifying what is considered a 'green' activity (eg Green Bond Principles, EU Taxonomy etc), there should be an equal recognition of the existing brownfield assets that may be deemed carbon intensive sectors. Simply turning a blind eye to these more challenging sectors would neglect the active role investors can play in supporting the transition. In the liquid markets, active engagement is used to pressure companies to progress towards climate goals. In private markets, a similar principle needs to be adopted albeit through different mechanisms, such as the structuring of transactions to minimise ESG risk or generate ESG impact.

This is where real asset investments, which involve investment into existing or new assets, can support economic and social development. For example, in infrastructure, a study conducted by the New Climate Economy (2016) estimated that, between 2015 and 2030, meeting SDG and climate objectives will require US$90 trillion of sustainable infrastructure assets. This amounts to roughly US$6 trillion per annum. Despite this recognition, the current global spend remains at around US$3.4 trillion per annum – half the amount needed.

ESG transparency challenges

There remains a difficulty in encapsulating the full range of ESG issues at the investment origination stage due to the inherent lack of ESG data in private markets. ESG risks are a key long-term indicator of whether expected cashflows are sufficiently future-proofed, and the failure for investors to identify material ESG factors may lead to premature project write-downs. The area remains complex due to the bespoke and opaque nature of private markets.

Demand-side pressures on developing real assets may also inadvertently raise risks as effective and robust ESG integration is foregone for a 'tick-box' mentality. Given the current gap in ESG data, transparency, structuring and engagement in transactions are a critical backbone of stewardship and active ownership in private markets.

Moving towards impact investing

Investors may have less appetite to invest in certain sectors that expose them directly to poorer ESG factors. However, this approach mainly assesses ESG risk profiles 'as is' and fails to acknowledge a dynamic assessment of forward-looking ESG commitments. The private market is moving in the direction of incentivising impact behaviours. it will become a basic expectation of lenders and borrowers that sustainability is central to any transaction. This will position private markets further to the right in the spectrum in Figure 1. For now, the way impact is measured remains a much-debated topic. Differences in what is considered impact lead to variations on what is subsequently reported as impact and, more importantly, whether impact being presented in a transaction is genuine.

It is important to distinguish between investments targeting impactful sectors and investments that are impactful in and of themselves. This can be thought of in two ways:

1) The underlying activity being invested in is within a sector deemed to make positive contributions to society, often seen in the cases of affordable housing or renewable energy investments.
2) The investments are impactful through their contribution to the asset's improvement of ESG factors. Investors are increasingly interested in generating impact in this area, for example through the inclusion of specific ESG targets that are ambitious and materially linked to the financial terms.

A recent report by the University of Zurich highlights this second point in a graphic (Figure 2) reproduced below.

Figure 1: Spectrum of ESG integration into the investment process

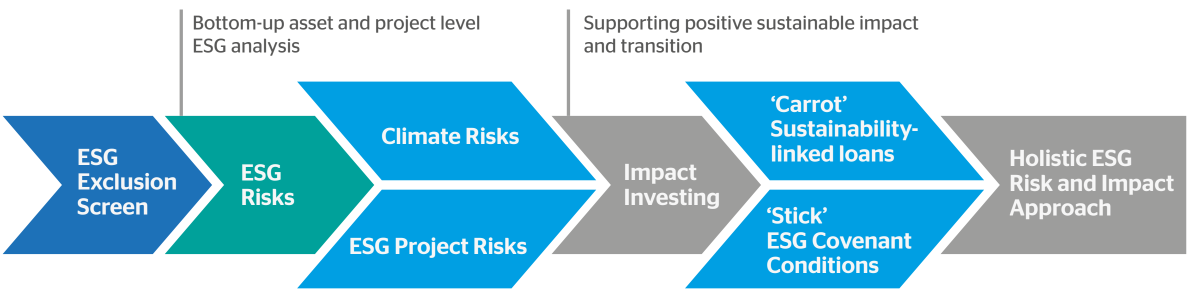
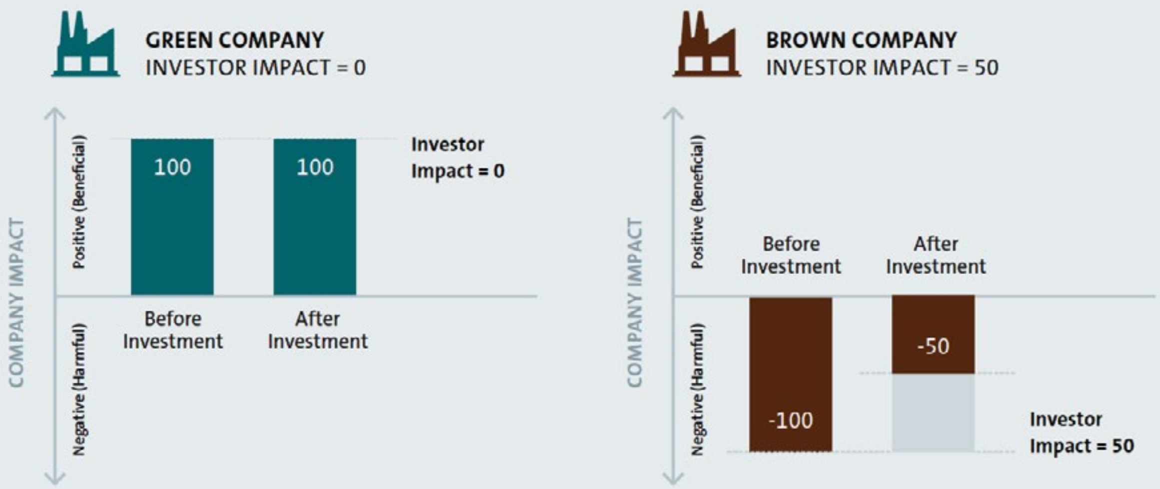


Figure 2: "Investor impact is about causing change – not about owning impactful companies." (Heeb and Kölbel, 2020)



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The implications of these two differences can be profound. An assumption that a sector inherently has a positive impact may divert from further opportunities to engage on ESG targets. For example, affordable housing can be viewed as fundamentally positive, but generating further impact can arise from improving the environmental performance of the houses (eg energy efficiency). Equally, ESG risks may be overlooked, such as social housing tenant engagement and housing association governance.

There is no one-size-fits-all approach when it comes to ESG impact. A suite of ESG origination and impact strategies needs to be bespoke to each asset class, whether that is equity or debt, while tailoring solutions that can best capture the most material ESG and impact issues.

Broadly, there are two mechanisms available to private market investors to ensure company and project commitments are turned into tangible ESG targets – through a 'carrot' or 'stick' approach. The inclusion of these mechanisms within a transaction can future-proof the ESG risk profile of projects, which can, in turn, lead to a wider pool of investment opportunities.

Carrots and sustainability-linked loans

Carrots can refer to financial incentives linked to ESG targets within the loan terms. Most commonly, these are loans that align with sustainability-linked loan principles (SLLP) by the Loan Market Association (2020). A downward margin ratchet is one incentive that could be used. Other possibilities could tie loan structure to improvements, such as lower amortisation or more favourable financial covenants, if it is deemed the improvements would provide stronger security on the assets.

This can work in line with a typical transaction structure for real estate debt, where there is direct negotiation with a potential borrower. This was shown in the case of an investment into a real estate developer, where a sustainability-linked loan was used to tie environmental targets to the underlying buildings (see Case 1). The parameters for Aviva Investors sustainable transition loan framework are publicly available (Aviva Investors, nd).

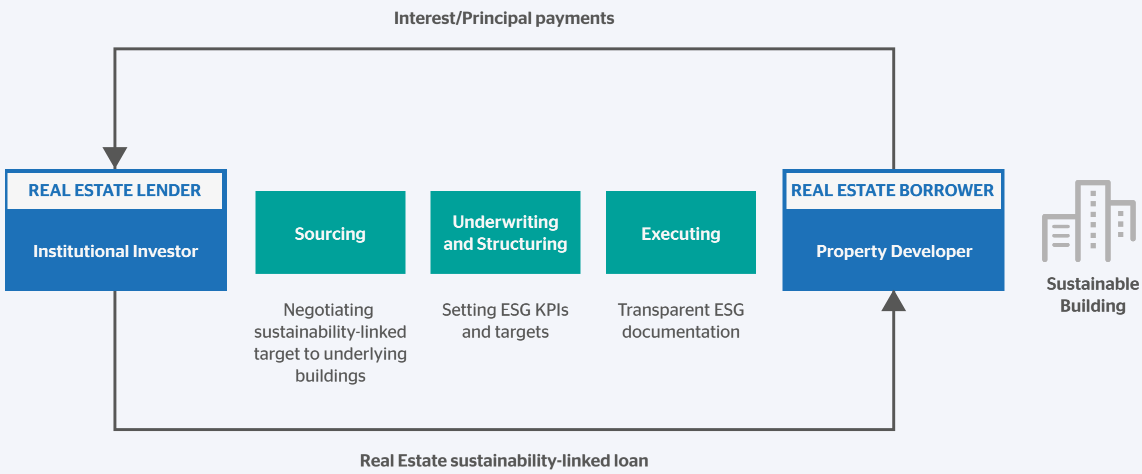
Case 1: The 'carrot' sustainable transition loan approach

The ESG consideration
We were considering the financing of a large UK real estate company, where we sought to improve the environmental performance of the buildings we lend against.

The 'carrot'
We structured a loan against our sustainable transition loan framework to allow for margin incentives linked to specific environmental performance targets.

The impact
The company now has dedicated ESG targets linked to improvements in the building's carbon reduction targets.

Real estate debt: typical transaction structure



Sticks and ESG covenants

There are opportunities to negotiate and impose an ESG-specific covenant onto a debt issuance. This can be used to require greater ESG disclosure or prohibit the use of proceeds into high ESG risk activities.

This is particularly effective in the case of infrastructure debt transactions that involve several other debt investors and a common set of ESG documentation. This was shown in the case of an investment into a European utilities' infrastructure, where an ESG covenant was included to restrict further investment by the utility company into coal and require decarbonisation reporting (see Case 2). The full case study is available on the UN PRI website (Aviva Investors, 2020).

Social factors increasingly prevalent

Whilst the industry's adoption of the UN SDGs and European Union's taxonomy for sustainable activities have helped bring a consolidated approach to impact measurement, there remains a long way to go for private markets. SDG mapping is only a starting point, in that it is making investors more aware of positive societal contributions from investments. More sophisticated impact approaches will also consider risk-adjusted returns in terms of measurable impact, alongside ESG investment strategies.

Local stakeholders, meanwhile, are demanding greater involvement in the decision-making process (Plimmer and Tetlow, 2017). Current stakeholder engagement mainly captures potential socio-economic impact at origination, and therefore only captures a single point for ESG factors.

Case 2: The 'stick' ESG covenant approach

The ESG consideration

We were considering the financing of a European utilities company, a supplier of energy generated from a highly polluting source, lignite.

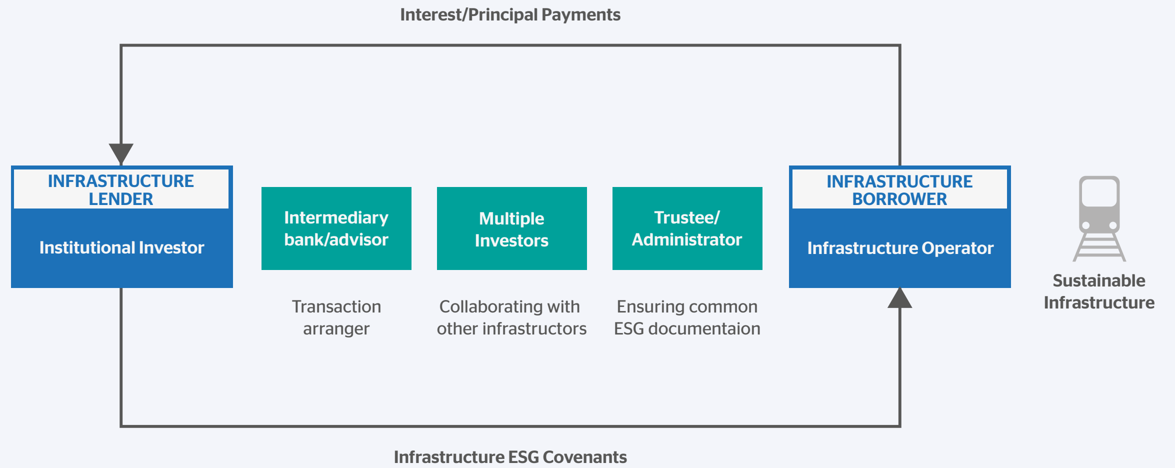
The 'stick'

We negotiated to impose an ESG-specific covenant onto an infrastructure debt issuance, prohibiting the building of any new lignite or coal plants.

The impact

The company now has an obligation to deliver annual updates on the implementation of its strategy, whilst having specific restrictions on further coal investments.

Infrastructure debt: typical transaction structure



New approaches aiming to provide a more holistic approach to impact and value, such as Arup's 'Total Value Case' on the Built Environment, may begin to bridge this gap (Arup, nd).

The focus on the prevailing demographic characteristics and social values may disregard the fluid nature of the 'social licence to operate' (SLO), which will lead to misidentification of ESG issues within real assets. This SLO can gradually disintegrate and the failure for investors to identify material ESG factors may lead to premature project write-downs.

Although real assets play an important role in addressing sustainability challenges, a failure to adopt a systems-thinking mindset, which accounts for long-term ESG risks, will mean a gradual misalignment of interests with the public. This was shown in the UK's private finance initiative (PFI) that faced criticism on poor value for money, despite clear original social aims to build schools, hospitals and infrastructure. This was abolished following the collapse of construction firm Carillion, which exposed inefficiencies on how UK public services were managed. Looking ahead, we will increasingly see this in the oil and gas industry, where climate activism (eg Extinction Rebellion) coupled with a climate conscious public will add pressure on this sector.

The COVID-19 pandemic has also highlighted the importance of a just climate transition – one that is equitable and fair. There is an expectation that social impacts, although currently difficult to measure, will becoming increasingly important. We need to actively seek and go one step further to identify 'S' factors within ESG, and to ensure these are appropriately understood and mitigated to allow the project's societal contribution to be realised.

Conclusion

Private markets have a critical role to play in the climate transition. The illiquid and long-term nature of this asset class means many of the critical (and challenging) ESG decisions are front-loaded, making forward-looking views on impact important. Despite this, ESG information remains opaque. This creates a market opportunity for investors that can harness strong ESG structuring and mitigating solutions. Through 'carrots' and 'sticks', the positive impact generated in private markets (whether through debt or equity) is no longer just talk. This is where high-level commitments become tangible, leading to effective futureproofing of an ever-evolving social licence to operate.

ESG has traditionally focused on public markets but there are many lessons that can be learnt from the private markets:

1) ESG engagement can take many different forms, including through applying different structures to limit ESG risk or generating impact
2) broad sector-level ESG views only provide an initial screen on risks – the true value lies from the forward-looking perspective, matching the future ESG commitments to tangible targets
3) the balance between the 'E', 'S' and 'G' factors are challenging, requiring a case-by-base assessment as more ESG information is provided on projects
4) data does not have to come from ESG rating agencies, but rather can be compiled from multiple sources of ESG-type information to provide a holistic view on a project.

Stanley *leads ESG origination and impact at Aviva Investors Real Assets (£49bn). His ESG expertise spans across the private markets including real estate, infrastructure, private debt and private equity. Stanley has deep experience structuring sustainable impact and nature-based investment strategies. He is also a member of the Investment Committee and Chair of the ESG Origination Forum.*

Stanley has over 10 years' experience in environmental finance. He previously worked in the UK Government and Parliament, advising green financing projects across various sectors. He has also supported sustainable development programmes for the UN and Hong Kong Legislative Council. Stanley holds a BSc from the LSE and Masters in Sustainability from Cambridge University.

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