Emerging trends in the Americas sustainable loan market

Geneviève Piché and **David Szmigielski** of Wells Fargo Corporate & Investment Banking outline how sustainable loan structures have evolved in the region and look to further innovation ahead

Overview

Sustainable finance structures in the loan markets in the Americas are maturing. Borrowers and lenders are increasingly focused on the value creation and risk mitigation potential of sustainability-oriented loans, both within syndication processes and for enterprises as a whole. The mainstreaming of sustainability considerations in loan origination has created an open dialogue among market participants around some of the most pressing environmental and social risks facing industries, as well as the capacity for enterprises to unlock economic opportunity in pursuit of more sustainable, resilient, and profitable businesses.

As borrowers look to execute on investments needed to achieve their sustainability strategies as well as seek to capture opportunities from tailwinds such as the Inflation Reduction Act, sustainability-oriented loan structures are evolving to provide support and we expect to see further innovation in the coming year.

"Private companies are pursuing sustainability strategies for the same reason as public companies: value creation. Sustainability-orientated financings can help them refine and articulate their strategies for growth, innovation, and risk management to a wide range of stakeholders, including employees, customers, suppliers and investors"
Geneviève Piché

Borrower sustainability sophistication is increasing

Borrowers are increasingly seeing sustainability as an important attribute of their capital allocation and financing strategies. Certain borrowers have publicly cited sustainable finance as an important consideration related to their continued and favorable access to liquidity in the loan and broader capital markets.

In addition to considering sustainability-oriented financing structures, treasury and investor relations teams are taking on a proactive stance to addressing lender and investor diligence by providing regular updates on their corporate sustainability undertakings. Further, some borrowers have indicated additional benefits to pursuing sustainability-oriented financing, most notably talent retention and management engagement. Ultimately, sustainability-oriented loan structures are meant to be win-win-win solutions which are intended to reflect borrower accountability toward the achievement of sustainability goals, lender skin-in-the-game via pricing incentives for higher impact and transitional activities, and a path toward addressing sustainability risks relevant to the business.

An example of a market segment becoming increasingly sophisticated is that of corporate and project-level financings for renewable energy. Market participants' focus is moving beyond simply considering the clean energy capacity or generation of a given asset. Loan parties are increasingly seeking to understand and address nature, water, social, and supply chain-related risks. Addressing these nascent matters is also creating transaction differentiation in market and serves as a proactive way to address lender questions in emerging areas.

We expect metrics and investments related to nature, biodiversity, and water to play a greater role in the sustainable finance markets. Businesses with strong sustainability underpinnings, such as renewable energy developers, are expected to increasingly utilise sustainable finance structures to enhance their management of environmental and social risks and lend additional governance to transactions.

Borrower profiles are becoming more diversified

The sustainable finance structures in the Americas have historically been utilised by large, typically investment-grade, corporations. Recently, the profile of the average sustainability-oriented loan borrower has diversified meaningfully. Smaller, often privately-held borrowers are beginning to borrow inaugural sustainable debt.

The reasons for this are varied and include the embeddedness of the concepts of sustainability and long-termism among private companies, particularly family-owned enterprises.

Another reason is large corporations cascading sustainability goals into their supply chain as they seek to reduce Scope 3 emissions and redefine procurement strategies which could ultimately impact privately-held companies within their supply chains.

The Americas market has seen momentum among leveraged corporate borrowers as sustainability becomes a lever to differentiate transactions amid an uncertain market environment. Institutional lenders continue to request information on ESG-related matters and have been supportive of the handful of sustainability-linked term loan B financings executed in the US market.

Furthermore, financial sponsors continue to embed sustainability in their investment strategies and have pursued green and sustainability-linked loans supporting leveraged buyouts in the US market.

Finally, fund finance market participants are adopting sustainability-oriented financing structures at a strong pace and private credit market participants are increasingly keen on adopting sustainability-linked financing constructs in deal structures.

"Environmental, social, and governance matters are of increasing focus for private equity funds, some of which are deploying highly sophisticated strategies for investment selection as well as post-acquisition investment performance. Financial sponsors are raising funds focused on energy transition, sustainable real estate, circular economy and more, providing opportunities for sustainability-orientated financing"

David Szmigielski

Market participants in the Americas are keen to enhance loan governance

The first half of 2023 marked the publication of not only updated versions of the Green, Social, Sustainability-Linked Loan Principles[1] and related guidance documents, but also inaugural legal drafting guidance for sustainability-linked loans (first in the Americas and subsequently in EMEA). The drafting guidance affords loan parties greater transparency into structural options such as declassification or rendezvous provisions that may help address or mitigate deal-specific risks. Additionally, model engagement letter language setting out the scope of the mandate of the Sustainability Structuring Agent helps establish a common market understanding of the potential roles and responsibilities for institutions acting in this capacity.

Furthermore, at the end of 2022, the ESG Integrated Disclosure Project (ESG IDP) was launched. This initiative is championed by the Loan Syndications and Trading Association together with the Alternative Credit Council and UN Principals for Responsible Investment. The initiative seeks harmonisation in ESG-related information furnished by private companies to participants in pro rata and institutional loans and private credit transactions.

We expect the Americas market to continue to optimise market practices and to account for growth in adoption in areas such as fund finance, commercial real estate and private credit as well as forthcoming milestones such as the finalisation of the SEC's climate disclosure rule.

Sustainability is becoming a mainstream consideration in loan origination and syndication

Whether a transaction has a sustainability-oriented structure or not, it has become increasingly important for borrowers to communicate their sustainability strategy alongside broader business and financial updates at launch of syndication. In emissions intensive sectors, for example, the provision of information around sustainability targets and key planned investments is becoming regular practice to address lender

1 Loan Syndications and Trading Association, 2023

and investor diligence. The engagement in the loan market is particularly conducive for private companies which may not have a public sustainability report but are increasingly developing and sharing their internal progress with lender groups.

In some cases, sustainability-oriented financing structures have contributed to more successful syndication outcomes, particularly in cases of volatile markets or more complex borrower profiles. In a recent example, a borrower revised a financing structure to include a Green and Social Loan Principles-aligned tranche as a result of tepid pre-transaction market sounding. The revised structure resulted in increased demand across both tranches, driven by particular support of the sustainability tranche. Complex situations like this show the value of restrictions on use of proceeds or the establishment of green tranches to aid in risk mitigation and to maximise lender participation.

Geneviève Piché says: "Independent of any labels or structures, borrowers' finance and investor relations teams are increasingly addressing a need to become effective communicators of their sustainability objectives as part of their broader plans in strategically and efficiently accessing liquidity in the capital markets."

Pricing adjustments in sustainability-linked loans are slowly widening, becoming relevant in use of proceeds structures

Despite market volatility and pressures on lender risk-return profiles, pricing adjustments for sustainability-linked facilities have not compressed and in some cases have widened. This is, in part, indicative of the continued integration of sustainability considerations in loan origination and underwriting.

Certain market segments have seen expansion in sustainability-linked pricing adjustments. A-rated corporates have progressively pushed the market to expand drawn pricing adjustments similar to those historically seen in facilities for BBB-rated companies. A handful of borrowing base financings in the BBB area have also pushed the market to greater drawn and undrawn adjustments.

The market for real estate investment trust (REIT) syndications has also moved away from discount-only structures to discount and penalty pricing with multiple metrics at higher magnitude adjustments. Facilities in the fund finance market as well as the institutional loan market are seeing adjustments in closer proportion to their opening pricing.

The Green and Social Loan Principles are silent on the topic of pricing as it is not an inherent quality as it is for a sustainability-linked loan. That has made the quantification of pricing benefits for green, social, and sustainability loans, such as those that might arrive from incremental demand for such assets, to be difficult. Recent loan financings in the Americas have made price savings more explicit by tranching between green and general purpose loans, creating incentivised sub-limits for eligible green draws, or providing a pricing benefit for a green loan at close which is subject to the continued compliance with the appended green loan framework or continued progress in obtaining, for example, a green building certification.

We expect lenders will price green, social and sustainability loans more competitively and explicitly as the market evolves. We also expect these pricing concepts to expand to other products.

Novel structures with pricing incentives for sustainability-related investments are being adopted

One of the most meaningful innovations in the North American market is sustainability investment-linked financing. These loans are revolving credit facilities available in full for either general purposes or for sustainability purposes. Eligible sustainability investments are defined in a principles-aligned sustainability loan framework appended to the facility agreement. Individual drawdowns may be classified as a sustainable loan and can benefit from a drawn pricing adjustment so long as the conditions and reporting undertakings under the framework are met.

These structures have been deployed in several sectors including the apparel, food/beverage, utilities, financial institutions, fund finance, commodities, real estate, and industrials sectors. While revolver tranching and sub-limits achieve similar objectives and can be priced at a differential, borrowers have been particularly receptive to this structure as it does not set a limit on green or social utilisation, nor does it curtail general purpose availability.

Further, it makes the sustainability-orientated pricing differential explicit under the facility agreement. Also, it leverages the nature of a revolving loan to allow for borrowings on demand as sustainability investments become actionable – as they become economically feasible, as technologies mature, and as needs arise. Lenders seeking funded assets are also receptive to the structure as it creates additional impetus for the borrower to utilise excess capacity under the facility.

David Szmigielski says: "From production electrification to employee safety equipment, offering practical financing solutions is critically important for treasury teams to execute on growing and sometimes hard to forecast sustainability-orientated spend pipelines which support companies' efforts to realise their sustainability goals."

Outlook

Sustainability and transitional use of proceeds loans, whether explicitly structured as a sustainable finance instrument or not, are expected to grow as the real economy shifts to cover the energy transformation.

Incentivised by the Inflation Reduction Act and similar policy developments, public and private companies seek investments in clean energy and nascent technologies to support the transition to a more sustainable economy.

As market volatility persists, this will likely bring new opportunities and challenges for the Americas loan market. Loan structures aligned with established principles will be appealing as new companies, technologies, and processes come to market at scale, while complementing lender sustainability and capital deployment strategies. ■

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