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FROM JUNK BONDS TO JUST BONDS – THE INCREASING IMPORTANCE OF ESG FINANCING IN EUROPEAN HIGH YIELD

In this article, we discuss the emerging demand from investors for Environmental, Social and Governance (ESG) financing and its potential effects for stakeholders in the leveraged finance market.

For an overview of recent precedents with successful ESG integration, please see the attached Annex 1.

Key issues

- As ESG concerns enter the mainstream, new products are developing in leveraged finance to meet investor demand
- Products integrating ESG may require more detailed disclosure under Rule 144A exempted transactions
- Credit rating agencies and the EU are aiming to make ESG disclosure more transparent through regulation and ratings
- Early movers in the ESG leveraged finance space have garnered strong investor buy-in for debt

Increasingly, investors want to know that their capital is contributing to a more sustainable future, and the capital markets have responded with a wide range of financial products to meet this investor demand. While historically there has been substantial focus on "green" financing products that raise funds for projects with tangible environmental benefits, investors are increasingly looking to issuers' broader ESG credentials as part of their commitment to sustainable investing. Issuers have the ability to design a product that conforms with "green" principles, such as Getlink SE's green bond to provide capital for clean transportation and energy efficient projects, or to focus on improving their overall ESG rating through initiatives like carbon emissions reduction or closing the gender pay gap. As such, the Financial Times has declared 2019 "the year when environmental, social and governance considerations are moving out of a specialised niche into the mainstream."

Investors are formally and informally integrating ESG principles into their management of global asset portfolios. A 2019 UBS survey with Responsible Investor found that 78% of institutional investors surveyed consider ESG factors in making their investment decisions. Although ESG is still emerging in the high yield market, Cerulli Associates estimates that in Europe, 24% of high yield investors currently apply ESG criteria to their investments. In another 2019 survey of asset and fund managers, 90% of managers believed that at least 35-50% of all global assets will be managed under ESG principles in the next five years. Ratings agencies are assisting investors with this integration by including ESG evaluations in their credit ratings analysis. The high yield and leveraged finance market has begun to offer a wider array of products with ESG principles in mind; ESG-focused markets are no longer solely dominated by green bonds. The sustainable investment movement has developed "social" bonds, such as a development bank's bond to improve education in a developing country, "sustainability" bonds, such as a bond to build green buildings on a university campus, and "blue" bonds, such as a sovereign bond to improve conservation of an endangered marine area, to capture a larger array of ESG concerns. ESG financing experienced rapid

growth in structured finance and sovereign debt, and now the high yield market is following. The first high yield funds managed under ESG principles were established by M&G Investments and Candriam Investors Group in late 2017. Fair Oaks Capital followed the lead of Bardin Hill and Permira Debt Managers to launch a European ESG-focused CLO in May 2019. As a result, issuers are increasingly asked to respond to the concerns of bond investors who prioritize ESG issues. Bondholders, especially the 2,237 signatories of the Principles for Responsible Investment, have begun to ask bond issuers about their ESG credentials during roadshows and meetings.

Paying attention to ESG credentials has the power to provide access to additional pools of capital and opportunities for better rates on debt in the coming years due to increased investor demand. Investors also benefit from ESG deals; there is preliminary research that selective ESG investing generates better returns for investors. A 2018 Barclays study of the US high yield market found that bond portfolios favoring issuers with high ESG ratings had a positive impact of 25-45 basis points over 2012-2018. Likewise, 2018 research from J.P. Morgan also indicates that incorporating ESG criteria in high yield portfolios can lead to increased returns.

Defining ESG

The International Capital Markets Association (**ICMA**) distinguishes between green bonds, which must conform to the Green Bond Principles criteria, and ESG bonds, which "integrate governance criteria which are not featured in the Green Bond Principles … and may refer to an issuer's overall sustainability credentials rather than a specific use of proceeds." Issuers hoping to finance specific projects to improve their environmental impact may be good candidates for green debt issuances.

Issuers looking to raise capital for purposes that may not seem compatible with the ICMA Green Bond Principles for a green financing instrument should not ignore how their ESG credentials can affect the market for their instruments, however. Investment managers are gauging what steps, if any, an issuer is taking to improve its long-term ESG credentials rather than screening investments for specific green projects. "We would rather see companies improve their full corporate wide ESG profile than spending too much time identifying a specific project that meets all the qualifications for it to be a green bond," the head of US stewardship and sustainable investments for Legal & General Investment Management America told the International Financing Review in May 2019.

In the context of European high yield, which is typically issued to investors across the globe, including in the US, in reliance on Rule 144A and which requires more detailed disclosure, defining ESG may prove to be an additional challenge. In particular, as the disclosure standard for a 144A transaction requires more detailed information to be provided to investors, care will need to be given to describing the nature of ESG elements included in the transactions, and in the case of issuances designed to fund specific projects, monitoring the use of proceeds to ensure that they are used for the purpose described in the offering memorandum. In instances where, for example, specific performance metrics are targeted, issuers will need to ensure that the information, including third party reports, provided in an offering memorandum or reporting on an ongoing basis is accurate and verifiable.

Demand for ESG Transparency Drives Credit Rating and Regulatory Movements

Credit rating agencies are responding to investor demand by expanding disclosure of entities' ESG credentials as part of their overall credit rating process. In January 2019, Fitch launched an "ESG relevance scores" program that will be rolled out across all entities that they rate. The relevance scores are designed to tell investors how ESG issues intersect with the overall credit risk for a particular entity. S&P offers a similar "ESG evaluation" to analyze how an issuer's ESG credentials could impact its financial future, and Moody's has committed to strengthening its analysis of ESG considerations. Third-party agencies that rate the sustainability of financial products are also increasing their coverage of the high yield market - by the end of 2017, major sustainability ratings agencies MSCI and Sustainalytics covered about one-third of the US high yield market with ESG ratings.

External ESG disclosure standards from regulators, particularly the European Commission, may drive issuers to consider their ESG credentials even more carefully. The European Commission's Action Plan on Sustainable Finance aims to create a Taxonomy Regulation to reduce confusion in identifying green financial products and a Disclosure Regulation requiring asset managers to identify a sustainable investment target and formulate policies on integrating sustainability risks into their investment decisions. The Disclosure Regulation was agreed in March 2019 and is currently moving through the EU legislative process. Potential issuers should start thinking about how these regulatory constraints on investors will affect the market for their high yield bonds.

ESG and Green Precedents in Leveraged Finance

Klabin Finance S.A. - $500 million of 4.875% Notes due 2027 (September 2017)

Clifford Chance's New York Capital Markets advised the Brazilian pulp and paper producer Klabin on its high yield green bond issuance in September 2017. Klabin used the proceeds of their $500 million bond to finance projects in sustainable forest management, restoration and water and waste management. As part of the financing, Klabin Finance created an internal Green Bond Framework and received a second-party opinion from Sustainalytics which certified the bond's alignment with the ICMA Green Bond Principles. Fitch Ratings affirmed Klabin's ratings at "BB+" in May 2019, one notch higher than Brazil's "BB" country ceiling.

Getlink SE - €550 million of 3.625% Senior Secured Notes due 2023 (October 2018)

Clifford Chance's London Capital Markets team represented the initial purchasers on the firm's debut European high yield green bond issuance by French company Getlink SE (formerly Groupe Eurotunnel SE) in October 2018. Getlink develops and manages "safe, modern, and environmentally-friendly mobility infrastructures" including the Channel Tunnel. Getlink issued €550 million in notes to finance its G2 Bridge Loan (also certified as a green bond under GBP) and cover capital expenditures for its ElecLink project. As part of the financing, Getlink received a second party opinion from DNV GL Business Assurance Services which certified that the notes align with the ICMA Green Bond Principles. As of May 2019, Fitch Ratings has affirmed Getlink's bond as 'BB+' with a stable outlook.

MasMovil - €100 million RCF and €150 million capex line, €1.45 billion TLB due 2026 (May 2019)

Term Loan B borrowers are also jumping on the ESG bandwagon and changing the structure of their loan agreements to include ESG features. In May 2019, Spanish telecommunications operator MasMovil launched Europe's first ever revolving €100 million revolving credit facility and €150 million capex line with ESG features that sit alongside a €1.45 billion seven-year TLB. The TLB allows MasMovil to refinance existing debt at a lower cost. The RCF and capex line include terms that will increase interest rates on the loan if MasMovil's ESG rating deteriorates and decrease them by 15 bps if the rating improves.

In all three of the transactions above, issuers and borrowers have chosen to incorporate a focus on ESG in different and flexible ways. Bond issuers in the high yield space have followed the practice of investment-grade green bond issuers in not including specific covenants from the issuer about the sustainable or green nature of the bond, in contrast to some borrowers who sign express covenants linking ESG credentials to interest rates. For example, in June 2019, Nokia signed a €1.45 billion RCF which will decrease in margin if Nokia can reduce its greenhouse gas emissions by 41% and its greenhouse gas emissions arising from the use of its products by 71%, as compared to a 2014 baseline. This does not mean that it is impossible to tie bond coupons to sustainability ratings, however, in June 2019, German manufacturer Dürr AG became the world's first-ever Schuldschein issuer to adjust their bond coupon in line with an ESG rating. Dürr AG has linked the bond coupon to their ESG rating as determined by third-party agency EcoVadis. If the issuer can increase their sustainability rating to a specific level defined by the third party, the margin of their debt will step down by 2 bps; if their sustainability rating falls proportionally, then 2 bps will be added to the coupon. The bond was several times oversubscribed and allowed the company to borrow at an average rate of 0.84% across various tranches, lower than the firm's previous cost of borrowing. Transactions of this type in investment-grade bonds illuminate ESG's potential to allow cheaper borrowing throughout the leveraged finance world.

As the demand for sustainable investment accelerates, efforts to conform to high ESG standards do not just protect an issuer's reputation; they have concrete effects for financing. Issuers that work to improve their ESG credentials can raise capital through innovative new financial products and ESG-governed funds, cooperate with investors bound by EU regulators and see their ESG credentials reflected in their credit rating. Early movers in the ESG leveraged finance space have succeeded in garnering strong investor buy-in for debt issuance. In 2019, paying attention to ESG is a smart form of strategic management for all players in leveraged finance.

Annex 1: ESG Precedents in European Leveraged Finance

	Issuance Type	ESG Integration	Reporting	Size
Klabin Finance S.A. (September 2017)	High yield bond under Rule 144A/Reg S	Use of proceeds for financing and/or refinancing, of investments and/or costs related to eligible Green Projects. Green Project categories include: Sustainable Forest Management; Restoration of Native Forests and Conservation of Biodiversity; RenewableEnergy; Clean Transportation; EnergyEfficiency; Waste Management; Sustainable Water Management; Eco-Efficient and Circular Economy Adapted Products; Production Technologies and Processes; and ClimateChangeAdaptation.	Klabin created an internal Green Bond Framework and received an opinion from third-party agency Sustainalytics which certified the bond's alignment with the 2017 ICMA Green Bond Principles.	$500 million
Getlink SE (October 2018)	High yield bond under Reg S	Use of proceeds for refinancing a green bridge loan used for construction of the Eurotunnel Fixed Link, financing a new cross-border electrical interconnector ElecLink, and financing several upgrade projects for the Fixed Link.	Getlink created an internal Green Bond Framework and received an opinion from third-party agency DNV GL Business Assurance Services Limited which certified the bond's alignment with the 2018 ICMA Green Bond Principles.	€550 million
MasMovil (May 2019)	RCF and capex line alongside Term Loan B	RCF and capex line that sit alongside the TLB include a sustainability pricing mechanism on the loans' interest that either steps up if MasMovil's ESG rating deteriorates or steps down by 15 bps if the rating improves.	BNP Paribas acted as Sustainability Coordinator and Lead Rating Advisor on the loan. Third-party agency MSCI will determine MasMovil's ESG ratings.	€100 million RCF and €150 million capex line, €1.45 billion TLB
Nokia (June 2019)	RCF	RCF includes a sustainability pricing mechanism linking the margin of the RCF to two of Nokia's key sustainability targets: a 41% reduction of greenhouse gas emissions by Nokia's operations and a 75% reduction of greenhouse gas emissions by customer use of	Nokia's sustainability targets are accepted by third-party agency Science Based Targets, ensuring that targets are independently validated to be in line with the 2015 COP 21	

	Issuance Type	ESG Integration	Reporting	Size
		Nokia's products. The margin of the RCF will increase or decrease depending on Nokia's progress towards reaching these targets by 2030 compared to a 2014 baseline.	Paris Agreement goals.	
Dürr AG (June 2019)	Schuldschein bonded loan	Loan coupon is linked to Dürr's sustainability rating. Dürr's current score is 51/100. If Dürr can score 62 or above on the EcoVadis scale, the debt will step down by 2 bps. If Dürr's sustainability rating falls to 40 or below, 2 bps will be added to the margin.	Third-party agency EcoVadis will determine Dürr's ESG ratings. The rating factors in ecological indicators such as CO2 emissions and water consumption, while also taking account of such aspects as fair working relations and conditions along the supply chain.	€200 million

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