ESG restrictions see limited impact on CLO credit quality
– by Prudence Ho

An increasing number of CLOs are adopting environmental, social and governance investment criteria, but for now, the exposure of leveraged loans to industries affected by ESG rules is limited, representing an average of just 3% of European CLO collateral, according to a Moody’s report.

Focusing on a more narrow set of ESG metrics, CLO funds with ESG criteria avoid investing in sectors including tobacco, gambling, pornography, weapons and hazardous chemicals. However, leveraged loans from these industries are scarce, so the investment restrictions do not have significant credit impact on the CLOs and their performance is comparable to peers, Moody’s said in a report published in August.

“If you apply an ESG filter to the leveraged loan universe, how much supply have you lost? On the face of it, very little. It’s a nice thing to say, but if you are just using an external score, it won’t change your management style too much,” said Stephane Michel, senior portfolio manager at Hermes Investment Management.

Five European ESG-compliant CLO funds have been issued since March 2018 when Permira Debt Managers issued the first one named Providus I. PDM then issued two more ESG-compliant CLOs, followed by Fair Oaks Capital and Bardin Hill.

Tyler Wallace, portfolio manager at Fair Oaks Capital admitted the restricted industries aren’t traditionally European leveraged buyout targets.

“We looked into 150 individual credits over the past year, and we turned down three explicitly because of ESG restricted industries or activities.”

The ESG restrictions on each CLO differ slightly. For instance, PDM has excluded gambling in its ESG CLOs, while Fair Oaks Capital does not.

“We have a firm level view on ESG restricted industries and activities and we then applied that to the CLO eligibility criteria,” said Wallace. “Gaming in our view is leisure.”

HOT TOPIC
The impact of ESG-restricted CLOs is also limited because increasingly, fund managers on regular CLO funds are taking into account sustainability as part of their credit analysis.

“Do you want to look at a company every other week to see if they have had an oil spill? And you think that’s a wise credit analysis? No, it isn’t,” said Michel. “Not every CLO puts their language on that, it’s not because they aren’t doing some form of it. It’s not necessarily possible to prove that they have done it fully and all the time.”

A US$500m-equivalent leveraged loan for Israeli cyber surveillance firm NSO Group earlier this year was one of the first deals to highlight investment decisions around ESG. The deal was

(STORY cont’d on p. 2)
The use of ESG standards in Europe’s leveraged loan market is going to see it more in 2020, said a head of leveraged finance. They have been limited to capital expenditure and revolving tranches. Bankers and investors believe the lack of deals that incorporate ESG principles remains a key hurdle for market development.

“ESG continues to be on the agenda and the leveraged loan market is going to see it more in 2020,” said a head of leveraged finance.

Global sustainability-linked leveraged loan completed. Masmovil issued the first €250m ESG-linked revolver, part of a larger €1.7bn debt package in May 2019.

ESG-linked CLO issues to come to market. Five CLOs have been completed and a sixth is expected to price in mid-October.

€2.16trn of priced ESG-linked CLOs. €359.4m CLO issuance expected to price in October.


In the News

Bank group for Voestalpine’s €1bn sustainable loan

The bank group has emerged on Austrian steel product group Voestalpine's €1bn sustainability-linked syndicated loan.

The financing was led by BayernLB, ING Bank and SEB as coordinating bookrunners and mandated lead arrangers.

Banco Santander, BNP Paribas, Commerzbank, Credit Agricole, Deutsche Bank, DZ Bank, Erste Group Bank, Helaba, Raiffeisen Bank International and UniCredit were also bookrunners and mandated lead arrangers.

SEB is documentation agent.

The financing, which has a five-year maturity with two one-year extension options, is a debut sustainable loan for the borrower and has a margin linked to an ESG rating from independent ratings agency Sustainalytics.

The loan replaces the company’s existing €900m syndicated loan that was originally arranged in 2015. – AR

Teekay bond tanks with investors

Norwegian shipping firm Teekay Shuttle Tankers got a cool response from investors for a US dollar green bond to fund four new energy-efficient tankers.

Teekay Shuttle Tankers, an operator of oil tankers headquartered in Bermuda, raised US$125m through a five-year floating-rate note.

That was US$25m less than the minimum the company was initially aiming for and much lower than the US$200m maximum target.

The structure of the note also caught the market’s attention after leads said investors were showing preference for an FRN during the roadshow. That signalled to one investor who did not buy the bonds that the deal possibly found more favour with CLOs.

“It may have ended up with people who would otherwise have bought leveraged loans or CLOs,” said Peter Schwab, a portfolio manager at sustainability-focused US investor Pax World.

Leads opened books at three-month Libor plus 625bp-650bp. However, the bookbuilding process was sluggish with the bond pricing at 650bp, equivalent to a yield of about 8.5% in fixed-rate terms. In the US high-yield market, the average yield is 5.75%, said Schwab.

The deal was dogged by questions over whether the green label was suitable for a bond that would help finance oil tankers.

But even for some investors with a broader conception of sustainable financing, the deal just was not worth the risks.

Schwab said he liked the fact that proceeds were being used for the fuel-efficient tankers but declined to participate for other reasons.

“From a technical standpoint, we feel that this could legitimately be labelled as a green bond,” he said. “It reduces CO2 production from certain vessels, and we legitimately be labelled as a green bond,” he said. “It reduces CO2 production from certain vessels, and we

Schwab said he felt conflicted over the fact that the company was still enabling oil and gas production in the North Sea, it was sector and liquidity risks that turned out to be the sticking point for him.

“Shipping has been a challenging and volatile sector.
GREEN LENDING ATLAS

US: PepsiCo launched an inaugural green bond. The 30-year note, expected to total US$1bn, will fund sustainable development projects.

France: Sodexo renewed its €1.3bn RC, linking the margin on the loan to the company’s efforts to reduce food waste.

UK: Bunol is out with a €105m sustainability-linked loan tied to carbon emissions reductions.

Germany: Neumann Gruppe signed a US$25m RC to support the company’s long-term sustainable sourcing initiative to provide loans to smallholder farmers.

Norway: Teekay Shuttle Tankers marketed a green bond to purchase four tankers that will be more energy efficient than all the thousands of Tesla cars in the country.

China: Beijing Enterprises closed a HK$3bn (US$385m) term loan that will help finance clean energy projects.

Singapore: ANZ appointed Stella Saris as head of sustainable finance.

Finland: Kesko signed a €300m loan with a margin linked to the company's sustainability targets.

Austria: Voestalpine signed a €1bn sustainability-linked syndicated loan with a margin tied to ESG rating. The company is moving away from coal.

New Zealand: Synlait Milk signed a NZ$50m (US$31.4m) ESG-linked loan with ANZ, the first such in New Zealand.

Germany: Neumann Gruppe signed a US$25m RC to support the company’s long-term sustainable sourcing initiative to provide loans to smallholder farmers.

In September, the UNEP launched The Principles for Responsible Banking during the United Nations General Assembly. The principles provide the framework for a sustainable banking system and will help the industry to demonstrate its positive social contribution.

LEAGUE TABLES

1-3Q19 Global Green & ESG-linked Global Top Tier Lender League Table (by Deal Count)

<table>
<thead>
<tr>
<th>Rank</th>
<th>Lender Parent</th>
<th>Total Deals</th>
<th>Volume (m)(USD)</th>
<th>Market Share</th>
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<tbody>
<tr>
<td>1</td>
<td>BNP Paribas SA</td>
<td>49</td>
<td>4,624.18</td>
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<td>2</td>
<td>ING Group</td>
<td>38</td>
<td>3,408.02</td>
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Source: Refinitiv LPC

1-3Q19 Global Green & ESG-linked All Participant Level League Table (by Deal count)

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<tr>
<th>Rank</th>
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<th>Volume (m)(USD)</th>
<th>Market Share</th>
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<tr>
<td>10</td>
<td>Citi</td>
<td>22</td>
<td>28,515.37</td>
<td>2.9%</td>
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</table>

Source: Refinitiv LPC
for high-yield investors historically,” he said. “Companies tend to order a lot of ships when pricing is good – and when they’re actually finished two to three-years later, the market isn’t in the same place.”

Another drawback for Schwab was that Teekay’s bond was unsecured, leaving investors subordinated to owners of secured debt, such as mortgage holders. “Shipping companies tend to have a lot of secured debt to finance vessels. This deal would leave bondholders last in line if things don’t go well.”

**MAKING THE CUT**

Green bond investors with a strict definition of the category told IFR the bond would not have made the cut for their portfolios.

Marte Siri Storaker, adviser for responsible investments at KLP, Norway’s largest pension fund, said the bond would not be eligible for inclusion in KLP’s funds that are either green or swan-labelled. The Nordic Swan Ecolabel sets the official sustainability standards for the region. The goal of swan-labelled funds is to use capital and ownership to influence companies and to develop them in more sustainable directions. KLP’s swan-labelled fund requires the bond to follow either the Green Bond Principles or the Climate Bond Standard and to be verified by an independent opinion provider. For KLP, it does not meet either standard, Storaker said.

A second large Nordic green bond investor agreed, adding: “If [the green bond] is supporting the structure around fossil fuels it is clearly problematic.”

**ENERGY EFFICIENT**

Money raised from Teekay’s deal will part-finance four new energy-efficient shuttle tankers, specialist vessels that transport oil from offshore fields instead of pipelines.

“These four shuttles save more CO2 emissions than all 42,000 Tesla cars in Norway,” Jan Rune Steinsland, chief finance officer of the parent company, Teekay Offshore Group, told IFR after the mandate was announced. “We saw this as a great opportunity to launch a green bond.”

Steinsland did not provide further comment after the deal had priced.

A report on the bond by second-party opinion provider Cicero said that each shuttle tanker features annual carbon dioxide savings of 47% compared with other tankers operating in the North Sea.

But that was not enough for some. “One must have lost all common sense to think the words ‘green’ and ‘oil tanker’ can possibly go together,” said one analyst. “If an issuer can make something more energy efficient, they should just use general funding and get on with it,” he said. – IFR

**IN THE NEWS**

**LSE launches green initiatives for bonds, equities**

London Stock Exchange (LSE) has launched two new initiatives to support sustainable finance on its markets and meet the increasing demand of investors for environmental products and services as the transition to a low carbon economy accelerates.

The LSE’s Green Economy Mark recognises listed companies that derive 50% or more of their revenues from environmental activities, and the Sustainable Bond Market (SBM) adds new sustainability, social and issuer-level segments. The LSE is the first major exchange to launch a green economy classification for equities. As sustainable financing continues to develop rapidly, the LSE is working on further initiatives, including a Transition Bond Segment.

“We continue to see growing investor demand for actionable climate related financial information, with global asset allocations to green and sustainable finance increasing each year,” said Nikhil Rathi, CEO of London Stock Exchange and director of international development for the wider LSEG.

**REAL TRANSFORMATION**

Mobile digitisation and secure data erasure firm Blancco Technology Group and biodegradable plastic technology firm Symphony Environmental Technologies are among 74 London equities firms to receive the Green Economy Mark. The Sustainable Bond Market (SBM) is home to more than 200 bonds.

Sustainable activity is accelerating quickly and driving changes in investor behaviour. In the first three quarters of 2019, 20 new environmental, social and governance (ESG) ETFs were listed and green funds raised £1.4bn of funds in primary and secondary issuance, up more than 200% year on year.

Twenty-five green, social and sustainability bonds and seven issuer-level classified bonds were issued in London in the same time.

“We are seeing a real transformation. ESG was initially integrated into active equity portfolios, and now institutional investors are looking at how to integrate it across asset classes and in passive index funds,” said David Harris, LSEG’s head of sustainable business.

LSE is also exploring introducing a segment to support companies across industries in their transition to low-carbon, sustainable business models.

The Green Economy Mark is voluntary and recognises companies and investment funds across the Main Market and AIM that derive 50% or more of their total annual revenues from products and services contributing to the global green economy.

The underlying methodology incorporates the green revenues data model developed by FTSE Russell, and captures “pure-play” green technology companies, and those in industries making significant transition contributions.

SBM adds new dedicated segments for social and sustainability bonds, which allow investors to distinguish between sustainable bonds and builds on the LSE’s Green Bond Segment of 2015, which was the first to be launched by a major exchange.

LSE has also created a new issuer-level segment for bonds issued by companies whose core business is aligned with the green economy, which will allow firms with more than 90% green revenues to admit bonds to SBM.

The exchange has also introduced mandatory annual post-issuance reporting requirements for SBM issuers to make use of proceeds more transparent and ensure bonds are eligible until maturity.

The increased level of data and reporting for companies is expected to continue to shape investors’ strategies, as climate change issues rise to the top of the list.

“We’re seeing new index approaches, and increasing use of climate parameters to weight investments in companies. ESG does have an impact on asset allocation and it’s important for companies to understand how the data is being used,” Harris said. – TW

**Owens-Illinois gets loan**

US-based food and beverage packaging company Owens-Illinois (O-I) has agreed a US$225m sustainability-linked bank loan. The loan, which is for wholly-owned subsidiary OI European Group BV, will be used to refinance existing bank debt.

The interest rate on the loan is indexed to O-I’s overall Environmental, Social and Governance (ESG) score as rated by Sustainalytics. Improvements in O-I’s ESG score will reduce the interest rate under the bank loan.

Bank of America Merrill Lynch will provide the funding and is also sustainability coordinator. Recently, O-I received improved ratings from two non-profit sustainability certifications: Cradle to Cradle and EcoVadis.

“We have made significant progress, but the journey continues,” Jim Nordmeyer, vice president, global sustainability at O-I, said. “Glass packaging is healthy, safe and 100% recyclable. We take great pride knowing the food and beverages that you consume are being provided in a product that is kind to our planet.”

The loan is one of the first sustainable improvement loans in the food and packaging industry and comes after Spanish glass consumer packaging company Vidrala closed a €260m sustainability-linked loan in June. That loan comprised an €80m term loan and a €180m revolving credit facility with maturities of between 2023 and 2024 with optional extensions out to 2025. Margins start at 75bp over Euribor but could fall to 5.85bp if debt reduces and certain environmental targets are met. Vidrala’s financing is being provided by a group of nine banks: Banco Santander, BBVA, Caixabank, Rabobank, HSBC, Barclays, BNP Paribas, Bankinter and Banca March. – AR

**Corestate secures €27m loan**

Luxembourg headquartered real estate investment manager Corestate Capital Holding has agreed a €27m 10-year loan from BayernLB.

The loan, which is for the MIKA Quartier property in Dresden, takes account of the growing environmental, social and governance (ESG) requirements of institutional investors.

The financing comprises a conventional bank loan and subsidies from development bank KfW for energy-efficient construction.

“We have thus succeeded in structuring an attractive financing package for this property in line with our ESG criteria, which is entirely in line with our investors’ requirements,” Matthias Heimann, head of debt finance & debt advisory at Corestate, said. The MIKA Quartier is part of Corestate Residential Germany II (CRG II), an open special alternative investment fund portfolio aimed at institutional investors.

The property, which is located in Northern Dresden, is nearly complete and will provide total rental space of nearly 15,000 metres square with 179 high-quality rental apartments, three commercial units and 145 underground parking spaces.

CRG II, which was launched in the first quarter of 2019, is focused on new residential properties in metropolitan regions and cities throughout Germany. The fund has a planned minimum target volume of €300m with an average annual yield distribution of at least 4%. – AR
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