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All editorial correspondence, manuscripts, etc., should be sent to:
Steven A. Meyerowitz, Esq.
President/Meyerowitz Communications Inc.
26910 Grand Central Parkway, # 18R
Floral Park, NY 11005
631.291.5541
smeyerowitz@meyerowitzcommunications.com

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Surging Sustainable Finance Market Presents Opportunities for Energy and Infrastructure

*Alexandra N. Farmer, Jennie Morawetz, Rachael L. Lichman, P.C., Sara K. Orr, Kelann Brook Stirling, and Emilie A. Jones**

While the COVID-19 pandemic disrupted many industries, it has not slowed down sustainable finance and, in fact, may have increased focus on social infrastructure and investor social responsibility, driving additional growth in this market. The authors of this article explain the growth and opportunities in the sustainable finance market.

The sustainable finance market is experiencing rapid growth, driven by many factors including an increasing number of capital providers seeking to meet their own environmental, social, and governance ("ESG") goals. There is a sense we are now at an inflection point, with many investors, businesses and financial services providers keenly focusing on climate mitigation.

Since the issuance of the first green bond by the European Investment Bank in 2007, which was used to fund renewable energy and energy efficiency projects, the sustainable finance industry has matured and expanded to include a range of other types of products, available to a much larger base of borrowers. The rate of issuance has been steadily increasing and accelerated dramatically in 2019 and 2020. According to BloombergNEF, sustainable debt totaled $732.1 billion in 2020, the greatest volume of issuance ever in a single year. While the COVID-19 pandemic disrupted many industries, it has not slowed down sustainable finance and in fact may have increased focus on social infrastructure and investor social responsibility, driving additional growth in this market.

Sustainable Debt Instruments

Sustainable finance products are designed to support environmental and social efforts, driven by strong market demand for investments that demonstrably support ESG initiatives and projects, allowing borrowers and issuers to take advantage of "greenium" pricing, e.g., lower financing costs. These products have been used to finance a broad array of energy and infrastructure projects, with proj-

*Alexandra N. Farmer (alexandra.farmer@kirkland.com), Jennie Morawetz (jennie.morawetz@kirkland.com), Rachael L. Lichman, P.C. (rachael.lichman@kirkland.com), Sara K. Orr (sara.orr@kirkland.com), and Kelann Brook Stirling (kelann.stirling@kirkland.com) are partners at Kirkland & Ellis LLP. Emilie A. Jones (emilie.jones@kirkland.com) is an associate at the firm.

ects that advance renewable energy resources being most prevalent. But, there is an increasing market for sustainable finance products that are focused on the "S" or "G" aspects of ESG.

Sustainable finance products include:

- *Green bonds* - Bonds used to fund climate adaptation and mitigation and other environmental projects.
- *Social bonds* - Bonds used to fund projects with positive social outcomes, such as improved employment, public health, or education. Social bonds had increased popularity in 2020, as many investors sought out products that addressed the impacts of the COVID-19 pandemic.
- *Sustainability bonds* - Bonds used to fund a combination of green and social projects.
- *Transition bonds* - Bonds designed to provide financing to transition high greenhouse gas emitting activities to lower carbon alternatives.
- *Sustainability-linked bonds and loans* - Bonds and loans in which a company agrees to a coupon step-up or pricing discount conditioned on its achievement of pre-determined ESG performance metrics or a certain third-party ESG score. For example, an ESG-linked subscription credit facility designed to incentivize portfolio companies to improve their performance in ESG categories such as workplace diversity or renewable energy transition.

Notable Recent Financings and Expectations for Market Growth

There have been a number of notable sustainable financings launched in 2021. For example:

- Toyota Motor Corporation issued its fifth green bond and announced plans to raise $4.7 billion from the sale of sustainability bonds to finance ESG projects, including developing zero-emission vehicles and increasing the use of renewable energy;
- Mastercard issued a $600 million sustainability bond in March to support commercially sustainable social impact activities;
- Goldman Sachs Group issued an $800 million sustainability bond in February as part of a plan to deploy $750 billion in sustainable financing and make ESG finance a core part of its strategy by 2030;
- Newmont Corporation, a leading gold and metal producer, signed a $3 billion sustainability-linked revolving credit facility that provides positive or negative pricing adjustments based on its public ESG rating;
- Solaris Water Midstream issued $400 million in unsecured senior notes with terms that vary depending on how much recycled groundwater the company sells;
- Klöckner Pentaplast refinanced its entire capital structure with an ESG-ratchet linked term loan in which pricing discounts applied if certain key performance indicators relating to use of post-consumer recycled materials, reduction

in greenhouse gas emissions and increases in diversity and inclusion; and

- Carlyle announced a $4.1 billion credit facility for its portfolio companies that ties the price of debt to the diversity of a company's board. Carlyle has previously announced more than $6 billion in ESG-linked financing, including loans for the packaging firm Logoplaste tied to emissions reductions, the denim manufacturer Jeanologia linked to water savings, and the gearbox maker Flender based on renewable power capacity, which it estimates has saved the firm more than $15 million.[1]

While the sustainable finance market currently only accounts for a small portion of overall global debt issuances, this market is poised for explosive growth based on the continued focus on ESG and climate by investors and regulators alike. Moody's projects that global issuance of green, social, and sustainability bonds will hit a record of $650 billion in 2021. Additionally, sustainability-linked instruments are expected to grow as well, as global investors and sponsors seek to take advantage of regulatory and market momentum around ESG.

Challenges and Opportunities

There are a number of challenges and opportunities for energy and infrastructure investors and companies seeking to pursue sustainable finance strategies, including:

- *Evolving Voluntary and Regulatory Frameworks*: Over the past decade, a number of voluntary guidelines have emerged to guide the development of sustainable finance products, but there is no firm consensus around what constitutes a sustainable project or how to measure success. Additionally, regulation appears likely to increase, but uncertainty remains over what it will look like. The EU's Taxonomy Regulation, which aims to provide a unified classification system for "green" and "sustainable" economic activities, could influence the market, and the EU is considering creating a standard for green bonds that would require second-party verification. Regulation impacting the market is also possible in the United States, given the Biden administration's focus on ESG and climate.

- *Metrics, Measurement and Assurance*: Because there is no centralized definition of what constitutes a "green," "social project," or "sustainable" business activity, issuers and borrowers have broad latitude in selecting impact metrics. Particularly for sustainability-linked instruments, it is important to ensure any impact metrics are objective, measurable, and can be assured. For use of proceeds instruments, third-party reviews and consultations are often required to evaluate the issuer's process for project evaluation and selection, as well as engagement of independent auditors to independently verify the allocation of funds. As regulation continues to evolve and frameworks become more consistent, it will be easier to compare and contrast the quality of projects and measurements of success. In the meantime, it is critical to carefully evaluate what metrics, measurement, and assurance mechanisms are being used in connection with a sustainable finance product.

- *Enforcement Mechanisms*: From a lender perspective, it is crucial to ensure that funds are actually used to promote sustainability, and lenders are increasingly seeking to mitigate the risk of "greenwashing" by requiring rigorous disclosure and enhanced management, legal and ESG due diligence. Monitoring of projects and contractual enforcement mechanisms are being used by both commercial banks and direct lenders to enforce ESG commitments. In many cases, lenders have few direct remedies (such as an event of default) against borrowers for failure to achieve sustainability objectives. However, some sustainability-linked instruments do provide that such failures result in an automatic margin increase. Bond issuers must also take care to avoid potential misstatements that could trigger alleged breaches of noncompliance with the Securities Exchange Act of 1943 Rule 10b-5.

- *Reputational Considerations*: In addition to the legal risks of a change of plans after issuing green, social or sustainability bonds or loans or sustainability-linked instruments, the failure to adhere to the promised framework could cause reputational damage to the issuer. Potentially misleading or confusing disclosures could also give rise to third-party litigation or reputational harm. For example, issuers of sustainability bonds who make statements about positive social impacts could later face scrutiny if third-party assessments find them lacking, such as a poor score on a human rights assessment. In certain cases, investors are refusing to invest in certain companies or projects that they deem not "green" enough. Comprehensive lender ESG due diligence and periodic third-party audits are therefore key to confirm disclosures are factually accurate and supported by underlying data, as the credibility of a company's ESG statements is critical to manage risks and optimize opportunities.

NOTES:

[1] https://www.nytimes.com/2021/02/17/business/the-carlyle-group-ties-a-4-1-billion-credit-line-to-board-diversity.html#:˜:text=The%20private%20equity%20firm%20Carlyle,rates%20associated%20with%20the%20loans.