Corporate & Investment Banking

Sustainability Integration for Fund-Level Financings

Sustainable Finance & Advisory | Fund Finance Group

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Executive Summary

- Sustainability continues to shape asset selection in many funds while the adoption of strict regulatory structures is lukewarm
- The loan market agencies have developed specialized guidance for the integration of sustainability-linked components in fund finance transactions
- Wells Fargo has worked with clients to develop novel alternatives to standard sustainable finance structures including sustainability catalyst sub-limits

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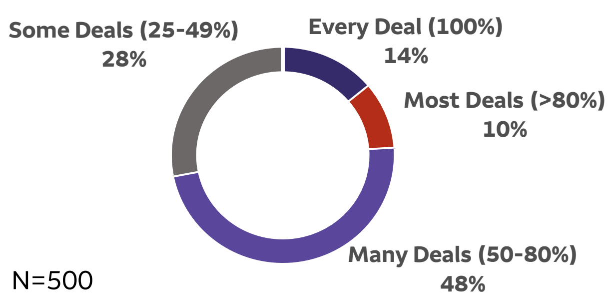
Sustainability Influences Asset Selection

In response to increasing demand from asset owners and limited partners ("LPs"), private equity sponsors have moved to develop sustainability goals and more thoughtfully consider environmental, social, and governance ("ESG") matters in asset selection. 90% of LPs factor ESG into their investment decisions, and 77% use ESG as a criterion in selecting general partners ("GPs").[1] Some LPs are developing more sophisticated in-house evaluation methodologies to screen GP ESG performance.

According to a PwC survey of 150 PE GPs, only one third of GPs report having incorporated ESG factors into valuation exercises.[2] Deloitte found that 72% of PE firms report that they consider ESG in more than half of their M&A transactions.[3]

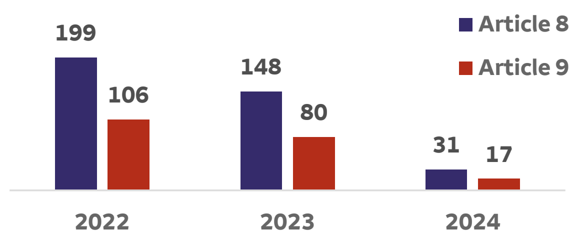
GP Screening of ESG in M&A[3]



Capitalizing on Transition

Although sustainability is woven into asset selection decisions for European sponsors, the value of adopting an EU SFDR[4] article 8 or 9 designation remains debated, with only 8% of LPs requiring article 9, and less than half (39%) even preferring article 9 vehicles.[5] One challenge many GPs face when considering an article 9 classification is that the strict requirements make the label at odds with the common private equity strategy of acquiring 'carbon-intensive' assets and then enhancing asset sustainability as a source of value creation. For this reason, many GPs are opting for the more malleable article 8 designation or other secondary labels.

SFDR-Aligned Fund Launches[5]



This trend is apparent in fund launch data, with the popularity of article 8 and 9 designations falling year-over-year since 2021.[5] ESG-focused fundraising remains robust, with early 2024 data showing 20% of all private capital raised going to ESG funds.[6]

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[1] INSEAD Global Private Equity Initiative, "Green Shoots: Can private equity firms meet the responsible investing expectations of their investors?" (2020)
[2] PwC, "Generating upside from ESG: Opportunities for private equity" (n=150, 2023)
[3] Deloitte, "2024 ESG in M&A Trends Survey" (n=500, 2024)
[4] European Union Sustainable Funds Disclosure Regulation, 'Implementing and delegated acts - SFDR" (2023)
[5] New Private Markets, "SFDR: A groundbreaking regulation in need of reform" (2024)
[6] Preqin, "ESG funds take more than 20% of all private capital fundraising in 2024 to April" (2024)

Connecting Fund Strategies to Financing Solutions

Fund borrowers have long used sustainability-linked subscription lines and other vehicles as a fundraising tool, but growth was limited due to challenges in customizing the Sustainability Linked Loan Principles (SLLPs) to fund finance.

With the release of new guidance from the LSTA, LMA, and APLMA, in partnership with the Fund Finance Association, fund borrowers can now link lines of credit to sustainability targets using a streamlined approach thanks to concessions in guidance on verification standards as well as novel target construction adapted to suit the context of fund finance. The new guidance includes relief to the verification requirement of the SLLP, allowing for the less-costly Agreed Upon Procedures (AUP) standard. The bank market has also grown comfortable with more bespoke targets and Key Performance Indicators (KPIs) that focus on the private equity strategy of "greening" assets over the investment horizon. This update has allowed for a wider acceptance of sustainability-linked lending across sponsors, with private credit, minority equity, infrastructure, and more traditional buyout strategies all successfully executing sustainable finance deals in the fund finance loan market.

Funds focused on transition can evaluate a novel approach that sits between a sustainability-linked loan and a green loan, referred to in market as "sustainability investment-linked" or a "sustainability catalyst" loan or sublimit. Under this structure, revolver borrowings to fund acquisitions or investments in pre-defined "green" or "transition" assets are subject to a reduction in margin, while the full revolver capacity remains available for traditional uses of proceeds such as investments that fall out of scope of the green or transition categories, fund management fees, or other expenditures. Our teams stand ready to discuss sustainability and other key trends impacting the fund finance market.

Closed Date	Fund / Strategy	Region	Sustainability Type	Sustainability Details
Q3 2024	Buyout	EMEA	Sustainability-Linked	Pricing linked to portfolio company GHG emissions target setting as well as governance of ESG related matters
Q2 2024	Various	Americas	Sustainability Catalyst	Discounts to margin for borrowings related to green and transition related activities
Q2 2024	CBRE IM	EMEA	Sustainability-Linked	Not disclosed
Q4 2023	Credit	EMEA	Sustainability-Linked	Pricing linked to portfolio carbon intensity and materialization of ESG related incidents
Q4 2023	Various	Americas	Sustainability Catalyst	Discount to margin for borrowings to fund qualifying green acquisitions or investments
Q4 2023	QIC Infrastructure	APAC	Sustainability-Linked	1. Science-based targets for portfolio companies 2. Gender diversity 3. GRESB rating 4. Portfolio company carbon reduction
Q4 2023	Blackstone	APAC	Sustainability-Linked	Not disclosed
Q3 2023	Minority Equity	EMEA	Sustainability-Linked	Pricing linked to fund carbon intensity as well as governance related matters
Q3 2023	PAG	APAC	Sustainability-Linked	1. Achievement of climate-related milestones by borrowers during their loan terms 2. ESG-focused training for PAG investment teams 3. ESG-focused training for borrowers 4. Measurable improvements in borrowers' environmental, social, and governance (ESG) management and performance during their loan terms
Q3 2023	Astorg	EMEA	Sustainability-Linked	Requires New Private Markets login, see link provided

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