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Sustainable Finance Comes to the Fore

In the midst of the Covid pandemic, issuances of green, social, sustainable and sustainability-linked financing products have surged. Once solely available in the investment grade space, ESG-related debt issuance has expanded into the high-yield market. Likewise, sustainable finance is not just for European issuers anymore; it has jumped the pond and landed in the mainstream in the United States. Notably, private equity sponsors and their portfolio companies have recently joined strategic companies as ESG issuers.

As we expected, the credit markets have sent two unequivocal messages as companies increasingly signal their commitment to accountability on ESG issues: (i) ESG risk is credit risk and (ii) investors are willing to pay modest subsidies to support progress on ESG issues. Massive inflows into ESG-oriented investment funds and seemingly insatiable demand for ESG-related issuances have led to "greenium" pricing (*i.e.*, a lower cost of capital for issuers) of many ESG-related issuances. Moreover, credit rating agencies are increasingly factoring ESG risks – including related regulatory risks – into their ratings, as are credit committees at banks into their determinations.

Most commonly, sustainable finance issuances fall within one of the following four product types:

- *Green Bonds / Loans*. Proceeds are allocated to fund green projects, such as renewable energy, pollution prevention, green building and clean transportation.

- *Social Bonds / Loans*. Proceeds are allocated to fund social projects, such as medicine distribution to underserved communities, affordable housing, sustainable food systems and expansion of basic services.

- *Sustainability Bonds / Loans*. Proceeds are allocated to fund a combination of both green and social projects.

- *Sustainability-Linked Bonds / Loans*. The fastest-growing sustainable financing product, in which a company agrees to either a coupon step-up or pricing discount conditioned on its failure or success in achieving specified sustainability-related performance metrics, for example, on board diversity. These companies typically produce reports on the relevant sustainability metrics that are evaluated and certified by third-party sustainability experts.

Companies considering participation in the sustainable finance markets would be well-served to consider in advance what key performance indicators could form the basis for an ESG-related bond or loan. They should be material and relevant to the company, measurable with a consistent methodology, and aligned with the company's sustainability strategy. Companies should also consider how their existing sustainability reporting can support sustainable finance, as both ESG and financial investors will want to see periodic disclosure on the relevant performance metrics and their qualitative and quantitative drivers.

As investors and companies alike prioritize establishing their ESG bona fides in 2021, we expect financial innovation to follow. Investors have already shown a willingness to reward issuers for creative social- and governance-related financing structures and ambitious performance metrics. The budding emergence of "Transition Bonds" – which are used to facilitate a shift in a company's business activities toward long-term climate goals – demonstrates some investors' willingness to engage with issuers previously excluded from ESG issuances that nonetheless have an important role to play in combating climate change. Additionally, as part of the sustainable finance market's continued evolution, we expect to see expansion outside traditional public financing markets toward more specialized financing spheres.

We encourage companies to proactively evaluate whether ESG-related financing may be utilized for their financing needs and whether ESG-related accountability can be incorporated into their existing capital structures. In 2021 and beyond, we anticipate greater market interest in companies that can demonstrate their commitment to ESG, and sustainable financing is one concrete way to do so.

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