



## **Sleeper SLLs awaken, more sustainable innovation ahead**

Australia's sustainability-linked loan market has experienced rapid growth and lenders say a wave of vanilla debt issued in 2021 could switch to sustainability-linked loan format this year if borrowers meet requirements. The next phase is a sign of the changing business culture, in which issuers, investors and intermediaries are embracing innovation and seeking to apply green financing principles as widely as possible.



he sustainability-linked loan (SLL) market is more opaque and harder to track than bonds but by existing largely outside the public realm it also lends itself to innovation. Loans offer a secure, private path to explore and experiment with methods of financing transition with much less headline risk if a strategy conducted on a best-efforts basis does not achieve its goals.

It is clear from all accounts that SLL usage has skyrocketed. The volume of Australian SLLs is set for a further, retroactive boost, deal sources say, as loans issued with “sleeper” conversion features reach exercise windows.

“These deals were arranged over the last 12 months and we have participated in several such transactions. They are typically with borrowers that were not in a position to develop and close an SLL supported by material, ambitious and credible KPIs and targets within the time available,” says David Jenkins, Sydney-based global head of sustainable finance at National Australia Bank (NAB).

Sleeper loans reflect businesses with a desire to access the SLL market but which did not have time to bring their ambitions to fruition ahead of financing or refinancing needs. Banks are arranging sleeper transactions with language making it possible to convert debt to SLL format in a set timeframe if the borrower meets requirements such as the creation of a sustainability framework with a second-party opinion.

While borrowers may not be able to meet these requirements at the time the loan is made, many are in the process of instituting sustainability goals and do not want to miss the opportunity to enter an SLL at lower interest rates.

Jenkins adds: “Sustainability cannot simply be catered for within a traditional syndication or refinancing timeline if the preparatory work and sourcing of material baseline data required to structure an SLL have not been factored in upfront.”

To bring an SLL to market, borrowers may need to provide three years of baseline data and gain board approval for new KPI commitments. “Many organisations are in the process of refreshing sustainability strategies, establishing net-zero commitments then seeking internal and board approvals – and these things take time,” Jenkins explains.

Lenders say sleeper transactions should not be viewed as a soft entry point to sustainable finance but as quite the opposite. Australian companies are aware of the risks of entering into SLLs too early: they could open themselves to claims of greenwashing if they do not first develop credible and ambitious KPIs. There is also the scrutiny of regulators and investors to be considered.

“Directors of listed companies are mindful of whether they are ready to come into the public domain with instruments of this nature,” Jenkins says. “In many cases, sleeper transactions are the first step toward establishing a sustainability-linked financing framework. Once established, this work can also be leveraged into sustainability-linked bonds [SLBs], derivatives or other issuance formats later.”

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**ready but they are keen to start, sleeper features can be a first step – and some very high-profile names have used them.”**

**DAVID JENKINS** NATIONAL AUSTRALIA BANK

The scale of the sleeper market is hard to judge. *KangaNews Sustainable Finance* understands at least three of the big-four banks are active in this space but none has disclosed data.

Jenkins says NAB has arranged loans across various sectors and that their use is gaining momentum. “Every conversation we have with borrowers about refinancing involves them exploring the sustainability path,” he comments. “If they are not ready but are keen to start, sleeper features can be a first step – and some very high-profile names have used them.”

Some of the very first sleepers, written about 12 months ago, are coming up for conversion, according to Madeleine Harmer, senior associate, sustainable finance at Commonwealth Bank of Australia (CBA) in Sydney. She agrees the feature is a good innovation for companies in transition as it can take time to collect required data and agree ambitious targets. The loan market expects companies to push beyond business as usual with these targets, she explains.

“Even if a company has publicly committed to, say, 50 per cent less carbon emissions by 2030, we would push harder than that within a loan,” Harmer says. “This is the advantage of having the convertible feature – it gives the issuer optionality and time to assess stretch goals beyond business-as-usual emissions reduction work.”

Ultimately, fear of failure and the resulting negative publicity is stopping much of corporate Australia from publicising targets and transactions. “The KPIs in these loans are stretch targets – we are trying to challenge borrowers beyond what they can already do,” Harmer confirms.

## **KPI DIVERSITY**

The path to market for new borrowers is also being assisted by the way sustainable finance instruments are evolving in the direction of nuance and variety rather than commoditisation. Use-of-proceeds (UOP) and sustainability-linked mechanisms are well understood at this point in their lifecycle but there is ongoing innovation in their format and, in particular, the diversification of KPIs.

Charlotte Plaisant Millecamps, director, sustainable capital markets at Westpac Institutional Bank in Sydney, says investor interest is driving the inclusion of reconciliation and first nation inclusion KPIs in recent deals.

“Biodiversity is also growing in importance and we are working on transactions with KPIs that target it,” she tells *KangaNews Sustainable Finance*. “This is tough to track as the timeline for biodiversity projects is not exactly in line with the annual testing of loans – it could be a 15-20 year project. We have to work around a product that typically measures on a yearly basis.”

Plaisant Millecamps says future adoption of industry-wide reporting standards, such as the International Sustainability Standards Board or those being developed by the Taskforce on Nature-Related Financial Disclosures (TNFD), will spur innovation and open issuance to a greater number and variety of issuers. This could include smaller or private companies and financial institutions as well as sovereigns.

Chile's recent pricing of a US\$2 billion SLB is an important development. The bond adheres to the Paris Agreement, including that the country emit no more than 95 metric tons of carbon dioxide and equivalent by 2030 and that 60 per cent of electricity production be derived from renewable energy by 2032.

Chile's deal, the first of its kind from a sovereign, priced on 2 March 2022 at 200 basis points over 20-year US Treasuries. Demand for the bond reached US\$8 billion with the orderbook spread across European, Asian and American investors.

"It took years for Chile to put all its KPIs in place," explains Plaisant Millecamps. "While this is something most countries are doing, the trick is to keep it simple but quite material and measurable. This takes time."

Chile has a track record of green, social and sustainability bond issuance and was the first country in the Americas to issue a green bond, in 2019. Plaisant Millecamps notes arranging a sovereign SLB deal is complex, requiring commitments from multiple government departments and legislatures. "UOP is an easier avenue for this type of issuer, but World Bank has issued KPI guidelines for sovereigns – which give more comfort to those in the market working on sustainability-linked products. This external guidance may provide more comfort to investors as well as issuers."

Plaisant Millecamps says the linked mechanism is likely to spread beyond corporations to additional sovereigns as well as supranational, agency and financial borrowers.

## Beyond green: securitisation issuers contemplate social bonds

The Australian securitisation market could be on the verge of a sustainability surge, market participants believe. Green deals are likely to be the first sign of this uptick in activity but issuers are also exploring social securitisations with hopes of issuance as soon as this year.

While Australia has seen a relatively steady supply of green securitisation of alternative collateral like household solar loans, there has been limited issuance of green residential mortgage-backed securities (RMBS) since this segment kicked off with National Australia Bank's February 2018, A\$300 million (US\$224.4 million) tranche.

Kensington Mortgages printed the world's first labelled social securitisation in the UK in February 2021. The £472 million (US\$619.8 million) transaction aligned with International Capital Market Association (ICMA) Social Bond Principles (SBPs) and was recognised by ISS ESG, a leading provider of corporate governance and responsible investments. The senior bonds priced at 59 basis points over SONIA.

According to deal sources, several Australian issuers are exploring their own social securitisations.



“ We can look to assist in providing access to essential financial offerings – such as mortgages by providing lending to segments of individuals that are not best served by major banks, such as the self-employed and small business owners. ”

ANTHONY MOIR PEPPER MONEY

## INNOVATION AFOOT

Sleeper features are indicative of a broader trend within sustainable finance – it is a youthful asset class and the energy that comes with this is breeding innovation. Market participants are pushing innovation among all forms of debt, including securitisation (see *beyond green: securitisation issuers contemplate social bonds* box), private credit (see *sustainability becomes a direct lending priority* box) and trade finance.

Pointing to recent innovative deals, Harmer argues issuers are “going deeper into carbon reduction and ESG [environmental, social and governance] analysis” in a bid to make their goals more impactful. She says while the market started with “traditionally green” assets – such as low emissions buildings and renewable energy – it is now progressing to financing more complex ESG characteristics. This includes innovation in UOP structures, particularly among real estate and construction borrowers.

“It makes sense for the industry to move from using green financing for existing assets to using UOP structures to fund the development of new assets,” Harmer notes.

Two innovative transactions stand out so far in 2022. On 1 March, Reliance Rail closed a deal combining the features of an SLL with a UOP green loan. The A\$1.8 billion (US\$1.4 billion), 21-year facility was a first for an Australian public-private partnership.

Deal sources also flag University of Tasmania (UTAS)’s A\$350 million UOP green bond for its innovative use of KPIs, which target embedded carbon. The university will use proceeds of the bond – which priced on 15 March – for construction of its new Hobart campus.

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CHARLOTTE PLAISANT MILLECAMPS WESTPAC INSTITUTIONAL BANK

The transaction structure encourages the reduction of carbon emissions over the building's lifetime by the use of construction materials, techniques and design. This contrasts with operational carbon generated through everyday activities, such as energy use. UTAS targeted embedded carbon as its operational carbon footprint is already low thanks to Tasmania's hydro-generated electricity market.

Harmer also notes the significance of the first Climate Bonds Initiative (CBI) certified development transaction to print in Australia: a A\$202 million five-year UOP green loan written in September 2021 for Charter Hall's 480 Swan Street development in Melbourne. The commercial office development – Australia Post's new local headquarters – is being constructed under a carbon-neutral framework, targeting a six-star green star rating and a five-star National Australian Built Environment Rating System energy rating.

Harmer comments: "We worked with CBI to ensure this green asset met the CBI scientific standard and that we could classify a building yet to be constructed as green. We are beginning to move from classifying an asset as green because of its operational performance to looking at the whole project end-to-end, which is also why the UTAS transaction's focus on embodied carbon was exciting."

## Sustainability becomes a direct lending priority

One of the challenges of sustainable debt is that debtholders traditionally have less influence on corporate behaviour than equity investors. The private debt space has a bigger lever, and while applying a sustainability lens to private businesses is not always an easy task specialist investors say it is a worthwhile one.

Ares Asset Management and Metrics Credit Partners are among the private debt lenders that believe their sustainability credentials can drive corporate environmental, social and governance (ESG) performance. This is drawing attention from asset allocators.

"A lot of our institutional investor clients want to work with us in relation to our capacity to originate transaction opportunities that can be structured to allow ESG criteria to be met more effectively," says Andrew Lockhart, managing partner at Metrics in Sydney.

He continues: "Institutional investors can buy a green bond or the like. But our ability to have real impact comes from our capacity to originate transactions directly, including negotiating terms and conditions. It is quite a different market opportunity."

Meanwhile, Ares arranged its first sustainability-linked loan (SLL) in March – to British private equity company Livingbridge. This A\$280 million (US\$209.4 million) deal supported the acquisition of Australian waste management company Waste Services Group.

**“ There is more to sustainability than just the screening processes – there is an opportunity for direct lending to be formative. We are often the largest, most prominent lender in a transaction – our relationship with a borrower and sponsor can be much more additive and in-depth, which in theory can create more space for engagement. ”**



Adam Heltzer ARES ASSET MANAGEMENT

## **WIDENING DEPLOYMENT**

Sustainability standards are finding their way into an ever-widening range of debt markets. This includes the private debt space – where lenders say their close relationships with borrowers provides notably strong leverage (see *sustainability becomes a direct lending priority box*) – and the agriculture industry. Here, borrowers aiming to enter the carbon sequestration market are also benefiting from technological advances.

Technology is facilitating innovation and wider adoption of sustainable finance, particularly for smaller borrowers and companies with complex business models that might otherwise struggle with data collection and reporting.

For example, Jenkins says NAB’s business bank has partnered with Downforce Technologies on a pilot project to scale up remote sensing technology, which allows farmers to determine historical and potential soil carbon levels and the carbon sequestration potential of their land. “This could potentially be used for sustainability-linked instruments that incorporate carbon emissions reduction targets or regenerative agriculture targets,” Jenkins explains.

NAB has completed a green loan pilot with a CBI agriculture criteria-aligned customers, requiring a baseline of sustainable farming practices and performance thresholds to be met. The loans can be used for low-carbon farming opportunities or the creation of carbon offsets, premised upon regenerative agriculture and improving the carbon sequestration characteristics of farmland. “The challenge is how to do it at scale,” Jenkins says. “There is a lot going on behind closed doors regarding technology partnerships.”

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MADELEINE HARMER COMMONWEALTH BANK OF AUSTRALIA

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## END-TO-END SUSTAINABILITY

The conversation is moving beyond cost of funds. Sustainable finance bankers say any borrower implementing an ESG framework for a pricing benefit is missing the point – which should be the injection of sustainability strategy into every aspect of business. Market participants say the application of a sustainability lens to any and every transaction will become the norm.

Harmer says: “We have been focused on carbon but the future will be about all aspects of sustainability. We are having this conversation more often.”

She suggests this started in the UOP space with Celsus’s loan in 2021, which covered green and social elements. Celsus closed a four-year, A\$2.2 billion UOP sustainability loan on 14 July 2021, aimed at refinancing a syndicated debt facility for the operation of the Royal Adelaide Hospital (RAH). The loan led RAH to become the first large hospital complex in Australia to secure a four-star Green Star – healthcare “as built” rating from the Green Building Council of Australia.

Harmer says the future of sustainable finance will consider a company’s entire ESG footprint, not just its climate impact. Banks will endeavour to tailor every aspect of a borrower’s financing needs to that impact. “The trend is toward something greater than just carbon,” she explains. “We are thinking much more about exactly what sustainability means and what range of aspects is important. The focus is growing and expanding from solely carbon emissions.”