



# IN CONVERSATION WITH LAURE VILLEPELET

Pioneering ESG Ratchets  
in Private Debt

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### Pioneering ESG Ratchets in Private Debt

The crisis provoked by the pandemic has brought ESG considerations into the spotlight. It is now accepted that environmental footprint, human capital management and business ethics need to be considered at the level of a company's products & services, operations and supply chain because they have an economic impact.

However, in an evolving landscape of multiple ESG labels and 'best practice' standards, managers need to demonstrate that ESG commitments represent more than 'greenwashing'.

In this short Q&A, we focus on one specific area which is the adoption of incentives for borrowers – a downward margin ratchet in this case. This feature is already becoming more popular as a reward for a lower risk profile achieved by meeting ESG objectives.

Initially structured on the basis of revolving credit facilities, loans with an ESG pricing ratchet are spreading to other types of facilities such as institutional term loans. This mechanism remains rare for lower-rated companies that are typically bought by private equity sponsors. According to Bloomberg, of the \$86 billion in loans raised globally in 2020 with ESG pricing ratchets, only \$3.2 billion has come from non-investment grade companies<sup>1</sup>.

#### What is an ESG Ratchet?

An ESG ratchet is a trigger that decreases the margin on a loan by a pre-set amount. We typically negotiate between three and five relevant ESG criteria and related ambitious targets with the company and/or equity sponsor. Upon achievement of the annual targets, issuers are rewarded with a margin reduction varying between -5 to -25 basis points. As a result, we can incentivize issuers to define a positive trajectory and raise their sustainability ambition.

All companies and equity sponsors stand to benefit from an interest rate margin reduction. However, we have noticed that some companies do not consider themselves mature enough. On the contrary, we believe it is our role to make this mechanism a market standard.



Borrowers stand to benefit from a reduced interest rate, but some do not consider themselves mature enough. We believe it is our role to make this mechanism a market standard.

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<sup>1</sup> <https://www.bloomberg.com/news/articles/2020-11-25/buyers-of-walmart-s-u-k-brand-weigh-tying-funding-to-esg-goals>



## How does the approach work?

We have four components to our approach. The first step is for the investment team to conduct ESG due diligence and the results are systematically included in the investment committee memo. Then we negotiate relevant and ambitious ESG targets with the company and/or equity sponsor. Our role is to push further the ambition of the issuer. We do this through the third step which is a financial incentive: achieving ambitious ESG targets justifies a slight reduction of the interest rate corresponding to an overall superior profile. The final step is review and reporting – the targets will be reviewed as part of the issuer compliance certificate and they will also be considered in the wider ESG monitoring exercise.

## Core components of our approach



Please click below to watch a video explaining the mechanism



If you are having problems viewing this video, please use the link below.




<https://bcove.video/2l5hMC0>

## Can you give us an example of an ESG ratchet?

We recently invested in a company called Talan. Founded by former Valoris top managers in 2002 and employing 2,500+ FTEs, Talan is an IT services player focusing on operations and consulting. Tikehau Capital has a long-standing relationship with the management team. The company's top line is driven by organic growth as well as selective acquisitions. Customer satisfaction, human capital management and innovation fuel future performance.

As the company expands, attracting and retaining talents will remain a competitive advantage. As a result, we decided to set up 4 criteria including (i) maintaining excellent scores with Great Place To Work® and EcoVadis, (ii) increasing training, (iii) increasing diversity at manager level, and (iv) bonus criteria linked to obtaining a globally-recognised ESG certification (ISO 26000, B Corp, etc.).

For example, with circa 36% of women in the workforce, Talan already appeared more balanced than the IT industry average and as a result, raising the ambition meant progressively improving the share of women in managerial positions at Group level (from 22% to 36%).

		Baseline	Year 1	Year 2	Final Year
	 <b>4 QUALITY EDUCATION</b>	ESG Criteria 1: Share of Group employees engaged in training programs			
		37%	40%	43%	60%
	 <b>5 GENDER EQUALITY</b>	ESG Criteria 2: Share of women among Group managers			
		22%	24%	26%	36%

For other business service portfolio companies, we have explored setting different ESG criteria such as decreasing the gender pay gap or increasing the customer satisfaction rate.

In a nutshell, ESG ratchets are an opportunity to materialise our conviction that sustainability and performance are interlinked. Achieving a lower leverage warrants a cash margin reduction, likewise, achieving ambitious targets around human capital management supports a robust performance and justifies a reduction of the interest rate. Leverage remains key and focusing on material ESG topics also generates long term performance.

The ESG ratchet mechanism is a core component of our Impact Lending fund and we have also been pioneering ESG ratchets in unitranche financing

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## Which strategies will this be implemented for?

The ESG ratchet mechanism is a core component of our activities across a variety of funds within our private debt platform. We believe that such a mechanism is attractive and relevant for mid-cap companies and equity sponsors, as well as for investors.

## Can you please tell us a bit more about your Impact Lending strategy?

The aim is to provide investors with competitive returns by investing primarily in companies which contribute to the sustainable economic transition in Europe through their offering, their resource management or processes.

The investment team headed by Nathalie Bleunven identified three themes to advance the sustainable economic transition in Europe:

- 1. Climate action** linked to SDG 13 (Climate Action) and SDG 12 (Responsible Consumption and Production)
- 2. Innovative growth** linked to SDG 9 (Industry, Innovation and Infrastructure)
- 3. Social inclusion** linked to SDG 8 (Decent Work and Economic Growth) and SDG 10 (Reduced Inequalities)

Impact roadmaps related to the fund themes and core SDGs will systematically be included in the legal documentation (ESG ratchet clauses) and impact metrics tracked over time at company and portfolio level.

## Our ESG Credentials

Tikehau Capital firmly believes that defining a responsible investing strategy is key to creating sustainable value for all of its stakeholders. This belief is engrained throughout the firm, from the investment and operations teams to the Manager and the Supervisory Board representatives, and is focused on the integration of ESG and Climate criteria across the firm's investment strategy. The Group's approach has been recognised by international organisations: A+ rating awarded by the UNPRI for ESG strategy and governance and private debt; more than 10 funds managed by the Group have received the ESG label from the Luxembourg Finance Labelling Agency (LuxFLAG) and we were ranked #2 out of 246 global asset managers and custodians for our CSR and ESG strategy by Sustainalytics in May 2020.

Tikehau Capital's responsible investing strategy covers all our assets under management based on four pillars: exclusion, ESG integration, engagement and sustainability and impact investing. While ESG integration is the backbone, we actively engage with portfolio companies to support improvements in their sustainability performance.

## Contacts

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## Laure Villepelet, Head of ESG

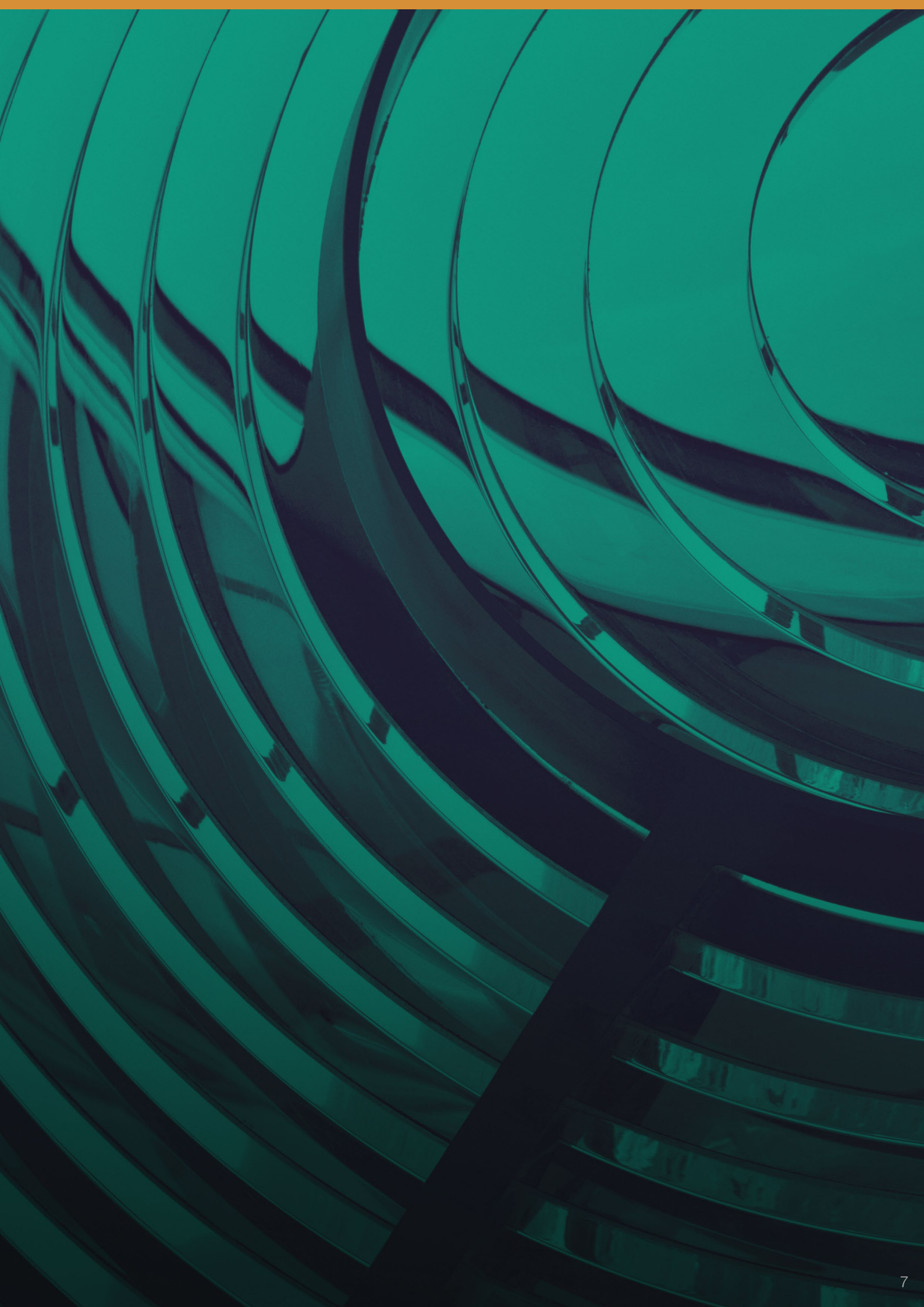
Laure Villepelet joined Tikehau in 2017 to promote and accelerate ESG initiatives across asset classes (private debt, real assets, private equity and capital markets strategies). Laure drives the creation, implementation and reporting of the Group's practices regarding ESG integration, engagement and impact (with a focus on climate change, healthcare, innovation and inclusion). Previously, Laure was sustainable development manager for L'Oréal France. She started her career with PWC valuations in NYC and London, and worked as financial analyst in Singapore. Laure holds a Master of Science degree from Sciences Po Bordeaux and is a CFA® charterholder.

## Disclaimer

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