With environmental, social and governance (ESG) now more important than ever, **Andy King**, principal associate and head of the Mills & Reeve London banking team, discusses green financing options that may be available to care home providers

Financing green ambitions

Environmental, social and governance (ESG) has become important to the care home sector. While increased regulation and political focus are undoubtedly key factors, building ESG into a care home provider's business strategy and planning can enable them to mitigate not only legal and reputational risks, but financial risk too. By proactively pursuing a positive and innovative ESG strategy, providers can increase value in their business and the underlying real estate which underpins it. Therefore, the ESG credentials of a care home business are no longer 'a nice to have', but a priority for many.

Whatever the ESG strategy, capital costs will likely be high initially, and funding may be required from a lender to fund the costs of implementation. Fortunately, lenders are increasingly aligned with providers on ESG, with many committed to transition to net zero alongside their customers.

Reputational factors, ESG-related reporting requirements, customer demand, and the opportunity to lend against more resilient and therefore less risky businesses and assets, mean lenders are putting ESG at the centre of their lending decisions.

Many now offer green finance products to borrowers. But how can these products help care home providers achieve their ESG objectives?

Finance

Green finance is not a term of art. Each lender may have a different framework and set of criteria as to what it deems green finance, and regulatory requirements across different jurisdictions also make it difficult to settle on a common definition. However, two new types of loan have developed over the last few years and are offered by an increasing number of lenders across the market – green and sustainability-linked loans.

A GREEN LOAN COULD BE USED TO FINANCE CONSTRUCTION OF A CARE HOME ORIENTATED TO MAXIMISE SUNLIGHT AND DAYLIGHT TO REDUCE THE AMOUNT OF ENERGY NEEDED

Green loans

The term green loan is often incorrectly used to describe all loans made in the context of green and sustainable lending. However, the fundamental defining feature is that it has a clear requirement for the loan proceeds to be used by the borrower for a green purpose or project. It may take the form of one or more tranches of a loan facility or may be made by way of a term loan or a revolving credit facility and there are many ways it could be utilised by a care home provider.

New builds

A green loan could be used for a provider to finance the construction of a care home, perhaps orientated to maximise sunlight and daylight to reduce the amount of energy needed for heating during the day and constructed using sustainable construction materials, to the highest standard set by the Building Research Establishment Environmental Assessment Method (BREEAM).

Older homes

Consider the impact of rising temperatures. In older care homes that are inefficient in cooling temperature, heatwaves can cause danger for vulnerable residents. For those homes that are inefficient in conserving heat, not only will it be more expensive to heat

but providers will find themselves on the wrong side of existing and proposed regulation designed to ensure minimum standards for energy efficient buildings.

A green loan could be used by a provider to increase energy efficiency, perhaps by installing solar panel systems or biomass systems or other low carbon heating.

Clearly, green loans can assist providers in funding projects to improve the environmental credentials of a care home. But what about other elements in an ESG strategy? This is where a sustainability-linked loan (SLL) may provide a useful green financing option for a provider.

Sustainability-linked loans

In contrast to green loans, SLLs incentivise borrowers to contribute to sustainability performance by linking the loan terms to pre-agreed sustainability performance targets (SPTs), which are measured by key performance indicators. Should the borrower meet these SPTs then it will pay a reduced margin on the loan.

Originally, many SLLs contained this 'one-way' pricing adjustment, so there was no impact for missing SPTs – the SLL would simply revert to full pricing. However, there is now a shift towards 'two-way' pricing adjustments whereby missing SPTs triggers a premium.

This has led to criticism of lenders benefitting from borrowers failing to manage their ESG strategies. However, solutions to this include the premium being ringfenced by the lender and applied by the borrower towards ESG initiatives or charitable purposes. A failure to comply with SPTs will not normally constitute an event of default.

Unlike green loans, there is no use of proceeds requirement for a SLL and many are general corporate purpose loans so can be provided alongside a borrower's other funding needs.

Some SLLs may have one or two SPTs, others six or more, and the range of these SPTs can be vast, which is why they can be more widely used by care home providers and have greater application to a wider ESG strategy that could include climate, environmental, health and safety, social, people, diversity and inclusion performance targets. For example, a provider with a portfolio of homes could agree a SLL with SPTs including the following commitments during the term of the SLL:

1. To reduce the carbon footprint of its homes
2. To improve diversity and inclusion through increasing the ethnic diversity of its leadership team
3. To address the mental health and wellbeing of staff
4. To divert waste from landfill, reduce plastic, and improve recycling
5. To improve biodiversity at each care home
6. To ensure that any new-build care homes are carbon neutral, have a certified 'excellent' rating by BREEAM and are EPC A rated

Lenders will expect quantifiable SPTs (achievable by means of assessment by an industry standard) and SPTs should become more challenging over the life of the SLL.

The SPTs may remain of the same type and form of measurement, but the difficulty in complying with them may increase over time by ratcheting up or down of the underlying quantitative metrics of measurement.

Conclusion

It is easy to see why SLLs may be a viable option for care home providers pursuing ESG strategies.

If funding is needed for working capital purposes and can be aligned with their ESG strategy, SLLs can be incredibly helpful.

However, green loans can also be useful for providers embarking on wholesale ESG-influenced changes to their businesses and underlying real estate. Both green loans and SLLs can therefore be extremely useful tools for providers with long term ambitions to achieve their ESG objectives.