Sustainability-linked Bonds, fuelling the growth of the ESG debt market

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March 2022

WHAT ARE SUSTAINABILITY-LINKED BONDS (SLBs)?

Sustainability-linked formats are relatively new. ENEL Finance issued the first SLB in late 2019. The real innovation in the format was to look beyond the green or social aspects of the projects financed with the 'proceeds' of the bond issue. Indeed, the issuer's commitment is at the corporate level. The issuer incorporates mandatory strategic targets. Otherwise, the issuer will be subject to a financial penalty (called a coupon step-up or premium; the increase is predefined). In practice, prior to issuing an SLB, the company will define environmental or social objectives (Sustainable Performance Targets - SPT), that will be measured using credible Key Performance Indicators (KPIs). If the company fails to meet its objectives by the target date, it will pay a premium for the remaining life of the bond.

For illustration purposes, consider a bond with a 1% coupon and a maturity date of 31/12/2028.

- **Sustainable Performance Targets - SPT:** "Reach carbon neutrality by 2050 with an intermediate 25% reduction in overall emissions by 2025"
  - ***KPI1:*** *"Reduce Scope 1 and 2 carbon emissions by 30% by 2025 vs 2021 level"*
    - **Target date:** 31/12/2025
    - **Coupon step-up:** 0.15%
  - ***KPI2:*** *"Reduce scope 3 emissions by 20% by 2025 vs 2021 level"*
    - **Target date:** 31/12/2025
    - **Coupon step-up:** 0.10%
- Therefore, if at the 31/12/2025 target date, the issuer falls short of the first KPI, it will have to pay a 1.15% coupon for the annual payments of 2026, 2027 and 2028. The coupon further increases to 1.25% if the issuer misses both targets (KPI1 & KPI2).

HOW DO SLBs SHAPE THE ESG DEBT MARKET?

The SLB format remained unused the year following ENEL's inaugural issuance. Thereafter, it was widely adopted in late 2020 and almost mainstream in 2021. The widespread adoption was facilitated by the ECB, when it declared SLBs as eligible collateral if the Sustainability Targets were linked to environmental objectives.

The most interesting aspect of the emergence of the SLB format relates to how it quickly influenced the ESG debt market, which was dominated by green bond issuances until 2020. By the end of 2020 and excluding sovereign and government related bonds, the ESG corporate debt market was comprised of 81% of green bonds, 7% of social bonds and 10% of sustainable bonds. In one year's time, this landscape changed substantially with the explosion of SLBs, making up 23% of 2021 primary issuance. As of January 2022, green bonds represent 70% of the mix and SLBs went from 0.1% a year ago to 10.7% of the ESG corporate debt market. (Source: Bloomberg and La Francaise AM)

HOW CAN THIS TREND BE EXPLAINED? THE GREATER FLEXIBILITY OF SLBs BONDS VERSUS GREEN BONDS

- ***The minimum issuance size of green bonds:***
  The benchmark-size USD300m-500m green bond format only fits companies with sizeable balance sheets/operating cashflows and annual funding programs of several billion USD. The green bond format does not however fit the funding needs of smaller companies

that seek only to raise USD500m every five years, for CAPEX funding or alternative corporate purposes.

- ***The limited eligibility of green projects:***
  To be eligible for Green bond proceeds, green projects are subject to the Green Bond Principles and/or the Climate Bonds Initiative (CBI) as well as the future EU Green bond framework. Green bonds are more suited to certain types of sectors as the current industry breakdown demonstrates. The green bond market is dominated by governments (37%) and focusing on the corporate segment, financials occupy a large share (32%), followed by European Utilities (17%). Other sectors account for only 14% of the green bond market. (Source: Bloomberg and La Francaise AM)

SLBs, given their added flexibility, constitute an interesting alternative. The issuer of an SLB can use the proceeds for green or non-green projects or even for general purposes such as traditional operating expenses etc. It is no longer a question of size of eligible projects relative to total funding needs. The Green bond market scrutinizes, and rightly so, the projects, but also the companies that try to access this form of funding. There is a pronounced risk of 'greenwashing', which obviously could lead to reputational risk for a company operating in a highly polluting industry which would opt to come to the Green bond market. From our discussions with issuers from the cement and energy sector, the Green bond market presented more risks than opportunities. By looking beyond, the projects themselves, SLBs, which focus rather on the long-term commitment of the company (emission or social inequality reductions), underline the firm's efforts, and provide transparency with regards to transition pathway without running the risk of "greenwashing". Greenwashing remains a risk if those ambitions are judged insufficient, but it is minimized as investors in SLBs might be less committed to the format of the bond.

WHAT ARE INVESTORS AFTER? GREEN BONDS AND SLBS ARE INDICATIVE OF A TRANSFORMATION JOURNEY…

Neither green nor sustainability-linked formats are better than the other. They are both indicators of a transformation towards a more sustainable way of consuming and producing. From our perspective, structural change within a company happens well ahead of the green/social or sustainability linked issuance. Indeed, a company first must acknowledge the materiality of the environmental or social risks it faces, then organize itself to better respond to those risks. All of this goes hand in hand with the effective monitoring of operations through global corporate data (individual production site CO2 emissions for example). Once this had been done, the company can consider its future investment plans to address those risks and opportunities. Then the company can articulate that around a Green or SLB format if it has the tools and the vision to be credible in front of ESG oriented investors.

THE BIG QUESTION REMAINS ON THE AMBITIONS BEHIND SUSTAINABILITY-LINKED BONDS…

The rosy picture described just above is obviously the ideal transformation scenario. However, in practice, we have also seen a good share of SLBs with disappointing Sustainable Performance Targets. Given the market's early stage of development, a pricing differential has yet to occur. We follow the below guidelines in order to assess the ambition levels of SLBs and their underlying SPTs and KPIs.

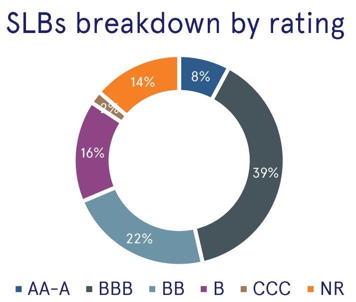
For illustration purposes, we will focus on emission reduction formats which have been the most popular so far.

- ***Has the decarbonization pathway been approved by the SBTi?***
  - This provides a level of assurance that a specialized third party has reviewed the ambition level.
- ***In the given sector, what are the commitments of the issuer's peers?***
  - While not every sector has a large set of comparable decarbonization pathways, it can provide a basis for comparison to investors.
- ***What is the baseline year / What percentage of the reduction target (and coupon step-up) has already been achieved at the time of issuance?***
  - Needless to say, committing to a 20% reduction from 2018 to 2025 when an 18% reduction has already been achieved by 2022 is not particularly ambitious.

- ***Are Scope 3 emissions included?***
    - In most sectors, Scope 3 emissions represent the largest portion of emissions. Leaving out Scope 3 emissions, reduces the ambition level.
- ***What is the company's action plan to reduce emissions?***
    - This can range from energy sourcing/efficiency to more complex and ambitious initiatives such as the revamping of product lines.

AND WHAT ABOUT VALUATIONS?

- ***Does the potential penalty (coupon step-up) reflect the SPT's level of ambition?***
    - The first step in pricing is linked to the credit profile of the issuer. But it could also be expected that the premium be lower if the targeted levels are very ambitious versus peers and the sector.
- ***Is the step-up in the form of a cash penalty, an obligation to purchase offsets or to make payments to a third party (foundation for instance)?***
    - We discourage offsets, which by definition do not constitute actual emission reductions.



The market is currently scattered, in terms of absolute coupon step-up levels and present value of coupons (which takes into account the number of years a step-up could be paid and how many years from now).

Based on a universe of ca.150 SLBs, as at 31/01/2022, 77% were issued by BBB, BB and B issuers as shown in the pie chart.

Source: Bloomberg, La Francaise, as at 31/01/2022

This is an important point to understand when interpreting aggregate coupon data. There is little statistical significance in the higher (AA and A) and lower (CCC) ends of the rating spectrum. While we do not observe a direct correlation between credit rating and coupon step-up, we do observe a steepening of coupon step-up ranges and averages as the credit profile of the issuer decreases.

There does appear to be a "floor" on step-ups at 25bps. Most of the SLBs with a step-up below 0.25% were issued over a year ago when the format was still relatively new to the market.

However, it is difficult to evaluate the present value of the coupon step-up, given the heterogenous scatter of target dates versus call/maturity dates. There are two conclusions that can be drawn:

- **18% of the SLBs have a call option prior to the SPT target date**, meaning that if the issuer fails to meet its objective, no penalty will be paid if it calls the bond prior to the SPT target date. *This is definitely a feature which does not inspire confidence, discredits the format and should disappear from future pricing structures.*
- What we can observe is **that the highest 'face value' coupon step-ups are concentrated in the segment of market where SLBs have a call option or maturity date coming up in the year following the SPT target date** (or said differently, step-up event). They represent roughly 35% of the universe. *One must then be mindful of high face value step-ups with distant target dates versus lower premiums, closer target dates, and the potential payment of step-ups over multiple years.*

WHAT IS OUR APPROACH TO THE ESG DEBT MARKET?

We aim to invest in companies that are turning their businesses around to meet the challenges of a low carbon economy. Our motivation is therefore not restricted to the format of the issue itself. We have observed that more and more companies included in our portfolios, that did not have ESG debt in the market at the time of investment, came to the market with SLBs in 2021, hence confirming our observations made in the transformation journey section. Our objective is to create value by detecting issuers well before they access the ESG debt market, therefore benefitting from the strengthening of their business model (and improved credit profile).

CONCLUSION

At La Francaise, we are committed to accompanying the low carbon transition of issuers and support the development of this market. We are firm believers that **the SLB format is here to stay** and **will allow a much-needed diversification of the ESG debt market**. This does not mean that we expect to generate value for our investors through step-ups. **We actually never count on receiving step-ups**… An SLB issuer that ends up paying its coupon premium is a disappointment and it does not bode well for the rest of its credit curve and profile in general. We do believe that missing a sustainable performance target, not only reflects an inefficient operational implementation of the transition measures, but more importantly reflects that sustainability was not a priority of the strategic agenda.

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