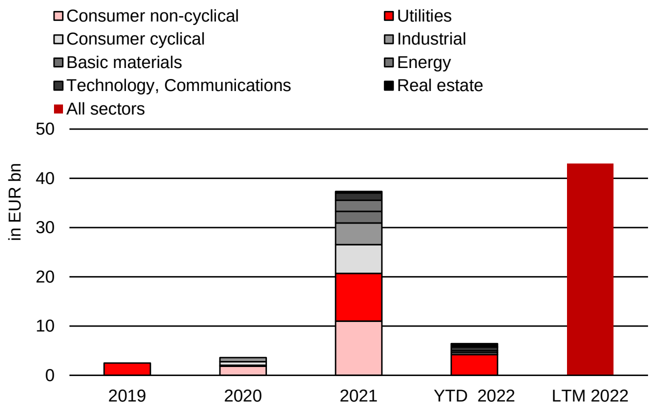
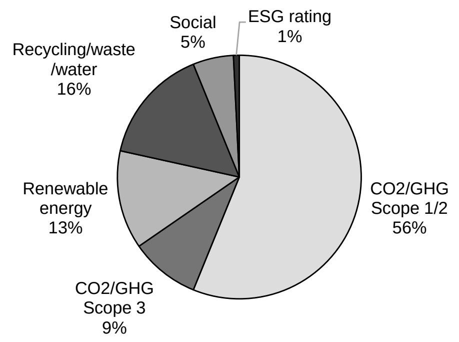
Sustainability-linked corporate bonds: gauging ambition

EURO-DENOMINATED SUSTAINABILITY-LINKED BONDS



SUSTAINABILITY PERFORMANCE TARGETS



LTM: Last twelve months

Source: company reports, Bloomberg, UniCredit Research

- After years of green bond issuance, euro-denominated sustainability-linked-bond (SLB) issuance volume from non-financial issuers increased tenfold in 2021 compared to 2020. Two important drivers were the release of the International Capital Market Association's (ICMA) SLB principles (see website) in June 2020 and the announcement that the ECB would accept bonds with coupons linked to certain sustainability performance targets from 1January 2021 as eligible collateral (see press release). Another growth factor was that, in contrast to green, social or sustainability bonds (also called use-of-proceeds bonds), SLB enables issuers and sectors with insufficient eligible financing needs for social and green assets to participate in the environmental, social and governance (ESG) bond market. The background is that the proceeds of an SLB offering do not have to be used for financing or refinancing green or social projects and as a result, SLB proceeds can be used for general corporate purposes (including M&A). In addition, SLBs also enable issuers to complement green bonds and diversify funding sources. In SLB documentation, issuers commit explicitly to future improvements in sustainability outcomes within a predefined timeline. Most SLBs carry a coupon step-up in case one or more sustainability/ESG objectives are not achieved. An issuer's sustainability/ESG objectives are measured according to predefined key performance indicators (KPIs) and assessed against predefined sustainability performance targets (SPTs). Demand from asset managers who want to buy ESG bonds remains high given that there is pressure from regulators and their investors to integrate ESG factors into processes. Given their resulting benefits in liquidity, but also in ESG reporting requirements compared to conventional bonds, use-of-proceeds bonds, but also SLBs, can often be priced with a yield difference to the yield of an identical non-ESG bond. In September 2019, ENEL launched the world's first SLB. Enel has issued in total 12 euro-denominated SLBs worth in total EUR 12bn (or 24%). On 5 January, Enel said that it expects to achieve its renewable energy targets after the first-ever SLBs met their deadline. Its installed capacity of renewable energy plants needed to have hit at least 55% of total capacity by the end of 2021 to avoid a coupon step-up on about USD 3.7bn of SLBs denominated in USD and EUR. This figure was 54.9% as of 30 September 2021, and the estimated figure as of 31 December 2021 was 58%, an Enel spokesperson told Bloomberg News, citing a company presentation.

- The two charts above show the strong growth in euro-denominated SLB issuance that has occurred recently but also show the distribution of SPTs. In total, we counted 77 euro-denominated SLBs worth a total of EUR 49.9bn issued by non-financial companies. The SLB market is composed of 68% of issues from IG, 30% from sub-IG and the remainder from unrated companies. Around two-thirds of bonds were issued with a tenor between 7 years and 11 years, with the remainder equally balanced with shorter and longer maturities. In contrast to use-of-proceeds bonds, the sector diversification of issuers of SLBs is greater, with 60% of issuance from the utility and consumer non-cyclical sectors. Another 30% was issued by consumer cyclicals, industrials and basic materials, with the remainder from the energy, technology, communications and real estate sectors. In terms of SPTs, 49% of bonds have one, 44% have 2 and the remainder have three. In terms of KPIs, almost 60% are linked to CO2/Scope-1 and 2 greenhouse-gas (GHG) emissions. The major reason for this is that climate KPI can be linked to international benchmark standards like the International Energy Agency's net-zero scenario or linked to a company's net-zero, science-based GHG emission-reduction targets, which are in line with the targets of the Paris Agreement. The remainder of KPIs used pertain to Scope-3 emissions, renewable-energy shares, recycling/waste/water and social and ESG ratings.

- We believe that as long as demand for ESG bonds and SLB is soaring, there will be greeniums at issuance. However, we also expect that the ESG investor community will increasingly be less lenient and scrutinize KPIs, SPTs and SLB documentation in order to detect potential "greenwashing", thus preferring SLB of issuers with higher ambition levels. A potential grid for debt investors to gauge and compare the ambition of an SLB structure should include the following criteria (which are also based on the ICMA's SLB principles): **1. selection of KPIs:** relevant, core and material; high strategic significance to an issuer's current and/or future business; measurable or quantifiable on a consistent methodological basis; externally verifiable; able to be benchmarked; **2. ambition of SPTs**: representative of a material improvement in KPIs beyond a "business as usual" trajectory, where possible compared to a benchmark or an external reference; consistent with an issuers' overall strategic sustainability/ESG strategy; and determined on a predefined timeline. In this respect, we would not be surprised if the number and variety of KPIs and SPTs in SLB issuance continue to increase to also cover aspects besides climate, although having more than three KPIs is likely to make monitoring and assessment more complex for investors. An example for new KPIs/SPTs could be for example the UN Sustainable Development Goal 15, which pertains to sustainable management of forests and aims to reverse land degradation and to halt biodiversity loss. Nevertheless, as mentioned, for KPI/SPT outside of climate goals, it is more difficult in terms of finding viable specific projects, creating frameworks, or set up consistent KPI indicators and disclosure. In this respect, we also note that the ECB only accepts coupon structures linked to certain SPTs (see press release); **3. sufficiency and timeliness of the coupon step-up penalty:** The higher the coupon step-up, the higher is the incentive for the issuer to achieve that SPTs. The step-up is often at 25bp in IG and usually higher, e. g. at 40-50bp, in sub-IG. The coupon step-up must be also seen in comparison to the overall coupon and credit spread to provide enough incentive for the issuer to avoid it and to achieve all SPTs. Apart from the risk of belated disclosure of KPI-related information, which could delay a necessary coupon step-up, it is also important to take a look at the maximum lifetime penalty payment in the SLB, i.e. when is the KPI reference year and when is the resulting effectiveness of the step up. In addition, not all responsible ESG investors do accept SLB in general, for example as they do not like to receive a monetary benefit if companies do not achieve their ESG targets and rather would like to see issuers to use charitable donations or carbon credits to replace coupon step-ups; **4. loopholes in the bond structure** (see article): for example, junk SLBs that have call dates set before the date scheduled for an assessment of an SPT. Others are, for example, escape clauses that allow for the exclusion from the KPI assessment at certain exceptional events, such as material acquisitions or drastic changes in the regulatory environment.

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