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Sustainability-Linked Bonds

What is a Sustainability-Linked Bond?

A Sustainability-Linked Bond (SLB) is a bond instrument with flexible characteristics at the financial or structural level, depending on whether the issuer achieves predefined Sustainability-Linked objectives.

Why issue a SLB ?

Sustainability-linked bonds do not finance particular projects but rather finance the general functioning of an issuer with explicit sustainability targets.

Green bonds are restrictive to some issuers due to its use-of-proceeds nature. Through SLB, a wider range of issuers get to showcase their commitment to sustainability.

Who can issue a SLB ?

All types of issuers in the debt capital markets can issue a sustainability-linked bond, provided it complies with the five core components of the Sustainability-Linked Bond Principles (SLBP).

Issuers are encouraged to publish an ESG framework, which would be separate from the legal documentation, to document commitment to the core SLBP components

SLB Principles

In June 2020, the International Capital Markets Association (ICMA) published the Sustainability-Linked Bond Principles (SLBP), building on earlier market publications for the Green Bond Principles (GBP) and Social Bond Principles (SBP).

The SLBP serve as voluntary process guidelines that outline best practices for structuring credible sustainability-linked bonds.

Recent ESG Publications:

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ECONOMIC RESEARCH AND STRATEGY

Source : ICMA's Sustainability-Linked Bond Principles (June 2020)

The 5 Core Components of your SLB

"Key Performance Indicators should be relevant to the issuer's business line"

The Sustainability-Linked Bond Principles (SLBP) lay down a clear structure for issuers, investors, and financial intermediaries to understand the characteristics of any given SLB. It sets an easy-to-follow recipe of 5 core components :

1. Selection of KPIs

The selection of Key Performance Indicators should be relevant to the issuer's business line, while addressing its environmental, social and governance challenges. It will be heavily influenced by the nature of the industry, but should remain within the following guidelines :

-Relevant, core and material to the issuer's overall business

-Measurable or quantifiable

-Externally verifiable

-Benchmarked against industry standards

2. Calibration of SPTs

The process of calibrating Sustainability Performance Targets is key to the structuring of SLBs. For each of the KPIs selected, an issuer must establish target levels to be reached, within a certain timeframe.

A set of realistic and ambitious targets will demonstrate the commitment of the issuer to its ESG footprint. The SPTs should be :

-Established at levels that incite considerable improvements versus current state of the company

-Benchmarked against industry's standards, issuers' own past performance or science-based levels

-Aligned with the issuers' ESG philosophy

-Set against a pre-determined timeline

3. Bond Characteristics

This is the variable feature that can be triggered by the missing of sustainability targets. Most common features are a step-up in coupon rate or premium at maturity.

4. Reporting

Issuers of SLB should publish at least once a year the information regarding its performance against the selected KPIs, with adjustments to the SPTs where needed.

5. Verification

The verification of the performance requires an independent and external opinion in order to assess whether or not the sustainability performance targets were met.

It is recommended to make the verification publicly available.

Source : ICMA's Sustainability-Linked Bond Principles (June 2020)

KPIs Tailored to your Activity

For a bond-issuing company, the access to the now popular Green Bond market is restrictive due to its use of proceeds nature. A SLB offers more flexibility through its unbounded use of proceeds feature, and grants access to the market to a wider array of issuers with customizable selection of KPIs.

As most of the SLB issuances so far have come in the energy sector, the vast majority of KPIs are related to GHG emissions and energy efficiency. However, for a company operating far from these sectors but still contributing to a more sustainable economy, the KPIs could then be tailored to their line of business, or edged towards the social and governance aspect.

The following can be elected as the contribution:

-Recycling rates

-Sustainable Sourcing

-Water Consumption

-Conservation of Biodiversity

-Community Relations

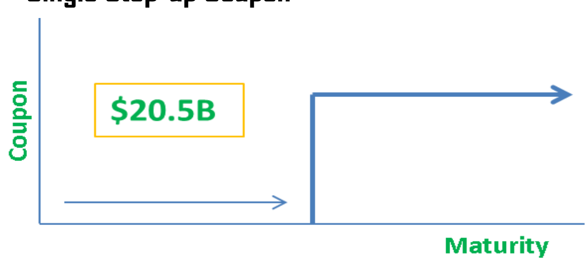
"The vast majority of KPI are related to GHG emissions and energy efficiency"

Impact of ESG performance on the Bond

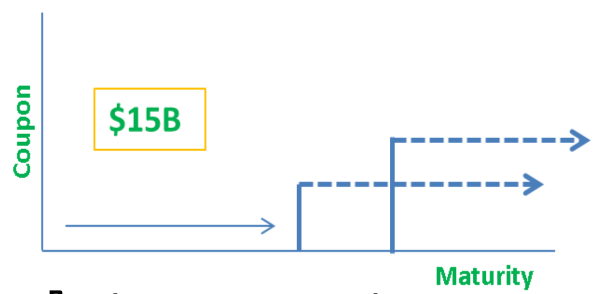
The cornerstone of SLB issuances is that there could be a financial or structural variation on the bond's characteristics if one of the selected KPI and its targets (SPTs) are not attained within the timeframe.

SLB Coupon Structure and Global Issuance Volume

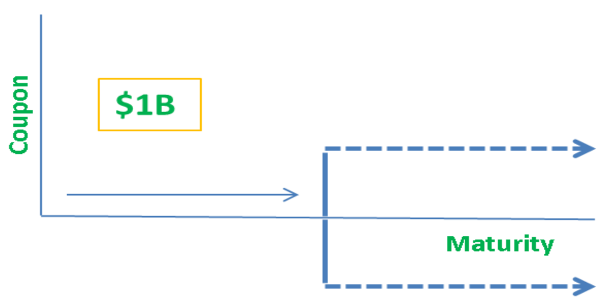
Single Step-up Coupon



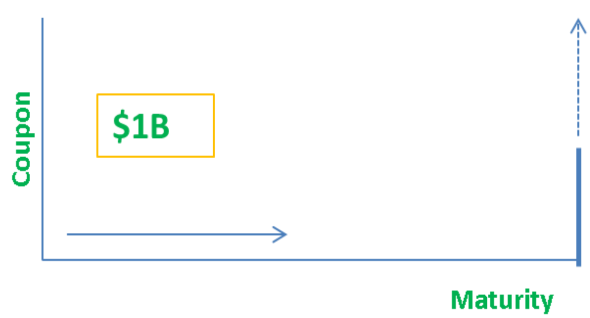
Multiple layers Step-up Coupon



Step-up/Step-down Coupon



Premium payment at maturity



As at July 2021

Most issuances to date have a chosen either a step-up in the coupon rate or a premium payment at maturity to be the outcome of missed targets. Rare instances also have built-in a step-down coupon alternative for exceptional delivery on ESG contribution.

Source : Bloomberg, LBS

Case Study

ENEL

Enel's ESG debt case has continued evolving across the years. With a total of EUR3.5B Green Bond issued in 2017, the Italian energy company innovated in 2019 by issuing a EUR1.4B SLB.

In Enel's case, the covenant started by being tied to the United Nations SDG goal number 7: Affordable Clean Energy. For instance, the company had to produce 55% or more of its energy from renewable sources in 2021. If it fails, the covenant stipulates that investors would have received a one-time coupon step-up of 25 basis points. By March 2021, given the success of their SLB instrument, ENEL launched their first Sustainability-Linked loan for EUR 10B.

Before the new facility, Enel updated the initial ESG framework in October 2020 by tightening the 2030 emissions performance target to 82gCO2/kWh from 125g CO2/kWh. The updated framework also added a 2023 emissions target of 148gCO2/kWh and a 2050 target of zero emissions entirely. Additionally, compared to 2017 targets, the updated targets would represent a 64% reduction in emissions by 2023 and an 80% reduction by 2030. Enel not only updated their KPIs and SPTs but also included a Step-down to the financial optionality of the instrument, allowing them to obtain a financial benefit when emission reductions exceed those targets previously mentioned.

The Enel case illustrates well the deep impact that an ESG-linked instrument can have on the core operations of the issuer. Also, it shows the possibility in adjusting the initial framework to set up more rigorous targets when data from KPIs and STP become available. The continued incremental improvement of KPIs will guarantee eventually to the investor the commitment of the issuer to have a meaningful effect in the business core.

Other Recent examples

In Canada

In June 2021, **TELUS** launched its first Sustainability-linked Bond for $500M in Canada, a milestone deal for the domestic market. TELUS Sustainability Performance Target was set up to reduce Scope 1 and 2 greenhouse gas ("GHG") emissions by 46 per cent by 2030 from a base year of 2019.

Enbridge included Greenhouse Gas Emissions indicators, in addition to **SOCIAL** indicators such as Racial and Ethnic diversity and Women on board of directors.

Worldwide

Brazilian paper and pulp firm **Suzano**, raised **$1 billion** from a SLB with environmental and social KPIs, One particularity is that Instead of a single point SPT, they have selected to use the average of years ended 2024 and 2025, making them less reliant on a single data point, while remaining on track towards their Strategic 2030 targets.

Following the structuring of their Sustainability-Linked loan (SLL), in February 2021 **Thai Union** issued their first SLB introducing the concept of step-up or step-down coupon related to the achievement of Sustainability Performance Targets (SPTs). We expect step-down to become more popular as historical data on average emission reductions become more reliable.

SLB impacting ESG Factors:

ESG encompasses quantitative and qualitative factors that directly impact the Sustainability of the company. So far, Green bonds have provided a substantial level of assurance under UN Sustainable Development Goals (SDGs) for individual high capital intensive projects, allowing to track the impact per project to a particular SDG. However, given the complexity of certain corporate structures, it's becoming challenging to measure the effect of a specific project on the overall sustainability impact of the company. For that reason, Sustainability linked instruments such as SLLs and SLBs are essential funding tools to measure the overall ESG impact of a company, taking implicitly into account the internal initiatives that other financial instruments cannot incorporate explicitly.

SLB and Private Markets:

Over the past few years, both lenders and investors have gathered data and monitored borrowers through a sustainability lens. This development has been happening quite rapidly in private credit, but also across the liquid credit markets, including in areas such as high-yield bonds and leveraged loans.

Overall, there is a much greater awareness and understanding of how capital can be directed towards the sustainability agenda. Investors want to be sure they are backing companies with a sustainable business model, which holds true across private credit, private equity, public equities and fixed income. That means companies increasingly need to demonstrate their ESG credentials and especially their readiness for climate transition to succeed in raising capital in both private and public markets.

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