



Towards a greener future: building credibility and demand for sustainability-linked bonds

By Holger Mertens, Head Portfolio Manager – Global Credit
06 June 2023

Key Takeaways



- As the green bond market diversifies, Sustainability-Linked Bonds (SLBs) – which are linked to an issuer’s broader sustainability performance – have garnered significant investor attention and scrutiny.
- While the concept is compelling, concerns have arisen that their sustainable targets are sometimes easy to beat and therefore easy to game.
- Structural improvements for SLBs should help make it a more attractive sustainable investment class within the ESG universe.

The green bond market has witnessed significant evolution and diversification. In 2008 the World Bank issued the first labelled Green Bond, pioneering a new approach to financing projects with environmental benefits, such as renewable energy or energy efficiency initiatives. In 2010, at Nikko AM, we formed a partnership with the World Bank to launch our first Green Bond Fund, which focused exclusively on investing in World Bank Green Bonds.

The market has continued to evolve with new types of bonds emerging to address broader social, environmental and sustainability issues. Social Bonds have been introduced to finance projects aiming for a positive social impact, such as affordable housing, education, or healthcare. The International Capital Market Association (ICMA) has also provided guidance on climate transition finance, focusing on instruments for companies looking to evolve from “brown” to “greener”. We have also seen the development of Sustainability Bonds which encompasses both Green and Social Bonds. However, it was the Sustainability-Linked Bonds

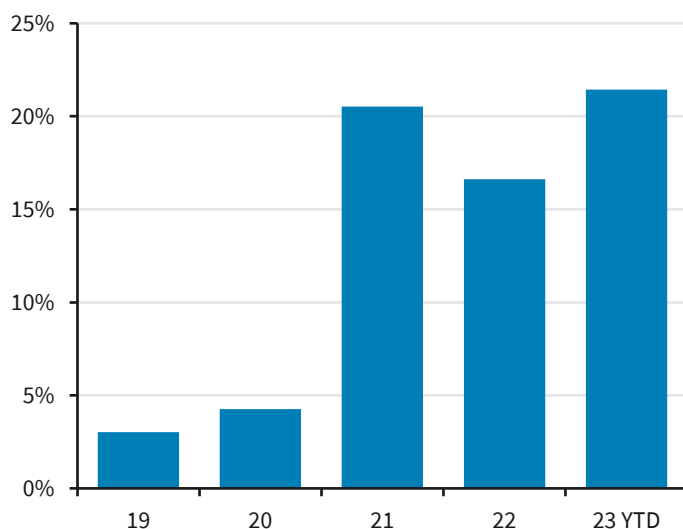
(SLBs) – which are linked to an issuer’s broader sustainability performance and were a departure from their more popular “Use of Proceeds” siblings – that have garnered most market attention (and scrutiny).

For sustainable fixed income investors, the widely accepted minimum standard for investing in a bond has been set by ICMA principles. These principles define the criteria for Green Bonds, Social Bonds, Sustainability Bonds, Sustainability-Linked Bonds and Climate Transition Finance, and serve as guidelines for issuers to determine the purpose and structure of an ESG bond issuance. However, for most investors, compliance with the ICMA principles, which ideally should be verified by an independent consultant, are just the starting point for whether a bond will be considered for inclusion into an investment portfolio. Further research is always required, including a credit-quality assessment and in-depth scrutiny of a corporation’s sustainability strategy.

Sustainability-Linked Bonds: Innovatively Designed Yet Vulnerable to Gaming

SLBs are the bond type within the group of ICMA principal bonds that has garnered the most investor debate in recent months. The concept behind SLBs is compelling, as issuers define sustainable targets for their business and agree to accept a coupon step-up as a penalty if the targets are not met. SLBs have made up approximately 20% of ‘ESG’ bond issuance volume since 2021 (see Figure 1). They differ from Green, Social, and Sustainability Bonds in that the proceeds are not earmarked for specific sustainable projects but rather for general corporate purposes, opening up the market for hard-to-abate sectors and other companies that would otherwise find issuing green or social bonds difficult. The pre-defined sustainable targets are implemented to ensure that companies are actively working toward a more sustainable future.

Figure 1: SLB issuance as a percentage of total ESG bond issuance



Source: Bloomberg, Dealogic, Barclays Research, Nikko AM (May 2023) Note: excludes local currency debt

The concept of accepting penalties when sustainable targets are not met is a recent innovation. However, SLBs have come under scrutiny as investors have found that the sustainable targets defined by the issuers were quite often easy to beat and therefore easy to game. Commerzbank¹ pointed out in a recent research paper that SLB issuers tend to have higher greenhouse gas (GHG) emissions (Scope 1 and 2) compared with the average GHG emissions of Stoxx 600 members. Furthermore, the reduction targets of SLB issuers were less aggressive than the Stoxx 600 average. Other questions about SLBs concern the timing of the test dates for their sustainable targets and the lack of an independent target verification mechanism. Often, the test date occurs closer to the maturity date, leaving only one or two years to collect the coupon step-ups. Some issuers even have the optionality to call the bonds after the penalty is triggered, further shortening the collection

¹ SLBs at the crossroads, Stephan Kippe, CFA, Commerzbank

Any reference to a particular security is purely for illustrative purpose only and does not constitute a recommendation to buy, sell or hold any security. Nor should it be relied upon as financial advice in any way.

period. As an example, Enbridge, a US midstream energy company, launched an SLB in March with a maturity date of March 2033, but the first test is only scheduled for September 2031, with an option for a 3-month par call thereafter. Another critical consideration is the low penalty payments. Commerzbank calculated in its research that the average maximum annualised penalty is just below 15 basis points (bps).

Easy-to-beat goals, low penalties and no independent verification mechanism have led to a slowdown in the acceptance of SLBs in the market. Investors to date have been reluctant to include them in their EU SFDR Article 9 funds given the market interpretation around Use of Proceeds and Do No Significant Harm (DNSH). This reluctance is also reflected in bond pricing, while Green Bonds trade at a premium to Brown Bonds, SLBs do not, and they are even sometimes cheaper than Brown Bonds.

Building a Stronger Foundation: Structural Improvements for SLBs to Drive Demand

SLBs require further structural improvements to become an attractive sustainable investment class within the ESG universe. The Climate Bonds Initiative (CBI), a non-profit organisation, summarised in a recent publication what it takes for SLBs to increase in credibility and to see higher demand from sustainable investors. Firstly, an SLB with an environmental angle is only as powerful as the entity's underlying transition plan and the ambition of associated performance targets. Secondly, SLB targets should include all material scopes of greenhouse gas (GHG) emissions (scope 1-3). Thirdly, it's advisable to avoid GHG economic intensity targets and select absolute GHG emissions targets or intensity targets with a unit of production as the denominator. Lastly, it's important to avoid weak features in the bond structure, for example a call before the first KPI test or step-ups only kicking in at the maturity date.

The most recent issuance from TDC, a Danish telecom operator, offered an SLB structure that has the potential for wider acceptance as it aligns closely with CBI recommendations. Firstly, TDC has implemented an ambitious climate strategy that aims to reach net zero across its entire value chain (Scope 1, 2 and 3) by 2030. These targets received external independent validation from SBTi (Science Based Targets initiative) and Sustainalytics, which provided a Second-Party Opinion and classified the targets as "Highly Ambitious" – its highest rating. The reduction goals outlined in the bond indenture appear ambitious and are in line with TDC's disclosed 2030 net-zero pathway, which aims for a reduction of its Scope 1 and 2 Greenhouse Gas emission (GHG) by 80% and Scope 3 by 35% by 2027. If the company fails to reach these targets, the bonds will be outstanding for another 3 years and allow investors the opportunity to harvest the step-up. The only criticism to note is the step-up amount is only 12.5bps, which could have been higher. Nevertheless, this structure demonstrates more meaningful progress compared with other issuances witnessed in recent months.

There is still a lot of work ahead for investors to engage with issuers to better incorporate the CBI and ICMA recommendations and to increase the appeal of SLBs for sustainable investors. Barclays highlighted in a recent publication that not all SLB issuers have fully embraced the ICMA SLB standards. Nonetheless, it's a worthwhile effort to develop alternative bond structures for the "use of proceeds" category. The appeal of SLBs is clearly the fact that they require the issuer, as a whole, to move toward a more sustainable future and be willing to accept penalty payments if targets are not met. However, the definition of those targets needs more work before SLBs will make their way into sustainable investment portfolios more fully.

Finally, it is important to emphasise that SLBs are not only important for corporate credit issuers, but even more so for sovereign issuers. A single sustainable investment project is often not critical to an entire country. What is more relevant, is how the country treats its natural resources and the wider environment in general. Last year Uruguay and Chile issued SLBs targeting nationally determined emission cuts – an exciting development that showcases the potential for SLBs.

Any reference to a particular security is purely for illustrative purpose only and does not constitute a recommendation to buy, sell or hold any security. Nor should it be relied upon as financial advice in any way.

For any questions in regards to this report, please contact:

Nikko AM team in Europe
 Email: EMEAenquiries@nikkoam.com

Important information: This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (Nikko AM) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute personal investment advice or a personal recommendation and it does not consider in any way the objectives, financial situation or needs of any recipients. All recipients are recommended to consult with their independent tax, financial and legal advisers prior to any investment.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this document will not affect Nikko AM's investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual securities, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association.

United Kingdom: This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority (the FCA) (FRN 122084). This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the FCA in the United Kingdom, and is directed at professional clients as defined in the FCA Handbook of Rules and Guidance.

Luxembourg and Germany: This document is communicated by Nikko Asset Management Luxembourg S.A., which is authorised and regulated in the Grand Duchy of Luxembourg by the Commission de Surveillance du Secteur Financier (the CSSF) as a management company authorised under Chapter 15 of the Law of 17 December 2010 (No S00000717) and as an alternative investment fund manager according to the Law of 12 July 2013 (No. A00002630).

United States: This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information to institutional investors as defined in the Securities and Futures Act (Chapter 289), and intermediaries only. Nikko Asset Management Asia Limited (Co. Reg. No. 198202562H) is regulated by the Monetary Authority of Singapore.

Hong Kong: This document is for information to professional investors as defined in the Securities and Futures Ordinance, and intermediaries only. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

New Zealand: This document is issued in New Zealand by Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562). It is for the use of wholesale clients, researchers, licensed financial advisers and their authorised representatives only.

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Holdings group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document neither constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree 80/98), nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.

Republic of Korea: This document is being provided for general information purposes only, and shall not, and under no circumstances is, to be construed as, an offering of financial investment products or services. Nikko AM is not making any representation with respect to the eligibility of any person to acquire any financial investment product or service. The offering and sale of any financial investment product is subject to the applicable regulations of the Republic of Korea. Any interests in a fund or collective investment scheme shall be sold after such fund is registered under the private placement registration regime in accordance with the applicable regulations of the Republic of Korea, and the offering of such registered fund shall be conducted only through a locally licensed distributor.