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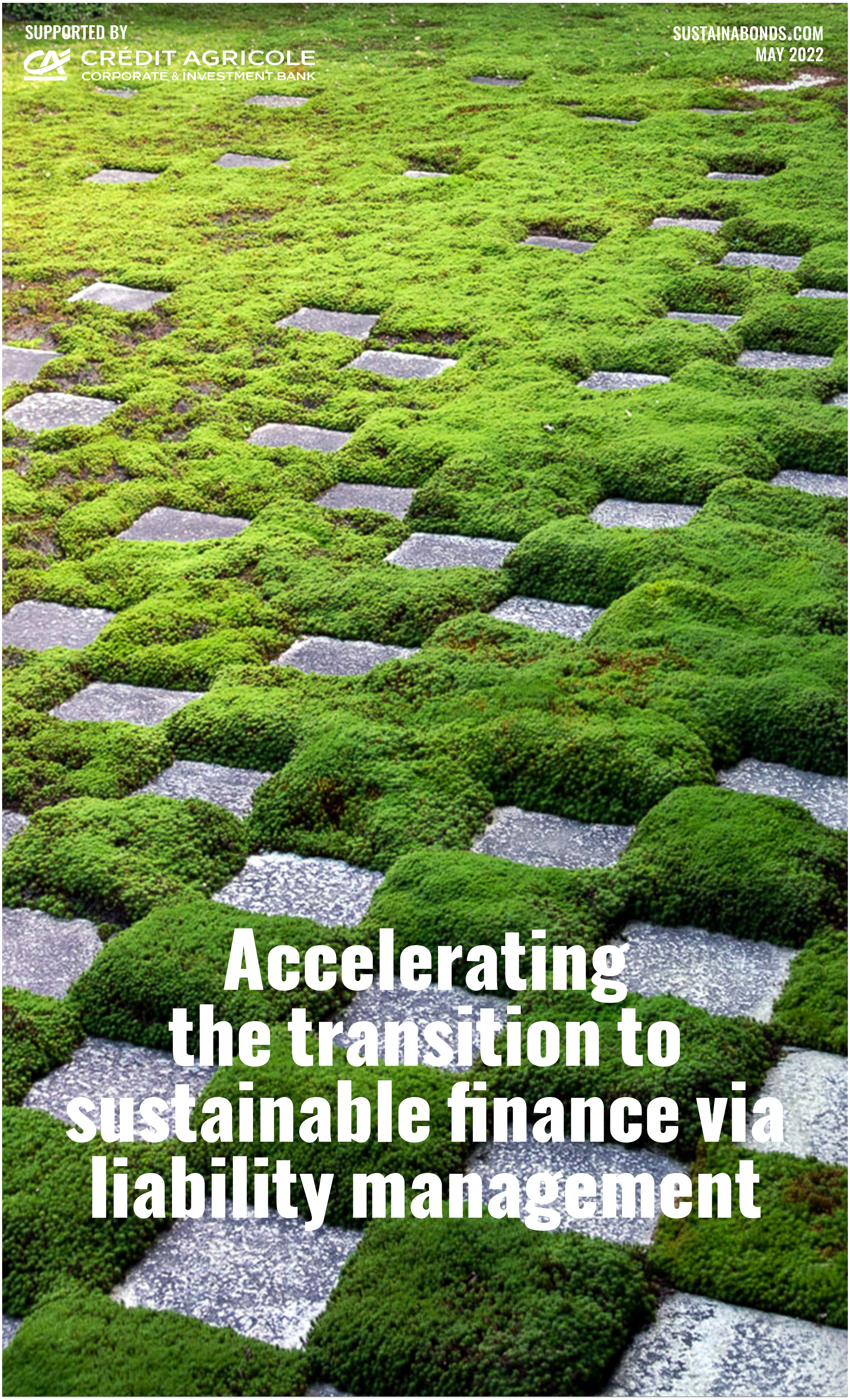

Accelerating the transition to sustainable finance via liability management

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A year on from the first conversion of an issuer's conventional bonds into green bonds, by Gecina, Crédit Agricole CIB hosted a roundtable to discuss such innovative exercises and to pioneer liability management strategies that enable issuers to accelerate their transition to sustainable finance. Could exploring these options complement and accelerate ESG dialogue in the debt capital markets? The discussion heard insights from representatives of Colonial, Enel, Gecina, Union Investment and members of Crédit Agricole CIB's DCM Solutions and Sustainable Investment Banking teams.

French listed real estate company Gecina launched its pioneering requalification exercise on 14 April 2021, seeking to convert its 15 outstanding conventional bonds totalling €5.6bn into green bonds under an inaugural framework.

"For quite a long time now, we have been very focused on ESG matters, both for ethical but also business reasons," said Nicolas Dutreuil, deputy CEO and CFO of Gecina, at Crédit Agricole CIB's event. "So we had the notion of closely aligning the way we manage our portfolio with the way we finance ourselves."

This idea was reinforced by investors' positive view on the company's bonds.

"Investors told us that even if our bonds were not green bonds, considering all the work done on the asset side of the portfolio, they would still consider them as green," said Dutreuil. "So we thought that it was a shame not to officially have green bonds, rather than having investors do the maths by themselves."

Gecina then sought out, with advisors Crédit Agricole CIB and Allen & Overy, a means whereby its bond issuance could be 100% green, rather than a mix of green and conventional bonds.

In its green bond framework, Gecina introduced an innovative dynamic carbon threshold among the eligibility criteria.

"We considered it important to have a green bond framework that is dynamic, with evolving criteria for assets to be eligible over time," said Dutreuil, "with the thresholds getting stricter year by year, and fully aligned with the company's climate commitments."

This framework was then included in the launch of the first ever requalification exercise of conventional bonds to green bonds.

"The alternative would have meant having to wait for the refinancing of all our outstanding bonds — the longest of which was a 15 year — to end up with a 100% green structure," added Dutreuil, "which would have been a shame."

Gecina's bondholders were asked to approve a change such that, rather than the proceeds being used for general corporate purposes, an amount equivalent to the proceeds from the issuance is allocated to the financing or refinancing of a portfolio of eligible green assets.

According to Dutreuil, a key decision in the exercise was whether or not to offer a consent fee for the requalification.

"As our move was driven by conviction, we felt that it was important to share this conviction with investors," he said. "And considering that it had to be a win-win situation — to help us accelerate the transformation of our financing structure and for investors to increase the green share of their portfolios — we decided not to offer a consent fee."

Gecina's team held several days of investor meetings and ultimately won support for the requalification. A majority of two-thirds or a simple majority was required, depending on the series in question, and over 90% of votes were in favour across the 15 series.

Although the main driver of Gecina's move was not financial, Dutreuil noted that its bonds enjoyed a price impact in the wake of the requalification.

"It's not often that you can compare exactly the same product being green and non-green, and that's exactly what we had with these bonds, which were not green a few weeks before, but green after," he said. "And when we looked at how our spreads moved compared to those of our peers, we have estimated that the positive impact on

Nicolas Dutreuil, Gecina: 'We considered it important to have a green bond framework that is dynamic'

spread was between 10bp and 15bp."

The second full requalification of all conventional bonds of an issuer into green bonds was launched at the beginning of this year, when real estate group Colonial on 12 January announced it was seeking to convert its €4.6bn of debt into green bonds. The move represented the first such initiative by a Spanish company, and also included outstanding bonds of French subsidiary Société Foncière Lyonnaise (SFL).

Speaking at Crédit Agricole CIB's event, Àngels Arderiu, CFO of Colonial, noted that it is committed to ESG at all levels of the company, from relevant committees at board and director levels, to teams in Spain and France dedicated to monitoring and improving the sustainability performance of assets. Colonial has also updated its decarbonisation plan to bring forward its target date for carbon neutrality from 2050 to 2030.

"ESG is a fundamental pillar in our strategy, and we are strongly committed to accelerating our leadership in ESG," said Arderiu. "So it was a question of coherence: if our assets are green, and if our strategy is focused on ESG, we thought that it made sense that the debt financing those assets is also green."

Having in 2019 converted its bank facilities into sustainability-linked loans with margins linked to its GRESB rating, and given that the group mainly finances itself in the debt capital markets, conversion of its conventional bonds into green bonds seemed "a natural step", according to Arderiu.

She noted that market practice regarding look-back periods could have proven an obstacle, with only sustainable assets originated in the past three years accepted.

"It seemed that for companies that first invested in converting their assets to green, it was more difficult to issue green bonds and to have all their debt converted into green," said Arderiu. "So there was a kind of penalty for those who had done their homework in advance.

"However, as was first indicated by Gecina's move, I think bondholders now understand and accept that companies need to be investing continuously in their assets to improve their sustainability — it's not a question of a one-off investment, but a long term process. We have to be investing year-on-year, as the requirements are every year more restrictive."

With advisors Crédit Agricole CIB and Freshfields Bruckhaus Deringer, Colonial successfully converted the 11 outstanding series of bonds into green bonds.

> **Our advice is really to get prepared to engage on CSR disclosure**

"As a result of the process," said Arderiu, "we have seen that investors now want to be there to support those companies that deploy continuously money and effort to improve the performance of their assets."

What would make green bond requalification projects palatable to the investor community?

"This requalification process is a disclosure exercise," said Pascale Forde-Maurice, head of the European corporate segment of Crédit Agricole CIB's Sustainable Banking

Àngels Arderiu, Colonial: 'It's not a question of a one-off investment, but a long term process'

group. "For investors, it does not involve new money, and the dialogue is therefore centred around ESG roadmaps, challenges and more globally the relative ESG performance of the issuer.

"Our advice is therefore really to get prepared to engage on CSR disclosure."

This sentiment was echoed by Johannes Boehm, senior ESG analyst, fixed income at Union Investment. An analysis of issuers' sustainability credentials is one of two stages Union Investment conducts when faced with a green bond, and once an issuer passes this stage — which involves negative screening for businesses such as weapons manufacturing or fossil fuels, and a review of its overall sustainability strategy — its green bond framework is then analysed.

"Ultimately, the question that we try to answer when looking at each green bond is, is the green issuance really a credible signal to capital market participants in respect of a genuine and sustainable business transformation?" said Boehm. "We focus on this because we believe that is where most impact is."

Union Investment also focuses on additionality.

"Specifically, would the assets have been financed if it hadn't been for the green bond? And the answer is in most cases, yes.

Pascale Forde-Maurice, Crédit Agricole CIB: 'It's important to carefully analyse the profile of bondholders'

"In a requalification exercise," added Boehm, "there is an additional reputational risk with regards to the particular green portfolio, because you can always basically argue that the company is refinancing assets that are already there."

The bottom line is that context matters, he said.

"Whenever it comes to a requalification exercise, extra care needs to be taken to show that the green or sustainable issuance really fits into the wider sustainability strategy of the issuer, and that there is real seriousness and a high level of ambitiousness.

"The additionality really comes in when there is a dialogue between the investor and the issuer," added Boehm. "Our goal here is to accompany issuers along their transition pathways, because after all, sustainability is not a status, but a process. And so in this context, the issuer really needs to show that there is real seriousness and a high level of ambitiousness behind the green issuance."

As well as being reinforced by a credible corporate sustainability strategy, requalifications will have the greatest chance of success when backed by a best in class green bond framework, according to Forde-Maurice at Crédit Agricole CIB. She cited as an example the inclusion of dynamic emissions thresholds in the green bond frameworks of both Gecina and Colonial group.

"These are innovative features for the market and also illustrate the continuous improvement of the underlying portfolios," said Forde-Maurice, "so are key topics to be communicated on."

Key to ensuring success is the quality and the size of the portfolio.

"The size of the eligible portfolio should at least cover the outstanding bonds that will be transformed," said Forde-Maurice, "but not only these — there is also the matter of having a buffer that will enable the company to become a repeat issuer in the green format going forward.

"And, more generally, the framework should be resilient over time to allow this."

While Gecina's and Colonial's exercises went smoothly, with many investors won over to the merits of requalification, there remain potential practical obstacles to success.

"It's important to carefully analyse the profile of bondholders," said Forde-Maurice, "because they will be asked to participate in the consent solicitation process, and some of them may not be allowed to do so.

"Specifically, some large public institutions may wish to remain neutral in this type of process."

Some issuers can be considered as assimilated to green

Some smaller investors may abstain from voting, relying, in the absence of a consent fee, on large institutions to take care of the requalification. A few investors have had internal constraints whereby they could only accept requalifications of bonds issued in the past couple of years.

Véronique Diet Offner, co-head DCM solutions and advisory at Crédit Agricole CIB and moderator of the discussion, nevertheless noted in response to a question at the event that although thresholds for quorums and majorities vary from jurisdiction to jurisdiction and bond to bond, 100% bondholder approval should not be required.

Véronique Diet Offner, Crédit Agricole CIB: 'There is a feasibility study and sometimes our recommendation will be not to launch such a requalification exercise'

"Overall," said Forde-Maurice, "the requalification process may take time, because we are talking about three main steps — CSR disclosure, ensuring the quality and size of the portfolio, and analysing the investor profile in parallel to preparing the documentation — all these steps may require deep analysis. Therefore, issuers need to get started in advance to be fully prepared."

And Diet Offner added that the option is not for everyone.

"There is a feasibility study," she said, "and sometimes our recommendation will be not to launch such a requalification exercise."

But asked whether similar moves from issuers beyond the real estate sector are on the cards, Forde-Maurice was positive.

"Echoing what Nicolas said about Gecina's thinking, there are some issuers in the market that can be considered as assimilated to green issuers in the sense that they are pure players, i.e. their underlying business activity is purely green," she said. "And this will become even more obvious once companies have published their alignment with the sustainable finance taxonomy.

"So indeed this could be deployed to other sectors — as long as the issuers' businesses and strategies are significantly aligned with the green criteria of the market."

Will we next see requalification to SLBs?

Beyond requalifications as green bonds, a next step could be requalifications from conventional bonds to sustainability-linked bonds (SLBs).

Union Investment's Boehm said such a move would provide additional opportunities vis-à-vis green bonds when it comes to a reclassification. SLBs could prove a handy option for some issuers.

"SLBs are inherently more forward-looking with regard to an issuer's sustainable business transformation," he said. "There is a particular advantage in that issuers can demonstrate a high level of ambition by merely focusing on the relevant KPIs, setting ambitious targets, and having skin in the game in terms of the coupon step-up."

Crédit Agricole CIB's Forde-Maurice echoed Boehm and underlined the importance of having a best in class SLB framework.

"The key to success is the quality of the sustainability-linked structure," she said. "It's important to reiterate that the Sustainability-Linked Bond Principles indicate that the KPIs must be relevant, core, and material to the issuer's overall business and strategy, while the SPTs should be ambitious, meaningful, and consistent with them.

"This is very much what we would be looking at to make such a transaction successful — formalising a framework that is very much at the best market practice, and supported by an independent second party opinion."

As well as appropriate sustainability-related KPIs and sustainability performance targets (SPTs), and a significant coupon step-up, Union Investment would for SLBs — as with green bonds — also need to be satisfied at the issuer level.

"No matter whether we're talking about green bonds or SLBs, all of them are in some way transition bonds, because it's always about the issuer signalling to the capital markets that they want to become more sustainable," said Boehm. "So it's always about the issuer and the business model as a whole."

In this regard, Union Investment assesses the willingness of issuers to transition in three dimensions. Firstly, its transition-related strategy: What are its intermediate and long term targets? Are these relevant and material? And what levers does the issuer have to bring about a more sustainable business model. Secondly, the issuer's transition-related investments.

"Does the issuer not only talk the talk," said Boehm, "but also walk the transition walk in terms of making the right and relevant investments?"

And thirdly, transition-related governance.

"A key component we specifically look at is, are there elements of a relevant transition implemented in board executive pay?" he said, "because only when incentives are aligned with the sustainability strategy will we believe it will be implemented over the long term."

> **Sustainability-linked bonds are inherently more forward-looking**

Crédit Agricole CIB's speakers flagged some practical considerations that need to be borne in mind when preparing any SLB liability management exercise.

"One point of attention is to review the maturity of the outstanding bonds to ensure the KPI observation dates fit into the residual life of the bonds," said Forde-Maurice. "And if not, the company could decide to define new intermediary targets that have an adequate structure in relation to the outstanding bonds.

"A second is that, as in the green bond process, we have to proceed to analyse the investor profile of the outstanding bonds to make sure that they have the capacity to include SLB structures in their investment universe."

Johannes Boehm, Union Investment: 'Does the issuer not only talk the talk, but also walk the transition walk?'

Answering an audience question on whether or not bonds would remain eligible for the European Central Bank's purchase programmes if requalified as SLBs, Forde-Maurice at Crédit Agricole CIB said that they should remain eligible as long as they continue to fulfil the relevant criteria, notably that KPIs exclusively contribute to one of the six EU environmental objectives and/or certain SDGs.

LM solution combining a new ESG instrument and the simultaneous repurchase of conventional bonds

"Another powerful liability management solution to accelerate the transition to sustainable finance is to combine a repurchase exercise on conventional bonds and the issuance of a new green or sustainability-linked bond," said Diet Offner.

Having in September 2019 sold the first ever sustainability-linked bond (SLB), Italy's Enel in June 2021 launched a new SLB initiative, issuing a €3.25bn multi-tranche transaction at the same time as tendering for up to €1bn aggregate of four of outstanding conventional bonds totalling €6.3bn. The issue attracted some €11.3bn of demand, and when the tender offer closed a week later, Enel repurchased around €1.07bn.

Under a programme of such liability management exercises across currencies last year, the company repurchased in total around €7.5bn-equivalent of conventional bonds, and issued some €10.1bn of sustainability-linked bonds.

"Through this huge liability management programme, we have been able to further accelerate the path towards the group's target of sustainable financing sources reaching a high percentage," said Nicole Della Vedova, Enel's head of corporate finance, at Crédit Agricole CIB's event.

As of the end of 2021, sustainable financing sources account for approximately 55% of Enel's total gross debt, in line with its target of this figure reaching around 65% in 2024 and above 70% by 2030, according to its industrial plan announced in November 2021.

"This has also driven a reduction in the group's cost of debt," added Della Vedova, "tendering for the higher coupon bonds, while issuing newer notes at a lower coupon."

According to Della Vedova, the success of the company's sustainable finance activity is predicated upon its broader ESG strategy.

"The liability management programme together with our global commitment to the sustainability-linked programme fit perfectly with our sustainable finance strategy, which is ultimately very much linked to our business model," she said. "We are not a financial institution, but a utility company, and the finance department of the company should serve the business.

"Companies that want to play a key role towards the transition should have an underlying sustainability strategy with ambitious, core and material targets behind it," added Della Vedova. "This is what differentiates a reliable company versus an unreliable company vis-à-vis the investor community."

Nicole Della Vedova, Enel: 'We have been able to further accelerate the path towards the group's target'

Enel conducted liability management not only in Europe, but also in the US, and

These strategies are also very beneficial in terms of refinancing

Della Vedova said the response across the Atlantic was encouraging.

"As we all know, sustainable finance was born in Europe," she said. "Now, we also see US investors very much focused in sustainable finance. And given the fact that ultimately the US fixed income market is the deepest in the world, that is very good news."

While sustainability considerations are uppermost for issuers and investors considering such liability management exercises, Diet Offner highlighted their broader potential, as demonstrated by Enel.

"Besides the benefit of quickly increasing the share of ESG instruments in the debt structure, we have to bear in mind that these strategies are also very beneficial in terms of refinancing," she said. "In the current context of high volatility, it has the benefit beyond the ESG front of derisking future funding plans, increasing duration and managing the cost of carry."

Diet Offner noted two points that have arisen in her discussions with issuers contemplating similar strategies. Firstly, that of modification accounting under IFRS, and she said that the fact that conventional bonds would be refinanced via an SLB has generally not been an issue in this respect, meaning that issuers may be able implement this accounting method (subject to other IFRS 9 rules).

The second point is how to increase the number of holders of outstanding bonds participating in the exercise.

"If the new ESG instrument has features and a tenor that are a sweet-spot for the current bondholders, we definitely see an increased chance of these investors switching into the new instrument," said Diet Offner, "which is of course very important in terms of reducing the amount of conventional bonds, but also creates a lead order in the new instrument.

"Even though we have unfortunately seen a reduction in overall issuance due to the difficult primary market conditions, we have seen that instruments with ESG features are representing an increasing part of the volumes issued," she added. "We therefore anticipate that we will keep seeing more and more of these liability management exercises." ●

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