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Sustainability-linked bonds go mainstream

Investors open to credible issuers with material targets

Featuring Gasunie case study: Transition in the pipeline

SLBs go mainstream

Issuers lacking projects appropriate to use-of-proceeds green bonds but with clear sustainability targets and transition strategies are increasingly finding sustainability-linked bonds (SLBs) a viable alternative for reflecting their ESG ambitions in the capital markets. In this special report, sponsored by ABN AMRO, *Sustainabonds' Neil Day* explores the surge in issuance and finds out what issuers need to be doing to win over investors.

Although green bonds comprised half the market in use-of-proceeds and sustainability-linked instruments last year, 2021 was arguably the year of the sustainability-linked bond (SLB). From just around $4bn-equivalent of SLB issuance in 2019 and $8bn in 2020, the market boomed to some $96bn (€87bn).

"That's very exciting and probably beyond anyone's expectations for such a young instrument only launched in the back-end of 2019 by Enel," says Dick Ligthart, director, sustainable markets, at ABN AMRO.

The Dutch bank is forecasting potential growth of around 150% for SLBs this year, which would take 2022 issuance to more than $200bn. Regardless of the issuance volume, the bank expects SLBs to leapfrog social and sustainability bonds in terms of market share.

Beyond the pioneering sustainability-linked bond issuance from Italian energy group Enel in autumn 2019, two initiatives are widely seen as catalysing the growth of the SLB market.

Firstly, the launch of the Sustainability-Linked Bond Principles (SLBP) by the executive committee of the Green Bond Principles (GBP) and Social Bond Principles (SBP) in June 2020. This laid down five core components of sustainability-linked bonds, including the selection of key performance indicators (KPIs), the calibration of sustainability performance targets (SPTs), and bond characteristics.

Secondly, the September 2020 announcement by the European Central Bank (ECB) that it would from 1 January 2021 accept bonds with coupons linked to sustainability (climate-related or environmental) performance targets as collateral, and potentially buy them under its Asset Purchase Programme (APP) and Pandemic Emergency Purchase Programme (PEPP).

"It's very impressive how this new instrument has been taken up by issuers, particularly after the publication of the SLBP by ICMA," says Ligthart. "What also really helped was the ECB's very significant step of explicitly supporting this new type of sustainable bond.

"That strengthened many issuers in their belief that this would be a very credible alternative to regular green or social bond issuance, and opened up the market for companies that had maybe been sidelined in the traditional use-of-proceeds market because they lacked the appropriate level of green assets or investment programmes but were nevertheless working towards very tangible sustainable results."

Investors give SLBs a fair hearing

The enthusiasm of issuers to find ways of getting involved in sustainability instruments is matched on the buyside. 65% of investors surveyed by ABN AMRO at the turn of the year expect to increase such assets by up to 20% in 2022 and 12% expect even greater growth.

While SLBs have ridden this green wave, their inherent characteristics have proven attractive to investors, according to Ligthart.

"Investors increasingly appreciate that companies are holding themselves accountable to their corporate ESG targets and are willing to accept a financial downside should they ultimately miss them — you'd better be committed to targets if you include them in an SLB.

"That's a powerful signal to send out as a company."

Among investors gearing up for the boom in sustainability-linked bonds is AXA Investment Managers, which sees the


Photo credit: NASA Earth Observatory

product as having a bright future as well as the potential to offer clients long term, sustainable performance. Last month it published a framework it has developed for assessing the new product, noting the voluntary nature of IMCA-managed principles and guidelines.

"Like everyone else, we have been monitoring this nascent market and our portfolio managers have been buying some SLBs on an ad hoc basis," says Théo Kotula, ESG analyst at AXA IM. "But in a similar vein to what we did for green, social and sustainability bonds, we decided to form a more stringent approach to this market and not take any SLB at face value, but undertake a deeper analysis of this new structure."

Asset manager Actiam has also been engaged in the development of the market, even though Foppe-Jan van der Meij, senior portfolio manager at Actiam, says the firm still prefers use-of-proceeds bonds, seeing sustainability-linked bonds as complementary.

"We know that several sectors are not able to participate in the use-of-proceeds market," he says, "and for these companies, SLBs are a really good addition. However, it is important that they explain why they are using that instrument and not use-of-proceeds, and also that the KPIs of their bond are a good translation of the sustainability targets of the company — if they have a good explanation, then we will stamp them as sustainable.

"We heard of one issuer saying that reporting for use-of-proceeds bonds is a bit challenging when discussing the rationale for sustainability-linked bond issuance," he adds, "and if there is no good reason why they are turning to SLBs, then we would say, that's not something for us at the moment."

As examples of appropriate companies, van der Meij cites Nederlandse Gasunie *(see case study)* and H&M. The Swedish fashion retail group issued a €500m 8.5 year sustainability-linked bond in February 2021, with emissions reductions and an increase in its use of recycled materials as sustainability performance targets.

"For some issuers it's just too difficult to source €500m of real green or transition projects for a use-of-proceeds bond," he adds, "but an SLB can be really fitting."

His Actiam colleague, responsible investment officer Tessa Eerenberg-van Kesteren, notes that the greater range of companies that can issue sustainability-linked bonds also offers diversification opportunities for investors.

"If you take the SLB of H&M," she says, "this was a good way for Foppe to diversify from all the utility companies issuing green bonds."

A viable transition option

A consensus is emerging that sustainability-linked bonds are well-suited to financing the transition, whether they are being issued by companies without appropriate assets for a use-of-proceeds bond, or ones with activities that cannot yet be clearly defined as appropriate for either a green bond or a transition bond. Although ICMA published a Climate Transition Finance Handbook in December 2020, transition bonds have not taken off.

"SLBs are a great way to track and evidence the transition that a company is making," says Ligthart at ABN AMRO. "It also moves away from the discussion you have around transitional activities, which has been understood to imply that they are being labelled green or light green, and that potentially raises reputational risk — just look at the debate around the inclusion

of gas and nuclear in the EU Taxonomy.

"The SLB format is a very viable alternative for companies in transition. Take cement producers, for example: we've seen a few tap the SLB market already, but had never seen them in the use-of-proceeds format — that shows the added value of the instrument."

The cement industry contributes to about 7.3% of global industrial carbon emissions, according to ISS-ESG, which provided the second party opinion for LafargeHolcim when it was the first from the building materials sector to issue a sustainability-linked bond, a €850m April 2031 deal in November 2020. The Swiss-based company's SPT is a reduction in net CO_2 emissions (kilogrammes of CO_2 per tonne of cementitious material produced) by 17.5% by year-end 2030.

AXA IM has been a proponent of transition bonds, but, echoing Ligthart, now sees SLBs as a complementary and potentially powerful tool for high-emitting issuers to finance their transition towards more sustainable business models.

"We have been working a lot on transition use-of-proceeds bonds," says Kotula, "and, in our opinion, SLBs are in the same vein, meaning more transition than pure green or impact investments."


Dick Ligthart, ABN AMRO

So whereas use-of-proceeds bonds have been included in the firm's green and impact investments, SLBs are likely to be included in its transition investments.

ABN AMRO's survey also suggested that sustainability-linked bonds could prove a better means of tapping into investor demand for ESG investments than use-of-proceeds transition bonds, with 65% of accounts deeming SLBs relevant or highly relevant versus 53% for transition bonds.

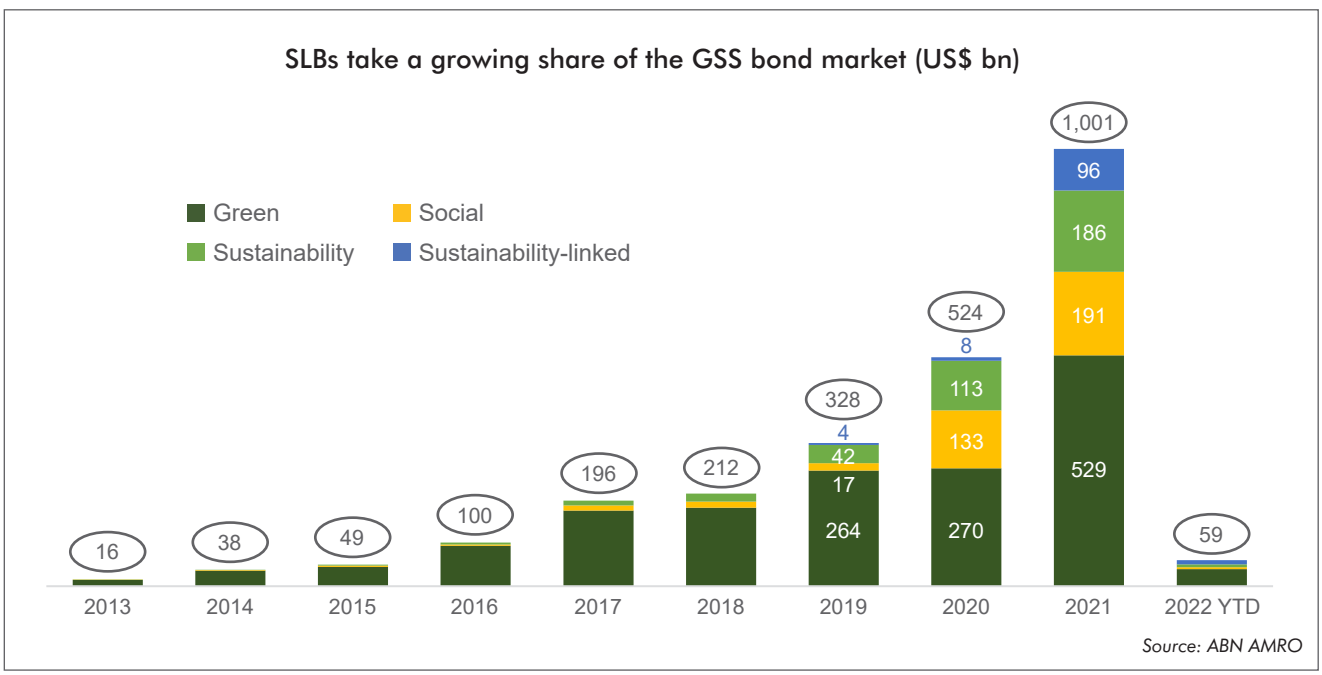
In line with this, Italian gas infrastructure operator Snam also took up SLB issuance in January after having been one of the few corporates to issue transition bonds (under the moniker Climate Action Bond (CAB)). Whereas investments in biomethane and energy efficiency were among the use-of-proceeds of Snam's CAB framework, the €1.5bn dual-tranche SLB issuance was more directly linked to its sustainability targets, with KPIs linked to reductions in natural gas emissions and Scope 1 and 2 emissions, in the second SLB from a European gas transmission system operator after Gasunie.

"Today's transaction is in line with Snam's commitment towards sustainable finance as a key pillar of its strategy which includes a carbon neutrality target by 2040 and the further development of its energy transition businesses," said the company. "It will also contribute to the target of achieving more than 80% of its funding through sustainable finance by 2025 compared to 60% as of end 2021."

Ambition, diversity welcomed

Reductions in greenhouse gas (GHG) emissions have thus far been the main focus of the SLB market, with around nine out of 10 deals focusing on CO_2 emissions.

While investors have generally welcomed this focus, not every issuer has been



equally thorough in its approach.

"We recently saw a company that has a good sustainability policy, but they failed to translate that into the sustainability-linked bond," says van der Meij at Actiam. "For example, they have a clear policy on Scope 3, but that wasn't taken into account in the KPI of the SLB — that's lacking ambition."

The ECB's focus on climate and environment-related targets has played into their major role in SLB issuance, as well as the requirement that KPIs be material to an issuer's business.

However, Ligthart notes that some issuers have been more daring, citing the example of a $1bn July 2032 sustainability-linked bond for US mining company Newmont. As well as being the first from the mining industry, the company included alongside Scope 1, 2 and 3 KPIs a target linked to the representation of women in senior leadership roles at Newmont. The latter reflects the company's involvement in Paradigm for Parity, an initiative aimed at achieving gender parity in corporate leadership by 2030, and the SPT is 50% of Newmont's leadership positions (senior director level up to and including CEO level) being taken by women by then, versus 25.3% in 2020 and 19.5% in 2018.

Second party opinion provider ISS-ESG found the gender KPI to be relevant, core and material to the issuer's business model and consistent with its sustainability strategy, but noted that it could have been more material if it had included all manager functions — the metric covers 1.1% of Newmont's workforce.

Ligthart suggests that an expansion of issuance beyond industrial companies could see a greater range of KPIs being adopted.

"Imagine HR companies or lenders where you could, for instance, have a 'jobs created' metric," he says. "You could have very powerful social impact KPIs, which have so far been a bit underrepresented — they are a bit harder to quantify, but I do hope that this year we will see some spillover into this area.


Tessa Eerenberg-van Kesteren, Actiam

"Maybe you could still have, let's say, CO_2 emissions intensity as a headline KPI, but complement that with social impact indicators. That would be a very relevant add-on to the format."

Eerenberg-van Kesteren at Actiam says the firm would be supportive of an increase in new KPIs such as gender equality.

"Sustainability-linked bonds provide a real opportunity in this respect," she says,

> **We also like to see innovations in this market**

"because a social bond with use-of-proceeds only related to gender, for example, would still be a bit difficult."

ICMA, the International Finance Corporation (IFC) and UN Women in November published a guideline outlining practical ways to use sustainable debt instruments to advance gender equality, which included examples of appropriate KPIs and SPTs.

"We also like to see innovations in this market," adds Eerenberg-van Kesteren. "And this is where the human factor comes into play — when we make our quarterly reports, we always pick out one bond to make a little case study out of it, and this is the kind of thing our clients want to see."

Investors nonetheless highlight the need for KPIs and SPTs, whether climate-related or social, to be material and ambitious. AXA IM, for instance, in its framework for assessing SLBs not only cites the SLBP but says that it seeks additionality and favours targets that are new or more ambitious than companies' existing ones. It suggests that an appropriate KPI for an auto company, for example, could be the percentage of sales related to electric vehicles.

"For any company, GHG emissions are probably material, but it is good to have some industry-specific KPIs," says AXA IM's Kotula. "What we want to avoid is issuers choosing a KPI that is not material for its sector.

"One example is ESG ratings as a KPI and an improvement in these as the SPT. Regardless of the sector of the issuer, that's not material — it's mainly about disclosure; it doesn't bring about a meaningful change in the issuer's ESG profile."

Hold-ups and step-ups

Financial institutions was the most popular (although perhaps broadest) sector when investors were asked by ABN AMRO which they prefer for ESG bond issuance in 2022, with senior preferred/OpCo FIG issuance also only second behind senior unsecured corporate issuance as the structure investors are most able to purchase.

Berlin Hyp issued the first SLB from a bank in April of last year, a €500m 10 year senior preferred bond with a 25bp step-up in the final coupon should its SPT not be met, but unfortunately for investors and its peers, the European Banking Authority's position towards the instrument has constrained further supply. The regulator sees step-up coupons or similar compensatory mechanisms as potential incentives to call, preventing their use on loss-absorbing instruments such as senior preferred contributing towards MREL requirements — something that did not apply to Berlin Hyp's deal but which — under current structures — undermines the viability of SLBs for most banks.

The German bank's pioneering issue


Foppe-Jan van der Meij, Actiam

nevertheless set a benchmark for the sector, including an SPT of a 40% reduction in the carbon intensity of assets refinanced in its loan portfolio between 2020 and 2030.

"For banks, Scope 3 emissions are the most relevant," says Ligthart, "and it was very courageous for Berlin Hyp, as a financial institution, to go out with a Scope 3 SLB."

Thus far, coupon step-ups have been the most commonly used feature that is triggered by an issuer failing to meet an SPT, but other structures have been floated. In ABN AMRO's survey, investors were asked what impact they would accept when considering SLBs, and while 64% of investors said they would accept some form of financial compensation — either a coupon step-up (35%) or a premium at maturity (29%) — 9% cited charitable donations, and 11% either a coupon step-down (6%) or discount at maturity (5%) as acceptable.

"When it comes to the more sustainable investors that you would hope to attract, some of them say, well, I'm not that keen on profiting from failure, so to speak," says Ligthart, "so can't you maybe work out a charitable donation or a commitment to invest an amount equivalent to the value of the step-up in remediation activities to get the company back on track as soon as possible?"

The use of charitable donations has already crept from the sustainability-linked loan market into private SLBs, and Ligthart says this is "one to watch".

"That could inspire the market. However, under the SLBP it still needs to be something linked to the instrument," he adds, "otherwise why not just make it a commitment on a corporate level?

"We're always trying to innovate and think of new structures, but maybe we risk missing the point — it's still important to make an offering relevant to investors in the capital markets."

Step-up coupons themselves are under scrutiny. In spite of the increasingly wide variety of issuers and KPIs/SPTs across the market, the level of coupon step-up typically remains 25bp three years before maturity or 75bp at the time of redemption, something investors find inappropriate.

"What I'm worried about at the moment is that you have many different ambition levels, but still the coupon step-ups are comparable with each other," says van der Meij at Actiam. "Some targets have to be met quite soon, others are further away. Some are more challenging, some are less challenging. But the coupon step-ups are more or less aligned.

"That aspect of the SLB market is not fair at the moment."

More SLBs, less haste

As the market heads towards a possible $300bn of outstandings this year, innovation and change is all but inevitable. But whatever the future brings, growth must not come at the expense of quality, says van der Meij.

"At times lately, 50% of the bonds in the market been sustainable bonds, and it's good that many companies are getting involved," he says. "But, to be honest, that makes me a little bit nervous that the hurdle is too low.

"Going forward, we will have to ask if our benchmarks are still good enough."

Eerenberg-van Kesteren says this thinking is likely to be reflected in Actiam's framework for analysing sustainable bonds.


Théo Kotula, AXA IM

"Our framework is a year and a half old and we're now seeing the need to update it to increase the level and make sure that we are at least still buying only the really sustainable bonds and not just those that are simply in line with regulation," she says.

Ligthart at ABN AMRO says that issuers could also benefit from clarity on best practice for their industries.

"For a couple of sectors, it has been a bit harder to align with the relevant climate scenarios," he says. "If you look at the Science Based Targets Initiative, they don't cover all industries — the oil and gas sector guidance, for instance, is still under development.

"It could be helpful for investors' analyses if such benchmarks were available and aligning with such guidance would also support the credibility of SLBs."

At AXA IM, Kotula also expects the firm's approach to sustainability-linked bonds to evolve, noting how young the market remains today.

"It would be a great idea to have the same kind of discussions in maybe a year's time," he suggests, "when we will have a lot more analysis available and examples of good and bad practice.

"One very interesting thing to see will be what happens if an SLB issuer fails in meeting its sustainability targets, how the market will react." ●

Gasunie Transition in the pipeline

Nederlandse Gasunie in October launched the first sustainability-linked bond (SLB) from the European gas transmission sector, a €300m 15 year deal with methane and Scope 1 and 2 emissions reduction targets. Here, Gea Paas Broekman and Loek Caris at Gasunie, and Dick Ligthart and Ton Roeten at sustainability structuring advisor ABN AMRO, discuss how the instrument furthers the Dutch company's sustainability objectives and transition into an energy infrastructure company.

As the Dutch gas transmission network operator, and in light of its broader interests, state-owned Nederlandse Gasunie has a key role to play in the Dutch energy transition. The company has been tasked by the government with developing the national infrastructure for the transport of hydrogen, and in line with its "Vision 2030" outlined in 2020, it plans to transform itself from principally a gas transmission company into an energy infrastructure company.


Gea Paas Broekman, Gasunie

This includes investments of €7bn in energy transition infrastructure in the period to 2030, which, alongside hydrogen, will take in carbon capture utilisation and storage (CCUS), heat and green gas. It has also created nine "Gasunie Green Deals" to translate the UN Sustainable Development Goals (SDGs) into concrete activities.

According to ISS ESG, which rates the company Prime, Gasunie ranks 14 out of 52 companies in its gas and electricity network operators sector.

"Compared to its peers, the company may offer further opportunities for achieving global sustainability objectives," said the second party opinion (SPO) provider.

With such investments and credentials in mind, Gasunie might seem an ideal candidate for a use-of-proceeds green or transition bond.

However, when Gasunie began discussing in 2019 how it might extend its sustainable debt finance activity and enter the bond market in a manner complementary to its vision — which in 2020 was reflected in a sustainability-linked revolving credit facility — it found that, as with many things in life, timing is everything.

A large part of the €7bn investment plan on obviously "green" spending such as hydrogen infrastructure is earmarked for the latter half of the decade and/or on projects yet to be finalised, and nearer term projects do not require a level of debt finance commensurate with a bond issue.

"We believe it's good to include sustainable elements in our bonds," says Gea Paas Broekman, front office manager in Gasunie's treasury. "So we looked internally at our projects in the coming years, as we initially thought a green bond would be appropriate. But it's currently too early for such an instrument, because we don't have final investment decisions for our key energy transition projects that are aligned with the EU Taxonomy.

"However, we have already stipulated certain initiatives and targets to comply with the SDGs, and so we thought it would make sense to issue a sustainability-linked bond."

The company therefore set to work on an SLB framework with sustainability structuring advisors ABN AMRO and NatWest Markets.

"While a green bond may be a longer term ambition, Gasunie already has the opportunity for sustainable issuance with the SLB format," says Dick Ligthart, director, sustainable markets, at ABN

AMRO. "It can thereby communicate its ambitious and industry-leading decarbonisation targets to investors."

Foppe Jan van der Meij, senior portfolio manager at Actiam, confirms the viability of the sustainability-linked bond option, saying that although the asset manager generally prefers use-of-proceeds bonds, SLBs can make sense for companies lacking appropriate projects.

"For Gasunie, there is still uncertainty about the regulation and how they will fit," he says, "so they cannot really make a commitment now for the use of proceeds. From that perspective, it is good that they have the SLB market available."

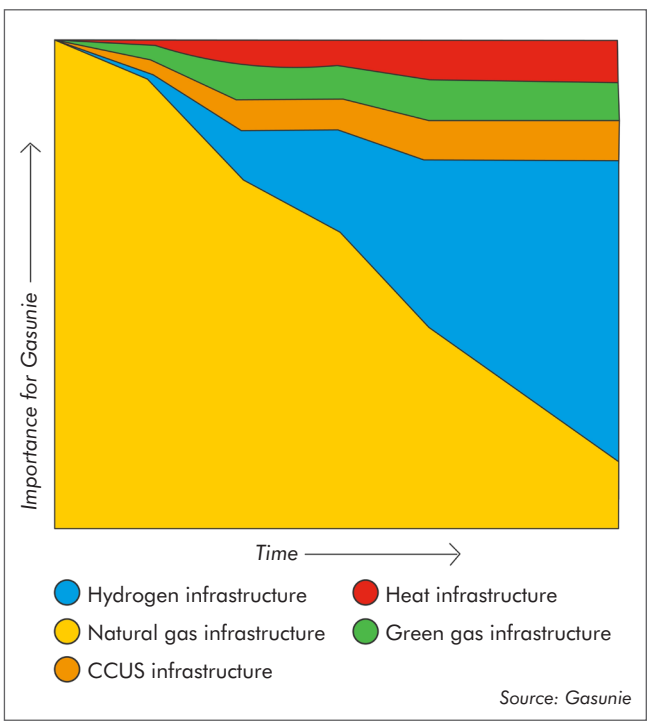

Loek Caris, Gasunie

KPIs, SPTs understood by SPO provider, investors

Central to the SLB framework are its KPIs and sustainability performance targets (SPTs), and Gasunie has included two of each that can be selected for its issuance, with a focus on those that it can control and for which it has data.

The first relate to cutting methane emissions, which accounted for 44% of the company's Scope 1 emissions in 2020. Gasunie is seeking to reduce these from 138 kilotonnes of CO_2-equivalent in 2020 to the SPT of 70 in 2030 through measures such as avoiding leakage.

"We want to make clear to the outside world that our transition pathway involves not only long term projects such as hydrogen," says Paas Broekman, "but, as we are now in a gas business, important measures such as methane reduction."



Source: Gasunie

Although the targeted reduction will be at a lower rate than that achieved between 2016 and 2020, when methane emissions were cut by 24%, ISS ESG agreed that the SPT goes "beyond business as usual" because further reductions will be more challenging to achieve. The SPO provider also found the SPT to be ambitious versus Gasunie's peer group and against national and EU emissions targets, and noted that the company could revise its target once the oil and gas sector guidance from the Science Based Targets Initiative becomes available.

The second KPI is Gasunie's Scope 1 and 2 emissions and it has set a variable target for these.

"We had some serious discussions around this during the preparatory phase," says Loek Caris, investor relations and external reporting specialist at Gasunie. "It might not be easy selling the idea of a variable target for Scope 1 and 2 emissions, but we firmly believe it's the right thing to do because we are not in control of the gas flows transiting through our network, so we can only control the amounts of emissions to a certain degree.

"The SPO provider agreed that this was appropriate and investors understood the rationale."

In terms of kilotonnes of CO_2-equivalent, the SPT for 2030 is 70 plus 0.137 times the transported gas volume in terawatt-hours (TWh) (with the 70 being the methane emissions target). According to Gasunie, if the amount of gas transported in 2030 is equivalent to the amount in 2020, then the SPT would imply a 30% reduction in Scope 1 and 2 emissions.

ISS ESG found the SPT to be material and ambitious, although noted that Scope 3 emissions, which represent 34% of Gasunie's greenhouse gas emissions, are not covered. Caris explains that other companies own the gas flowing through Gasunie's grids and already add these volumes to their own Scope 3, hence the exclusion of these emissions in Gasunie's Scope 3 emissions avoids double-counting.

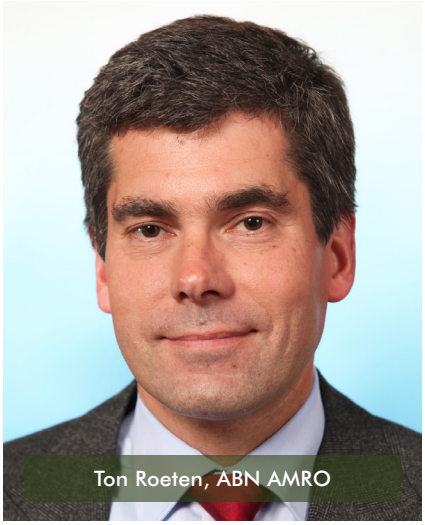
As with the methane KPI, the rate of reduction of the Scope 1 and 2 emissions will be slower than that achieved in recent years, but, again, the SPO provider acknowledged that further cuts will prove more challenging.

As well as affirming that the framework is aligned with the Sustainability-Linked Bond Principles, ISS ESG also confirmed its consistency with ICMA Climate Transition Finance Handbook recommendations, with some exceptions. Ligthart at ABN AMRO notes that Gasunie's framework is one of only a few that reference the thematic guidance.

"There was no specific need with an SLB structure for them to have incorporated the guidance," he says, "but they decided to embrace it

because the transition is such a part and parcel of Gasunie's strategy.

"That meant the framework is maybe a bit lengthier than some others," he adds, "but it's a comprehensive and transparent framework overall — addressing in detail the KPI trajectories and the risks of not achieving those, for example — and investors mentioned that positively during the roadshow."


Ton Roeten, ABN AMRO

SLB accelerates transition discussions, more to come

Having published its finished sustainability-linked bond framework in September, Gasunie held investor meetings to discuss its broad ESG strategy and credit developments, before launching its inaugural sustainability-linked bond on 1 October after a day of deal-specific marketing.

To best highlight Gasunie's ambitions, the debut sustainability-linked bond incorporated both SPTs, with the 0.75% coupon stepping up 0.10% for each target that is missed on 31 December 2030.

Active joint bookrunners ABN AMRO, Crédit Agricole and ING, and passive bookrunner NatWest, went out with initial price thoughts of the mid-swaps plus 65bp area for a €300m no-grow 15 year transaction, rated A1 by Moody's. Guidance was then set at mid-swaps plus 40bp-45bp on the back of around €1.1bn of orders, and the deal was ultimately priced at 38bp, and a yield of 0.763%, on the back of a final book above €750m.

"The book filled up quite quickly and overall it went very smoothly," says Ton Roeten, head of corporate bond origination at ABN AMRO. "We saw the new issue premium as approximately minus 1bp, which for the long maturity in a market where inflation fears were raising their ugly head was quite nice.

"If there were any constraints," he adds, "it was that in some cases investors wanted to participate, but couldn't because of the sub-benchmark size."

ESG investors were estimated to have taken some 45% of Gasunie's sustainability-linked bond (14% considered dark green and 31% light green).

"We are very proud of the framework, but also the deal itself," says Paas Broekman. "This is the first time we have issued such a long tenor and we were quite excited to see it work so well."

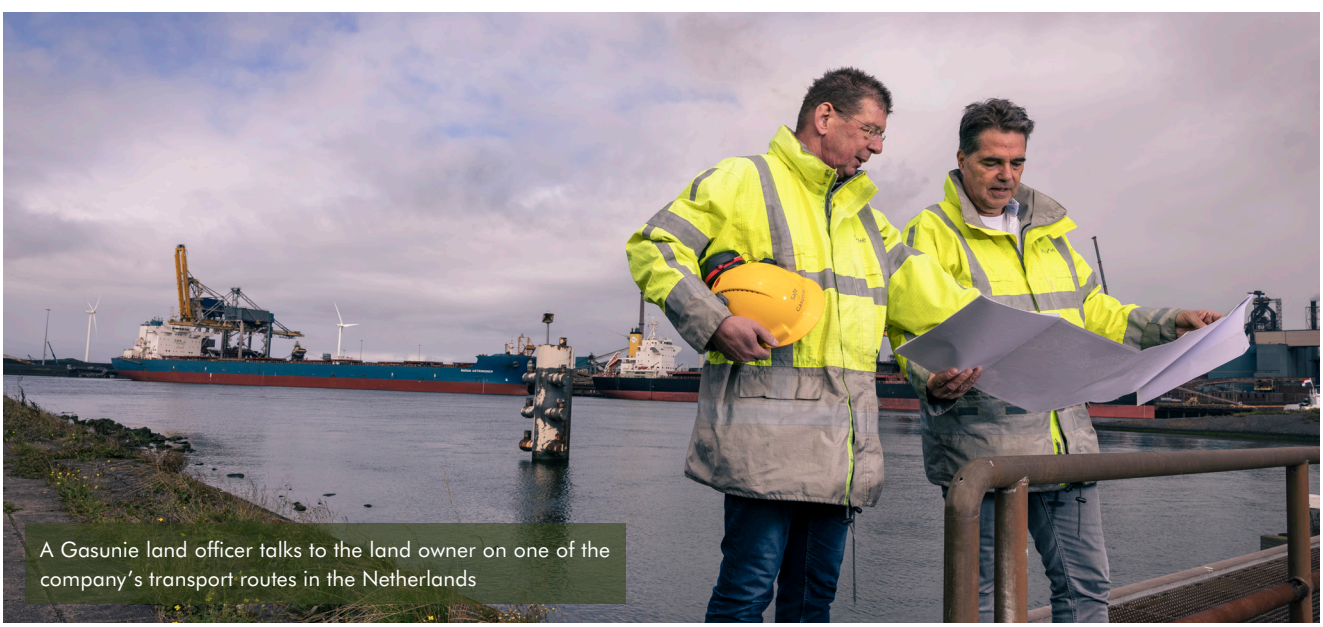
As well as engaging investors in Gasunie's ESG story, the sustainability-linked bond project catalysed sustainability discussions internally.

"In the past, our colleagues were never really conscious of financing instruments and what we do in treasury," says Paas Broekman, "but we explained that it was important to also include sustainable elements in our financing strategy, and in fact the SLB accelerated our discussions regarding methane emissions and CO_2."

Having taken its first sustainable step into the bond market, Gasunie is already eyeing further opportunities, not least as an outstanding issue comes up for redemption in July.

"In the coming months we will look at whether a green bond is doable," says Paas Broekman, "but I expect we will issue another sustainability-linked bond.

"There is a greater chance that we will then issue a green bond in the following years." ●


A Gasunie land officer talks to the land owner on one of the company's transport routes in the Netherlands