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ESG Investing: Keeping Score on Sustainability-Linked Bonds

A growing number of bonds are tied to issuers' achievement of ESG goals. Here's what we look for when aligning investor and issuer interests to achieve sustainability objectives.

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KEY POINTS:

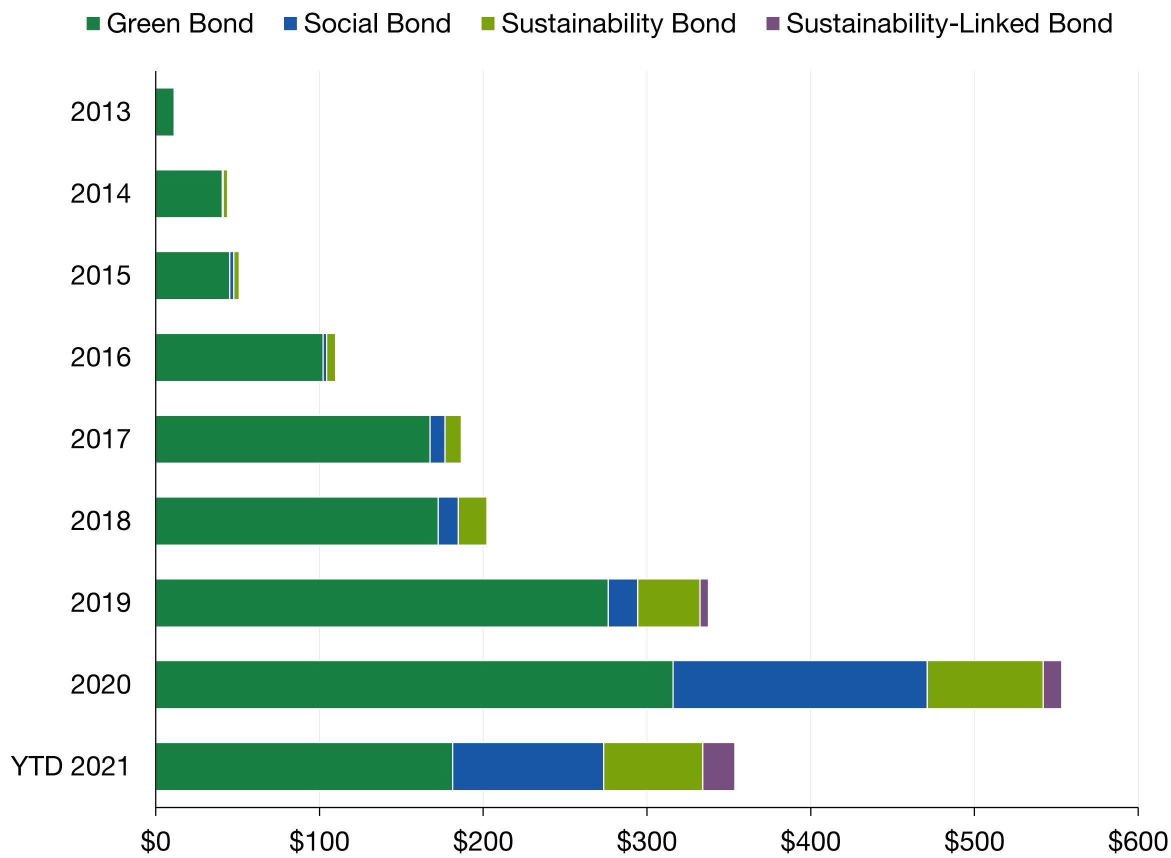
- Sustainability-linked bonds (SLBs) are a relatively new, but rapidly growing, entrant into the ESG (environmental, social and governance)-labeled debt universe.
- The distinguishing feature of an SLB is that the issuer is incentivized to achieve one or more clearly quantifiable sustainability objectives; SLBs issuers are financially penalized if they do not achieve their stated sustainability objectives.
- When assessing SLBs at Lord Abbett, we look for strong alignment between the ESG strategy of the issuer and the sustainability goals of the bond, clearly defined and measurable objectives, and well-designed structural terms.

Issuance of ESG-labeled debt (i.e., explicitly tied to environmental, social, and governance investment criteria) continues to grow as investor demand, issuer interest, and regulatory evolution all contribute to a rapidly growing market. According to a recent report from Morgan Stanley, there is approximately US$1.6 trillion in ESG-labeled debt outstanding globally, with US$353 billion issued through April 2021 alone (see Figure 1).[1] A small but increasingly relevant segment of the ESG-labeled debt market is sustainability-linked bonds (SLBs). SLBs issuance totaled US$19.7 billion year-to-date through the end of April, already surpassing the US$11.3 billion issued in calendar 2020. In this article, we will explore 1) what SLBs are, and how they differ from other forms of ESG-labeled debt, 2) why an issuer would choose to issue them, and 3) how we evaluate SLBs in our various strategies.

Sustainability-Linked Bonds – An Overview

In most forms of ESG-labeled debt, a given bond will be issued in order to finance a specific project or set of projects with an environmental focus (green bonds), social focus (social bonds) or both (sustainability bonds). While there are no legal criteria defining what constitutes each of these, the International Capital Markets Association (ICMA) has established widely accepted principles for each of these types of ESG-labeled debt. These principles outline acceptable uses of proceeds (eligibility of projects; ongoing management transparency and tracking of proceeds; and ongoing reporting) and provide the foundation for the methodology for various independent certification schemes. ESG-labeled bonds are pari-passu, or of an equal status, with conventional bonds from the same issuer.

Figure 1. ESG-Labeled Debt Issuance (US$ billion)



Source: Bloomberg. Data as of 5/14/2021. The historical data shown in the chart above is for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment.

Unlike green, social, or sustainability bonds, where the proceeds are used to finance or refinance one or more discrete projects, sustainability-linked bonds (also known as KPI (key performance indicator)-linked bonds) generally have no restrictions on how the proceeds may be used. Instead, the bond's terms are structurally linked to the issuer achieving specific and measurable targets for their broader business. In June 2020, ICMA published voluntary guidelines for SLBs, outlining best practices for issuers looking to incorporate measurable and time-based ESG-related commitments into their financing strategy.[2]

Underpinning every SLB are one or more key performance indicators outlining environmental, social, or governance objectives that are relevant to the issuer's business. For example, KPIs can include target emissions reduction, percent of recycled materials used, or percent of renewable energy used. In our view, KPIs should be ambitious, material, and aligned to the issuer's overall business and sustainability strategy. For each KPI, the issuer will define one or more measurable sustainability performance targets (SPTs), which reflect the issuer's sincere commitment to sustainability and reflect significant changes to their business not achieved in the ordinary course of business. These targets should outline the timeframe for performance evaluation and express goals based on science-based scenarios or a relevant regulatory or governmental target. Figure 2 illustrates examples of recent SLBs alongside their KPIs and measurable performance targets.

Figure 2. Examples of Emissions-Focused SLB KPIs

Issuer & Bond Details	Sustainability KPI	Measurable and Meaningful Targets	
Chanel €0.5% 2026s €300M	Materially decrease Scope 1, 2, & 3 emissions	Reduce absolute Scope 1 & 2 emissions by 50%	2018 baseline: 41,800 tCO_2e 2030 target: 20,900 tCO_2e
		Reduce Scope 3 emissions by 10%	2018 baseline 829,000 tCO_2e 2030 target: 746,100 tCO_2e
Suzano $3.75% 2031s $750M	Reduce GHG emissions intensity of product produced	Lower GHG emissions intensity from Scope 1 & 2 emissions due to paper and pulp production by 10%	2020 baseline: 0.200 tCO_2e 2024/25 target (average): 0.190 tCO_2e

Sources: Bloomberg, Barclays, and Lord Abbett. GHG = greenhouse gas. Carbon dioxide equivalent or CO_2e means the number of metric tons of CO_2 emissions with the same global warming potential as one metric ton of another greenhouse gas. The historical data shown in the chart above is for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment.

The key characteristic of a SLB that distinguishes it from other types of ESG-labeled debt is that these bonds contain structural or financial terms that may vary depending on whether the issuer achieves (or fails to achieve) the pre-defined sustainability performance targets. These terms could include, for example, a step-up in coupon or a premium due at maturity. In any case, the variation in terms should be meaningful relative to the KPI and to the original terms at issue. In other words, investors are compensated should the issuer fail to meet the explicit sustainability performance targets referenced in their SLB framework. Using the same example issues from above, in Figure 3, we include how the terms of the bond are changed to the benefit of the investor should the issuer not achieve their targets outlined in their KPIs.

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Figure 3. Examples of SLB Terms

Issuer & Bond Details	Bond Feature
Chanel €0.5% 2026s €300M	Issuer will pay an additional 0.75% of par value upon maturity if both targets have not been met by end of 2025
Suzano $3.75% 2031s $750M	Coupon will increase by 25bp if target has not been met by December 31, 2025

Sources: Bloomberg, Barclays, and Lord Abbett. Bp = basis point. A basis point is a financial unit of measurement that is 1/100th of 1%. The historical data shown in the chart above is for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment.

From an SLB investor's perspective, transparency is key. On a regular basis, SLB issuers should publish information on their progress in achieving the KPIs, along with any related impact-metrics. Issuers should also provide external and independent validation, such as from an auditor or environmental consultancy, on their progress towards the sustainability targets. This is particularly important around the triggering dates. Third party review of progress against the targets should be made publicly available.

Figure 4. Comparing Traditional ESG-Labeled Bonds to Sustainability-Linked Bonds

Bond Characteristic	Traditional ESG-Labeled Bond	Sustainability-Linked Bond
ESG rationale	Finance or refinance specific ESG-related eligible project(s)	Attainment of ambitious, material, and measurable ESG-related goal(s)
Use of proceeds	One or more specific projects	Can be general purpose or initiative-specific
Second party opinion	Best practice	Best practice
Implications of not meeting/completing ESG commitment	n/a – remains a general obligation of the issuer; can be refinanced without financial implications	Material change to bond terms based on structure, including coupon step-ups or higher repayment premium
Auditor for impact reporting	Optional	Recommended
Annual Progress Reports	Optional	Required

Source: ICMA, Lord Abbett. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

Why Issue Sustainability-Linked Bonds?

We have previously noted the dramatic rise of traditional ESG-labeled debt, and especially in green bonds. With such a receptive market for green, social, and sustainability bonds, why would an issuer choose to issue a sustainability-linked bond? The biggest incentive to use SLBs is the flexibility in spending the proceeds. Many companies, particularly smaller ones, do not have enough dedicated green or social projects on which to spend the proceeds of an entire bond issuance. For these companies, it makes more sense to issue an SLB which they can use for general corporate purposes, but still link it to the sustainability performance of the business. SLBs provide issuers with flexibility and provide an opportunity for investors to align themselves with specific and measurable sustainability objectives. If financial implications are material enough, it also provides investors with some reassurance that the issuer is incentivized to meet their sustainability targets.

Further, SLBs allow issuers to express their commitment to specific issues, initiatives, or development goals. As with other forms of ESG-labeled debt, the cost of financing can be lower and/or can access a wider investor base. There are also reputational benefits–internally, an SLB can demonstrate alignment to company values and business model; externally, they can also express ESG commitments in a more consequential manner.

What Do We Look for in SLBs?

As is the case with green, social, and sustainability bonds, SLBs can reflect a varying degree of authenticity in the issuer's commitment to an ESG-related initiative. To better illustrate the characteristics of this emerging segment of the ESG bond market, we have outlined the terms and features of some recent issues, and what we specifically look for in considering SLBs for inclusion in our portfolios. A specific focus for Lord Abbett in evaluating SLBs is whether the financial terms of the bond incentivize the issuer to achieve their sustainability targets. Is the coupon step-up material enough for the issuer to be incentivized to hit the KPIs? For example, a 12.5bps step-up on a 4.5% coupon is not, in our opinion, very material. How far in advance of the bond's maturity are the KPIs measured? If it's only six months to a year before maturity, the financial implications of a higher coupon may not be that material. We prefer to see several years between a financial term's measurement date and the bond's maturity.

Figure 5. Sustainability-Linked Bond Investment Considerations

Security-level	Issuer-level
Is the SLB framework aligned with ICMA principles?	How ambitious is the issuer-level sustainability strategy?
Does the bond have a second-party opinion? ▪ If Yes, which rating agency? ▪ If Yes, what is the rating?	Do the KPIs reflect the issuer's existing sustainability commitments? Does the issuer have emissions reduction targets?
Are the financial incentives in the security's structure sufficiently material to incentivize achievement?	Is the management team's remuneration linked to ESG KPIs?
Are the targets SMART (specific, measurable, attainable, relevant, timebound)?	
How much transparency does the issuer provide into progress towards its targets?	

Source: Lord Abbett. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

Closing Thoughts

Today, SLBs represent only a very small percentage of the vast amount of ESG bond issuance coming to market. That said, remember that in 2015, only US$45 billion of green bonds were issued, and we think SLBs have the potential to see a similar growth trajectory. We believe demand for SLBs from European issuers is set to remain firm–the European Central Bank recently decided that sustainability-linked bonds, including those with coupon structures linked to sustainability performance targets, will become eligible for asset purchases under the Asset Purchase Programme and Pandemic Emergency Purchase Programme, subject to compliance with the relevant eligibility criteria. They will also be permitted as central bank collateral.[3]

In our view, SLBs represent a compelling opportunity for issuers to effectively communicate their ESG-goals to a wide range of stakeholders, pursue strategic objectives, and obtain favorable financing costs. Investors can align themselves with issuers that match their own ESG objectives and benefit from enhanced terms should an issuer fail to achieve its objectives. As with all ESG-labeled debt, investors must make their own determination as to whether the SLB is authentic, structured appropriately, and aligned with best practices.

Finally, an attractive SLB structure does not necessarily mean an attractive investment in and of itself, as all ESG securities should be evaluated in a broader context based on macroeconomic views and relative value. These issues–authenticity, alignment, and value–form the foundation of our approach to this nascent and exciting form of ESG bond issuance.

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[1]Morgan Stanley, ESG Labeled Debt Tracker, April 8, 2021

[2]International Capital Markets Association, Sustainability-Linked Bond Principles, June 2020

[3]https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200922~482e4a5a90.en.html

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No investing strategy can overcome all market volatility or guarantee future results.

Environmental, social, and governance (ESG) criteria are a set of standards for a company's operations that socially-conscious investors use to screen potential investments.

Green bonds: Labeled green bonds are bonds that earmark proceeds for climate and environmental projects. Labeled green bonds are often verified by a third party, which certifies that the bond will fund projects that include environmental benefits. Unlabeled green bonds (or climate-aligned bonds) are securities whose proceeds are supposed to be used for climate-aligned projects and initiatives but are issued without formal certifications.

Pari-passu ("equal footing") describes situations where two or more securities are equally managed without preference and are treated the same under various circumstances.

Under greenhouse gas protocols defined by the World Resources Institute, Scope 1 emissions are direct emissions from company-owned and controlled resources. Scope 2 emissions are indirect emissions from the generation of purchased energy from a utility provider. Scope 3 emissions are all indirect emissions (not included in Scope 2) that occur in the value chain of the reporting company, including both upstream and downstream emissions.

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