MOODY'S | ESG Solutions

Credible targets and structures key to long-term growth of sustainability-linked bonds

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ABOUT

Moody's is committed to helping market participants advance strategic resilience, responsible capitalism, and the greening of the economy. Our offerings span across credit, ESG, sustainable finance, and climate risk solutions and help our customers identify risks and opportunities and provide meaningful performance measurements and insights.

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Sustainable Finance – Global

Credible targets and structures key to long-term growth of sustainability-linked bonds

Summary

Recognised market standards, ambitious corporate agendas and strong investor demand provide fertile ground for rapid growth of the sustainability-linked bond (SLB) market. By focusing on general purpose spending, SLBs open the door to a more diverse group of sectors and issuers seeking to burnish their sustainability credentials via the debt capital markets. Broader sector and issuer participation will, in turn, boost demand for SLB paper by mitigating diversification risk in ESG bond portfolios and providing investors with a wider spectrum of opportunities to support companies' transition and sustainability efforts.

Selected key performance indicators (KPIs) must inform an ambitious sustainability pathway to maintain long-term market integrity. Issuers will need to clearly articulate the robustness of sustainability performance targets (SPTs) embedded within SLBs to ensure investor buy-in. Interim goals, historical performance, science-based criteria, transparency on scope and coverage and limited reliance on offsets can all strengthen the credibility of targets. According to our analysis of 43 SLBs since June 2020, we find that issuers committed to an average of 1.6 individual KPIs per transaction with an average SPT duration of 4.7 years. Only 24% of climate-related SPTs directly reference science-based measurement criteria.

Variations in financial characteristics that are meaningful to an issuer's overarching business and financial profile will emerge slowly. The most popular features are interim coupon step-ups, followed by premium payments at maturity and the purchase of carbon offsets. Where coupon step-ups are used, the average adjustment to the debt instrument is 34 basis points (bps). Furthermore, adjustments are typically not directly linked to the characteristics of the bond (such as tenor) or credit profile of the issuer, reflecting the relatively immature nature of the market.

External reviews will remain widely used to demonstrate the value and credibility of an issuer's SLB structure to market participants. Moody's ESG Solutions, through its affiliate V.E, has delivered second party opinions on SLB frameworks across a diverse array of sectors, with coverage including Chanel, Enel S.p.A, Etihad Airways, NRG Energy, Rexel and Schneider Electric SE. We assess whether the issuer's framework aligns with the core components of the Sustainability-Linked Bond Principles (SLBP) and industry best practices. They also consider the issuer's overall environmental, social and governance (ESG) performance, as well as potential involvement and management of stakeholder-related ESG controversies.

Sustainable Finance at Moody's ESG Solutions

Sustainable finance is on the rise. Moody's Investors Service forecasts $650 billion of new issuance across the sustainable bond market in 2021 alone. In turn, market participants are increasingly demanding accurate assessments detailing the sustainability credentials of an organization's bond and loan issuance or their broader activities.

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For more information, visit esg.moodys.io/sustainable-finance.

Moody's ESG Solutions provides insights and analyses on ESG themes and multi-stakeholder performance, climate-related risks and opportunities and global sustainable finance trends.

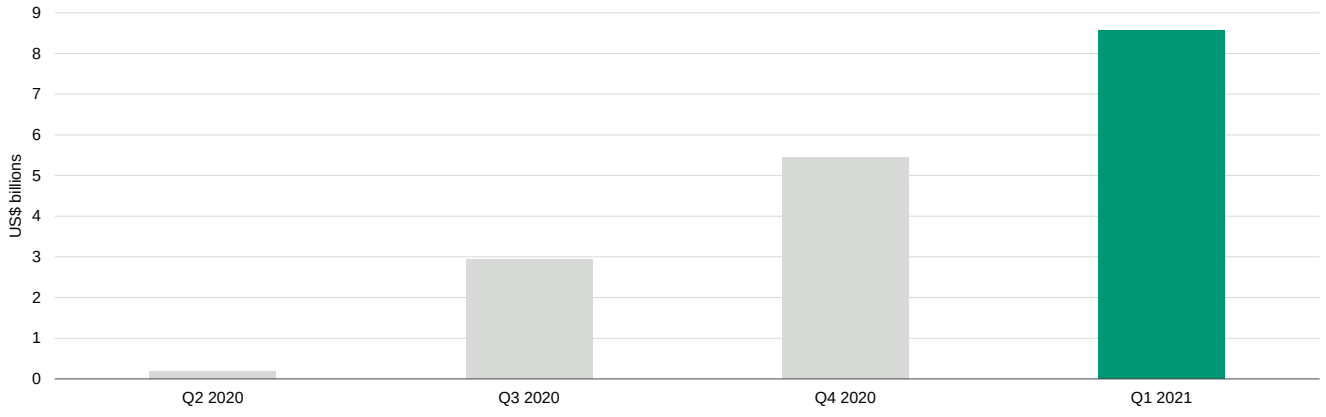
Recognised market standards, ambitious corporate agendas and strong investor demand provide fertile ground for rapid growth of the sustainability-linked bond market

Sustainability-linked bonds (SLBs) are instruments for which the financial or structural characteristics vary depending on whether the issuer achieves predefined environmental, social and governance (ESG) objectives. By offering flexibility on the use of proceeds, they afford organizations with a forward-looking and dynamic way to embed public sustainability commitments into their financial structure. This differs from the more established use-of-proceeds market, where bond proceeds are earmarked for specific green or social assets or activities, and issuers typically commit to maintaining proceeds separately from general corporate accounts.

While still a nascent market, SLBs are quickly attracting the attention of issuers and investors. Global SLB issuance hit US$8.5 billion (in US$ equivalent terms) in the first quarter of 2021 – already on par with the full-year total from 2020 – and we expect global supply to remain extremely healthy (Figure 1).

Figure 1 Issuance outlook for SLBs is favourable following a record first quarter

Global issuance of sustainability-linked bonds, US$ billion (equivalent)



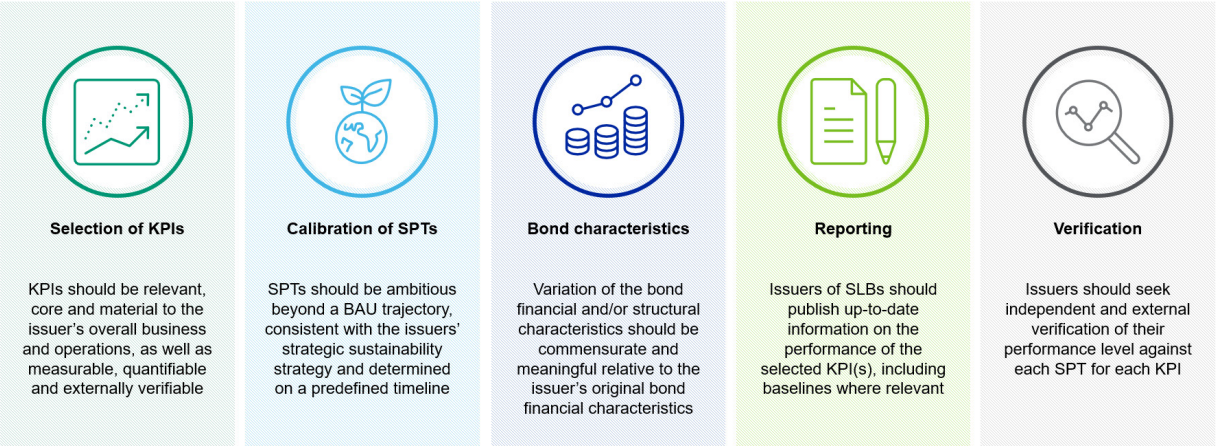
Sources: Moody's ESG Solutions and Environmental Finance Bond Database

From our perspective, several key drivers will underpin robust SLB issuance momentum and provide impetus for the market to continue venturing into new geographies, sectors and credit quality segments.

First, market standards and policy support will underpin the credibility of SLBs and lead to the development of industry best practices. First published in June 2020, the International Capital Market Association's (ICMA) Sustainability-Linked Bond Principles (SLBP) are already gaining widespread recognition as the market standard for SLBs globally.[1] As shows in Figure 2, the SLBP aim to provide best practice guidance across five key components: (1) selection of key performance indicators (KPIs); (2) calibration of sustainability performance targets (SPTs); (3) bond characteristics; (4) reporting; and (5) verification. We expect the SLBP's publication to represent an important step toward formalising best practices associated with issuing instruments in this nascent category. This will provide a strong tailwind for market growth – as previously seen when the launch of the Green Bond Principles led to a tripling of issuance for use-of-proceeds green bonds in 2014. Another important signal for the SLB market came in January 2021 when the European Central Bank began accepting SLBs as central bank collateral.[2] The announcement signals increasing policy support for such instruments and will further reinforce market acceptance of the construct.

Figure 2 Market standards will support SLB growth and development

Selected highlights from the Sustainability-Linked Bond Principles



Sources: Moody's ESG Solutions and International Capital Markets Association

Second, by focusing on general purpose spending rather than on specific assets, SLBs open the door to a broader group of sectors and issuers seeking to burnish their sustainability credentials via the debt capital markets. SLB momentum taps into a groundswell of collective ambition across cities, businesses and investors to achieve global climate and sustainability targets, including "net zero" objectives. Notably, the Race to Zero campaign – launched in the lead-up to the 26th UN Climate Change Conference of the Parties (COP26) in November 2021 – is mobilizing a coalition of cities, regions, businesses, investors and higher education institutions.[3] According to a recent study, countries with net zero targets together represent 61% of global emissions, while companies with net zero commitments generate combined sales of nearly $14 trillion, or 33% of total sales worldwide.[4]

The SLB market is already more diversified than the early days of the use-of-proceeds green, social and sustainability bond markets. Figure 3 shows the sector diversification of SLBs issued since the launch of the SLBP in June 2020. Global SLB coverage includes companies from across traditional sectors seen in the use-of-proceeds market (such as electric utilities). However, companies from across consumer staples, industrials (including transport and logistics and construction), materials, energy, health care and financials are also pricing SLB deals. For example, companies Suzano, Klabin S.A. and Inversiones CMPC from the paper and forest products sector have all issued benchmark SLB transactions as a means to commit to reducing their carbon or natural resource footprint. Meanwhile, Berlin Hyp AG became the first commercial bank globally to issue an SLB in April 2021 – testament to the increasingly mature climate risk management reporting and environmental risk management practices employed by leading players in the sector.[5]

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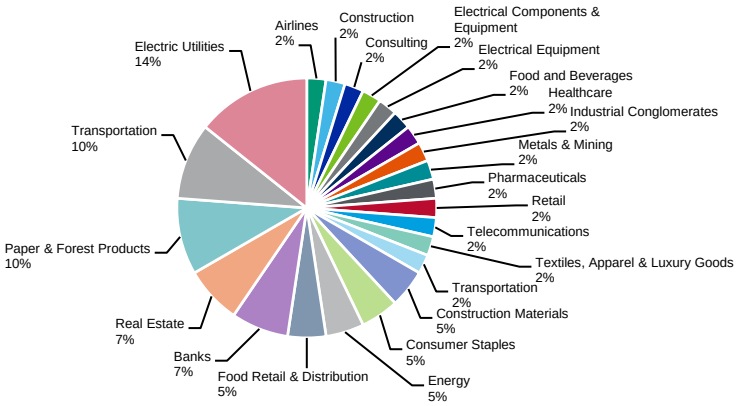
1 Sustainability-Linked Bond Principles (SLBP) 2020, International Capital Market Association, June 2020.
2 FAQ on sustainability-linked bonds, European Central Bank.
3 https://unfccc.int/climate-action/race-to-zero-campaign.
4 Taking Stock: A global assessment of net zero targets, The Energy & Climate Intelligence Unit and Oxford Net Zero, March 2021.
5 Berlin Hyp AG: Issuance of sustainability-linked bond is a first for banking globally, Moody's Investors Service, April 2021.

Figure 3 SLBs open to issuers from across a more diverse group of sectors

Global SLB issuance since June 2020 by sector, % share

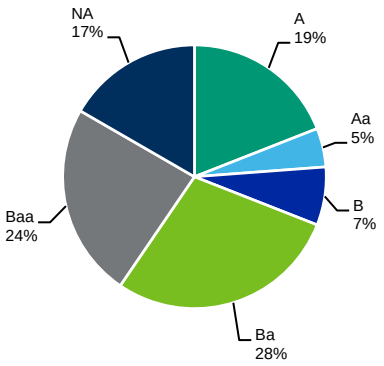


Note: For our analysis, we include 43 sustainability-linked bonds, including private placements, issued since the launch of the Sustainability-Linked Bond Principles in June 2020.

Sources: Moody's ESG Solutions, Environmental Finance Bond Database and company reports

Market diversification is not just limited to industry composition. Figures 4 and 5 show the distribution of SLBs by credit segment of the issuer and country of issuance. According to our estimates, roughly 35% of SLB issuance to date falls with the non-investment grade, or "high-yield" segment. Traditionally, companies with weaker credit quality have played a much less significant role in the use-of-proceeds market. The opening up of sustainable finance to riskier parts of the market may have a greater marginal impact given the greater potential for environmental or social improvements. Relatedly, emerging markets account for roughly one quarter of total supply, providing further evidence that SLBs can be a tool to facilitate greater market access. For example, Etihad Airways became the first issuer to launch an SLB sukuk in November last year, with the carrier linking the terms of the transaction to its carbon reduction targets.[6]

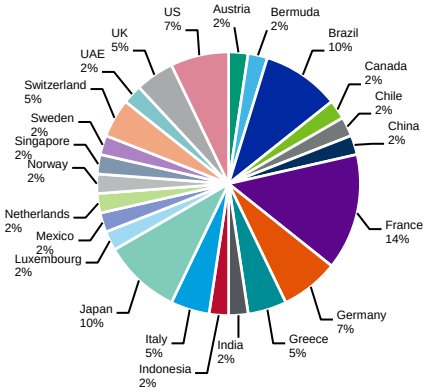
Figure 4 Number of SLBs since June 2020 by rating category



Note: Benchmark local or foreign currency rating shown depending on individual SLB, with Moody's Investors Service rating provided where available. Rating category proxied using Moody's Investors Service's rating scale.

Sources: Moody's ESG Solutions, Environmental Finance Bond Database and company reports

Figure 5 Number of SLBs since June 2020 by country



Sources: Moody's ESG Solutions, Environmental Finance Bond Database and company reports

[6] Etihad becomes first Airline to issue sustainability-linked Sukuk, Etihad Airways, October 2020.

Finally, we expect strong investor appetite to provide one of the principal engines of growth for the SLB market. For investors, an increasingly diverse range of sectors and issuers will help mitigate diversification risk in ESG bond portfolios, which are typified by heavy sector, geographic and credit quality concentration. There is also growing market recognition that the financing of green, social and sustainability activities should be linked to an issuer's overarching sustainability objectives. Against this backdrop, SLBs provide investors with a wider spectrum of opportunities to finance, support and engage with companies' efforts to transition to a low-carbon and sustainable business model. They also allow investors to better consider ESG aspects in their investment due diligence process, a key tenet of the UN-backed Principles for Responsible Investment.[7]

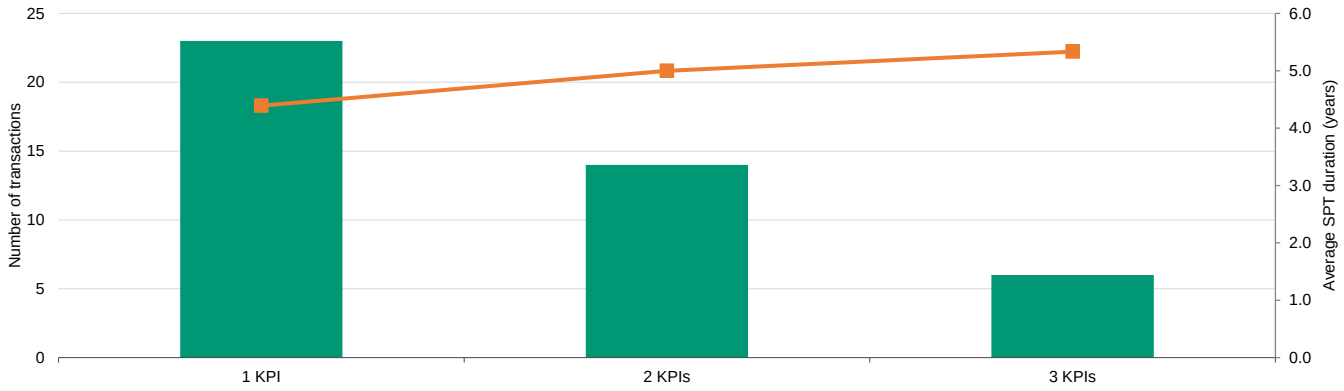
Selected key performance indicators must inform an ambitious sustainability pathway to maintain long-term market integrity

SLBs are tied to the selection of one or more KPIs that are relevant and material to an issuer's sustainability and business strategy. In turn, KPIs feed into the implementation of sustainability performance targets (SPTs) that, according to the SLBP, should be consistent, time-bound and ambitious beyond a "business as usual" pathway.

According to our analysis of 43 SLBs issued since June 2020, most issuers commit to a single KPI with an average duration of 4.4 years, although a sizeable number also embed more than one performance indicator (Figure 6). In summary, we find an average of 1.6 individual KPIs applied per transaction informing SPTs with a mean duration of 4.7 years (or 56% of bond maturity).

Figure 6 Most SLBs leverage a single key performance indicator

Number of KPIs and average SPT duration, years



Note: For our analysis, we include 43 sustainability-linked bonds, including private placements, issued since the launch of the Sustainability-Linked Bond Principles in June 2020.

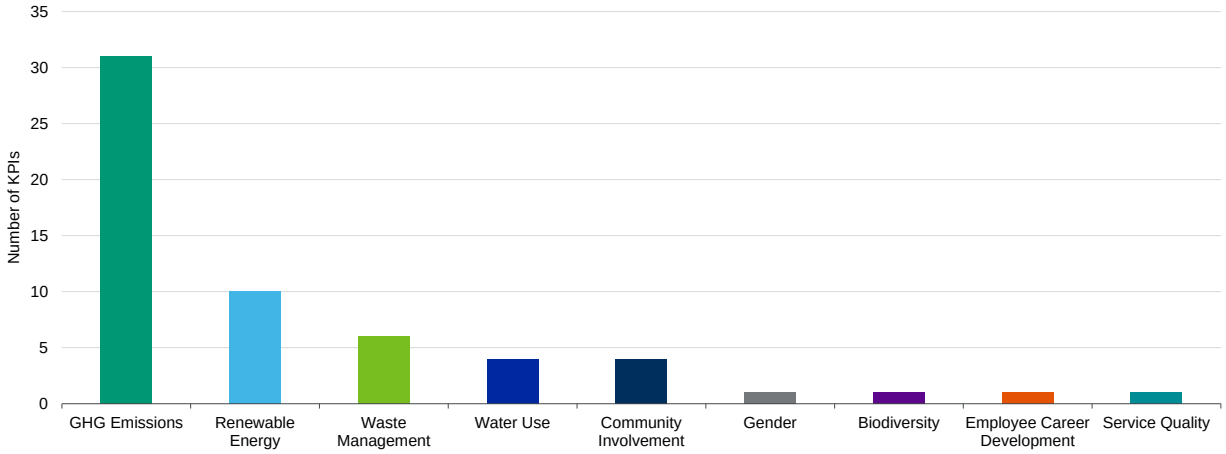
Sources: Moody's ESG Solutions, Environmental Finance Bond Database and company reports

A breakdown by category type reveals that KPIs related to greenhouse gas (GHG) emissions reduction are most common, representing 60% of all targets (Figure 7). However, others – such as those related to renewable energy, water use, waste management, community involvement or gender diversity – also exist. For example, European multinational Schneider Electric, which launched its maiden SLB worth €650 million in November 2020, incorporated 3 KPIs related to GHG emissions, gender diversity and the training of underprivileged people into its framework.

[7] https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment.

Figure 7 Majority of KPIs are associated with GHG emissions reduction

Number of KPIs by broad category



Note: For our analysis, we include 43 sustainability-linked bonds, including private placements, issued since the launch of the Sustainability-Linked Bond Principles in June 2020.

Sources: Moody's ESG Solutions, Environmental Finance Bond Database and company reports

Given that proceeds are earmarked for general corporate purposes, market practitioners rely on the formulation of KPIs and SPTs to determine the ambition of SLB frameworks. In this regard, data comparability across SLBs is a key challenge. While some KPIs adhere to widely used reporting frameworks or metrics (such as the reporting of carbon emissions), sector comparisons can still be difficult due to differences in disclosure practices or lack of disclosure amongst peers for KPI benchmarking. There may also be limited scalable technologies for deep decarbonization in some sectors today (such as airlines and steel, for example). Other KPIs, such as those related to social objectives, may adopt more qualitative or idiosyncratic metrics. In addition, differences in SPT implementation periods, reporting baselines and complex company operations can all make it difficult to determine the credibility of selected KPIs. In extreme instances, such challenges may fuel market concerns of perceived "green-washing".[8]

While issuers need to carefully balance ambition with feasibility when selecting KPIs and SPTs in their SLB frameworks, it is important that targets are based on clearly defined pathways and robust assumptions. Interim goals, historical KPI performance, science-based criteria, transparency on scope and coverage (in the case of GHG emissions) and limited reliance on offsets can all strengthen the credibility of targets.

Our analysis shows that most issuers (roughly two thirds) have provided the three-year prior trend of KPIs where such data is available or applicable. This is in line with recommendations set out in the SLBP and is helpful because historical trends provide context and credence to the level of ambition of performance targets. Most targets will also provide some reference to global initiatives such as the Paris Agreement or UN Sustainable Development Goals.

However, the picture is more mixed when it comes to the scope and methodology of KPIs related to GHG emissions. Of the 31 SLBs that embed at least one KPI related to GHG emissions, only eight include explicit reference to Scope 3 emissions (that is, emissions which are the result of activities from assets not owned or controlled by the reporting organisation, but that it indirectly impacts in its value chain). In addition, only 10 transactions directly reference science-based targets validated by the Science Based Target Initiative as the internationally recognised measurement criteria applied to SPT calibration.[9]

We expect best practices on KPI and SPT selection and reporting to strengthen as the market reaches critical mass. In some instances, issuers are seeking to provide transparency and credibility above and beyond recommendations enshrined in the SLBP.

[8] While there is no universally regarded definition of "green-washing", the term generally refers to the conveying of false information or unsubstantiated claims that an organization's products or services are environmentally friendly or sustainable.

[9] The Science Based Targets initiative (SBTi) drives ambitious climate action in the private sector by enabling companies to set science-based emissions reduction targets. See sciencebasedtargets.org.

For example, Austrian electricity provider Verbund AG issued an SLB in March that combined elements of the use-of-proceeds model (ringfencing of proceeds for specific projects) with a coupon step-up linked to company-wide sustainability goals. The company also aligned its framework with the existing delegated acts of the EU Taxonomy for sustainable activities.[10] While it remains to be seen whether this dual-structure approach will gain traction, it reflects the lengths that leading companies may go to in order to demonstrate their credibility to the market.

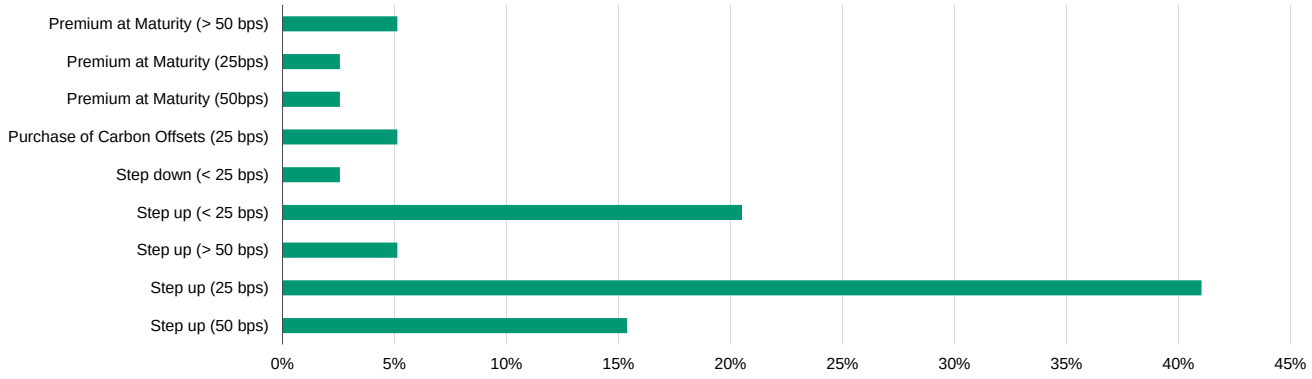
Variations in financial characteristics that are meaningful to an issuer's overarching business and financial profile will emerge slowly

The cornerstone of a SLB is that the bond's financial characteristics vary depending on whether selected KPIs meet the predefined SPT. Where targets are not met, SLBs typically include some form of financial or structural modification involving pre-selected trigger events and timelines. SLB structures to date have incorporated variable coupons (in the form of interim coupon step-ups or coupon step-ups at maturity of the bond), additional payments (both via coupon or lump sum) to non-profit groups and the purchase of carbon offsets. Some transactions will incorporate different adjustments depending on individual tranches. Others may be weighted by the relative importance of KPIs.

Of the outstanding SLBs assessed in our study, we find that the most popular structural features are interim coupon step-ups, followed by premia paid at maturity and the purchase of carbon credits. As Figure 8 shows, an interim coupon step-up of 25 basis points (bps) is the most prevalent form of structure used. In instances where coupon step-ups are used, the average adjustment to the debt instrument is 34bps. Nevertheless, adjustments are typically not directly linked to the characteristics of the bond (such as tenor) or credit profile of the issuer, reflecting the relatively immature nature of the market.

Figure 8 Interim coupon step-ups are the most popular type of structural adjustment

Types of structural adjustments incorporated into SLBs, % share



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Sources: Moody's ESG Solutions, Environmental Finance Bond Database and company reports

As investors are generally not looking for issuers to fail in pursuit of their objectives, sustained poor corporate performance against KPIs could potentially lead to heightened selling pressure for SLBs. The failure to hit sustainability targets could also increase credit quality risks, impacting the issuer's cost of capital.[11] Over time, the failure of an entity to show reasonable efforts to meet sustainability targets could result in significant reputational risk and/or constrained ability to raise additional ESG-compliant financing. Furthermore, we would expect that the financial features of SLBs would become more precise if the market can more accurately "price" the added risk that failure to hit the sustainability target would yield.

On this front, a critical element of market development will be the exhaustiveness and timeliness of post-issuance reporting. According to the SLBP, issuers should publish up-to-date information on the performance of selected KPIs, a verification assurance report outlining the performance against the SPTs and any information enabling investors to monitor the level of ambition of the SPT. Reporting should be disclosed at least annually. While it is premature to determine trends in SLB reporting, a perceived failure

[10] Innovative EU taxonomy aligned "Green and Sustainability-linked Bond" was successfully placed, Verbund AG, March 2021.
[11] Cross-Sector – Global: Net-zero pledges increase credit pressure on major emitters, Moody's Investors Service, April 2021.

of issuers to demonstrate how their performance is evolving in accordance with SPTs would be looked upon unfavourably by bondholders.

External reviews will remain widely used to demonstrate the value and credibility of an issuer's SLB structure to market participants

Although there are a handful of exceptions, most issuers in our sample population have solicited external reviews, principally in the form of second party opinions (SPOs), to evaluate their SLB frameworks. We expect the use of external reviews, both pre- and post-issuance, to remain commonplace as the market continues to blossom.[12]

Moody's ESG Solutions, through its affiliate V.E, has delivered second party opinions (SPOs) on SLB frameworks across a diverse array of sectors, with coverage including Albioma, Chanel, Enel S.p.A, Etihad Airways, Grupo Pikolin, Natura Cosméticos S.A., Nomura Research Institute, NRG Energy, PT Japfa, Rexel, Schneider Electric SE and Verallia. Our opinions assess whether the issuer's SLB framework aligns with the core components of the SLBP and industry best practices. They also consider the issuer's overall ESG performance, as well as potential involvement and management of stakeholder-related ESG controversies.

SLB Case Study – NRG Energy, Inc

Moody's ESG Solutions, through its affiliate V.E, has delivered second party opinions (SPOs) on SLB frameworks across a diverse array of sectors.

In November 2020, NRG Energy, Inc. debuted $900 million in senior secured notes, thereby becoming the first North American company (and first energy company outside of Europe) to issue a sustainability-linked bond. NRG's SLB framework incorporates a KPI related to the absolute reduction of GHG emissions covering Scope 1, 2 and 3 emissions (Scope 3 emissions are limited to employee business travel). The company is aiming to decrease absolute emissions 50% by 2025 versus a 2014 baseline, equivalent to 31.7 million metric tons carbon dioxide equivalent (MMtCO2e). In the event that the SPT is not met as of the reference date, a step-up margin or margin adjustment, as applicable, of 25bps will be triggered for the bond, bringing an increase in the interest rate applicable to interest periods following such reference date.

Our SPO was of the opinion that NRG's SLB framework aligns with both core components of the SLBP and identified best practices. The selected KPI reflects material ESG challenges for the sector, is measurable using a consistent methodology (using science-based targets) and is underpinned by externally verified historical performance data. Furthermore, we consider the SPT to be sufficiently advanced compared to industry standards and peers. Finally, the issuer has committed to annual reporting until the maturity of the bond.

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[12] As opposed to the pre-issuance external review such as a Second Party Opinion, which is recommended, post issuance verification is a necessary element of the SLBP.