BlueBay
Asset Management

Sustainability-linked bonds

A quick guide

The sustainable bond market is showing an accelerating pace of growth in response to the urgent need to fund global environmental and social sustainability challenges and as a result of growing investor demand.

Over the past two years, sustainability-linked bonds (SLBs) have emerged onto the market, joining social, green and sustainable bonds in the ESG-focused fixed income arena.

The first SLB issuance was made by an Italian energy distributer in 2019, with emerging markets quickly following suit, recording their first SLB in September 2020 in the pulp and paper sector. Outstanding SLB issuance exceeded USD10 billion in 2020 with all issuance coming from corporates. No sovereign bonds have been issued under the SLB framework to-date, but governments are exploring possible ways to use the structure.

What is a SLB?

SLBs have environmental, social and governance (ESG)-related key performance indicators (KPIs) embedded in their structure. If the issuer fails to meet the KPIs, it accrues additional payments to the bondholder – this is known as coupon 'step-up'. In other words, an issuer's financing costs increase if it fails to achieve the sustainability-linked performance objectives associated with the bond.

Step-up increments have typically been 25bps per annum, although we have seen issuers come to market with step-ups of 50bps and 75bps. Missing a KPI costs the company more to service the debt, creating a financial incentive to follow more sustainable ways of operating.

Unlike green or sustainable bonds, financing raised through SLBs is not tied to specific use of proceeds. It can be deployed as required by the issuer.

SLBs provide another way for debt markets to support companies looking to improve their sustainability and meet ESG objectives.

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Key performance indicators (KPIs) & sustainability performance targets (SPTs)

KPIs & SPTs are science-based indicators/targets an issuer must meet to maintain the base level of coupon payment. They help to provide credibility, transparency and accountability around an issuer's intention to improve its ESG credentials.

KPIs should be:

- **relevant and material to the issuer's overall business**
- **measurable on a consistent basis**
- **externally verifiable**
- **able to be benchmarked.**

SPTs (KPI target levels) should be:

- **ambitious in terms of materiality of improvement**
- **benchmarked to the issuer's historical performance as well as its peers**
- **anchored in a clear timeline.**

Issuers can base their KPIs/SPTs on the objectives set out in international agreements, such as the Paris Agreement or the 2030 Agenda on Sustainable Development, or construct their own based on clear calculation methodologies.

How are SLBs different to green, social & sustainable bonds?

Green, social and sustainable bonds are linked to a particular project, with the use of proceeds clearly defined in relation to this project. SLBs are issued for general corporate fundraising with no restrictions on the use of proceeds (which can include non-green projects), but they do incorporate forward-looking sustainability objectives.

Not meeting a SLB's KPIs results in a financial penalty; green, social and sustainable bonds carry no penalties but have much stricter use of proceeds.

SLBs: An example

Company XYZ states it will deliver a 20% reduction in its CO2 emissions intensity versus its 2019 emission level by December 2024. It issues a 7-year SLB with a coupon of 2%. The step-up on the bond coupon is set at 25bps, which will be payable with the first interest payment after December 2024 in the case the company fails to reach its sustainability-performance target (SPT) by then. It can use the proceeds of the issuance however it wishes. Proceeds do not have to be used to fund meeting the SPT.

SLBs give a good overview of an issuer's long-term ESG objectives and suggest it is looking to improve its ESG footprint. They can act as a transition step between standard corporate bonds and green/ social bond issuance.

Responsible investing bond universe

Use-of-proceeds bonds	Performance-based bonds
Green bonds – Earmarked to raise money for environmental/'green' projects	**Sustainability-linked bonds** – Linked to the performance of a certain key performance indicator (linked to sustainability), if not achieved, certain characteristics of the bond will vary
Social bonds – Earmarked to finance projects with an identified social objective	
Sustainable bonds – Earmarked to finance both green and social projects	

Why would you choose one over the other?

SLBs are not always suitable for dedicated ESG-focused investment mandates because the use of proceeds is not restricted to green/social projects. They do however give a good overview of an issuer's long-term ESG objectives and suggest it is looking to improve its ESG footprint. SLBs can act as a transition step between standard corporate bonds and green/social bond issuance.

Their less rigid use-of-proceeds structure means SLBs can potentially be more flexible and dynamic than green and social bonds, allowing issuers to set relevant KPI targets over a realistic timescale. They allow more issuers the opportunity to finance a transition towards more sustainable practices by accessing a wider pool of ESG-aware investors.

Do they suit some industry sectors more than others?

We've seen SLBs coming out of resource-intensive industries, suggesting these types of companies are looking to signal their intentions towards ESG initiatives. However, SLBs are such a new structure that there isn't a clear bias towards any one particular type of issuer at present. While all of the SLB bonds issued so far have been corporate bonds, sovereign issuers are actively reviewing this instrument for future financing potential.

Do SLBs require a different investor mindset compared to traditional credit?

While there is a natural synergy between issuers looking to clean up their business practices and investors needing to improve the ESG credentials of their portfolios, SLBs offer no credit enhancement over a traditional corporate bond, so the investment process remains unaltered. You have to be comfortable with the issuer, the credit and the repayment prospects – if not, it doesn't matter if you're buying green, sustainability-linked or plain vanilla bonds, you shouldn't invest. Solid fundamentals and rigorous analysis should remain at the core of the investment process.

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