

# Where's Your Ambition?

*As ESG-linked bonds rise in popularity, are issuers being ambitious enough with their use of proceeds?*

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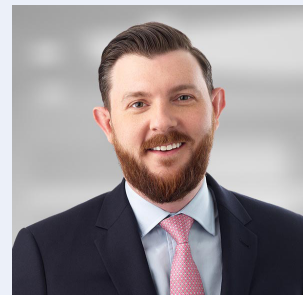
**We have seen sustainable finance grow from a nascent market to a fully-fledged part of many issuers' capital structures, and the trend is expected to continue.**

## The Growing Opportunity in ESG-Linked Bonds

One of the most important developments in global credit markets has been the exponential growth of ESG-linked instruments that have been issued across many sectors and from companies at different stages of their ESG development. We have seen sustainable finance grow from a nascent market to a fully-fledged part of many issuers' capital structures, and the trend is expected to continue.

The reasoning is clear; through these instruments, companies can:

- fund projects that align with the interests of their stakeholders (capital providers, customers and communities);
- often gain a funding advantage as many ESG-linked bonds carry a lower cost versus the conventional bonds of the same issuer;
- take advantage of the growth in demand from investors as ESG-linked strategies proliferate



**Aaron Young**

*Associate Portfolio  
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Author and Editor of this  
publication

## Defining ESG-Linked Instruments

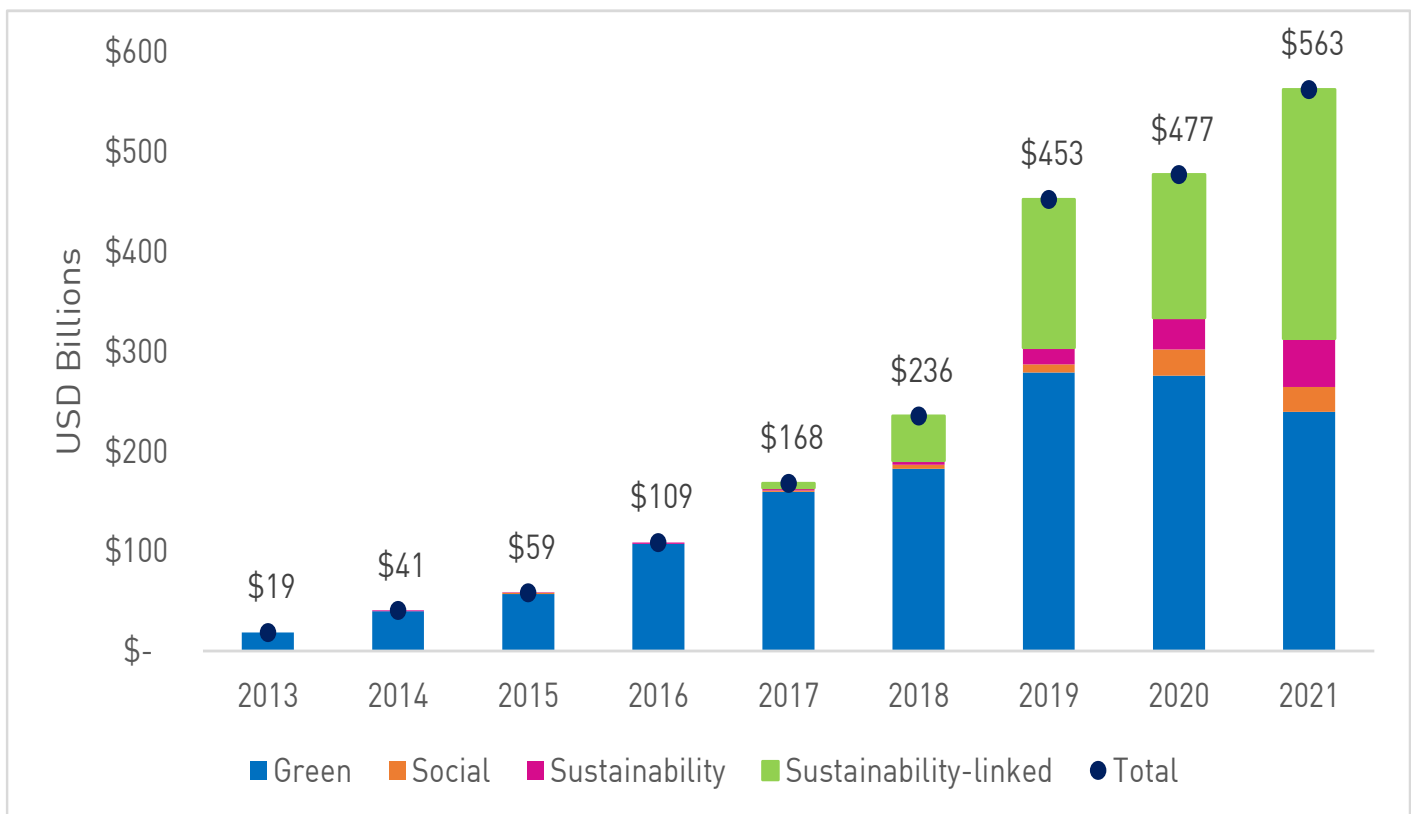
**Green Bonds:** Use of proceeds are dedicated to financing new and existing projects with environmental benefits. Examples include the financing of renewable energy projects (wind & solar) or the construction of energy-efficient buildings.

**Social Bonds:** Use of proceeds are dedicated to financing new and existing projects with positive social outcomes. Examples include the financing of affordable housing or lending for minority-owned businesses.

**Sustainable Bonds:** Use of proceeds is a combination of both Green and Social projects as defined above.

**Sustainability Linked Bonds:** Use of proceeds from these bonds can be used for any corporate purpose. However, the interest cost of these bonds is tied to environmental, social and/or governance targets that must be achieved or the issuer will face an increase in their funding cost.

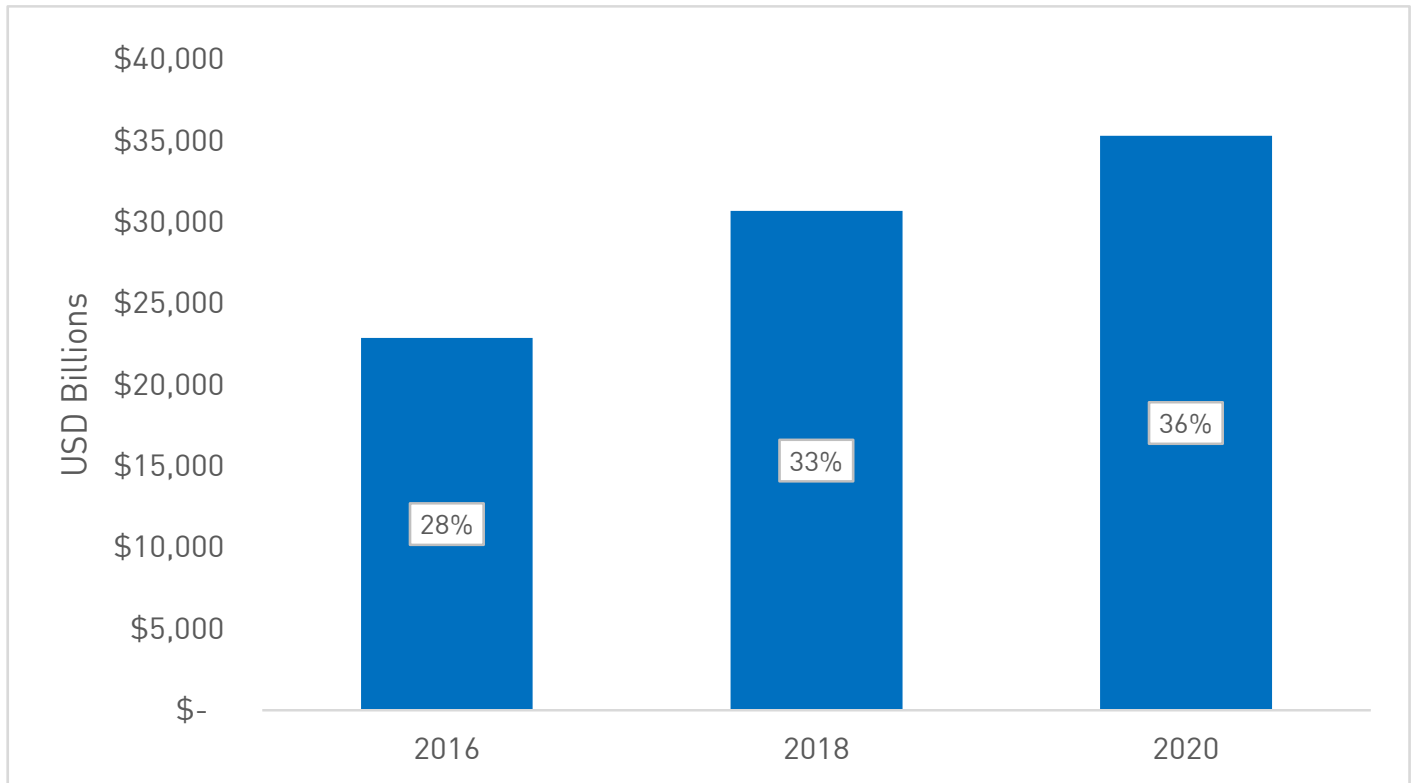
## Exponential Growth in ESG-Linked Borrowing Driven by Demand from Investors



Not only has the size of the ESG-linked bond market grown exponentially since 2013, but the composition has changed dramatically with once dominant Green Bonds now sharing the stage with other ESG-linked instruments.

Global issuance expressed in USD. Source: Bloomberg

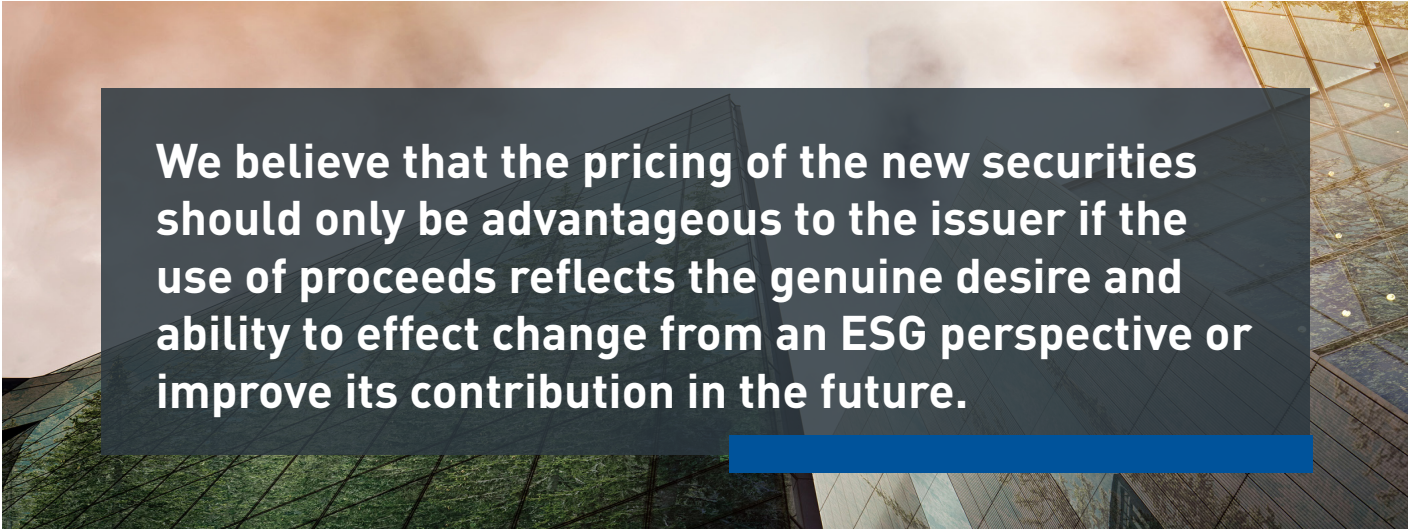
## % of Total AUM Linked to ESG Consideration



A larger amount of investment funds are now integrating ESG factors into their investment decisions. Nearly 40% of 2020 assets under management are now linked to some form of ESG consideration.

**Based on all asset classes across global asset managers surveyed (expressed in USD Billions). Source: Global Sustainable Investment Review**





**We believe that the pricing of the new securities should only be advantageous to the issuer if the use of proceeds reflects the genuine desire and ability to effect change from an ESG perspective or improve its contribution in the future.**

## The Fine Line Between ESG-linked Bonds and Greenwashing

In theory, these bonds should create clear alignments between the ESG outcomes we target for our investors and the issuer's operations. However, as part of our ongoing ESG analysis, we try to ensure that the companies we may invest in are not engaging in increased "greenwashing" through these ESG-linked instruments. We define greenwashing as a generalized term for companies that claim to be furthering green and social causes but are simply trying to achieve lower borrowing costs or appear environmentally or socially conscious. Importantly, we believe that the pricing of the new securities should only be advantageous to the issuer if the use of proceeds reflects the genuine desire and ability to effect change from an ESG perspective or improve its contribution in the future.

We are committed to finding a reliable way to avoid investments in "greenwashing" and aim to ensure that our analysis includes an in-depth understanding of the level of ambition driving a management team's motivation to issue these instruments. We define ambition as the level to which the ESG-bond is financing the environme-

ntal, social, or governance impact. In other words, does the company intend to effect change through this new financing, or are the proceeds from the bond issuance being used for "business as usual" or previously financed activities?

***We define ambition as the level to which the ESG-bond is financing incremental or future environmental, social, or governance impact. In other words, does the company intend to effect change through this new financing, or are the proceeds from the bond issuance being used for "business as usual" or previously financed activities?***

Of course, we would prefer to see a company use this issuance to effect change or set more ambitious targets for improving its ESG profile. However, we are also looking to identify companies that are simply seeking a lower cost of debt without meaningfully impacting change in operations. If the latter is indeed the case, then

we believe that the company's borrowing rate should be "business as usual" as well. Simply labelling a bond as Green, Social, or Sustainable by meeting minimum requirements on activities already undertaken by the company is not enough to ensure a funding advantage for the issuer in our view. We would advocate for additional targets for new activity when the issuer subsequently accesses the bond market.

We have also raised concerns to companies about their Green, Social, and Sustainable bond reporting. These issuers meet the minimum (current) guidelines which only require them to report on the use of proceeds one year after issuance if the proceeds are fully allocated. This means that low-ambition issuers who allocate all proceeds to refinance existing projects will only be required to disclose the actual ESG impact in a single reporting period. As a result, there are no disclosures in any subsequent periods, even if the bond is a longer-duration instrument. This structure is concerning and does not align with market convention in more established asset classes of the credit market. For example, in the asset-backed security market, issuers must report on the allocation of proceeds on a regular and reoccurring basis. We believe that it is incumbent on the management of each company to go beyond meeting minimum guidelines and consider what would be the best practice and in the best interest of stakeholders over the short and long term.



**Our Credit Research Portfolio Managers highlight some specific examples below of recently issued bonds where we have questioned the issuer's level of ambition.**

## Case Studies



### Financials

#### Louise Pitt Brindle

*Principal, Head of Credit Research*

In July, a European-based banking group issued a Social bond with proceeds intended to be allocated for financing or refinancing small-and-medium-sized enterprise loans that will help ease the impact of COVID-19 with guarantees by public sector entities. More than £8.7bn of loans were distributed all over the country to companies with less than 250 employees, turnover of less than £50mn, and total assets of less than £43mn. The loans could not be extended to businesses with activities that were defined as controversial or that have a negative environmental and/or social impact, such as tobacco, arms/weapons, alcohol, gambling and betting activities, carbon and gas industries, or plastics industries. While we understand the purpose of the financing to help small-and-medium sized

businesses and supported the strict criteria determining who received such loans, the company confirmed that it had already selected a portfolio of ~£960mn loans that they originated between April 2020 and April 2021. Hence, this social bond funding was not intended for new loans, resulting in zero incremental impact in our opinion.

***We would have liked to see the company commit to additional financing of ESG-related loans or at least split the proceeds between existing and future assets.***



We acknowledge the excellent focus on ESG factors at the issuer and will follow other initiatives that the company is planning to advance its ESG footprint in the future. However, we would have liked to see the company commit to additional financing of ESG-related loans or at least split the proceeds between existing and future assets.





## Energy: Positive Issuance via Sustainability Linked Bonds

**Ryan Vaughn**

*Portfolio Manager*

Energy and Utilities are sectors that stand to benefit the most from ESG-linked bond issuance as they face the highest transition risks. Energy and Utility-related ESG financing has, thus far, been limited to participants in the broad renewable energy and power generation space and midstream companies whose businesses are better-positioned to reduce emissions. A survey of Green and Sustainable bond issuance in these sectors shows that nearly half of the bonds have been issued by Renewable Energy Generation issuers, including companies that already derive most of their revenues from “green” projects. Oil & Gas and Fossil Fuel Power Generation sectors, where Green bond issuance could have the highest impact, represent only 12% of these bond issuances.

Nevertheless, one area where we see issuers aligning their financing with longer-term environmental and social goals is through Sustainability Linked Bonds (SLBs). We are encouraged by this trend, although the devil remains in the details. Issuance from the Energy sector includes a North American midstream company leading the way with a 12-year SLB in June, with two performance targets. The bond’s coupon is set to increase 50bp if the company fails to reduce Scope 1 and 2 emissions intensity by the end of 2030 and increase 50bp if less than 28% of the company’s employees are ethnic or racial minorities.

*One area where we see issuers aligning their financing with longer-term environmental and social goals is through Sustainability Linked Bonds (SLBs).*



These targets are modest in ambition, given the company’s current progress on both measures, but can provide an incentive for the company to continue improving in these areas. We expect this deal to have set a baseline for peers who issue in this market moving forward and hope that the targets increase in scope in successive deals if pricing also remains an advantage for the company.





## Materials

### Colin Du

*Associate Portfolio  
Manager*

Despite being supportive of the SLB asset class, we saw a high yield company in the Materials sector issue two SLBs which were less favourable to investors in our view. Both bonds had eight-year terms to maturity, totaled ~\$800mn in size, and carried a 12.5bp increase in coupon if greenhouse gas reduction and/or recycled metal targets were not met.

However, the timing of the coupon increases and the expected life of the bonds did not align. This is because both bonds can be redeemed by the issuer anytime between 2024 and 2026 – up to the exact year that the funding cost of the bonds could increase if targets are missed. In other words, the penalty for missing the targets is set so far into the future that we believe the bonds are likely to be refinanced before the company is assessed on its environmental goals. This structure allows the company to avoid the coupon increase through redemption instead of meeting their environmental targets.

***One of the key tests for “business as usual” greenwashing is to conceive of projects or activities that would not qualify for the Social bond use of proceeds.***



## Health Care

### Arnav Gupta

*Associate Portfolio  
Manager*

In mid-July, a Health Care company issued its inaugural Social bond, the proceeds of which would be allocated to finance “access to essential health care services.” The company was not a typical Health Care issuer, managing a portfolio of biopharmaceutical royalty streams that they receive for financing new and existing therapies. The company focuses on therapies for rare diseases, cancer, and neurological disorders.

The issuer’s Social bond framework raised several red flags when we conducted our due diligence. First, we believe there was a lack of ambition as financing drug therapies in exchange for royalties was the company’s core business model. Since the proceeds were going toward activities that the issuer would have undertaken anyway, the Social bond was funding “business as usual” rather than incremental contributions to health care accessibility. One of the key tests for “business as usual” greenwashing is to conceive of projects or activities that would not qualify for the Social bond use of proceeds. For this issuer, a strong case could be made that all of the company’s future bonds could qualify as Social, which is often a warning sign that the use of proceeds may not provide any incremental change.

Second, the measurements being used to classify projects under the Social framework were unclear and not sufficiently well-defined in our view. Finally, the subsequent impact reporting was primarily qualitative, with quantitative metrics only available on a best-efforts basis. The lack of quantifiable impact metrics also concerned us on a forward-looking basis.





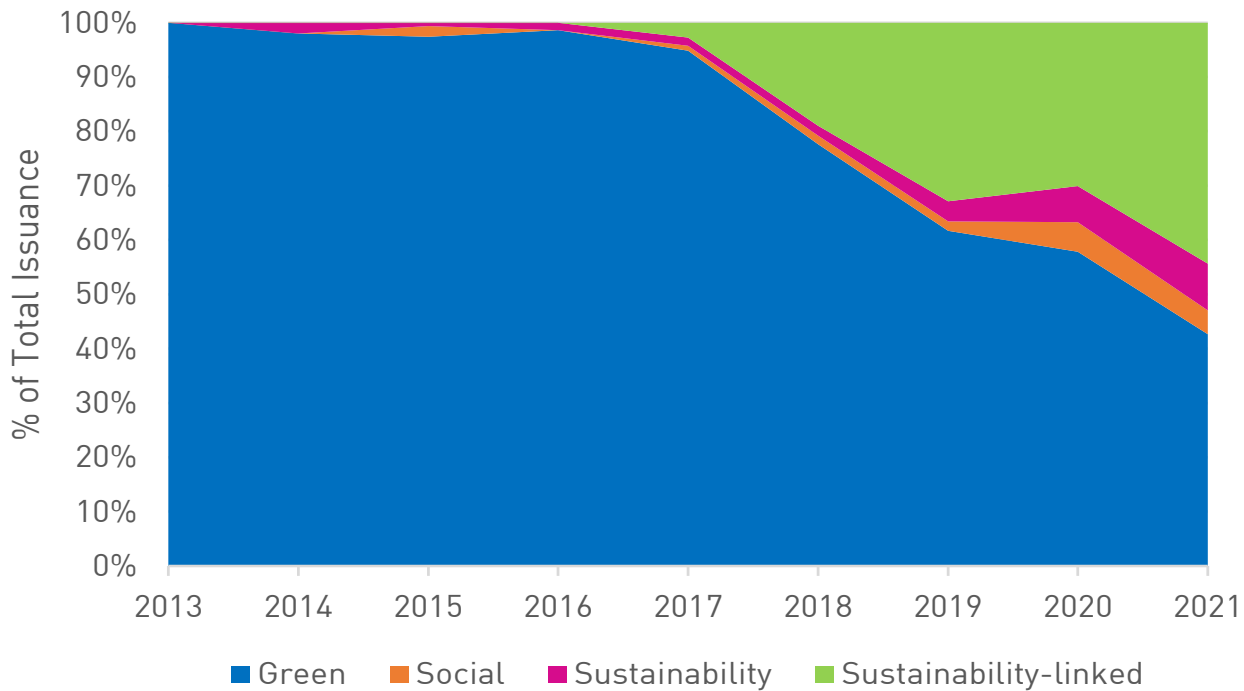
**The growth in the SLB market reflects our views, with an increase from \$5bn USD of issuance in 2017 to nearly \$250bn USD of issuance year to date in 2021 and representing 44% of all ESG-linked issuance.**

## Finding Ambition at the Heart of SLBs

We often find SLBs provide the best exposure to more ambitious ESG targets. We recognize that the use of the proceeds is not limited to eligible Green or Social projects, introducing a level of ambiguity that some ESG-focused investors may not be comfortable with. However, the structure of SLBs, which tie funding costs to hitting specific improvements in Environmental, Social, or Governance factors, gets to the core of our definition of ambition. SLBs can incentivize issuers to enact incremental change in their operations. The growth in the SLB market reflects our views, with an increase from \$5bn USD of issuance in 2017 to nearly \$250bn USD of issuance year to date in 2021 and representing 44% of all ESG-linked issuance. This focus on change also makes the ESG-linked bond space more inclusive as issuers can access capital that recognizes their commitment to positive future impact rather than continuing with business as usual.

*We often find SLBs provide the best exposure to more ambitious ESG targets.*





While the ESG-linked market has diversified away from just Green Bonds, we see trends in Sustainability Linked Bond issuance continuing as it entices a wider universe of issuers, and ties funding costs directly to ambition.

#### Global Issuance expressed in USD and converted to %. Source: Bloomberg

As with other ESG-linked bonds, we remain vigilant for the materiality of an SLB's key performance indicators and attempts by management to put in place easy-to-reach targets. To this end, we have actively engaged with Canadian issuers to help bring their first SLBs to market, utilizing our experience in US and European issuance and promoting the highest feasible levels of ambition and materiality for these issues. By participating, we try to ensure that our pricing suggestions reflect the relative level of ambition we believe the issuers are setting.

As the ESG-linked bond space grows, our investment team stays updated and attentive so that we are not making investment decisions based on market labels. Instead, we continue to focus on ambition as the key pillar for defining "true" ESG-linked instruments and will aim to ensure that the pricing of these securities is assessed accordingly.

*The structure of SLBs, which tie funding costs to hitting specific improvements in Environmental, Social, or Governance factors, gets to the core of our definition of ambition.*



[Learn more about our views on sustainability](#)

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