20 April 2022 | Rothschild & Co Asset Management Europe

When bonds meet transition

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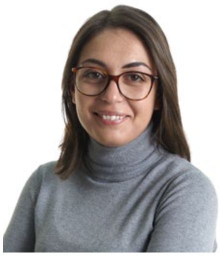

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Green Bonds, Social Bonds, Sustainability Bonds and Sustainability-Linked Bonds... the universe of bonds meant to support the transition just keeps expanding. Nicolas Racaud and Andrea Sekularac discuss the main developments occurring in the market.

How has the sustainable bond universe changed in recent years?

Globally, the market passed the 2,200 billion dollars mark in 2021, or 87% higher than in the previous year[(1)]. Green Bonds continue to dominate, at 58%1 of the total. This asset class is dedicated exclusively to funding green projects and must come under a benchmark framework (ICMA, CBI, etc.)[(2)]. The amounts raised must be used to shift issuers' business model towards greater environmental sustainability and contribute to the energy and environmental transition. Green bonds serve projects offering a clear environmental benefit, which the issuer assesses and quantifies annually.

The second segment, Social Bonds, are based on the same logic, but while serving socio-economic projects. Social Bonds developed mostly in 2020 and currently make up almost 18% of the total pool1. The third segment, Sustainability Bonds, are hybrids, half-way between Green and Social Bonds, and are issued with the goal of funding both socio-economic and environmental projects. Sustainability Bonds have been more active since 2020 and now account for about 19% of the market[(1)]. These three types of bonds are classified in the "use of proceeds" family of instruments, which states that the proceeds of the issue are used for clearly identified projects.

The latest category to emerge is Sustainability-Linked Bonds (SLBs). Despite emerging only very recently (in 2019), SLBs had a banner year in 2021, with a significant increase in issuance and marked interest from investors. SLBs accounted for about 12% of issuance of corporate bonds with a sustainable purpose in 2021[(1)]. However, their unique characteristics keep them from being included in the "use of proceeds" category, as the issuer does not commit itself to projects, but rather to a KPI[(3)] that it has defined itself.

The nature of this indicator is variable, but the standard that is tending to take hold is Scope 1 and 2[(4)] CO_2 intensity. If the issuer fails to achieve its quantitative objective within the timetable set upon issuance, it is charged a pre-determined "malus", which is most often an upward revision of the coupon. This "penalty" may take various forms but, generally speaking, the conversion of an environmental or social aim into financial compensation does not strike us as very satisfactory, especially if it turns out to be negligeable for the issuer.

(1) Source: Bloomberg, Rothschild & Co Asset Management Europe, April 2022.
(2) Climate Bonds Initiative and International Capital Market Association. These are two non-profit organisations of finance professionals who have determined a strict framework to define Green Bonds.
(3) KPI: key performance indicator
(4) Scope 1 emissions correspond to direct carbon emissions from fixed or mobile installations located within the organizational perimeter. Scope 2 emissions relate to indirect carbon emissions from energy consumption.

What sort of momentum is the market showing?

The market is growing exponentially. In 2021, more than one quarter of euro-denominated corporate bonds were sustainable bonds[(5)], and Green Bonds already account for almost 5% of the market[(6)]. Bond indices now include a significant portion of them (almost 8% in the case of the IHS Markit iBoxx EUR as of the end of 2021[(6)]). Growth has been breath-taking in just a few years. To cite one example, in 2020, the year we launched our R-co 4Change Green Bonds fund, its benchmark consisted of about 200 bonds from just over 100 issuers The same index now holds almost 500 bonds from 267 issuers[(6)].

Sovereign issues still account for the majority, and the trend is likely to continue accelerating, due to post-Covid-19 governmental and supranational programmes. However, we are concerned mainly with corporate bonds and keep an eye on the penetration rate in the various sectors. Historically focused on banks and utilities in particular, the Green Bond market has been diversifying considerably by sector over the past several years. Listed real-estate, for example, was the second-largest issuing sector last year, behind banks, but ahead of utilities. The market is mature, and most sectors will remain active, although the pace of growth could end up being highly erratic.

We also expect most green issuance to be in those sectors most heavily exposed to the challenges in transitioning and transforming their activities. This was the case in 2021, and it drove the attractiveness and competitiveness of the SLB market. Market participants who are underrepresented or not represented at all on the “use of proceeds” instruments market are beginning to gradually move into this asset class. In 2022, these same transition sectors could opt more for strategies of combining green issues and SLBs in order help them meet their Net Zero objective[(7)].

Green Bonds are nonetheless likely to be the main market segment, in terms of issuance and amounts of projects funded, although Social Bonds last year achieved the strongest growth in “use of proceed” category (+107%[(5)]) and although, as in 2021, we expect a big increase in Sustainability-Linked Bond issuance in 2022.

What trends are taking shape?

The projects that are the most represented in Green Bonds fund renewable energies, green buildings, and mobility. The segment therefore has a sector bias that the emergence of Sustainability-Linked Bonds could erase partially by diversifying issuer profiles. This asset class is an attractive path when the objectives set through the KPI used are ambitious enough and combined with components that can be realistically achieved.

It is fair to ask about the very nature of these bonds, which appear to be less binding than “use of proceeds” instruments. The issuer does expose itself to both reputational and financial risk and could be denied access to the market if failed to meet its commitments, especially with investors who have themselves set sustainable objectives. Elsewhere, a new standard looks close to emerging, so-called Transition Bonds, which are “use of proceeds” bonds dedicated to the energy transition, including the Net Zero objective.

How have the prices of these assets changed?

As the sustainable bond pool has developed, it has gradually been assigned a negative spread[(8)] vs. traditional bonds, called “Greenium”, which works like an ordinary risk premium. A Green, Social or Sustainability Bond offers a better ESG profile and provides a guarantee, as well as additional transparency, which is paid for in the form of a yield slightly lower than the one of a comparable “traditional” bonds. This differential may also be due to a supply/demand imbalance. Although the number and size of issues are considerable, investor appetite is even greater, and regulations are pushing in this direction.

This mismatch has had the effect of pushing prices up. The difference nonetheless amounts to just a few basis points and is not uniform between the various segments. It currently averages 4 basis points, but 6 basis points for green bonds, the most mature market[(6)]. Moreover, investors feel that the “use of proceeds” issue category offers greater guarantees than SLB KPIs, as those KPIs are impacted to a lesser extent.

Should this market be regarded as expensive?

The “Greenium” may indeed suggest that the market is expensive, particularly compared to “traditional” bonds, as, in theory, there is indeed no difference with a traditional bond. Risk remains attached to the issuer, and the nature of the project and the KPI selected does not affect this parameter at all. That being said, the valuation gap does not look overdone and is still limited. It is justified by its greater sustainability value, enhanced project visibility and the underlying impact to which the market is now able to price. Despite the widespread adoption of sustainable investments and SRI products, few strategies or assets offer such a level of transparency.

(5) Source: Natixis, January 2022.
(6) Source: Bloomberg, Rothschild & Co Asset Management Europe, April 2022.
(7) "Net Zero" is a goal derived from the Paris Agreements that induces the decrease of anthropogenic greenhouse gas emissions in order to approach a theoretical zero.
(8) The spread is the difference in yield between a bond and a loan of equivalent maturity considered "risk-free".

The above information does not constitute investment advice or a recommendation to invest.

Meanwhile, the market's development has been promoted strongly by economic stimulus programmes but, above all, by regulations. With this in mind, the introduction of the European Taxonomy should make the asset class even more attractive. Valuations will therefore continue to be driven by investors' appetite and sustainability requirements. Demand is therefore not about to fade, as the nature of these bonds seems to be meeting both their requirements and environmental and social challenges.

What expertise have you developed in this asset class?

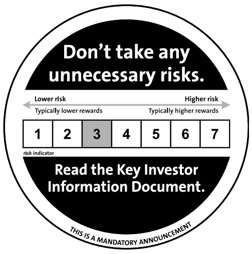
We have invested in this asset class since 2019 with the launch of our 4Change range and, more precisely, since 2020 in Green Bonds, the date on which we launched R-co 4Change Green Bonds, an impact fund, categorised as SFDR Article 9 and been awarded the Towards Sustainability label. Specialising in Green Bonds, it offers exposure to environmental projects aligned with the European taxonomy. Its portfolio, consisting exclusively of "use of proceeds" bonds complying with ICMA principles, makes it possible to monitor projects by type and SDG[9], by environmental thematic strategies, and through an estimate of its consolidated impact based on the four indicators of environmental performance (tonnes of CO_2 emissions avoided, renewable energy production capacity installed, quantity of renewable energy produced and number of green m^2 funded). This strategy innovates in investing in international companies offering both sectoral and geographical diversity, combined with a crossover approach for identifying investment opportunities in various bond profiles in terms of maturity, rating, etc.

We have also developed expertise in the "Net Zero" theme through our R-co 4Change Net Zero Credit Euro fund. This SRI-labelled[10] investment strategy aims to reduce the portfolio's CO_2 intensity between 5% and 7% on annual average. This steering of CO_2 intensity requires investing in a few strategic sectors within which we must be particularly selective. To do so, we select issuers who make a firm commitment to reduce their greenhouse gas emissions. SLBs' CO_2 intensity KPI is especially relevant in this framework by offering us visibility on objectives and the trajectory that companies have embarked upon.

Based on our expertise, we therefore chose the pool that is most consistent with our sustainable ambitions. Moreover, in this context that is especially favourable to sustainable bonds, all of our "traditional" credit strategies incorporate a growing portion of them within their portfolios. This is consistent with the market's current structure and with our commitment in favour of the climate transition.

(9) United Nations Sustainable Development Goals.
(10) SRI label from the French Government.

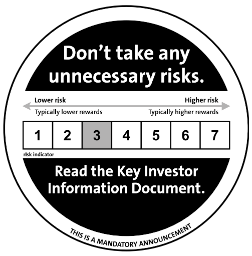
R-co 4Change Green Bonds



Recommended investment period: 3 years

The risk level of this sub-fund is 3 (volatility between 2% and 5%) and mainly reflects its positioning on private debt products denominated in international currencies while having a sensitivity between 0 and +8. The historical data used to calculate this synthetic indicator may not be a reliable indication of the sub-fund's future risk profile. The risk category associated with the sub-fund is not guaranteed and may change over time, either upwards or downwards. The lowest risk category does not mean that it is risk-free. The sub-fund's capital is not guaranteed. Other important risk factors not adequately taken into account by the indicator: credit risk, liquidity risk, impact of techniques such as derivatives. The occurrence of any of these risks may result in a decrease in the net asset value of the sub-fund. For more information on the risk profile and its main contributors, please refer to the prospectus.

R-co 4Change Net Zero Credit Euro



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