Europe's ESG-linked corporate debt booms Regulation, investor demand broadens, deepens issuance pool, drives innovation

Europe's utilities have issued more green-or social-labelled than ordinary bonds so far this year amid a rush by European corporate treasurers to meet demand for sustainability-linked debt, with year-to-date volume ahead of all of 2020's.

We expect the surge to continue. As a proportion of the whole bond market, issues tied to environmental, social and governance (ESG) factors make up only around 18% of volumes in the year to date, more than double the 8% of all non-financial corporate bond issuance in 2020 with a green, social and sustainability label. By the end of 2021, the share of ESG-linked bonds should easily exceed 25% of the total which would imply a steep increase of the share of ESG-linked bonds in H2 2021 to about 30% of the total.

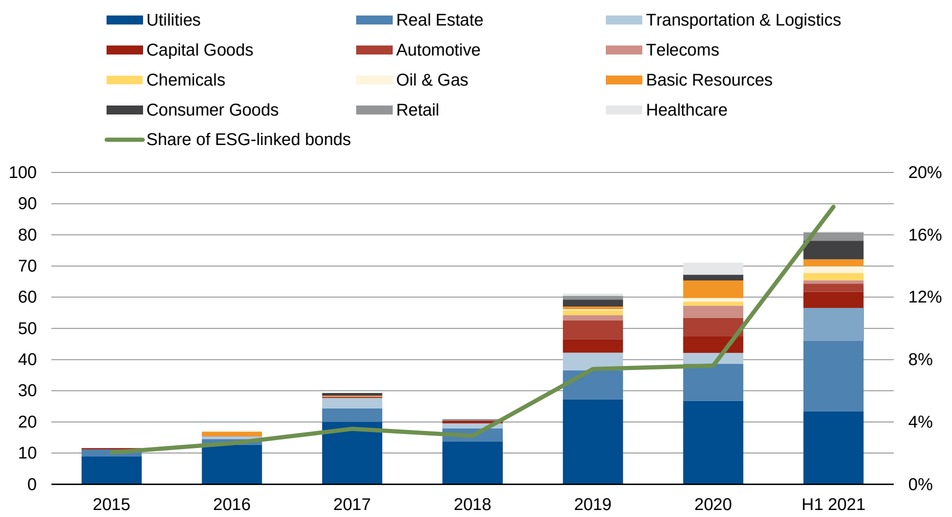
The market is a long way from being saturated. The rapid growth in ESG-linked bonds[1] reflects the powerful combination of the political, regulatory and investor pressure to put sustainability at the top of Europe's economic and financial agenda.

Less clear is the relationship between ESG-linked bond issuance and credit quality. We are sceptical that such fund raising can or should be done at a premium near term. Longer term, we do see sustainability-linked funding underpinning corporate credit quality, but this finally depends on many parameters such as the potential risks that can be avoided or mitigated, the economics of completed projects and measures that aim at a better ESG footprint including the costs associated with efforts to achieve sustainability development goals or specific KPIs.

The tougher regulatory environment associated with Europe's "Green Deal" has coincided with the Covid-19 pandemic, giving new impetus to sustainability in economic policy making. Many environmental projects may benefit from the EUR 750bn Next Generation EU post-pandemic recovery plan, with a quarter of funds earmarked for climate-change mitigation and a "green recovery". The new EU Taxonomy and the associated EU Green Bond Standard (GBS), plus the potential definition of standards for bonds linked to the UN's sustainable development goals (SDG), will all help define what constitutes sustainable business activity.

Figure 1: Europe's ESG-linked bond landscape becomes more colourful

More European companies in more sectors are issuing more debt with a sustainability label (lhs, EUR bn), making up more of overall issuance (rhs, %)



Source: Bloomberg, Scope

[1] Green, social, sustainability-linked bonds; bonds linked to UN sustainable development goals (SDG) and other ESG-related key performance indicators (KPIs).

Analysts

Sebastian Zank, CFA
s.zank@scoperatings.com

Marlen Shokhitbayev, CFA
m.shokhitbayev@scoperatings.com

Eugenio Piliego, CFA
e.piliego@scoperatings.com

Klaus Kobold
k.kobold@scoperatings.com

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Scope Ratings GmbH

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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Tougher EU ESG disclosure requirements come into force

Another factor is the European Commission's proposed Corporate Sustainability Reporting Directive. The CSRD, in updating and expanding the Non-Financial Reporting Directive, will require greater ESG disclosure from 49,000 listed and large unlisted companies responsible for 75% of the revenue of all EU limited-liability companies.

Low interest rates also a driver of labelled bond issuance

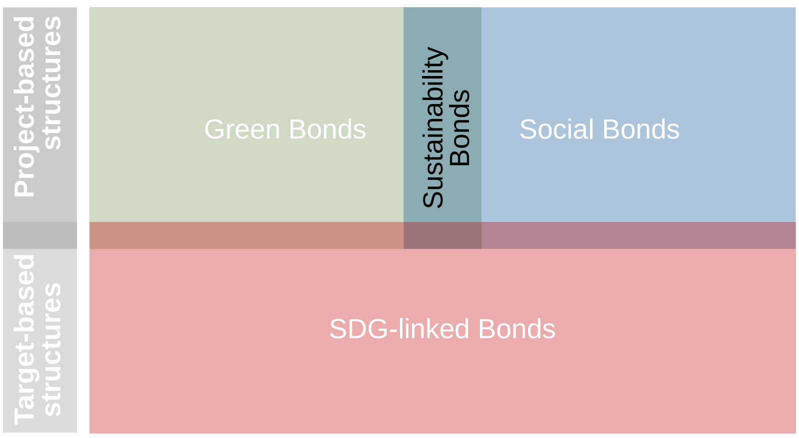
The broader economic context is also important: low interest rates, investors' search for yield and the multibillion-cost of the transition to a more sustainable economy – focused initially on the energy sector but spreading to real estate, transport and other sectors – all in the middle of a global pandemic.

An ESG-linked bonds overview: distinctions in increasingly complex debt segment are blurring

Since the creation of green bonds, many other labels for debt have now emerged, including social bonds, sustainability bonds, and, since 2019, bonds linked to the UN's Sustainable Development Goals (SDG) or individual sustainability development targets. Until recently, such bonds have fallen into two categories. Project-based bond instruments are issued within a framework, committing funds to specific projects and require an impact report. Target-based bonds include predefined key performance indicators which, if not met, alter the costs for the issuer. Such KPI-linked bonds provide an incentive to the issuing company to achieve higher ESG standards across the business rather than just for a specific project.

The overlap between the different funding instruments is increasing (Figure 2). While still rare, some bonds include a combination of different features, most recently with a blending of project and target-based structures as in the case of Austrian utility Verbund AG. This is also happening in other debt segments. In Europe's leading private debt market, Mann+Hummel has issued Schuldschein which blends features of a green and SDG-linked instrument. Abu Dhabi-based Etihad Airways has issued a sukuk transition deal which had a similar blend. We expect differences between ESG-different structures to become more blurred in the future.

Figure 2: Rising complexity among ESG-linked bond instruments with growing overlap between them



Main features

- Subject to bond framework
- Bond proceeds dedicated to specific projects
- Impact report

- No requirements for use of proceeds
- Issuer committed to meet SDGs/KPIs/ESG ratings
- No framework mandatory
- Penalties and/or incentives applied when certain goals are met/not met

Source: Scope illustration

Volumes led by capital-intensive sectors, closely tied to energy transition

Energy transition puts funding pressure on utilities

Capital-intensive companies whose activities are most directly concerned by the transition to a more energy-efficient, low-emission economy remain the leading issuers of ESG-linked bonds in Europe.

Utilities unsurprisingly still have the greatest opportunities and incentives to issue green and other ESG-linked debt related to their leading role in the energy transition at various levels: from greening generation portfolios to enabling grids to handle increasingly decentralised power generation and investing in innovative technologies. As such, ESG-linked bonds - whether project- or target-based - are already the norm rather than the exception. Around 54% of all bonds issued by utilities had an environmental or social label, up from 32% last year, making up most of the top-25 issuers of ESG-linked bonds.

Figure 3: Europe's utilities make up most of top-25 biggest European* ESG-linked bond issuers, followed by real estate, transport

* Only companies headquartered in Europe, disregarding non-European firms which used European subsidiaries to issue a sizeable amount of ESG-linked bonds

Source: Scope Ratings

TenneT relies fully on ESG-linked bonds for funding

Indeed, grid operator TenneT BV is one utility that is funding itself entirely with ESG-linked bonds. The Netherlands-based utility is the European sector's fourth biggest issuer of ESG-linked debt so far to date, raising EUR 11.25bn, just behind Italy's Enel with EUR 12.5bn, France's Engie SE with EUR 12bn and Spain's Iberdrola (EUR 11.4bn).

Sustainability-linked bonds may attract heavy future issuance

However, issuance trends show that corporate treasurers across a wide and growing range of other industrial sectors are responding to the sustainable-financing challenge. The emergence of sustainability-linked bonds tied to sustainability targets and KPIs has opened up ESG-linked funding to many more issuers than just those usually capital-intensive companies with sufficient eligible projects to finance to help enhance their overall ESG footprint. Target- and KPI-based bonds offer a much greater degree of flexibility in terms of helping a company finance a wide range of activities related to improving the sustainability of its business. Furthermore, we see that the potential for innovation is immense for sustainability-labelled bonds (SLBs), looking at the wide spectrum of potential ESG-related goals they might address, and the potential penalties for any failure to achieve the goals.

Strong momentum for ESG-linked debt across multiple sectors

Companies in the real estate, consumer goods and retail, chemicals and basic resources, and transportation have sharply increased the proportion of ESG-linked debt they have issued, accounting a double-digit percentage of all debt issued so far this year, again a much higher proportion than in recent years. We believe that many more corporates are waiting in the wings to issue such debt, preferring to see the market to mature more, such as French telecoms operator France's Orange SA, or are first testing the waters with target-based loans, such as German chemicals firm Altana AG.

Figure 4: Shades of green: ESG-linked deals make up growing proportion of non-financial corporate debt issuance across sectors in Europe

	2015	2016	2017	2018	2019	2020	H1 2021
Utilities	14%	22%	21%	19%	37%	32%	54%
Real Estate	6%	5%	6%	7%	11%	18%	37%
Transportation & Logistics	0%	3%	7%	4%	12%	6%	30%
Chemicals	0%	0%	0%	0%	5%	4%	22%
Basic Resources	0%	9%	1%	0%	2%	20%	16%
Consumer Goods	0%	0%	1%	0%	5%	3%	13%
Capital Goods	1%	0%	0%	1%	5%	5%	10%
Retail	0%	0%	0%	2%	6%	1%	10%
Automotive	0%	0%	0%	0%	7%	9%	10%
Oil & Gas	0%	0%	0%	0%	1%	1%	7%
Telecoms	0%	0%	0%	0%	2%	5%	5%
Healthcare	0%	0%	0%	0%	1%	6%	1%
Leisure	0%	0%	0%	0%	0%	0%	0%
Technology	0%	0%	0%	0%	0%	0%	0%
Share of ESG-linked bonds	**2%**	**3%**	**4%**	**3%**	**7%**	**8%**	**18%**

Source: Bloomberg, Scope

Chemicals companies are good candidates for SDG bonds

Some sectors are likely to become much bigger issuers of labelled debt. Among European materials companies, the large, frequent debt issuers such as industrial gases supplier Air Liquide SA, petrochemicals company Arkema SA, chemicals company BASF SE, industrial minerals supplier Imerys SA and chemicals and biotechnology company Herens (Herens Holdco Sarl and Herens Midco Sarl) have led the way so far. But we expect more issuance to come, particularly for SDG bonds for general corporate purposes and sustainability-related investment. European chemicals companies are coming under pressure to reduce their carbon footprint by investing in better production processes to reduce energy consumption and change the mix of raw material inputs, for example, by using steam crackers powered by electricity instead of fossil fuels.

Consumer good, retail sectors positioned for KPI-based bonds

Recent ESG-linked bond issuers in the consumer goods and retail industry have predominantly issued debt within green finance frameworks for SDG-bonds aiming at reducing emissions, decreasing waste and enhancing recycling. Issuers range across Europe, including Denmark's Arla Foods, Netherlands-based Ahold NV, Sweden's Hennes & Mauritz, Norway's Norgesgruppen ASA and Orkla ASA, Spain's Grupo Pikolin and Tesco PLC of the UK. KPI-based SDG bonds are natural candidates for companies whose less energy-intensive businesses are not so well suited to raising funds dedicated to green investments.

Oil & gas sector prepares more issuance of ESG-linked debt

Companies in other sectors are following suit. Take the oil & gas industry. Under investor and legal pressure to be more ambitious in setting and meeting low-carbon emissions targets, companies need to find ways of securing access to funding given there is a growing number of investors calling for a halt to financing of oil projects, similar to what we have seen for coal. Italy's Eni SpA has pushed ESG-linked issuance with its sustainability-linked bond - a seven-year maturity, under its existing euro medium term note programme - after Repsol's EUR 500m green bond in 2017 and two ESG-linked bonds from Polish PKN Orlen. In February 2021, TotalEnergies announced that all of its new bonds will be sustainability linked. Repsol has just launched its first SDG-linked bond, just a few days after publishing its green "transition" framework. We expect more oil & gas companies will prepare sustainability-linked financing frameworks or similar documents to enable them to place debt quickly when needed. Nevertheless, we don't expect large amounts of placements from the sector this year, as the sector is still deleveraging following the Covid-19 shock. Funding requirements can currently be covered by internal cash generation, supported by favourable commodity prices.

ESG-linked corporate issues set to exceed 25% of total, end-2021

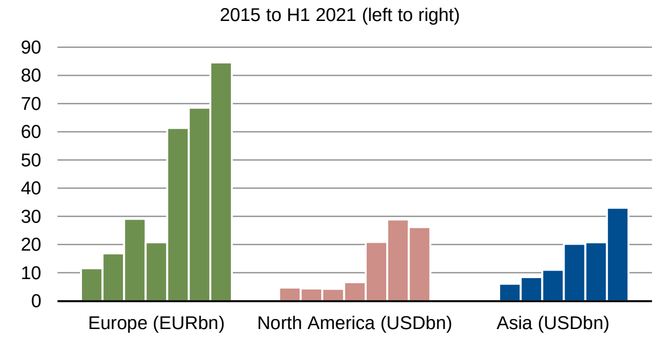
Overall, around 18% of debt issued by Europe's non-financial corporates this year has a green, social or sustainability label, up from 8% in 2020. The market is a long way from being saturated given how wide a range of corporates can tap SGD/KPI-based bonds. By the end of 2021, we expect the share of ESG-linked bonds will well exceed 25% of the total which would imply a steep increase of the share of ESG-linked bonds in H2 2021 to about 30% of the total. Looking at the Europe's largest GHG emitters besides companies in the utilities sector, we expect significant momentum in new issuance– particularly SDG-linked - bonds from companies in the oil & gas, chemicals and materials sectors.

European firms lead non-financial ESG issuance; Asia firms catching up

Europe's non-financial corporates are leading the way with the fastest roll-out of green, social or sustainability labelled debt, but Asian companies are catching up.

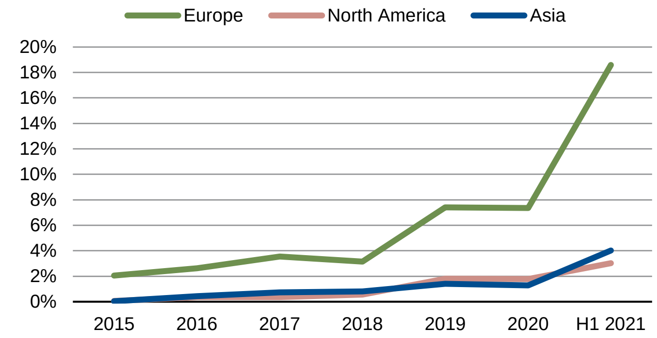
North American corporates are issuing more ESG-linked debt, but issuance, with this year's volumes trailing 2020's, is yet to take off in the same way even though the administration of President Joe Biden has pushed environmental issues back toward the top of the US policy-making agenda.

Figure 5: ESG-linked placement volumes EURbn for European corporates, USDbn for North American and Asia companies)



Source: Bloomberg, Scope

Figure 6: European non-financial corporate issuers with the fastest pace: Share of ESG-linked bond placement of total bond placements



Source: Bloomberg, Scope

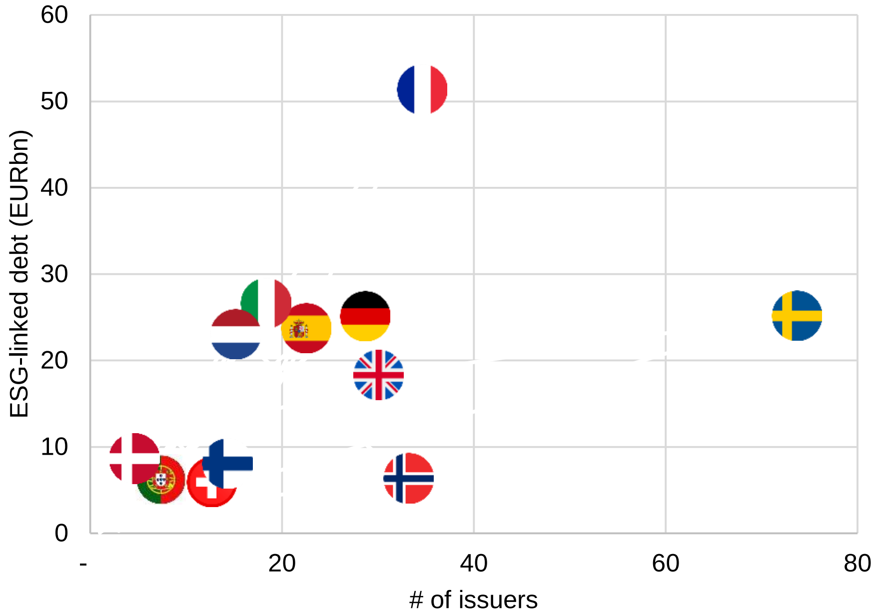
Swedish and French corporates leading in Sustainable Finance

Among European non-financial corporates, Swedish and French corporates are on the vanguard in sustainable financing. While France is home to those issuers with very large placement volumes, Sweden stands out with the variety of users of ESG-linked bonds, with almost 80 different corporates representing more than 20% of total European issuer of such bonds.

Major European economies lagging behind

Overall placement volumes under Sustainable Finance frameworks of German, British, Italian and Spanish non-financial corporates overall are reasonably high at a total of more than EUR 20bn in each jurisdiction compared with nominal issuance elsewhere. However, such volumes are rather modest in the context of the size of their economies or the share of overall corporate funding on public debt markets, notably compared with France or Scandinavia. Companies in Central and Eastern Europe are proving to be even more sluggish if not entirely absent from this part of the market.

Figure 7: French and Swedish corporates leading on the usage of ESG-linked bonds (all ESG-linked bonds placed so far)



* based on group's headquarters, not on country of origin of issuing company

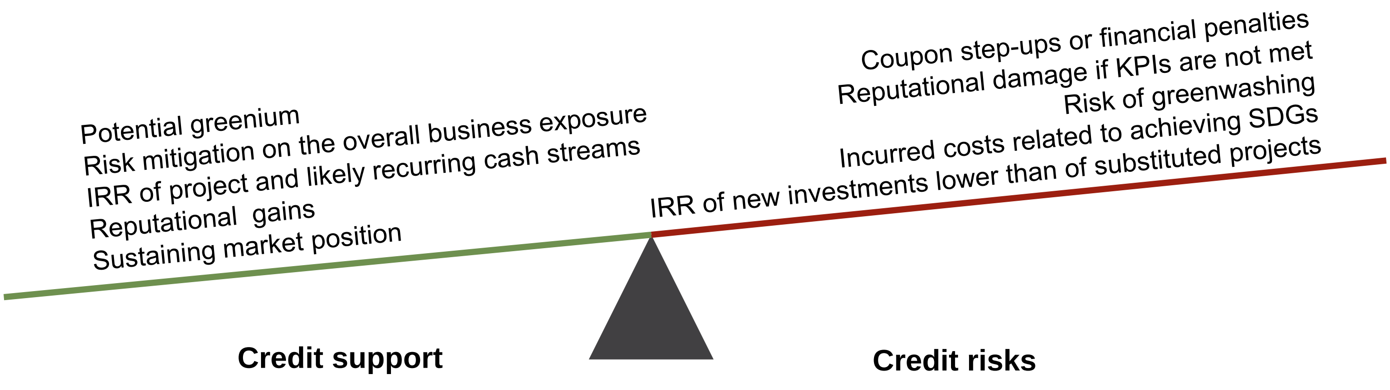
Source: Bloomberg, Scope

Credit implications: a look at funding purposes

Linking ESG-linked funding to credit quality

For a credit rating agency, the most interesting question remains whether ESG-linked bonds or ESG-linked debt in general have a noticeable impact on an issuer's credit quality. Besides the links to pricing and investor subscription rates for ESG-linked issues, the use of bond proceeds and the chances/risks attached to such placement are the most important factors.

Figure 8: Credit-supportive factors from ESG-linked bond issuance tend to outweigh potential credit risks



Source: Scope illustration

ESG-linked bonds attract higher investor demand for now

One important aspect is demand for the placement of a new ESG-linked bond. Regular data updates from "The Climate Bonds Initiative" show that green bonds are often more oversubscribed than plain vanilla bonds - last year's oversubscription factor was about 4.5 times (vs 3 times for vanilla bond equivalents) – partly reflecting the success issuers have had in tapping investors attracted to ESG-labelled debt, typically wider than that for ordinary bonds. With likelihood that investors will subscribe more enthusiastically to labelled bonds, issuers can be more confident of raising the funds they want.

Oversubscription can influence pricing; ESG debt is in demand

Such oversubscription can potentially have a positive impact on pricing, creating a so-called "greenium" – a coupon premium over a comparable plain-vanilla senior unsecured bond. But to what degree does such a "greenium" exist? And should it? The answers are not straightforward.

Issuers of ESG-linked debt are reaping financial rewards for their investment strategies, with some claiming to be paying lower coupons of up to 20 basis points (bps) on their green, social and sustainability bonds. Whether this strong demand has created a green premium or "greenium" is up for debate[2].

No inevitable link between sustainability and bond pricing

There is no clear reason why the "sustainability label" of a bond should have an impact its price, since green bonds rank *pari passu* with bonds of the same payment rank and issuer. Nor is there any credit enhancement to explain pricing differences. Given they are on an equal footing, green bonds and vanilla equivalents are subject to the same market dynamics such as supply, rate expectations, geo-political issues, and the fall-out from global pandemics. In addition, any coupon advantage is less likely to have a significant positive impact on an issuer's credit quality in today's low-interest environment.

How companies invest ESG bond proceed is important factor

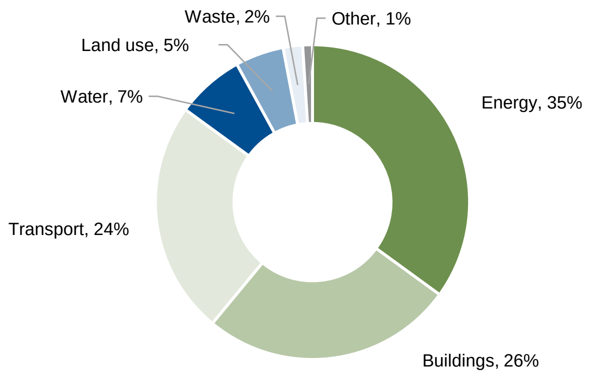
Any credit impact is likely to depend on how a company invests the funds raised and if it meets ESG-linked targets:

- **For project-based bonds:** how a company uses proceeds of such bonds can have an impact on the profile and stability of corporate cash flow – depending on the investment's internal rate of return (IRR), time to amortise – as well as on its reputation and exposure to political, regulatory or stranded-asset risk. Furthermore, one should not forget the economics of the project(s) which might be substituted by the newly financed project.
- **For target-based bonds:** rewards and penalties following the achievement or non-achievement of sustainable development goals and related KPIs in tandem with the efforts and costs attached to fulfilling such goals and KPIs.

Choice of KPIs in target-linked bonds is key consideration

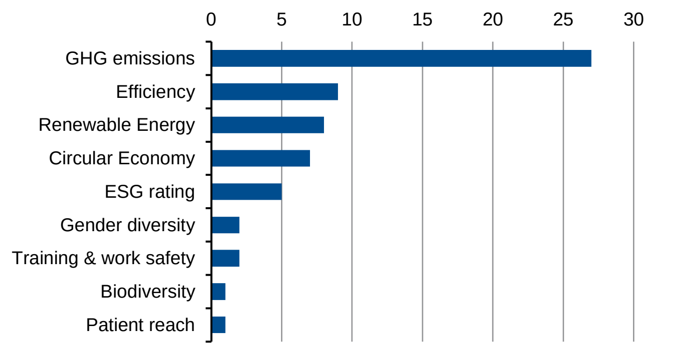
It is worth remembering that ESG-linked bonds are debt instruments that encourage investments based on the issuer addressing certain ESG criteria, so that management is incentivised to achieve higher ESG standards across the board. A look at the use of proceeds for green bonds (Figure 9) or the most frequent KPIs attached to SDG-bonds (Figure 10) provides an idea about the magnitude of a potential positive effect on an issuer's credit quality.

Figure 9: Use of proceeds of green bonds 2020



Source: Climate Bonds Initiative, Scope

Figure 10: Frequent KPIs for SDG-linked bonds (measured by frequency*)



* One bond can have multiple KPIs/SDGs

Source: Scope

[2] Companies tend not to issue green bonds and traditional bonds with the same terms at the same time, so it is hard to make clear-cut comparisons. The Climate Bond Initiative analysed 46 green bonds issued in the first half of 2020 and was able to create a yield curve for only 21 of them. Of that sample, only five showed evidence of "greenium" pricing inside the yield curve.

Sustainability linked bond should support credit quality

ESG-linked bond issuance should support the credit quality of the issuer, depending on the type of project that is funded with the proceeds of the bond issue and the resulting cash flow. Most issuers are using the proceeds predominantly for avoid credit risks, from complying with regulations, addressing environmental challenges and enhancing corporate reputation to protecting cash flow and avoiding the problem of stranded assets.

Cash flow from ESG bond financed projects under scrutiny

While project-based bonds such as green, sustainability and social bonds do not provide protection to investors through covenants related to the sustainable performance of the issuer, we can measure the financial impact of direct investments in, for example, energy-related assets, buildings that focus on sustainability or climate- and society-friendly transportation projects. Companies have to disclose investment costs which can be set against corresponding net cash returns over the anticipated amortisation period. Moreover, cash flow streams can potentially be compared directly to cash flows of substituted projects or costs that can be avoided through the operation of the new project. Ultimately, it may be possible to judge the magnitude of the effect on the issuer's market position, profitability and asset risk.

Indirect credit enhancement from SDG bonds

An SDG bond, however, might stabilise or strengthen an issuer's credit quality in a more indirect way. There are no restrictions on how an issuer uses the money raised from an SDG-linked bonds. The consequences of a failure to meet the sustainability performance targets (SPT) - from a coupon step-up or other financial penalties to the reputational loss from failing to meet the relevant performance criteria - create incentives for management to deliver on ESG targets, in case the bonds are not called/redeemed before the ESG-related covenants play a role. In doing so, such a fund programme may help aligning the interests of management and investors on meeting sustainability goals.

Benefits of hitting targets have to be set against related costs

What KPIs and SPTs are chosen can vary widely depending on the sector the issuer operates in and the corporate structure of the issuer. Choosing KPIs and SPTs carefully is crucial for issuers and can diminish the danger for investors of greenwashing. The same applies to choosing the path to reaching the SDG. Depending on the KPIs, the issuer is required to incur up-front costs – new investment, setting up new efficiency programs, amending production or service processes, implementing restructuring – which might exceed potential interest savings and reputational gains.

The risk-reward balance depends on:

- the types of performance indicators[3] (soft vs hard KPIs)
- distance from the target(s) and
- time allocated to meet SDG target(s).

Greenwashing remains a risk

Soft covenants, primarily relating to social factors such as a gender balance and training, might be easier to achieve and have less impact on corporate credit quality than harder covenants that focus on emission reductions, reduced inputs of raw materials in production processes or reduced waste.

Similarly, we have seen issuers whose KPIs didn't seem too difficult to achieve as the issuer was already close to achieving the SDG-linked goals. Likewise, the potential adverse effects from breeching established covenants may not be very painful, such as a small coupon step-up which would not make a big difference in today's low interest rate environment.

[3] In order to be meaningful chosen KPIs need to be i) relevant, core and material to the issuer's overall business, and of high strategic significance to the issuer's current and/ or future operations; ii) measurable or quantifiable on a consistent methodological basis; iii) externally verifiable; and iv) able to be benchmarked, i.e. as much as possible using an external reference or definitions to facilitate the assessment of the SPT's level of ambition.

Measuring impact of investment decisions is crucial

In the end, the magnitude of any positive effect on an issuer's creditworthiness depends on measurable/assessable quantitative and qualitative consequences on corporate credit drivers: the company's competitive position, reputation, risk exposure as well as net costs incurred in meeting each of the sustainability performance targets.

ESG debt aimed at risk reduction usually credit-supportive …

All forms of ESG-linked bonds in theory focus on the avoidance of current or future risk and the aim of sustaining a company's activities so the bonds would tend to support an issuer's mid- and long-term credit profile.

… but always depends on specifics of related investment

In terms of our credit-rating framework, our credit analysts will ultimately incorporate a company's overall risk profile including environmental, social and governance risks/weaknesses but also strengths/opportunities and the company's funding profile. The conclusions will always depend on the issuer's industrial context and individual ESG-related circumstances. For further guidance, please refer to the following:

- Scope Ratings Corporate methodology
- Key credit-related ESG themes for European real estate, metals and mining, and utilities

APPENDIX: General ESG framework at Scope in credit ratings for non-financial corporates

Scope's ESG framework for non-financial corporate credit ratings evaluates the extent to which ESG factors are credit-relevant for different industries. Our corporate credit rating analysis remains focused on credit quality and credit assessment drivers. We only consider an ESG factor relevant to our credit rating process if it has a ubiquitously discernible and material impact on the rated entity's cash flow profile and, by extension, its overall credit quality. Contrary to ESG ratings, which are largely based on quantitative scores for different rating dimensions, credit-relevant ESG drivers are mostly of a qualitative nature. Hence, identified ESG rating factors are based on an opinion in a relative context (factors are ordinal rather than cardinal).

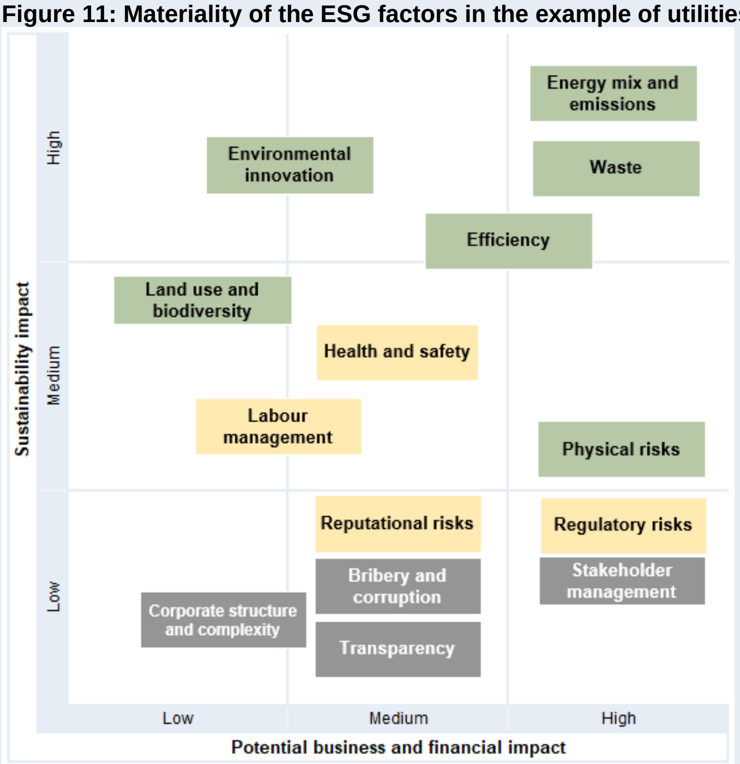
The importance/relevance of certain ESG factors is specific to each rated entity, industry and region, except for the dimension of governance, which is universally applicable across all industries. For example, the risk of pollution and environmental damage is important in the utilities, chemicals and natural resources industries but less relevant to the retail sector, where governance and social factors are much more relevant. The same applies to an assessment of ESG-related factors that might have a significant impact on a company located in western Europe but no effect on an eastern Europe corporate with a similar business model. A good example is the impact of regulatory risks, which may be significantly greater in some jurisdictions.

Governance is an indication of how well a corporation is controlled and directed and the extent to which the interests of different stakeholders are safeguarded, including the payment of all due amounts on time and in full. Governance is thus relevant to all rated entities. In contrast, environmental and social variables capture risks and opportunities that are often specific to the activities of a company and the industry in which it operates. All such factors may have a direct or indirect impact on a rated entity's market position and its financial performance.

ESG-related factors can directly or indirectly affect all the rating elements which make up our assessment of an issuer's business risk profile, financial risk profile and supplementary rating drivers. We provide a list of ESG factors that we normally consider for a given industry, although only some of the factors listed are likely to apply and be relevant to any given company.

Within our ESG framework we look at various broader categories related to E, S and G. We seek to differentiate the sustainability impact of the companies' internalities and externalities, between what is considered sustainable (sustainability impact) and the potential business and financial (credit) impact of ESG factors. Not all ESG factors influence an issuer's creditworthiness to the same extent.

Figure 11: Materiality of the ESG factors in the example of utilities



Source: Scope

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid
Edificio Torre Europa
Paseo de la Castellana 95
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

111 Buckingham Palace Road
London SW1W 0SR

Phone +44020-7340-6347

info@scoperatings.com
www.scoperatings.com

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