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Investments

Spotlight on sustainability-linked debt

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SUMMARY

The gradual increase of green bond issuance through the 2010s accelerated into a tidal wave of ESG-labelled debt issuance in the early 2020s. The original green bond concept has developed into a "use of proceeds" category that includes green, social and sustainability (GSS) bonds. This category works well for government issuers as well as corporate issuers in sectors such as power, utilities, financial and real estate that have specific green project categories that qualify under the International Capital Markets Association frameworks, and that can be verified by second-party opinion providers. Previous reports cover the description and differences between green, social and sustainability bonds.

The newer concept of sustainability-linked debt has a coupon structure that is linked to corporate ESG targets and specific ESG key performance indicators (KPIs) that are defined at issuance and go by the labels sustainability-linked bonds (SLBs) and sustainability-linked loans (SLLs). This category, known as sustainability-linked debt, is open to any issuer from any sector so long as they have relevant corporate ESG targets, along with consistent reporting for their ESG KPIs (Figure 1).

Companies are generally motivated to issue SLBs to align financing strategy with company strategy as it relates to sustainability. Critics argue that this is all greenwashing because companies can set their own KPIs and thus have an incentive to make them easy to achieve. Supporters argue that the entire concept of ESG targets is voluntary because they are not required by governments. Companies have the choice to do nothing on sustainability and yet those who choose to do something are regularly criticized for not doing enough. Not all ESG targets and SLB KPIs are relevant or ambitious. There is a significant effort required from credit analysts and ESG analysts to sort out good SLBs from bad SLBs. A robust process is required to decide which SLBs are worthy of investment.

The more times that companies repeat and reinforce their sustainability strategy and their ESG targets, the more likely they will be achieved. What gets measured gets managed. Mechanisms such as ESG-labelled debt – including the growing category of sustainability-linked debt – as well as ESG-linked executive compensation ensure that words turn into action and that failures to achieve ESG targets will be high profile and result in significant reputational damage for both executives and the company. The current and evolving structure of SLBs includes coupon step ups if the issuer fails to achieve their stated ESG KPIs, so there is no additional downside to the bond investor – only additional upside in the form of that penalty payment. The benefit to the issuer is primarily as a boost to their reputation and their sustainability credentials. It is a way for them to affirm their commitment to their ESG targets.

In recent years, companies have set targets in their SLB frameworks ranging from the reduction of greenhouse gas emissions to the increased use of renewable energy or achieving specific targets related to gender equality (Figure 2). An available universe of over 300 SLBs shows that half of issuers use one KPI and half use more than one KPI (Figure 3). By setting environmental and social KPIs in their SLBs, companies are sending a strong signal to their medium- and long-term commitments to positive socio-environmental impacts for the benefit of people and planet in line with the UN Sustainable Development goals (SDGs).

This paper will outline recommendations to corporate debt issuers about which ESG KPIs are most relevant and material for SLBs from the perspective of the Mackenzie Fixed Income Team.

ESG KPI #1:

Greenhouse gas (GHG) emissions reductions targets by 2025 and 2030

Corporations can follow government GHG emission reduction targets or select their own targets by 2030 as a key milestone towards their net-zero-by-2050 commitments. Within environmental KPIs, GHG emission reduction targets are the most popular, with over 50% (Figure 2) of SLBs having at least one target related to GHG emission reduction. Issuers prefer to use targets related to absolute emissions – only 26% of the targets are related to intensity measures. For this environmental KPI, companies are focused on Scope 1 and 2 emissions, with less than 20% of those SLBs targeting Scope 3 emissions (Figure 4). Scope 3 emissions are more difficult to estimate and generally outside of the companies' control because they represent the emissions of their customers and their supply chains. Companies that include Scope 1, 2 and 3 in their targets for their SLBs would be considered more ambitious.

Examples include the few SLBs issued to date in Canada. The three SLB issuers below represent the full set of SLB issuers in Canada, but many more are expected in the coming years. These few Canadian issuers add to a growing list of SLB issuers from the US, Europe, Latin America and Asia.

	GHG reduction target	Target date	Reference date	Coupon step-up
1st in CA – Telus	46% absolute emissions	2030	2019	+100 bps at maturity
2nd in CA – Enbridge	35% emissions intensity	2030	2018	+50 bps at maturity
3rd in CA – Tamarack Valley	39% emissions intensity	2025	2020	+75 bps at maturity

ESG KPI #2:

Increased production or consumption of renewable energy by 2025 and 2030

Companies can accelerate the energy transition by increasing their consumption and/or their production of renewable energy. The percentage of electricity from renewable sources and the percentage of renewable energy produced are the second most frequently used KPIs (Figure 2) by companies issuing SLBs – along with energy efficiency KPIs. Here are some examples:

	Renewable energy target	Target date	Reference date	Coupon step-up
Wesfarmers	100% use of renewables	2025	2020	+12.5 bps per year
Nobian	50% use of renewables	2025	2020	+12.5 bps per year
Enel	80% of installed capacity	2030	2020	
Enel	100% of installed capacity	2040	2020	

ESG KPI #3

Women in leadership (typically VP+) targets by 2025

There has been a significant shift towards gender diversity at the board level from 2015 through 2020 – especially for larger corporations. However, the expected trickle-down effect to executive teams has been slow over that same time frame. The inclusion of targets by 2025 signals that corporations are serious about moving quickly to develop diverse executive and management teams that will strengthen their diversity of thought and ability to be creative and innovative and responsive to all stakeholders.

	Women in leadership target	Target date	Reference date	Coupon step-up
Enbridge	40% of board	2025	N/A	+10 bps at maturity
Suzano	30% in leadership	2025	N/A	+25 bps per year

ESG KPI #4

Racial and ethnic diversity targets by 2025

The diversity conversation has expanded from mostly focused on gender to include racial and ethnic diversity. Specifically, the underrepresentation of Black and Indigenous people is most pronounced in corporations and deserves dedicated strategies and targets. Here are some early examples:

	Racial and ethnic diversity target	Target date	Reference date	Coupon step-up
Enbridge	28% racial & ethnic representation in workforce	2025	N/A	+10 bps at maturity
Tamarack Valley	6% indigenous employees	2025	N/A	+25 bps at maturity

Conclusions and recommendations

In 2022, the Mackenzie Fixed Income Team advanced its ESG engagement program by sending "Dear CFO" letters directly to company executives encouraging the issuance of green bonds and SLBs. The total amount of reverse interest was more than $1 billion (CAD) and the team intends to repeat this process on an annual basis. This program expands the team's pre-existing active engagement program, spanning over five years and defined by asking questions and making recommendations to corporations related to key ESG topics.

The recommendation from the team to corporate debt issuers is to focus on two or three ESG KPIs to be included in their SLB frameworks and issuance and reporting. We advise that they select their most important environmental KPI, their most important social KPI and any other KPI that is specific and material to their business. The list above provides context for generally material ESG KPIs; however, companies should select the metrics that are most material to their company and to their sector. This process should start at the top of the company with the development of corporate ESG strategy by the executive team and the board of directors. The corporate ESG strategy and any related targets should be important to and driven by the CEO and communicated as such to all stakeholders.

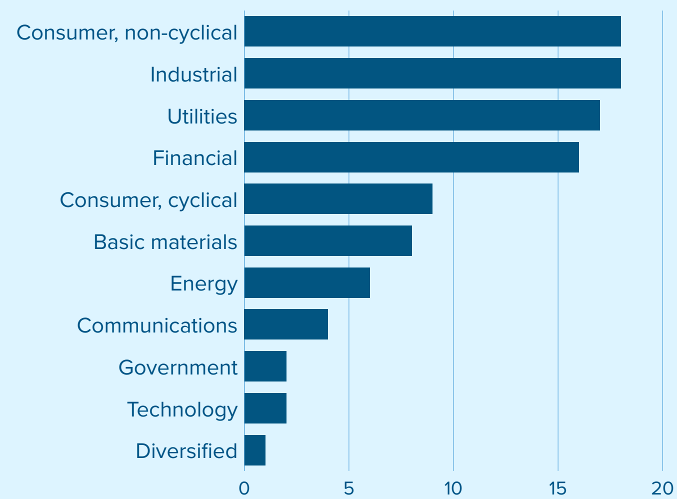
As it relates to financial policy, capital structure and debt issuance, the CFO then plays the key role in translating corporate ESG strategy into ESG-labelled debt issuance. This provides an essential signal to market participants that the targets are important and integrated into their broader corporate strategy. As mentioned, corporate finance teams have different types of ESG-labelled debt available to them. A certain amount of their projects can be financed with green, social and sustainable bonds. The rest of their debt financing and refinancing needs can be met with sustainability-linked bonds and loans. We are starting to see companies that are driving towards, or that have already achieved, 100% ESG-labelled debt by using a combination of green use-of-proceeds debt and sustainability-linked debt.

One note on public companies versus private companies. SLBs are typically issued by public companies and SLLs are typically issued by private companies. For the latter, terms and KPIs typically remain private, so there is no theoretical greenwashing benefit. These private companies focus on sustainability-linked debt for the same reasons as public companies – to affirm their commitment to their ESG targets and their broader sustainability strategy to key stakeholders, including their owners and their lenders.

The Mackenzie Fixed Income Team looks forward to continuing to encourage the issuance of SLBs through the 2020s – **while being selective and identifying good SLBs versus bad SLBs** – to drive progress towards the UN Sustainability Development Goals by 2030.

FIGURE 1 – INDUSTRY CLASSIFICATION

Sustainability-linked structures



Consumer, non-cyclical

- Agricultural operations
- Beverages
- Cosmetics & toiletries
- Fisheries
- Food - meat products
- Medical instruments & drugs
- Medical - drugs
- Medical - nursing homes
- Schools
- Security services
- Soap & cleaning products
- Warehousing & harbour transportation services

Industrial

- Airport develop/maintenance
- Building & construction - misc.
- Containers - metal/glass
- Containers - paper/plastic
- Electronic components - misc.
- Environmental consulting & engineering
- Hazardous waste disposal
- Machinery - construction & mining
- Non-hazardous waste disposal
- Transportation services

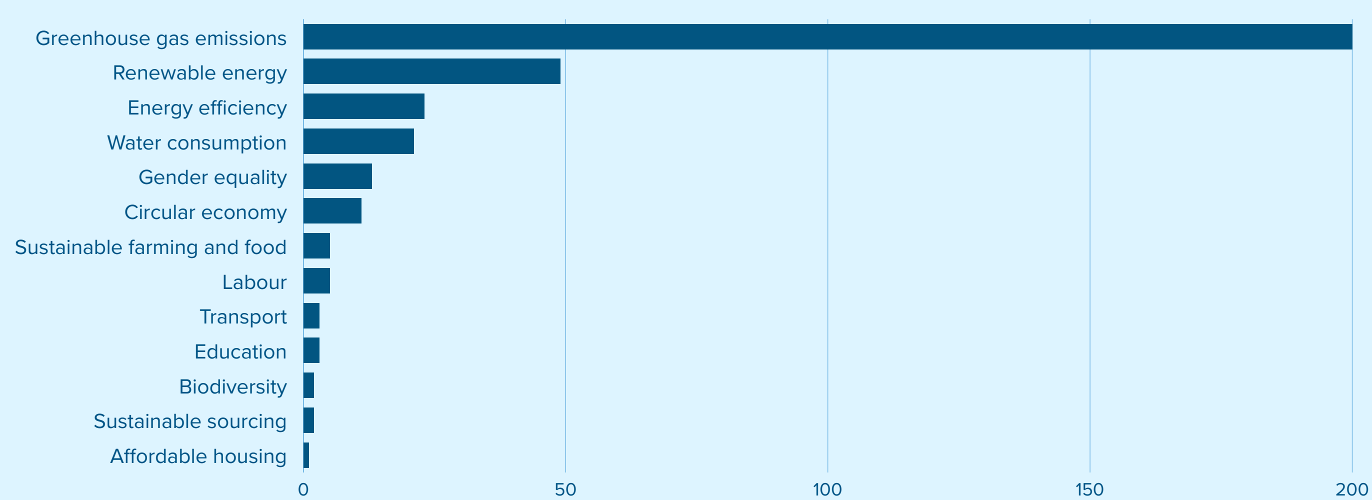
Basic materials

- Chemicals - diversified
- Metal - aluminum
- Paper & related products
- Steel - producers

Source: Bloomberg, Environmental Finance Data, Mackenzie Research. Historical data 2019 - 2022 – 308 SLB assessed

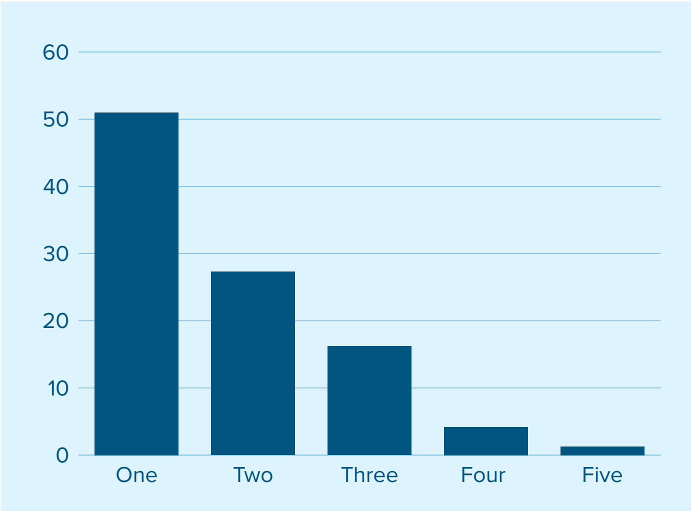
FIGURE 2 – KPI - KEY PERFORMANCE INDICATOR

SLB - ~96% data coverage



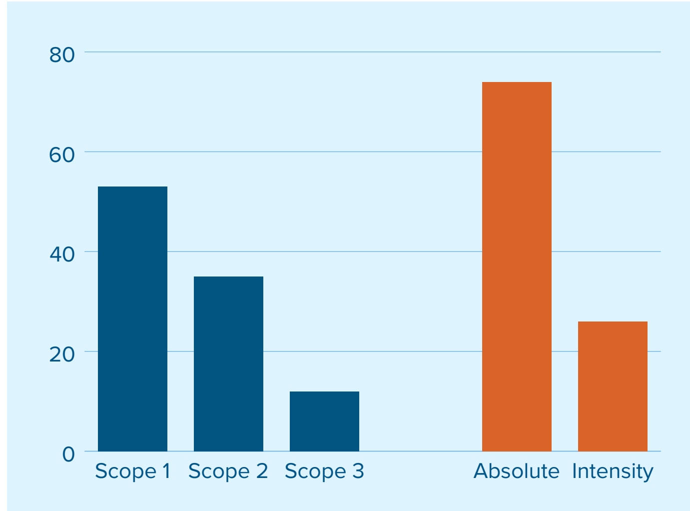
Source: Bloomberg, Environmental Finance Data, Mackenzie Research

FIGURE 3 – NUMBER OF TARGETS - KPI
SLB universe



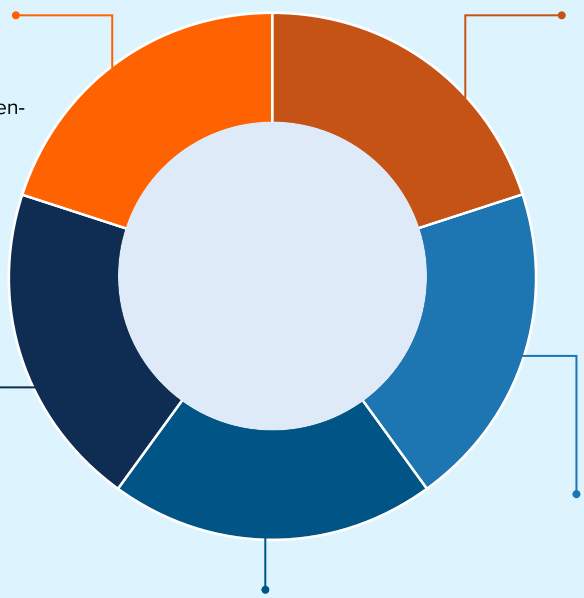
Source: Bloomberg, Environmental Finance Data, Mackenzie Research

FIGURE 4 – GHG EMISSION REDUCTION TARGETS - TYPE
(SLB - ~96% data coverage)



Source: Environmental Finance Data, Mackenzie Research. Historical data 2019 -2022 – 308 SLB assessed

FIGURE 5 – SUSTAINABLE DEBT 101



Sustainability-linked bonds

Debt with sustainability targets that the issuer needs to achieve before maturity, otherwise a financial penalty is applied as a premium paid to the bondholder.

- Reduce GHG emissions by 50% by 2030
- Gender-balanced board by 2025

Sustainable bonds

Bonds with use of proceeds that combine environmental and social issues, allowing companies and governments to have a wider-ranging influence.

- Sustainable food production for underserved communities

Best-in-class ESG bonds

Debt issued by issuers in positive environmental standing. These bonds are directed towards the advancement of environmental sustainability, without applying for certification. Formerly referred to as "light-green" bonds.

- Energy efficiency
- Clean transportation

Green bonds

Debt issued to companies or governments, with the use of proceeds directed towards financing environmentally related projects: certified by third-party verifiers

- Renewable energy
- Pollution prevention
- Water infrastructure

Social bonds

Debt issued with the intention of addressing social issues or supporting the transition to positive social outcomes.

- Affordable housing
- Diversity and inclusion programming
- Funding for Indigenous-owned businesses and initiatives

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