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THE STATE OF THE SUSTAINABILITY-LINKED BOND MARKET

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The term green bond has become synonymous for all ESG-related debt instruments. However, the truth is that the market consists of various labeled products that serve different purposes. At Aegon AM we use the term labeled bonds to discuss these various instruments, but there are key differences between use-of-proceeds labeled bonds and sustainability-linked bonds (SLBs).

Before we go further, we should define our terms. A sustainability-linked bond (SLB) is a general proceeds debt instrument, meaning the issuer does not have to predetermine projects and allocation of proceeds. Instead, the funds may be used for general business purposes. Use-of-proceeds bonds, by definition, fund initiatives with a dedicated environmental or social benefit. SLBs also differ from other green, social, or sustainability labeled bonds in that SLBs are tied to sustainability performance targets determined by the issuer. These targets are linked to a financial incentive for the investor. If the issuer meets (or fails to meet) these targets over a specified time period, the financial incentive kicks in for the bond holder. Financial incentive is usually in the form of a coupon step-up, which increases the coupon payments the company must make to its bondholders. Other structures, such as cash payments at maturity and coupon step-downs, also exist.

Recent trends

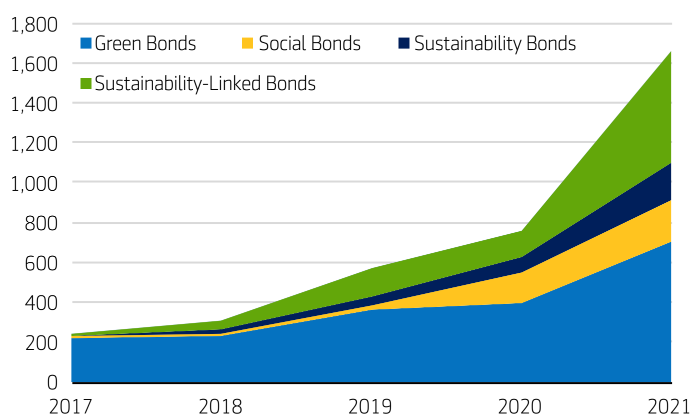
The sustainability-linked bond market is still nascent compared to that of use-of-proceeds bonds, but it has seen tremendous growth over the past two years. One of the main growth drivers relates to the release of the International Capital Market Association (ICMA) Sustainability-Linked Bond Principles, which outlines the voluntary process guidelines. The ICMA's Green Bond Principles, Social Bond Principles, and Sustainability Bond Guidelines were pivotal in accelerating the growth of use-of-proceeds debt issuance for the past decade because they provided a standardized framework for both issuers and investors to follow.

The Sustainability-Linked Bond Principles have had a similar effect on issuance and market growth in the SLB market in recent years. SLBs grew to $564 billion in annual issuance in 2021, up from $136 billion in 2019, more than a threefold increase. For context, other labeled bonds also experienced tremendous growth. Over the same time period, green bonds, which own the largest share of the market, grew by close to 80%.

We think another reason for the recent popularity of SLBs is that, unlike use-of-proceeds bonds, they provide issuers in more carbon-intensive sectors access to a form of issuance that is well-received by investors due to the financial incentives provided therein. For better or worse, when it comes to these more polluting or controversial sectors (e.g., industrials, materials), the overall impression from investors of late has been mixed and marred by concerns over greenwashing. This means prior "transition" bonds, which were meant as use-of-proceeds bonds for carbon-intensive sectors, have gone out of popularity and SLBs have quickly become the de facto instrument for issuers. In fact, issuers have changed their expectations in 2022 to focus on operational key performance indicators (KPIs) targeted at long-term sustainability:

- **Materials:** in 2021 SLBs were 82% of sector issuance, up from 64% in 2020
- **Industrials:** in 2021 SLBs were 61% of sector issuance, up from 53% in 2020
- **Energy:** in 2021 SLBs were 45% of sector issuance, up from 25% in 2020

Exhibit 1: Labeled bond market, 2017–2021



Source: Bloomberg *Each label includes loans and, in some cases, ABS structures

Looking ahead: future of the SLB market

In our view, SLBs show tremendous promise in terms of shifting industries to become more sustainable. Investor reception has been particularly strong for issuers in carbon-heavy sectors compared to those issuing green bonds. However, key concerns still remain for Aegon AM regarding SLBs:

1. **Ambition:** Are the KPIs ambitious enough or could they be biased toward issuers' ability to achieve them?
2. **Relevance:** Are the KPIs relevant for the business to truly move toward long-term sustainability?
3. **Financial significance:** A 25-basis point step-up in coupon has quickly become the market standard. There is a case to be made that this is not a significant financial incentive/ penalty for the issuer if they fail to achieve stated long-term sustainability targets.
4. **Timing:** Does the date of the sustainable targets and potential financial incentive/penalty occur early enough in the bond's life to be material and before relevant call dates? If not, this could be a red flag as the issuer may, in reality, have no material financial incentive and/or could call the bonds before they are held accountable to hit the sustainability targets and avoid facing the financial penalty.
5. **Failure:** What happens when the issuer fails on KPIs? The sustainable investor receives an increased coupon, but may deal with the negative press of failed long-term sustainability targets of the issuer.

We expect 2022 SLB issuance to continue at a robust pace. Given the increasing focus on ESG and sustainable investments, we expect investor demand to remain strong. However, SLBs and other labeled bonds are often issued at a premium with lower yields than non-labeled (i.e., "plain vanilla") bonds. One recent study from SSRN[1] found that sustainability-linked bonds were issued with a yield that was approximately 29 bps lower than non-labeled bond equivalents. While that so-called "greenium" – or the premium paid for labeled bonds/SLBs – can vary greatly bond by bond, in general, we expect this premium to persist amid heightened demand and accommodative capital markets.

Given the potentially lower cost of capital for issuers and strong investor demand, coupled with the broader shift toward more sustainable businesses, we expect issuers will continue to bring SLBs to the market at an accelerated pace. However, we expect issuers to face more scrutiny, as investors favor more ambitious targets and well-structured SLBs.

Key themes and investment considerations

At Aegon AM, we believe the sustainability-linked bond market, and broader labeled bond market in general, provides interesting investment opportunities. That said, prudence and caution are warranted given the greenwashing that persists and potential yield give-up that can occur within this segment. As a result, when investing in sustainability-linked bonds, we scrutinize the debt issuance from various perspectives. Key considerations include:

- **KPI's alignment with business model:** Are the sustainability targets relevant to the business in order to achieve long-term sustainability?
- **Calibration of sustainability performance targets:** Are the sustainability targets too easy for the company to achieve?
- **Bond characteristics:** What is the financial penalty? Is it a coupon step-up? Are there call options before step-up?
- **Reporting:** Is the reporting part of existing ESG reporting?

Importantly, these factors are not viewed in isolation; we take a holistic approach to assessing investment opportunities by combining our views on fundamentals, valuations and market technicals with ESG and/or sustainability considerations. After all, our focus is on finding opportunities that best align with clients' financial objectives and ESG preferences, whether that is a labeled bond or not.

[1]Source: Kölbel, Julian and Lambillon, Adrien-Paul, Who Pays for Sustainability? An Analysis of Sustainability-Linked Bonds (January 12, 2022). Available at SSRN: https://ssrn.com/abstract=4007629 or http://dx.doi.org/10.2139/ssrn.4007629.

Study based on sample of corporate sustainability-linked bonds from Bloomberg's fixed income database as of December 31, 2021. Includes 329 SLBs issued by 189 companies.

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