

Enel – A case study in transition finance using SLBs

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Enel is the largest issuer in the Sustainability-linked bond (SLB) market.

It issued its inaugural SLB in Sep 2019 and has subsequently published three Sustainability-linked Financing Frameworks - in Oct 2020, Jan 2021 and Jan 2022.¹ In 2020 and 2021 all traditional bonds issued were perpetuals. **Enel is migrating toward having a majority of SLBs in the debt capital structure, currently with over 40% of its**

outstanding bonds in this format across 23 separate issues. In 2022, Enel has only issued in the SLB format.

This makes Enel the early mover in a nascent market; only seven other issuers have issued more than two SLBs, with Holcim, a Swiss-based building materials and aggregates producer, taking the position as the second most prolific with 11% of their debt in SLBs, totalling USD 1.7bn across five issues.² Given Enel currently stands alone in its scale use of SLBs, we want to review its capital structure and issuance to identify trends we can expect as other issuers follow.

We observe some counter-intuitive behaviour in the bonds, notably a compression of ‘greenium’ and increased volatility of SLBs compared to traditional products. We believe that once an issuer makes a strong commitment to transition (as Enel has done), the financing instruments to support that transition become the benchmark. As a result, SLB pricing becomes the pricing for all debt, and SLBs are the most liquid and fastest to react to market moves.

A strong commitment to sustainability can therefore be a signal to invest in legacy products that will benefit from this compression as more transition finance is issued.

We also note that through increased size of SLB issuance, companies can experience a more material exposure to their KPI performance, even in a world which is criticised for using only a 25bp step-up as standard.

Figure 1. ENEL outstanding issuance. Source: Bloomberg.

| USD bn | Traditional | Green | SLB |
|----------|----------------|-------|------|
| pre 2015 | 15.0 | 0.0 | 0.0 |
| 2015 | 1.0 | 0.0 | 0.0 |
| 2016 | 0.9 | 0.0 | 0.0 |
| 2017 | 4.0 | 1.3 | 0.0 |
| 2018 | 2.3 | 1.3 | 0.0 |
| 2019 | 0.9 | 1.0 | 4.1 |
| 2020 | Perpetuals 0.6 | 0.0 | 0.6 |
| 2021 | 2.3 | 0.0 | 10.9 |
| 2022 | 0.0 | 0.0 | 7.2 |
| TOTAL | 27.0 | 3.6 | 22.7 |

¹ The frameworks including Second Party Opinions are available as “[Sustainability-Linked Finance](#)”, Enel company web-page, accessed 22 Jul 2022.

² Holcim 5x 1.7bn; Teva Pharma 4x 5.0bn; ASTM SPA 3x 3.4bn, Suzano 3x 2.8bn, Brookfield AM 3x 1.7bn, Wesfarmers 3x 1.5bn, Woolworths 3x 1.2bn. Notionals are converted to USD at the prevailing rates on date of issuance.

Enel SLB Structures

Enel is an Italian manufacturer and distributor of electricity and gas in 31 countries around the world. It has 63.4m customers for electricity and 6.0m in gas. It has made strong statements around decarbonising its business; transitioning generating capabilities towards renewables and exiting the gas retail business by 2040.³ To that end, it has shown a strong commitment to using SLB as a transitional product, to raise attractive financing for its decarbonisation strategy.

Enel’s SLB frameworks have focused on two KPIs - Scope 1 Direct GHG emissions, and Renewable Installed Capacity percentage. Scope 1 emissions will cover Enel’s generating operations, so there is arguably overlap with Renewable Capacity, whereas impact from gas retail business is not covered. Nevertheless, a commitment has already been made to exit the gas business, and sale and transport of gas make up only 8.8% of Q1 2022 revenue.⁴

The two KPIs have timelines of targets, committed to at different points in time. In Oct 2020, emissions targets were certified by the Science Based Targets initiative (SBTi) with the “Well Below 2C” pathway. In Jan 2021 the targets were reduced and certified by SBTi with the 1.5C pathway.⁵ In Jan 2022 full decarbonisation was brought forward from 2050 to 2040.⁶

Figure 2. Enel SLB framework KPI targets, and outstanding issuance referencing each target. Source: Enel & Bloomberg & JPMorgan.

| SLB framework | Oct-20 Direct GHG emissions | Oct-20 Renewable Capacity | Jan-21 Direct GHG emissions | Jan-21 Renewable Capacity | Jan-22 Direct GHG emissions | Jan-22 Renewable Capacity |
|---------------|-----------------------------------|---------------------------------|-----------------------------------|---------------------------------|-----------------------------------|---------------------------------|
| 2021 | | 55% | | | | |
| 2021 actual | 227 | 57.5% | 227 | 57.5% | 227 | 57.5% |
| 2022 | | 60% | | | | |
| 2023 | | | 148 | 65% | | |
| 2024 | | | | | 140 | 66% |
| 2030 | 125 | | 82 | | | 80% |
| 2040 | | | | | 0 | 100% |

³ “Italy’s Enel cranks up spending to become carbon-free by 2040”, Reuters, 24 Nov 2021.

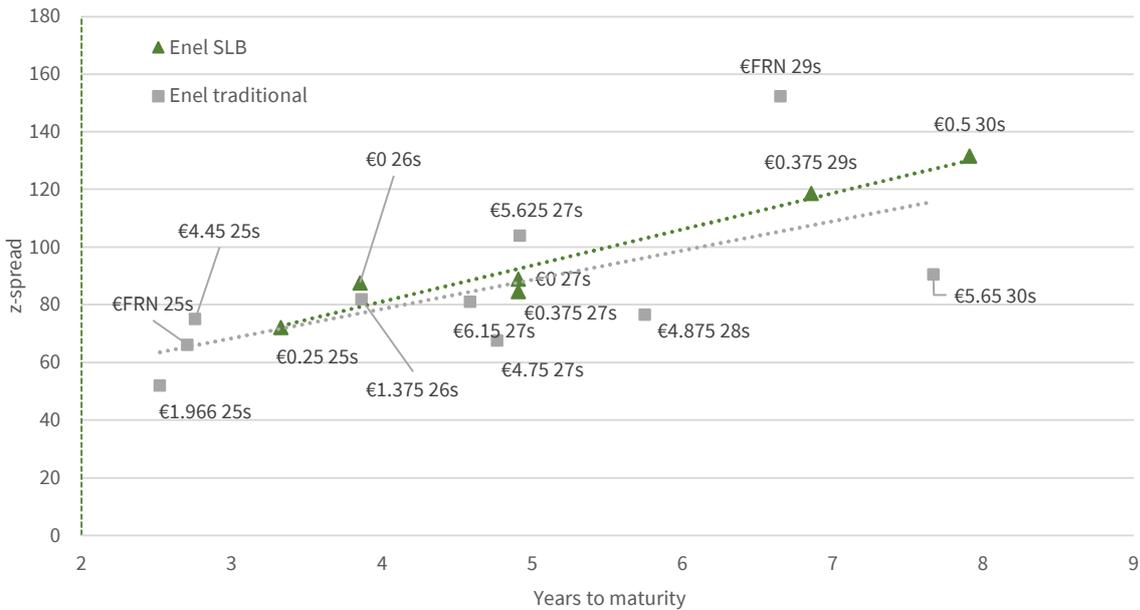
⁴ “Interim Financial Report”, Enel company web-page, 31 Mar 2022, Page 26.

⁵ Note that SBTi revised the “Well Below 2C target” to a “Business Ambition for 1.5C” six months after Enel had their policy change, see “Climate ambition: SBTi raises the bar to 1.5°C”, SBTi web-page, 15 Jul 2021.

⁶ “The decade of electrification”, Enel Press Release, 13 Dec 2021

EUR bond pricing and performance

Figure 3. Spreads for EUR Enel bonds with maturity between 2025-30. Source: Bloomberg. Pricing as of 22 Jul 2022.



When looking at Enel bond pricing and performance, we see some counter-intuitive behaviour when comparing SLB with traditional products. Firstly, spreads for Enel SLB are flat, if not slightly higher, than for traditional products as illustrated in Figure 3. In this context it should be noted that many of the older bonds trade with substantially higher coupons than the SLBs, which normally would lead to the inverse relationship, i.e. the high-coupon, high-cash price bonds trading wider than low-coupon bonds on a spread basis.

Secondly, SLBs exhibit higher mark-to-market volatility than traditional products; 40% higher since Jan 2020 (see Figure 4).⁷ Again, given that many of the non-SLB bonds are of a substantially older vintage, those bonds may be locked away with investors not actively trading them, which can have an effect of subduing mark-to-market volatility as few transactions in the bonds go through the market.

Figure 4. Recent performance for EUR Enel bonds with maturity between 2025 and 2030. Source: Bloomberg 21st July.



We believe these are both due to SLBs becoming the benchmark securities for Enel, and so quoted and traded more frequently. We believe the ‘greenium’ has not collapsed by SLB trading wider to the traditional product, but rather all legacy bonds moving towards the SLB levels. The SLBs show

the price discovery for financing going forward, as there is an expectation this product will continue to be used.

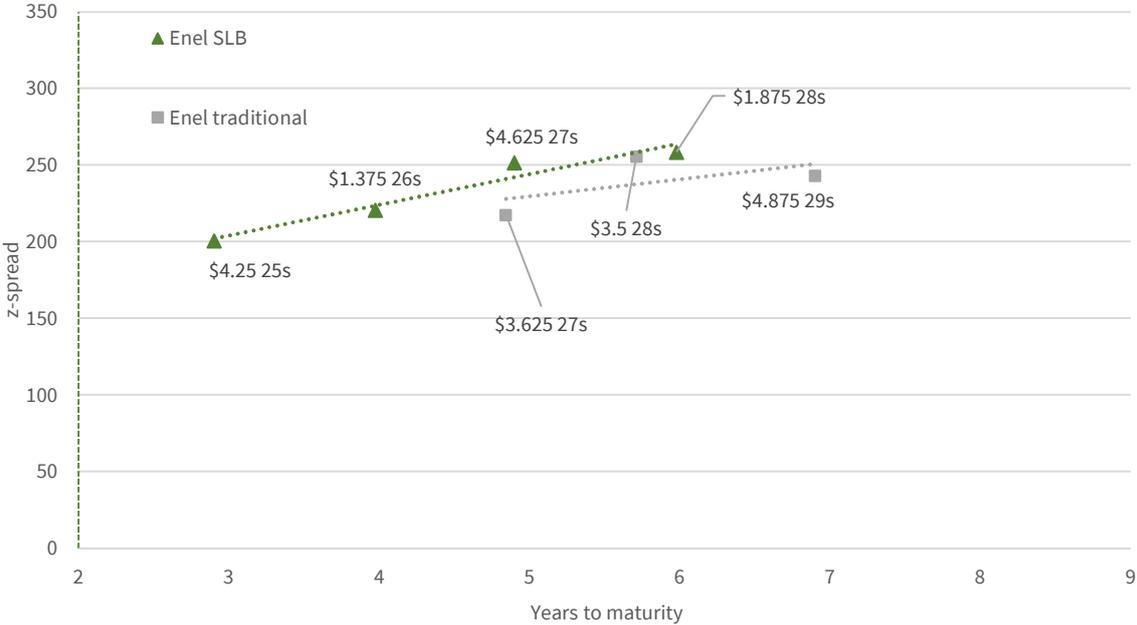
For investors in issuers where we expect to see near exclusive use of SLBs going forward, it may make sense to hold the traditional products, to benefit from this collapse in basis, and reduction in volatility (albeit alongside lower liquidity).

For a company with a strong commitment to sustainability improvement demonstrated through SLB issuance programs, the traditional products will also benefit from the strong transition of the company, and so SLB issuance can be a signal to invest in the legacy instruments too.

Non-EUR issuance

We observe a similar pattern on pricing of USD bonds, albeit with fewer data points. The spreads themselves are significantly higher, signifying higher cost of USD funding, but the SLBs do price with slightly higher spreads, despite shorter maturities (see Figure 6). Enel has some debt outstanding in GBP and CHF, but the low number of bonds makes a comparison hard.

Figure 6. Spreads for EUR Enel bonds with maturity between 2025-30. Source: Bloomberg. Pricing as of 25 July 2022.



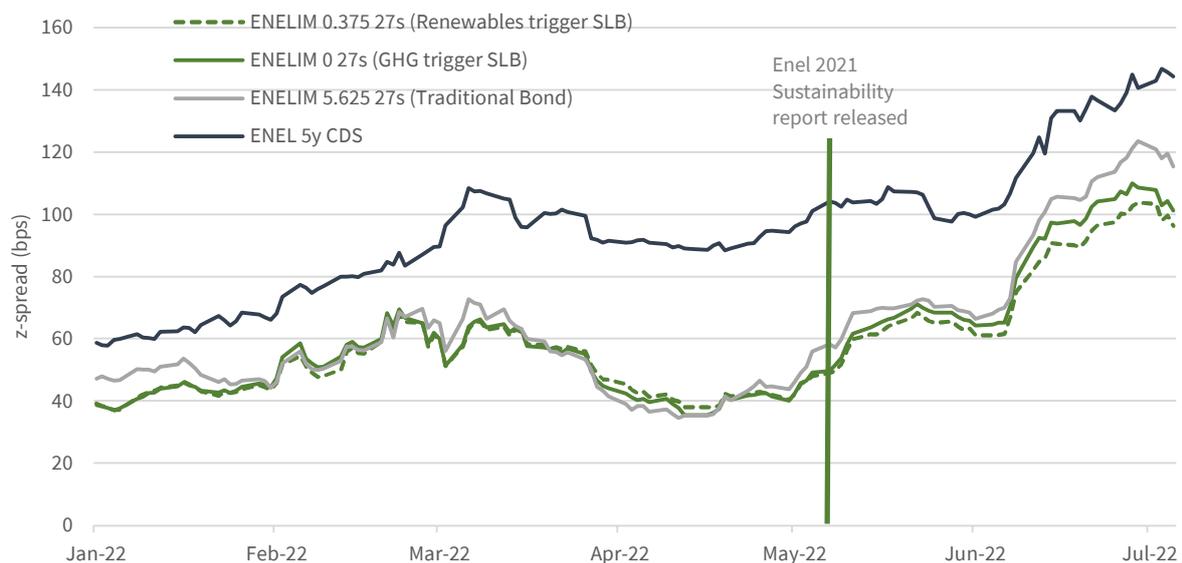
Analysis as SLBs reach their observation dates

As shown in Figure 2, Enel is in the unusual position of having some SLB issuance which has reached its observation date; 3.5bn of outstanding SLB issuance refers to a Sustainability Performance Target (SPT) which has already been met. These bonds referenced the renewable capacity, with a target of 55% by Dec 2021. Enel delivered 57.5%.⁸

While this is a positive for the sustainability objectives of the company, and we believe the long-term financial health of Enel, these bonds will not receive the step-up coupon which represents a near-term economic loss for bondholders.⁹ It is interesting to look at the relative performance of these instruments when the SPT was confirmed to have been met, to understand market expectation around Enel's sustainability performance.¹⁰

We do not know the exact timeline of communication to bondholders. The sustainability report confirming the Dec 2021 number was released at the start of May 2022. The Jun24s and Jun27s pay annual coupons in June, but the 2.65 Sep24s pay semi-annually in March and September, so a non-stepped-up coupon was paid in Mar 2022. Figure 5 shows performance throughout 2022 of 3 2027 securities, one traditional, one SLB with a GHG trigger, and one SLB with the renewables trigger in question. As we can see, there is very little difference in performance, suggesting strongly that the market saw the Enel sustainability target as credible, and assigned a very low probability to the target not being met.

Figure 5. Bond and CDS spread performance for some 2027 instruments. Source: Bloomberg.



⁸ [“Sustainability Report 2021”](#), Enel company report, May 2022.

⁹ This argument rests on the purely mathematical definition that the bondholder, prior to the observation date, assumes some economic value to $\text{Prob}(\text{Coupon step-up}) \times \text{NPV}(\text{Coupon step-ups}) > 0$.

¹⁰ An interesting quasi-philosophical question arises from this: once an SLB has passed all its SPTs, is it still to be considered an SLB? Would that consideration depend upon the bond actually invoking/not invoking the coupon step-up, or just the lack of future exposure to KPI? We expect to return to this discussion at a later date.

SLBs as a tool to leverage conviction in sustainability

There is an interesting strategic question around ongoing use of SLBs for companies which comes to the fore when analysing the Enel debt capital structure. Once you have committed to one or more sustainable KPIs and enjoyed a lower cost of funding by issuing an SLB¹¹, why would you issue a traditional product again?¹² This could signal to the market that the management team did not have full confidence in meeting their SPTs. Enel has shown very strong conviction, not only in exclusively using SLBs for its non-perpetual debt since 2020, but also in incrementally moving its SPTs to be more aggressive with each subsequent financing program.

It is one thing for management to show confidence in their sustainability objectives, but can even a highly rated company such as Enel have too much financial impact at risk to their achieving their KPIs for this strategy to be considered prudent?

Across their 12 EUR SLB issued between 2019-2022, the average coupon paid was 0.54%. Much is said on the lack of significance of a 0.25% step up, but here it does represent a meaningful uplift on the original coupon, in percentage terms. This becomes especially interesting in the context of significantly higher yields and spreads in the current market, where investors should ask whether SLB step-ups should be proportional to spread/yield or viewed in absolutes.

Enel currently reports an interest coverage ratio of 3.25x on EBIT of USD 7,680bn.¹³ Even if all its SLBs stepped up, that would increase its annual interest payment by USD 113mm, reducing interest coverage approximately to 3.0x. This is a very conservative scenario, given that the observation dates of the SPTs are staggered, and typically a few years before the maturity of the security. Figure 2 shows how much SLB is outstanding to each SPT at each observation date, with the largest being 9.9bn at Dec 2023. The high overall interest charges are driven by much higher coupons on both legacy debt and USD SLBs. As legacy debt is potentially refinanced with cheaper EUR SLBs, the materiality of this number could rise.

CDS market and deliverability exposure to SLBs

As noted above, SLBs are now the liquid benchmark securities for Enel. This has some implications for the CDS market, which trades assuming a basket of deliverables. If all those deliverables are SLBs, then this becomes a 'sustainable-CDS'. In terms of default experience, SLBs will be pari passu to traditional products, and there will be no change to the claimed amount. However, if we assume some correlation between missing SPTs and credit distress (both correlated with poor climate scenarios), having a stepped-up coupon will increase the size of your claim, and so make both bonds and CDS will become a more levered play on the company, especially if issuance is so large that the coupon step-ups become material for the overall interest cost of the company.

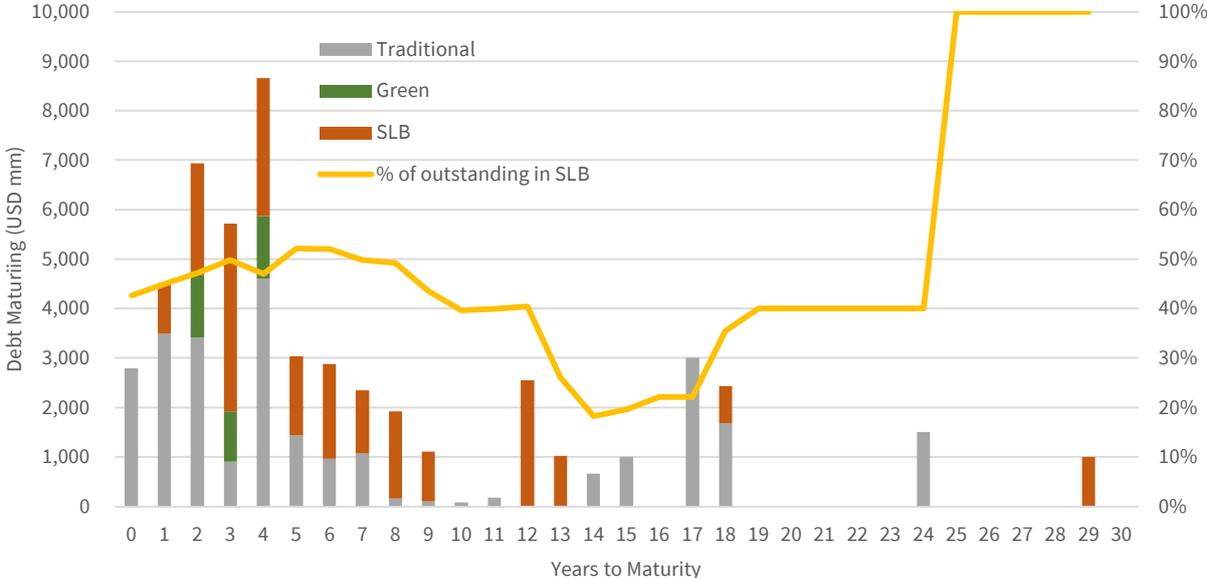
¹¹ The 'greenium' enjoyed by SLBs is more mathematically defensible than for Green Bonds, where having ringfenced use of proceeds does not change your economic exposure to the issuer. In an SLB, the issuer is selling an option to an investor, who has some probability of receiving an enhanced coupon. This financial exchange explains the spread differential of SLBs. For full details see "[An option pricing approach for sustainability-linked bonds](#)", AFII, 18 Mar 2022.

¹² We also discuss this in "[SLB bond radar: Eni \(potentially\) coming to market](#)", AFII, 19 Jul 2022.

¹³ Sourced from Bloomberg.

Figure 7 shows the maturity profile of outstanding debt. While there are large redemptions of traditional products in the next few years, there are also redemptions of the first SLBs which keeps the overall capital structure relatively balanced. We would expect refinancing to be focused on SLBs, and so drive the percentage outstanding in SLBs higher with time.

Figure 7. Maturity profile for Enel outstanding debt. Source: Bloomberg.



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