

SLB triggers: What next if Nobian or PPC miss their targets?

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As the Sustainability-Linked Bond (SLB) market matures, investors will need to prepare for the potential impact of bonds missing their Sustainability Performance Targets (SPT).

The market currently awaits confirmation of the results of three SLBs with observation dates at the end of 2022, from energy companies Enel and PPC, and chemicals business, Nobian.

The only investment grade security, ENELIM 1% 27s (rated BBB+/Baa1/BBB+), will meet its target based on preliminary results.¹ The two high yield securities, NOHOLB 3.625% 26s² (rated B/B2/B-) and PPCGA 3.875% 26s³ (rated BB/ /BB-), are unlikely to achieve their targets. These are both benchmark-eligible bonds, with wide investor bases. They could potentially be the first SLBs included in indices to pay a coupon step-up.⁴

We consider the possible implications of a “thematic default” by Nobian or PPC, in which the issuer defaults on its sustainability objectives. This may lead to dispositions from climate-focused funds and have an associated negative price impact.

Our analysis suggests that a higher percentage of the Nobian SLB is held in ESG-labelled funds than the PPC SLB, and so we expect any reaction to be of greater size.

The resulting price dynamics will give us valuable insights into SLB investor reactions when sustainability targets are breached. **We see it as an important development that the SLB product is treated as the rest of the bond market, with sustainability events driving flows, and sustainability risk forming part of all investor decisions.**

¹ “[Enel raises EUR1.5bn from SLB despite pressure on targets](#)”, IFR, 17 Feb 2023.

² Our analysis is at the end of this document, which is consistent with other reports for example, “[SLB issuers ‘likely to miss majority of 2022 and 2023 targets’](#)”, Responsible Investor, 5 Feb 2023.

³ The issuer is guiding the market to expect a miss as reported in “[Global ESG-Linked Bond market faces its first set of penalties](#)”, Bloomberg, 18 Nov 2022. Our earlier analysis can be found in “[A review of SLBs approaching KPI observation dates](#)”, AFII, 17 Nov 2022.

⁴ For a non-index eligible SLB which has paid a penalty please see “[One small step for Orlen, one giant leap for the SLB market](#)”, AFII, 29 Nov 2022.

Thematic default

When investment grade issuers are downgraded, and securities are no longer eligible for investment grade indices, the market can see ‘forced selling’ from index funds, which are no longer able to hold those securities. This can drive underperformance based on crystallisation of a downgrade to sub-investment grade, even though ratings often lag the market event which drove the credit deterioration.

Nobian and PPC are both eligible for inclusion in general bond indices. This is important as when a security is index-eligible, it will likely have a broader investor base than SLBs not included in indices, and a wider impact on the market.

A miss by Nobian or PPC may constitute a “thematic default”, in which the securities are either no longer attractive, or contractually no longer eligible for certain sustainability investment criteria. **This may lead to dispositions from climate-focused funds, negatively impacting the price of the SLBs.** The coupon step-up will provide a hedge for investors against poor economic performance that should be price-supportive.⁵ However, the impact on pricing of any selling flows remains hard to predict, given no benchmark SLB has so far missed an SPT in the nascent SLB market.

Fund holdings

There is no legal requirement to report bond holdings, but some information is available on Bloomberg via the HDS function. We have sorted the reported holders of the Nobian and PPC SLBs into categories, and looked for funds with an explicit ESG lens.⁶

Figure 1. Classification of funds holding Nobian and PPC SLBs. Source: Bloomberg, AFII, accessed 22 Feb 2023.

| | NOHOLB | | Percentage (excl CDO/CLO) | | PPCGA | |
|-------------|------------|------------|---------------------------|--|------------|------------|
| | 3.625% 26s | Percentage | | | 3.875% 26s | Percentage |
| CDO/CLO | 215,921 | 59% | | | 0 | 0% |
| Active | 128,049 | 35% | 84% | | 270,062 | 92% |
| Passive | 11,153 | 3% | 7% | | 19,714 | 7% |
| ESG | 12,955 | 4% | 9% | | 2,836 | 1% |
| TOTAL | 368,078 | | | | 292,612 | |
| Outstanding | 525,000 | | | | 775,000 | |

Figure 1 shows a summary of this data. It is much more complete for the Nobian SLB, with just over 70% of holdings covered. CDO/CLO vehicles are by far the largest category with 59% of reported holdings in these funds. These vehicles often have locked up financing until maturity, and so assets will not be traded as actively as other investment vehicles. Removing this category from the ‘free float’ available suggests 9% of the bond is held in ESG-labelled funds. For PPC, only 37.8% is covered, and a much lower percentage is held in ESG-labelled funds, only 1%.

In conclusion, given the higher holding percentage of Nobian SLB within ESG-labelled funds, flows of this bond following confirmation of an SPT miss will be more representative of how sustainability-minded investors treat target underperformance.

⁵ These ideas are discussed in more detail in “[Understanding dynamics between SLB and traditional debt](#)”, AFII, 26 Jan 2023.

⁶ These classifications are not directly available; this is an AFII judgement-based classification based on fund name.

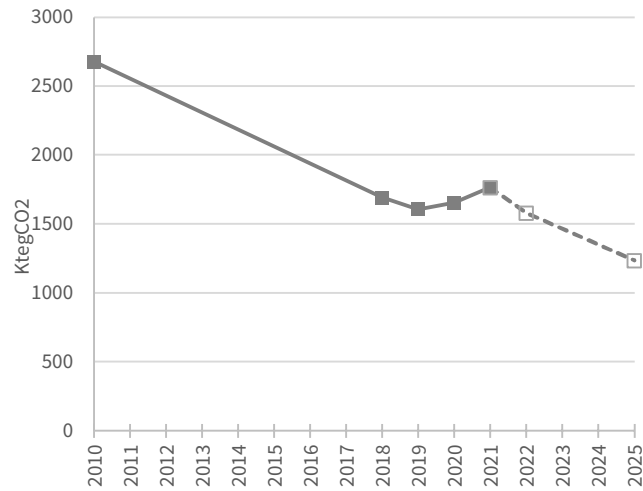
Nobian SLB

Nobian, a privately-owned European chemical company, produces base chemicals for industry. It has one bond outstanding, NOHOLB 3.625 26s (ISIN XS2358383466), a Sustainability-Linked Bond (SLB) issued in Jun 2021. The bond pays a step-up on failing to meet either of two sustainability KPIs by YE 2022, 12.5bp on each.

KPI1

The first KPI is Scope 1 and Scope 2 absolute emissions measured in KT equivalent CO₂, with a Sustainability Performance Target (SPT) set as a 4% reduction from a baseline at YE 2020. The Nobian Sustainability-Linked Financing Framework⁷ gives historic and target levels, and the 2021 Sustainability Report⁸ gives slightly different numbers for 2010 and 2020. Historic and target levels are shown in Figure 2.⁹ Using the data from the Financing Framework, emissions rose 11.9% from 2019 to 2021. To meet the YE 2022 target an annual reduction of 12.1% is needed, which would mean a change in direction of more than double the recent annual increase in size of emissions. This target seems very hard to achieve.

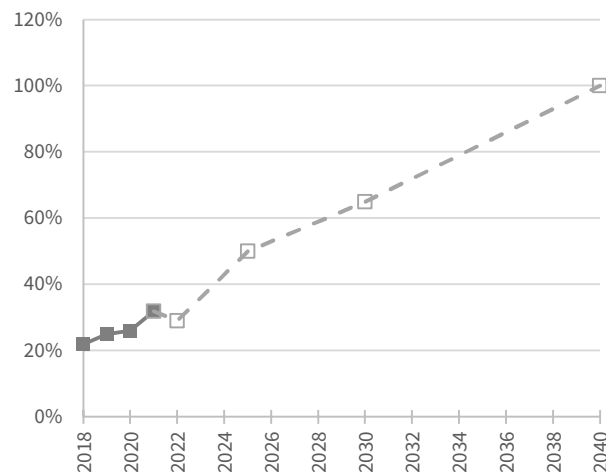
Figure 2. Nobian KPI historic levels and target. Source: Nobian.



KPI2

The second KPI is percentage use of energy from renewable sources, with a target increase from 26% in 2020 to 29%. Historic and target levels are shown in Figure 3.¹⁰ There is a larger discrepancy in Nobian’s reporting for this KPI; the Sustainability-Linked Financing Framework reports a figure for 2020 of 26% (the baseline level), but the Sustainability Report gives 28.9% for 2020 and 35.5% for 2021 (an annual rise of 6.6%). This is both an increase of over 3% (the relative target) and exceeds the absolute targeted level. Hence it looks very likely that the target will be achieved. We expect final numbers to be released soon.

Figure 3. Nobian KP2 historic levels and target. Source: Nobian.



⁷ “[Nobian Sustainability-Linked Financing Framework](#)”, Nobian, Jun 2021.

⁸ “[Nobian Sustainability Report 2021](#)”, Nobian, YE 2021.

⁹ Note, the Sustainability Report gives figures for 2010 and 2020 that are slightly different to the Financing Framework. We have inferred a value for 2021 using the annual change in the Sustainability Report, then applying that to the historic levels.

¹⁰ 2021 figure is the 2020 level with the relative change applied from the 2021 Sustainability Report.

Bond pricing

Nobian has only one outstanding bond and, therefore, there are no comparable instruments to which one can compare the pricing of the SLB. Figure 4 shows historic pricing on the Nobian SLB since its issuance in Jun 2021. The bond has traded poorly throughout 2022; it fell below 75% in September (around the time of its downgrade¹¹) and is now at 87% (approximately z+500).

Figure 4. Historic price of Nobian SLB. Source: Bloomberg, accessed 21 Feb 2023.



The structure of this SLB is such that its observation date is very near the start of the bond, only 18 months after pricing, with step-ups accruing nearly immediately for seven semi-annual coupons on 0.125%. Discounted by the risk-free rate, we estimate the present value of the step to be 0.82%.¹² The pay-out is long, but the step-up is low. Only one SPT is at risk, so the value of that step is only half the total, 0.41%.

We note separately that this bond has been criticised for being callable before any coupon steps are payable, potentially as a way to avoid paying any penalty.¹³ The bond appears to have a make-whole call (sometimes called a Doomsday call, designed to provide investors with financial recompense in the event of early redemption) in Jul 2023 at 50bp. That equates to a call price of 101.938%.¹⁴ Given the trading level of the bond, it is not economically rational for the issuer to call this bond to avoid paying a 25bp coupon increase for 4 years.

Conclusions

Two high yield SLBs are expected to have missed their SPT in December 2022, and the market waits both for confirmation but also for the investor reaction when it is confirmed. As both are index-eligible, a thematic default could impact a wider range of investors than other SLBs we have observed.

Nobian SLB seems to be more widely held in ESG-funds than PPC, and so we expect to watch the reaction in that bond with particular interest.

It is not yet known how investors will treat such SLB ‘fallen angels’. If there were to be ‘forced selling’ from ESG-index funds, **anticipation of this flow should form part of future SLB risk management around observation dates.**

¹¹ “[Fitch downgrades Nobian to B; Outlook stable](#)”, Fitch, 30 Sep 2022. “[Moody’s changes Nobian’s outlook to negative from stable; affirms B2 rating](#)”, Moody’s, 21 Sep 2022.

¹² “[Standard step-ups now ‘worthless’ for SLBs](#)”, GlobalCapital, 9 Feb 2023.

¹³ “[T. Rowe Slams Goal-Linked ESG Bonds Doing Little Good](#)”, Bloomberg, 14 Sep 2022.

¹⁴ Details from Bloomberg, accessed 9 Feb 2023.

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