

# One small step for Orlen, one giant leap for the SLB market

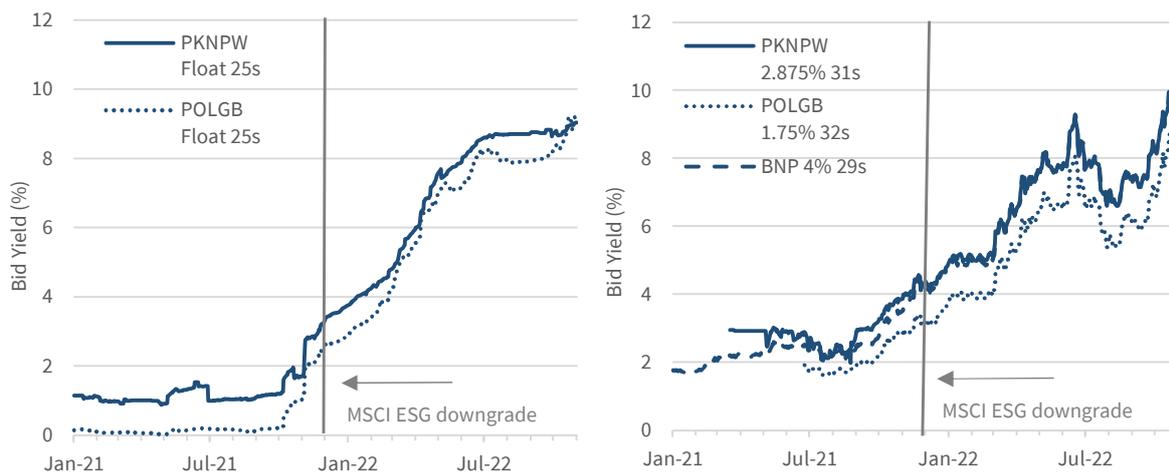
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PKN Orlen, a Polish oil refiner and petrol retailer, has issued two Sustainability-Linked Bonds (SLBs), whose coupons depend on the issuer's MSCI ESG rating. In December 2021 the issuer was downgraded from A to BBB,<sup>1</sup> which triggered a step-up to the coupon on both bonds.

**According to our research, this is the first SLB to have missed its sustainability target, resulting in the issuer paying a financial penalty for sustainability underperformance.** While it is not financially material to Orlen, due to the size of the step,<sup>2</sup> **this is a significant event for the nascent SLB market.**

As the coupon steps were very small, we did not observe a major market reaction to the news. **What is clear is that the security worked as expected, which should help to give investors confidence in the robustness of the SLB product.**

Figure 1. Bid yields on PLN bonds. Source: Bloomberg, accessed 23 Nov 2022.



## PKN Orlen bond issuance

PKN Orlen has five bonds outstanding. These include two EUR securities (one of which is a green bond), one PLN (Polish Zloty) vanilla bond, and two PLN SLBs.

<sup>1</sup> See graph of historic rating on [MSCI website](#), accessed 23 Nov 2022.

<sup>2</sup> It increases their annual interest payment on public debt by 0.63%, or roughly EUR 318k per year compared to a market cap of just under EUR 16bn.

Its first SLB, PKNPW Float 25s (PLPKN0000208), was issued in Dec 2020, and is a floating rate note paying 90bp over 6m WIBOR, increasing 5bp on a downgrade to BBB and 10bp to BB or lower.<sup>3</sup> Its second SLB, PKNPW 2.875% 31s (PLO037100016), was issued in Mar 2021, and has a fixed coupon which steps 10bp on a downgrade to BBB and 20bp to BB or lower.<sup>4</sup>

Coupons whose accrual periods began after the MSCI ESG rating downgrade in Dec 21 have been paid at the higher rates. PKNPW Float 25s paid an increased spread of 95bp in Jun 22, and PKNPW 2.875% 31s paid 2.875% in Mar 22 but stepped up to 2.975% in Sep 22.<sup>5</sup>

## SLB triggers

When there is new information on an SLB trigger, the market reaction tells us how the coupon step compares to the change in market price of the credit risk.

If there is no correlation between sustainability performance and credit, receiving an increased coupon is pure upside for investors, and a commensurate yield tightening would be expected. If yields widen on news of a missed target, this suggests that the market expects a larger deterioration in credit than the coupon step will compensate. No market reaction suggests that the coupon step exactly balances any impact to credit.<sup>6</sup>

Looking at PKN Orlen's performance, Figure 1 shows yields on its bonds and available market comparables.<sup>7</sup> The graphs suggest that any market reaction to the downgrade was certainly muted. It is worth highlighting how small the steps were: 5bp on the 25s, which was 1.3% of the yield in Dec 21, and 10bp on the 31s, which was 2.1% of the yield. It may not be possible to observe a tightening of that amount, which would be suggestive of no associated credit deterioration. However, there is also no evidence of a material widening, which could have been indicative of a thematic default and selling by green investors.

Market response to sustainability target adherence is a useful observation in understanding the relationship between sustainability performance and credit performance.<sup>8</sup> Despite the lack of reaction in this case, we are encouraged that, operationally speaking, the product worked as expected.

Given these are illiquid PLN-denominated bonds we caution against extrapolating these conclusions too broadly. However, our view is that the PKN Orlen step up should give confidence to investors that the SLB structure can and has worked as envisaged.

We will continue to monitor SLB prices as they move through their KPI observation dates.<sup>9</sup>

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<sup>3</sup> [“Basic information about series C bonds”](#), PKN Orlen, accessed 23 Nov 2022.

<sup>4</sup> [“Basic information about series D bonds”](#), PKN Orlen, accessed 23 Nov 2022.

<sup>5</sup> Coupon details have been confirmed with PKN Orlen's Investor Relations team on [ir@orlen.pl](mailto:ir@orlen.pl).

<sup>6</sup> There is also the question of what is priced in prior to a public announcement that impacts the KPI on an SLB; in this case it may be that the MSCI downgrade was only the crystallisation of ongoing poor sustainability performance that an attentive analyst would have identified at an earlier stage. In this example, we will assume the downgrade gave new information to the market.

<sup>7</sup> Finding market comparables is hard. Polish government bonds are rated only one notch higher at A- so are included. Pekao Bank Hipoteczny is rated BBB+ and issues some PLN securities, but they are backed by mortgages and so are not included. BNP issues some local PLN debt and is rated A+, so is included.

<sup>8</sup> For details please see [“Notes on risk-neutral pricing of SLBs and step-down structures”](#), AFII, 25 Oct 2022.

<sup>9</sup> Please see [“A review of Sustainability-Linked Bonds approaching KPI observation dates”](#), AFII, 17 Nov 2022.

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