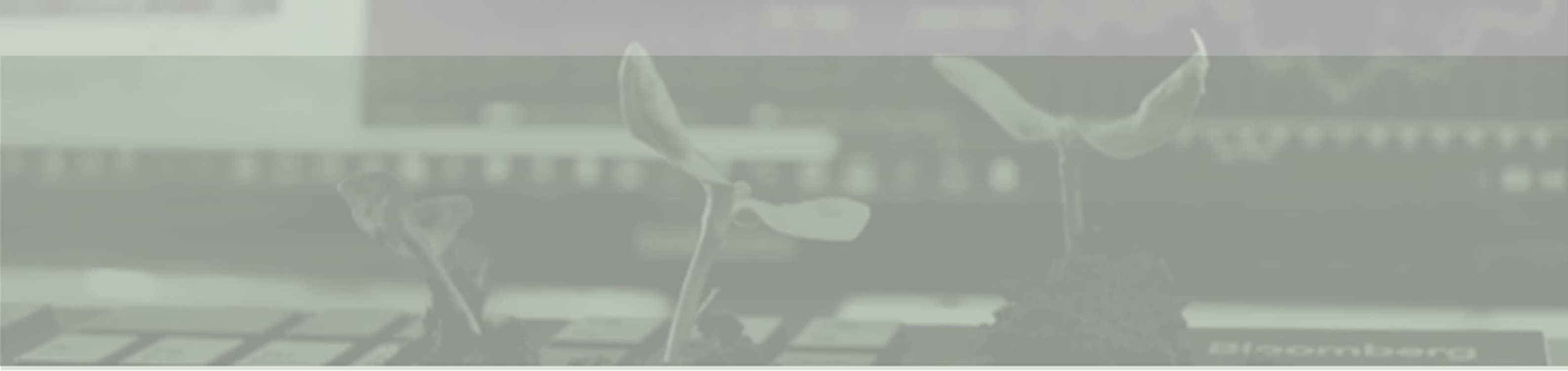

SLBs: complementary, my dear Investor

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In the light of the recent debate around the pros and cons of Sustainability-Linked Bonds (SLBs), this note analyses the different characteristics of issuers in the SLB market compared to the to-date dominant labelled bond product, green bonds.

The SLB market shows a complementary issuance profile to green bonds. As a product, it has demonstrated broader accessibility, successfully allowing a wide range of issuers to access capital while committing to sustainability improvements.

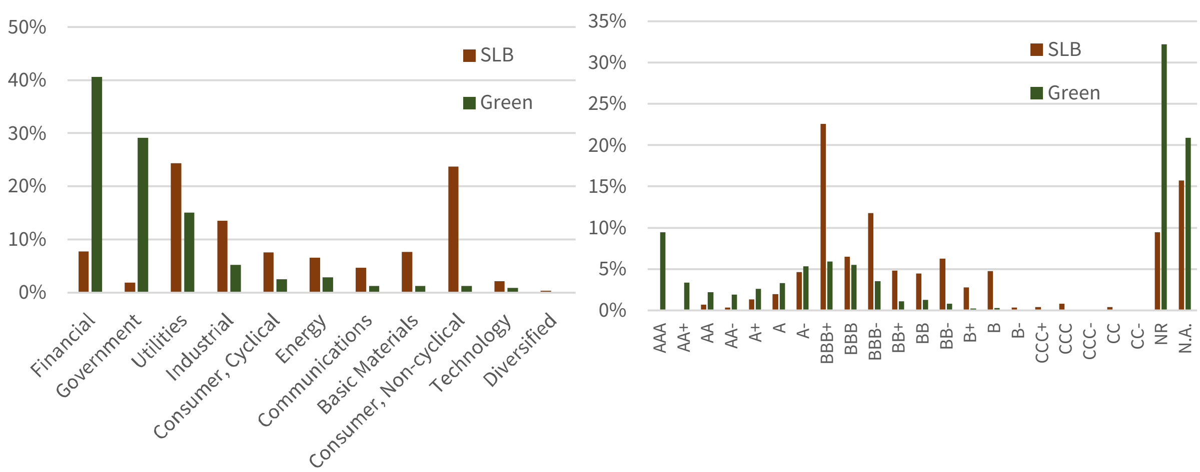
- **SLBs are used by a broad range of sectors, including hard-to-transition industries which find it hard to attract more traditional 'green' capital but are essential for transition.**

- **SLBs are used more by lower rated issuers including HY companies. This data suggests the market demands sustainability commitments and targets to access the capital markets.**

- **SLBs are particularly popular in emerging markets, increasingly for sovereigns, where there are challenges in having sufficient eligible projects for green issuance.**

There has been speculation that the recent drop is SLB issuance is related to criticism of the climate impact of SLBs issued to date.[1] Our analysis highlights that before drawing conclusions on SLB issuance patterns, observers should consider the different characteristics of the issuer base, and the advantages of enabling a wider range of issuers and sectors to transition.

Figure 1. Proportion of SLB and green bond issuance since 2007 by industry and Bloomberg composite rating. Source, Bloomberg, accessed 8 Mar 2023.



[1] "Sustainability bond market stumbles as investors get picky", FT, 14 Feb 2023.

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Product background

A key distinction between SLB and Green, Social and Sustainable (GSS) bonds, or Use-of-Proceeds (UoP) bonds, is how the capital can be used. In GSS, issuance capital is ringfenced for specific investments subject to certain eligibility criteria; in a green bond this is typically green CAPEX. These investments can be used to develop new projects but decommissioning or transitioning existing 'dirty' businesses tend not to be eligible. An SLB has no restrictions on capital usage; rather it directly engages an issuer on its whole environmental impact, for example, a company's carbon emissions. This enables a much broader spectrum of investments to be eligible.

a. Sector diversity

Figure 1 shows SLB and Green bond issuance by industry, highlighting the broader usage of SLBs. Only a small subset of issuers have been able to restrict investments appropriately to raise capital through green bonds; around 70% come from financials and government issuers, while only 13% of SLBs come from these issuers. Amongst non-financials, only utilities have used green bonds, generally for new renewables investment, whereas virtually all sectors use SLBs.

Problematic sectors, such as energy and industrials, urgently need capital to transition their business models. Transition investment is rarely eligible for green bonds, as the sustainability benefits are at a future point in time, but is perfect for SLB. The beginning of this is highlighted by the different sector breakdown of SLB issuance compared to green bonds.

b. Rating diversity

Figure 1 also shows issuance split by rating, highlighting that SLBs account for more of the middle rating section, BBB (the lowest investment grade rating), and high yield issuers, than green bonds. This is because poorer rated issuers tend to have smaller capital structures, and struggle to identify sufficient numbers of eligible projects to ringfence for a benchmark UoP issuance, as required by green bonds.

It can also be noted that non-rated entities are over twice as common in green bond issuance versus SLBs, with over 50% of green bond issuers un-rated. Hypothetically, this could reflect the SLB market's demand for stronger requirements on external verification and governance.

c. Regional diversity

As shown in Figure 1, governments have historically been a proportionately higher issuer of green bonds compared to SLBs. Two Latin American sovereigns, however, have successfully issued SLBs in 2022; Chile issued $2bn 20-year step-up SLB in March and Uruguay issued $1.5bn 12-year symmetric step-up/step-down SLB in October.[2]

"The breakout in SLB issuance observed in recent quarters will also likely continue given the challenges that some EM issuers face in having a sufficient amount of eligible projects to support benchmark use-of-proceeds sustainable bonds."[3]

Figure 2 shows issuance split by region. Europe is the leading region for SLB and green bonds, with

[2] For case studies on these sovereign issues please see "Understanding dynamics between SLB and traditional debt", AFII, 26 Jan 2023.

[3] "Emerging market sustainable bond outlook remains constructive despite market headwinds", Moody's, 8 Jun 2022.

60% and 57% of issuance respectively. What is interesting however is the relative balance for APAC and Emerging markets.

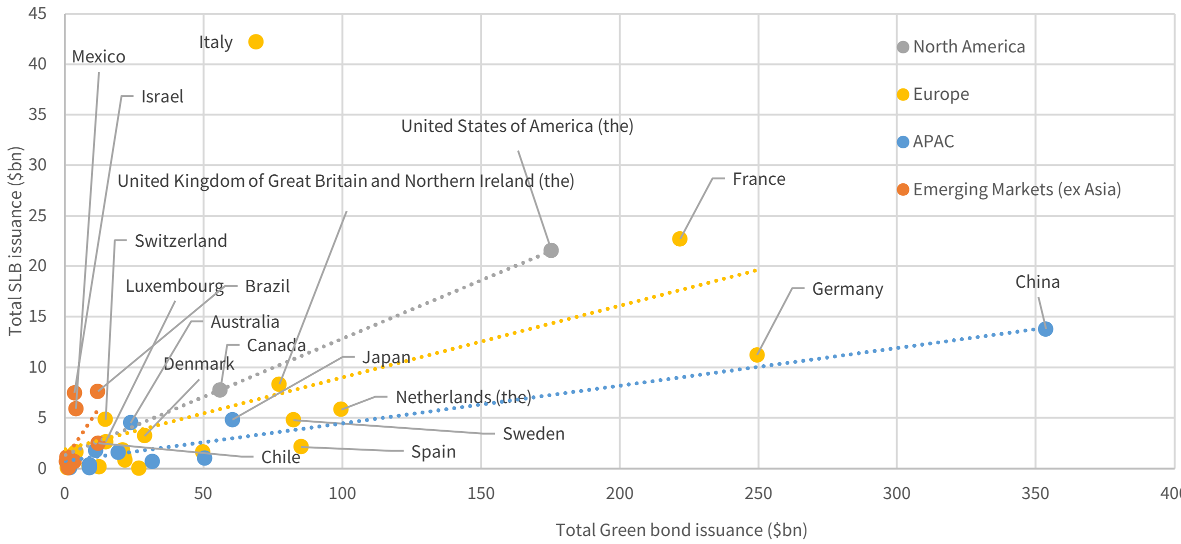
In APAC, SLB issuance is relatively unrepresented, and this is repeated in China which is split out separately for illustration. There is still a tremendous opportunity for growth in the region once investors become more familiar with the structure.

Figure 2. SLB and Green issuance since 2007 by region. Source: Bloomberg, AFII, accessed 13 Mar 2023.

	Total Green issuance ($bn)	Percentage of Green issuance	Total SLB issuance ($bn)	Percentage of SLB issuance
North America	233.0	12%	27.6	14%
Europe	1,116.4	56%	115.0	57%
APAC (ex China)	224.6	11%	14.6	7%
China	353.6	18%	13.7	7%
Emerging Markets (ex APAC)	73.8	4%	30.9	15%

For emerging markets excluding Asia, SLBs are overrepresented, with a few key jurisdictions such as Brazil, Israel & Mexico highlighted in Figure 3. Even though issuance numbers are small, total issuance of SLBs is larger than for North America, which highlights how attractive the structure has been for these countries.

Figure 3. SLB and green issuance since 2007 by country. Source: Bloomberg, AFII, accessed 13 Mar 2023.



Conclusions

Capital investment to transition to a net-zero economy is currently falling well short of what is required.[4] Sustainable debt will play a key part, but we will need to maximise volumes of all available products to achieve the necessary scale.

Our analysis concludes that SLBs have been effective at raising capital into a very different parts of the market compared to green bonds; they reach broader sectors, with broader ratings, and a contrasting regional breakdown.

They are a complementary product to green bonds, with the potential to enable all issuers to raise capital to transition.

[4] It must quadruple in the next two decades according to "[Financing the Transition: How to Make the Money Flow for a Net-Zero Economy](#)", Energy Transitions Commission, 21 Mar 2023.

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