ESG Now Podcast

“The Cost of Missing Sustainability Targets”

Transcript, 19 July, 2024

Bentley Kaplan

Hello and welcome to the weekly edition of ESG Now, the show that explores how the environment, our society and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for this episode.

On today's show, we are going to be taking a look at how things are shaping out in the world of sustainability-linked bonds. Because it has been a good two or three years since companies started issuing debt tied explicitly to their sustainability targets. And for the most part, these sustainability-linked bonds would see a step-up in coupon. So more money going back to investors if companies were to miss their targets. And well, a couple of years down the line and we have seen some companies missing their targets. Public Power Corporation and Enel, two utility companies missed a sustainability target in 2022 and 2023 respectively, and they have paid for missing those targets. But that's not where the story ends. That's kind of where it's just getting started. So, we're going to take a look at why these companies missed their targets, how investors might be thinking about these misses and what to make of sustainability-linked bonds more broadly. So, thanks for sticking around. Let's do this.

Back in early 2021, things were moving and a-shaking in the world of sustainable debt. We had seen some rising enthusiasm for green bonds and the recent launch of sustainability-linked bonds, or SLBs, because you know how much I love an acronym. And at the time, I sat down with Meghna Mehta, a veteran guest of the show and top-tier MSCI colleague to figure out what sustainability-linked bonds were all about. Because SLBs are quite different from green bonds. You see, green bonds have a prescribed use of proceeds. Investors basically buy the bonds knowing the specific technology or project that's being financed. From building wind turbines or installing solar capacity, the funds that are raised through the debt issuance are basically ring-fenced for that purpose. But by contrast and in general, SLBs don't have any prescribed use of proceeds. Companies can take the funds raised and use them like they would for a general-purpose corporate bond and for some investors this difference was important.

And all those years ago, while I was busy talking to Meghna about these new financial instruments, my guest on today's episode, Guilherme de Melo Silva, out of MSCI's London office, was busy in his previous role at a bank helping to build these instruments.

Guilherme de Melo Silva

I watched the beginning of this market in 2019 and was closely involved in the global SLB boom that happened in 2021. During this time, I was the sustainability manager of a bank and supported our clients and also our internal teams in the issuance of a number of labeled instruments, including SLBs. And it was interesting to notice some changes in the sustainable bond market after SLBs were introduced. Some corporates were not interested in use-of-proceeds instruments such as green and social bonds. But based on their operations and strategy and sustainability targets, some companies found SLBs a good opportunity to enter into the sustainable finance market. Compared to use-of-proceeds bonds, SLBs offer more elements for investors to assess, such as the relevance of the coupon step-up, the risk of the company missing the targets, the alignment of such targets with market practices, among other elements. This combination was very interesting to our clients and we saw new companies deciding to explore sustainable finance after SLBs were announced.

Bentley Kaplan

Right. So as Gui mentioned, for some investors, green bonds weren't what they were looking for. They weren't looking for a prescriptive use of funds. SLBs offered a different investment angle while still including a dimension of sustainability. As a side note, companies are also making use of sustainability-linked loans where an institution, like a bank, will include specific criteria that link interest rates with sustainability metrics. And it's quite possible that companies are going to be running both sustainability-linked bonds through the market and taking sustainability-linked loans from banks.

But let's not complicate matters too much. Because when it comes to SLBs, because of the flexible use of proceeds, their utility and growth may well decouple from that of green bonds as the market matures. Which is not to say that sustainability-linked bonds don't have strings attached. You see, companies will set specific sustainability targets and build in a coupon step-up, should they miss those targets. And really a target can be anything that's sustainable, from lowering emissions to a certain level or raising the representation of women in the workforce by a certain date. Some targets contain multiple components or milestones, it's really up to the company to decide.

One of the early criticisms leveled at SLBs from advocates of sustainable investing is that because companies set their own targets and they have a financial incentive to hit those targets that they might be tempted to set themselves soft targets. They won't really be stretched and that SLB-linked targets won't really mean much except as a marketing device. But as we'll see, some companies are stretching themselves so much so that they're missing their own targets.

Enel, one of the world's biggest utility companies and one of the first to issue an SLB, is one of them. One of Enel's sustainability targets was to get its production-based carbon intensity down to 148 grams of carbon dioxide equivalents per kilowatt-hour by the end of 2023, which was a fairly ambitious target. But come the end of 2023, its intensity was at 160 grams. And missing that target triggered a 25 basis-point step-up across 10 separate sustainability-linked bonds, which added up to $113 million through the end of the bonds' maturities. And these SLBs are tied into another target that's coming due at the end of this year, aiming for 140 grams of carbon dioxide equivalents per kilowatt-hour, which remains unchanged despite the company missing its previous year's goal. And despite having missed last year's target, Enel has not stepped back and in some ways doubled down by issuing a new $2 billion sustainability-linked bond tied to the same 2024 target.

A second company to miss an SLB target is Public Power Corporation, or PPC, a Greek utility. PPC was aiming to get its absolute scope one emissions down by 40% from 2019 to 2022. By the end of 2022, PPC was 4% short of that. A missed target on a 775 million euro sustainability-linked bond meant a 50 basis-point coupon step-up or around 4 million euros over the bond's maturity, which is into 2026. But like Enel, PPC didn't throw in the towel. The company accelerated its coal decommissioning timeline and by the end of 2023 had reduced its absolute emissions by 58% compared with its 2019 baseline, nudging ahead of a 57% target for the year. And that was a handy thing too because its 2023, target was tied to a 500 million euro SLB, which was threatening a 25 bp coupon step-up if PPC had fallen short.

And as Gui told me, both companies will serve as helpful case studies in understanding these early years of sustainability-linked bonds.

Guilherme de Melo Silva

In 2023 PPC was one of the first companies to miss a target linked to a SLB. Enel was the very first company to issue an SLB back in 2019 and is currently the world's largest issuer of this instrument. And in April '24, the company reported that it missed its 2023 target. In PPC's case, it is interesting to notice that after missing the targets, PPC managed to accelerate its coal decommissioning plan, and achieved its carbon intensity targets for 2023. And Enel reported that it would maintain the objective of expanding the share of sustainable finance sources in its total debt, reaching 70% by 2026. In just a few weeks after confirming a target failure, the company announced a new $2 billion SLB also linked to the same carbon intensity target.

SLBs are criticized regarding a number of aspects such as unambitious targets and insufficient penalties, greenwashing concerns and lack of standardization, among others. And the cases that we're discussing here might demonstrate that at least some of the aspects of these instruments are actually working as intended from the issuer, investor and impact points of view.

Bentley Kaplan

Right. So both PPC and Enel missed their emission reduction targets. Both of these targets were focused on meaningful metrics, production-based emissions. And both companies cited the change in energy markets that followed Russia's invasion of Ukraine. A drop in gas supplies meant that companies needed to rely more than anticipated on coal-fired generation, and that led to more emissions.

For investors in sustainability-linked bonds, the case for investing in Enel might be quite different to investing in PPC even if they are both utilities. For starters, there's the size. PPC had around 7.7 billion euros in revenue in 2023 compared with around 98 billion for Enel. And if we take into account some of MSCI's assessments, and this is data that I'm looking at on the 18th of July, we see different angles to consider as well.

Under our ESG ratings model, which aims to assess how companies are managing their financially relevant sustainability risks, we see some key differences. Enel is rated as a leader at AAA. It scores positively for lowering its risks related to carbon emissions and capitalizing on renewable energy opportunities. PPC has a middling ESG rating of BBB. And although it scores favorably in our Carbon Emissions Key Issue, it falls below the industry average in developing its renewable capacity.
And they also differ on our Implied Temperature Rise metric, which measures how our companies projected carbon emissions compare with global carbon budgets and how they would align with future global warming scenarios and targets. Enel has an Implied Temperature Rise, or ITR, of 1.3 degrees Celsius, which is in line with the Paris Agreement. But PPC's ITR is three degrees Celsius, well outside the upper end of the Paris Agreement.

Enel had tied 10 separate SLBs to its production-based emissions target. A 25 basis point step up in these, as I said, is going to total $112 million through the affected bonds' maturities. For PPC, its initial missed target affects just one SLB, but sees a coupon step up of 50 basis points and about a $4.4 million increase in interest costs. So based on its sustainability characteristics, Enel may have looked more likely to meet its target, but the company's also looking at a bigger cost relative to current revenue of having missed its target compared with PPC.

Seeing both companies miss their target might similarly provoke different investor conclusions, especially when taking into account the actions of either company in light of their misses. And so my last question to Gui was about how investors might be thinking about companies that do fall short of their targets and what that tells us about investing in SLBs.

Guilherme de Melo Silva

This market is still evolving. SLBs are way younger than green bonds, for example, in the sustainable finance market. But what we can say now is that some investors might have decided to divest from those companies. Considering the target failures for some others, the way they managed those cases and for example, PPC managed to achieve the following target or Enel making their position in the market stronger after the case, making them gain more confidence on this type of bond. Historically, some investors had their ESG analysts in one room and credit risk analysts in another room. And those cases that we're discussing here reinforce the relevance of integrating ESG and climate data and definition analysis, and especially how investors monitor their SLB portfolios.

Bentley Kaplan

So sustainability linked bonds are a new frontier in sustainable finance. In 2023, they only made up a relatively small cut of the overall labeled bond market, less than 10%, compared with green bonds that accounted for nearly 60%. But we're starting to learn more about them and the companies that issue them. And as Gui says, investors may be coming at them from different angles. Maybe it's to align investments with companies that are becoming more sustainable. Maybe these SLBs are acting as a hedge against rising sustainability risks if companies can't hit their targets. The risk of greenwashing might still be there if companies opt for soft targets. And even if companies are more ambitious, you could argue that the actual financial impact of a coupon step up is not really that significant.

But what is seeming clearer is that SLBs are shedding more light on sustainability targets and how companies do or don't reach them, and maybe most intriguingly, how companies choose to respond if they do miss their targets. And ultimately, for investors that can bridge the gap between traditional credit risk analysis and sustainability data, these SLBs are going to become a very interesting corner of the market indeed.
And that is it for this week. A massive thanks to Gui for his take on the news with a sustainability twist. Thank you very much for tuning in. If you like what we're doing, then let us know. Drop us a review, rate the show on your platform of choice and tell a friend or a colleague about this episode. Thanks again, and until next time, take care of yourself and those around you.

should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The information contained in this recording is not for reproduction in whole or in part without prior written permission from MSCI ESG Research. Issuers mentioned or included in any MSCI ESG Research materials may include MSCI Inc., clients of MSCI or suppliers to MSCI, and may also purchase research or other products or services from MSCI ESG Research. MSCI ESG Research materials, including materials utilized in MSCI ESG indexes or other products have not been submitted to nor received approval from the United States Securities and Exchange Commission or any other regulatory body. The information provided here is as is, and the user of the information assumes the entire risk of any use it may make or permit to be made of the information. Thank you.

About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process. To learn more, please visit **www.msci.com**.